Schroder Fixed Income

Quarterly Investment Option Update

31 December 2022

Aim and Strategy

To obtain exposure to a range of domestic and international fixed income assets with the objective of outperforming the Bloomberg AusBond Composite 0+Yr Index, whilst delivering stable absolute returns over time. The option adopts a Core-Plus investment approach whereby a core portfolio comprising of Australian investment grade bonds (including government, semi-government, supranational and corporate bonds) is complemented by investments in a diverse range of global and domestic fixed income securities. The targeted result is a defensive strategy which is broadly diversified with low correlation to equity markets.

Investment Option Performance

To view the latest investment performances for each product please visit amp.com.au/performance

Investment Option Overview

Investment Category	Fixed Interest
Suggested Investment timeframe	3 years
Relative risk rating	5/ Medium to high
Investment style	Core
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Aust. Investment Grade	100%	82.5%
Cash & Equivalents	0%	7.1%
Global Investment Grade	0%	1.1%
Australian High Yield	0%	6.6%
Global High Yield	0%	2.5%

Sector Allocation	%
Government	20.0%
Semi-Government	23.5%
Supranational/Sovereigns	12.9%
Corporates	33.3%
Subordinated	2.1%
Collateralised	4.0%

Quality Allocation	%
AAA	34.4%
AA	25.8%
A	9.9%
BBB	20.8%
Below BBB	2.7%
Not Rated	1.5%

Top Holdings	%
NEW SOUTH WALES TREASURY CORPORATI GOVTGUAR 3.0 20-MAR-2028 Reg-S	3.7%
AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2029 Reg-S	3.4%
AUSTRALIA (COMMONWEALTH OF) 2.25 21-MAY-2028 Reg-S	2.7%
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.75 21-AUG-2031 Dual 144a|Reg-S	2.4%
AUSTRALIA (COMMONWEALTH OF) 4.75 21-APR-2027 Reg-S	1.9%

Investment Option Commentary

Over the quarter the portfolio marginally outperforming the benchmark. Schroder's small long-duration position added value as yields retreated from the highs reached in October, while Schroder's overweight to Australian investment grade and underweight to US high-yield credit detracted value.

Schroder made two keys changes to positioning over the quarter. Firstly, Schroder increased interest rate duration and began positioning for yield curves to steepen. These moves are anticipating that Schroder are close to the top of the interest rate cycle. Secondly, Schroder materially increased Schroder's exposure to Australian and global investment grade corporates by 10% in total. These reflect the good value on offer in these high-quality parts of the fixed income universe.

Together these moves have Schroder more constructively positioned to enter 2023. Schroder anticipate a much better year for fixed income returns.

Market Commentary

Both the US Federal Reserve (Fed) and European Central Bank (ECB) delivered a 50 bp increase to official rates in December, while the RBA raised rates by 25 bp. While bond yields moved higher globally, the moves were more pronounced in Europe as the ECB's messaging was more hawkish than the market had anticipated, with ECB President Lagarde indicating that rates would still need to increase significantly in 2023 in order to curb inflation. In the US, inflation continued to ease and came in below expectations, with headline inflation moving to 7.1% on a year on year basis, while core inflation slowed to 6%. Meanwhile, the Bank of Japan (BoJ) adjusted its yield curve control policy to allow 10-year Japanese bond yields to move up to 0.5%. In December, Australian 10-year bond yields moved 0.52% higher to finish at 4.05%, while US 10-year yields increased by 0.27% to end the year at 3.87%. German 10-year bond yields increased by 0.64%, while Japanese yields also increased by 0.17%, after being capped at 0.25% for an extended period. Over the month investment grade credit and emerging market debt spreads both tightened moderately, while high yield spreads moved wider. Through the fourth quarter, bond yields moved moderately higher, with the most notable change in German yields which moved 0.46% higher for longer dated bonds, and over 1.0% higher for shorter maturity bonds. Credit spreads and emerging market debt spreads also tightened somewhat over the quarter, with the exception of Australian investment grade spreads, which were flat over the quarter.

Outlook

The last 12 months have delivered the worst returns for fixed income in decades – worse than the famed 1994 selloff, and on par with the worst episodes of the late 1970s and early 1980s.

