Schroder Fixed Income

Quarterly Investment Option Update

30 June 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	4/ Medium
Investment style	Core
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Aust. Investment Grade	100%	82.7%
Cash & Equivalents	0%	17.4%
Global Investment Grade	0%	-7.4%
Australian High Yield	0%	6.0%
Global High Yield	0%	1.3%

Sector Allocation	%
Government	25.0
Semi-Government	24.3
Supranational/Sovereigns	11.5
Corporates	28.2
Subordinated	2.0
Collateralised	4.5

Quality Allocation	%
AAA	37.8
AA	25.9
A	7.8
BBB	19.6
Below BBB	2.2
Not Rated	1.3

Top Holdings	%
NEW SOUTH WALES TREASURY CORPORATI GOVTGUAR 3.0 20-MAR-2028 Reg-S	4.5
AUSTRALIA (COMMONWEALTH OF) 0.25 21-NOV-2024 Reg-S	3.4
AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2027 Reg-S	2.7
AUSTRALIA (COMMONWEALTH OF) 2.25 21-MAY-2028 Reg-S	2.6
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.75 21-AUG-2031 Dual 144a|Reg-S	2.3
AUSTRALIA (COMMONWEALTH OF) 4.75 21-APR-2027 Reg-S	1.8
AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2029 Reg-S	1.7
WESTERN AUSTRALIAN TREASURY CORP 1.75 22-OCT-2031	1.7
AUSTRALIA (COMMONWEALTH OF) 3.25 21-JUN-2039 Reg-S	1.6
AUSTRALIA (COMMONWEALTH OF) 3.0 20-SEP-2025 Reg-S	1.6

Investment Option Commentary

In a dramatic quarter, assets repriced sharply lower, led by concerns that surging inflation will force hyper-aggressive tightening by central banks. Bonds led the selloff, with yields peaking in mid-June before recession fears began to dominate, however credit assets continued to weaken. The Bloomberg Ausbond Composite Index returned -9.46% to complete the worst six-month period on record.

The Portfolio underperformed the benchmark over the quarter. Schroder maintained a defensive strategy involving running limited relative interest rate risk and positioning for continued flattening of yield curves and hedging their corporate allocations with credit derivative overlays. Despite this caution, the portfolio underperformed the benchmark mostly due to small overweight to Australian duration (which underperformed) and as short derivative positions in US credit outperformed Australian credit, until late in the quarter.

Schroder is becoming more confident the repricing of interest rates is nearing an end and have begun rebuilding long duration exposure. Their credit positioning remains defensive but is expected to be shifting more constructively. Fixed income is offering much better absolute value following the repricing, and good value relative to other assets given the challenging cyclical outlook.

Market Commentary

As developed market central banks aggressively raised official interest rates targeting persistent inflation, bond yields continued to climb over the month and the quarter. The US Federal Reserve increased its policy rate by 0.75%, while the RBA increased the local cash rate by 0.5%, with more hikes expected over the coming months. Australian 10 year yields increased by 0.31% over the month to close at 3.66%, while US 10 year yields increased by 0.17% to finish the month at 3.01%. German 10 year yields increased by 0.21%, while Japanese yields were flat as the Bank of Japan continues to maintain yields below 0.25%. It's also worth noting that US 30 year mortgage rates continue to climb, increasing by 0.70% over the month, and 1.00% over the quarter to reach 5.7% at the end of June. Credit spreads widened across all sectors as risk assets sold off, most notably in US high yield where spreads widened by more than 160bps over the month, and almost 250bps over the quarter.

Outlook

The cyclical picture is challenging, as central banks are aggressively fighting inflation at the same time as growth is decelerating. Schroder's key views regarding the cycle are:

- Inflation pressures appear to be peaking, imminently in the US, and by year end in Australia. However, inflation may not recede greatly, as labour markets remain tight, pushing up wages and services inflation more broadly, and food and energy supply disruptions remain persistent
- Growth is clearly slowing, but activity is holding up better than sentiment. Consumers are vulnerable to a real income squeeze on consumption, higher rates in indebted countries (such as Australia), and eventual weakening in labour market conditions
- Corporate profitability will come under pressure both as volumes soften and as cost pressures crimp margins. Markets appear too sanguine about this risk
- The central bank tightening cycle is currently in its most aggressive stage. Bond yields and credit spreads have arguably priced most of the official interest rate and liquidity withdrawal impacts, but are priced for neither ongoing high inflation nor a growth recession
- Policy error risk is high; because central banks are acting belatedly, they are now moving very quickly with little time to assess the effects of tightening. Given the hawkish shift, tightening to at least neutral seems guaranteed, but this is unlikely to be the right level, and with high levels of uncertainty, policy paralysis beyond this point could develop.

It seems probable the post-GFC economic and market environment has ended, however not as intended. The RBA and other central banks were caught flat-footed by an inflation surge, and have been forced to abandon stimulatory policy well before strong growth could help reduce the debt burden. It remains unclear what the next regime will be, however in our assessment:

- Economies and markets are undergoing a dramatic adjustment. Economies are adjusting to accelerated labour market and energy supply disruption, and markets to significantly tighter central bank policy

- Macroeconomic volatility is likely to stay high, with an elevated risk of stagflation. Greater risk premium in most assets is required. High rates volatility and wider spreads in less liquid markets (such as Australia) suggests much of this is priced into rates
- Bond-equity correlations are subject to a positive shift should inflation stay elevated, causing a rethink on traditional portfolio construction techniques. Some alternative asset 'safe harbours' may prove illusory.

As described above, the cyclical picture is becoming more supportive of bonds and valuations are much more appealing than at the start of the year or even three months ago. The strategic value of fixed income has also improved with higher yields and a potentially more uncertain, higher volatility environment.

- Schroder is moving to a more positive view on rates exposure, as cyclical risks are shifting from upside inflation to downside growth
- Schroder expect central banks to stay hawkish and deliver aggressive hikes in the next few months as inflation remains high. They are therefore continuing to position for yield curve flattening, staying short duration in short-dated bonds, but moving long duration in maturities beyond 2023
- As official rate increases are delivered by central banks, Schroder is expected to increase aggregate portfolio duration
- Credit faces a very uncomfortable macro mix, with downside growth and profitability risk adding to liquidity headwinds. However, spreads have moved significantly wider already, and while the manager believe riskier credit is still vulnerable, higher quality corporates offer good carry especially on an all-in-yield basis
- Schroder remain defensively positioned in credit but our most recent steps have been to tentatively add back. The manager will become more constructive as recession risks are increasingly priced.

In no sense is the manager relaxing, as the next six months or more could prove as challenging as the last, however Schroder is now optimistic that better fixed income returns are ahead and that fixed income will retain strong strategic value to diversified portfolios. The portfolio is well placed to deliver on both.

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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