Schroders Fixed Income

Quarterly Investment Option Update

30-June-2018

Availability

Product name	APIR
Flexible Super – Choice (Retirement)	AMP1376AU
Flexible Super – Choice (Super)	AMP1505AU
CustomSuper	AMP1288AU
Flexible Lifetime – Allocated Pension	AMP1295AU
Flexible Lifetime – Super	AMP1288AU
Signature Super	AMP1302AU
Signature Super – Allocated Pension	AMP1309AU

Investment Option Performance

Investment performances are subject to product fees and where relevant tax as outlined in the product PDS. Therefore investment performance may differ between products. In addition, activity on your account such as contributions and deductions will also impact the investment performance specific to you. To view the latest investment performances for each product, please visit **www.amp.com.au**. You can also view the last investment performance specific to you by visiting your My Portfolio account.

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Overview

Aim & Strategy: To obtain exposure to a diversified range of domestic and international fixed income securities with the principal aim of outperforming the UBS Composite Bond Index over the medium term. The objective is to provide a diversified portfolio delivering low capital volatility and competitive risk-adjusted returns with low correlation to equity markets by investing in a broad range of domestic and international fixed income assets. The investment adopts a "core-plus" approach whereby a core portfolio comprising of low risk Australian bonds is complemented by investments in a diverse range of low correlation, non-benchmark fixed income securities. International securities are hedged to the Australian dollar.

Investment category: Enhanced Fixed Interest

Suggested Investment Timeframe: 3 to 5 years

Relative Risk Rating: Low to medium

Investment Style: Active

Asset Allocation	Actual (%)	Range (%)
Australian Investment Grade	82.24%	20-100%
Global Investment Grade	3.95%	0-50%
Australian Higher Yielding Credit	3.38%	0-20%
Global High Yield	-3.10%	0-20%
Cash & Equivalents	13.53%	0-50%

Holdings

Industry Exposure	%
Government	56.17%
Banks	12.22%
Cash & Equivalent	7.46%
Other	6.27%
Utilities	4.44%

Top Ten Securities	%
Australian Government Sr 133 5.5% 21 Apr 2023	5.03%
US Treasury Infl (Tii) .25% 15 Jan 2025	3.99%
Australian Government Sr 137 2.75% 21 Apr 2024	3.46%
Queensland Treasury Corp Sr Regs 3.25% 21 Jul 2026	2.71%
Australian Govt Sr 140 4.5% 21 Apr 2033	2.53%
Australian Government Sr Regs 3.75% 21 Apr 2037	2.44%
Intl Bk Recon & Develop Sr Mtn 2.8% 13 Jan 2021	2.25%
Australian Government Sr 142 4.25% 21 Apr 2026	1.93%
Australian Government Sr 139 3.25% 21 Apr 2025	1.76%
New S Wales Tsy I/L Sr Cib1 3.5189% 20 Nov 2025	1.76%

Market Commentary

June was a challenging month as markets were buffeted by trade war tensions. Early in the month, President Trump imposed steel and aluminium tariffs on Europe, Canada and Mexico, prompting each country to retaliate with tariffs on US products. The Trump administration also announced a $US34bn list of Chinese goods that will be subject to tariffs beginning July 6. Diverging economic trends saw a widening gap between global central banks, with the US Federal Reserve signalling more aggression in their policy tightening, while the European Central Bank indicated it will end its bond purchases in December, it also made clear interest rates will remain at their present level until at least the middle of 2019, if not longer. The June quarter also saw Italian politics cause volatility in bond markets as anti-establishment parties formed a government.

Global and Australian government bond yields closed June at similar levels to which they started. While over the quarter there were significant moves in German and US yields, with German yields lower and US yields higher. In global credit markets, poor performances were put in by Emerging Market bonds and to a lesser extent investment grade credit. High yield bonds unusually did well as lack of supply supported the market.

Investment Option Commentary

While still maintaining a significant short position, the fund has trimmed its size near the highest point for yields in the quarter, and also pared the credit exposures before the spread volatility in May and June. Over the quarter, the short interest rates and long inflation positions both contributed to performance, while the credit positions slightly detracted from overall performance. Despite short-term noise, the relative performance is gradually lifting and the fund anticipates the shifting environment – involving higher yields and higher volatility – will be more conducive to the fund's style.