Both central banks and markets underestimated the extent to which inflation would increase – a result of a powerful combination of pandemic-related supply issues, the disruption to energy markets due to the war in Ukraine, and strong pent-up demand supported by loose fiscal and monetary policy. The surge and the broadening of inflation has forced central banks to raise official interest rates much faster and further than they anticipated, and markets to reprice bond yields higher and prices lower.

2023 promises to be a much different year:

- Firstly, inflation will moderate. Headline inflation in particular should move lower as supply chains and goods markets normalise (to a degree), and demand-driven price pressure should ease in response to tighter policy.
- Secondly, growth will slow, perhaps significantly. The effect of slowing growth in 2022 was overshadowed by the acceleration of inflation – which actually drove nominal growth up. This year, slowing growth – in both real and nominal terms – will be a much more important influence.
- Thirdly, the policy cycle will mature. The rate hikes will end, likely before mid-year, and quantitative tightening will mostly be complete by year end.

With the inflation and policy shock waning, 2023 would seem to be a more pleasant year for markets. This may be an illusion, however, as:

- Labour markets remain very tight, presenting continued upside risk to core inflation.
- While inflation and interest rate risk is likely mostly priced, recession and weakening corporate earnings risk is not. Markets are banking on a ‘soft landing’ or mild recession, but these are very rare, especially as this policy shift has been so abrupt.
- Markets are still grappling with a large transition in liquidity risk as central banks reduce the size of their balance sheets. This showed up in isolated incidents in 2022, such as the Gilt and FTX meltdowns, but reduced liquidity could keep asset volatility higher, even if macroeconomic volatility subsides.

Together, this set up for 2023 suggests a good year ahead for high-quality bonds. The key arguments are:

- Firstly, that after the repricing, fixed income offers significantly better value. The jump in yields means prospective through-time returns will be higher. And at current yields, Schroder assess that government bonds are ‘cheap’ both on an absolute basis given medium-term economic inputs, and on a relative basis to equities and other assets. Similarly, high-quality corporate bonds are ‘cheap’ relative to the likely range of default stress scenarios.
- Secondly, the cycle is turning in favour of bonds. Bonds are now worth owning simply for their higher yields – i.e. higher ratios of income to price – and the improved value this represents. However, the shift in the balance of risks from upside inflation to downside growth means there’s a decent probability Schroder will see bond prices rise, lifting total returns.

Positioning

As discussed above, Schroder think most of the interest rate re-pricing is complete. In conjunction with Schroder’s assessment of underpriced recession and liquidity risk in riskier assets, this makes high-quality bonds, both government and corporate, very appealing sources of low-risk income and diversification over medium-term investment horizons. Australian investment grade credit stands out as particularly appealing, given its high risk-adjusted spread.

Schroder’s strategy is to steadily accumulate high-quality assets at good levels, being patient to wait for better opportunities in riskier assets. While eventually the downside risks to growth are likely to dominate market pricing, these may not eventuate for some time. This suggests Schroder should embrace the good income on offer now in high-quality assets, and be flexible and prepared to firstly increase interest rate duration and later to add to riskier assets.

The current portfolio settings are:

- Neutral to small long interest rate duration. Schroder are long in the US and Australia, and short in regions where policy tightening is lagging, namely Europe and Japan.
- Overweight short-dated and underweight long-dated bonds in the US and UK. These positions will benefit from yield curves steepening from significantly inverted levels, which will occur when markets move to price in the next down cycle in interest rates.
- Moderately overweight investment grade corporates, mostly in Australia. This asset class is offering good value and should be insulated, should credit conditions deteriorate. Schroder also continue to run a small weighting to Australian residential and commercial mortgages.
- Low weightings in riskier credit. Schroder retain small positions in Asian credit and EM sovereigns, given attractive pricing, and small exposure to Australian subordinated debt, paired against a derivative short position in US high-yield.

With fixed income now standing out to the investment manager as offering good absolute and relative value, and the cycle potentially turning in favour of bonds, Schroder are confident 2023 will look significantly different for the asset class. Schroder have moved to position constructively in interest rate duration and high-quality corporate debt, and expect to become even more constructively positioned through the year.

Availability

Product name	APIR
Flexible Lifetime Investment (Series 2)**	AMP2040AU
SignatureSuper*	AMP1302AU
SignatureSuper Allocated Pension*	AMP1309AU

*Closed to new investors
**Closed to new and existing investors

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