Outlook

Through the first six months of the year, several themes have been playing out. The US economy has powered on and the Fed has steadily tightened. Other economies are also seeing solid growth but their lagged cyclical position (generally still with spare capacity) means tightening elsewhere is delayed, and at the margin, data has softened. While US rates have underperformed, US equities and credit have outperformed versus other markets, as US corporate profitability looks to be tax-fuelled over the next 12 months.

The renewed rally in the USD and higher US yields is creating concern for emerging markets but the situation appears more stable than in 2015 when commodities were plummeting and China faced a capital flight crisis – indeed, oil has rallied, partly due to politics. Inflation is lifting but not yet accelerating.

2018 to date has been a choppy experience for investors compared to the smooth sailing of 2017, as markets grapple with the retreat of USD liquidity as the Fed tightens, the transition to a less friendly growth-inflation mix as output gaps close, and the prospect of a more general withdrawal of central bank accommodation. The recent rise of trade protectionism – likely to be inflationary, and likely to hurt growth elsewhere more so than in the US – only adds to the story. Volatility is higher, and risk appetite has stalled, though not yet retreated.

The fund manager is reasonably upbeat on the economic outlook but are cautious on markets given the starting point of generally compressed risk premiums.

The US economy remains solid. Unemployment has finally moved down through 4%, and growth back up to 3% as Trump's tax cuts kick in. Much has been made of the flattening of the yield curve as a recession warning signal, however the detailed recession modelling is indicating US recession is still 18-24 months away. The hangover could well be worse due to the magnitude of fiscal largesse at this stage of the cycle … but that is an issue for later. This leaves the Fed at the sharp end of the policy tightening spectrum with (amazingly) a neutral cash rate setting in its sights after so long well below. Markets are happily priced for a Fed that tightens back to neutral but not beyond. The risks are in both directions, but to us the more likely surprise is that stronger growth and especially more inflation requires further tightening. A move to a tighter policy position would likely be difficult for markets.

Markets are currently making a deal of economic divergence. It is true that the US cycle is further advanced than elsewhere, and China has slowed over the past six months. The latter has impacted China's trading partners, including Europe. Were this downturn more prolonged, it would be more serious, especially as it could help to underpin USD dominance and hence further undermine emerging markets. However, while cautiously monitoring developments, the fund does not think there is reason to become more concerned about the non-US growth trajectory just yet. It does seem clear, however, that policymakers outside the US – including in Australia – are in little hurry to hike.

Bond valuations remain overwhelmingly expensive, though as bonds – especially in the US — have to a degree already repriced but expensive riskier assets have not, fixed income is starting to look appealing. The fund manager's judgement, however, is that it is still too early to add back much duration with the cyclical risks to the upside. Portfolio duration relative to benchmark stands at one year shorter than benchmark. While this remains a significant relative position, the portfolio has taken advantage of yield rises year-to-date to trim the short from 1.7 years earlier in the year. Despite persistent underperformance, and hence improved relative valuation, the US Treasury market remains the preferred underweight given earlier comments about the Fed. The fund also short in Europe where valuations remain rich, but cautious on the size of the position pending more concrete evidence the ECB is prepared to tighten policy, and in Australia which is little priced for a possible lift in the cycle. The fund is moderately positioned for the yield curve to flatten in each of Europe and Australia to capture policy-driven increases in short-dated yields, and also have in place explicit inflation protection in both the US and Australia via inflation-linked bonds.

Credit risk, meanwhile, is priced for a healthy economy, but not for liquidity or policy withdrawal. Cyclical fundamentals are supportive, but valuations are extended. This environment may prevail – especially as in the fund manager's view recession is still some way off – but the skinny margins for earning carry warrant a defensive stance. The credit exposure is modest in absolute terms and only slightly overweight relative to the benchmark. The portfolio continues to prefer Australian credit to global, for its high quality and short tenor, though global investment grade credit is starting to look attractive in a relative sense given its underperformance so far this year. The fund's small global and higher yielding (riskier) exposures are effectively hedged.

Altogether this leaves the portfolio well placed to weather higher yields and greater volatility, and to capitalise on the opportunities created.