Schroder Fixed Income

Quarterly Investment Option Update

31 March 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%	78.0%
Cash & Equivalents	0%	14.9%
Global Investment Grade	0%	-3.0%
Australian High Yield	0%	6.4%
Global High Yield	0%	3.7%

Sector Allocation	%
Government	27.1
Semi-Government	22.5
Supranational/Sovereigns	5.3
Corporates	27.0
Subordinated	2.3
Collateralised	4.0

Quality Allocation	%
AAA	33.2
AA	23.2
A	7.2
BBB	21.0
Below BBB	2.3
Not Rated	1.5

Top Holdings	%
NEW SOUTH WALES TREASURY CORPORATI GOVTGUAR 3.0 20-MAR-2028 Reg-S	4.3
AUSTRALIA (COMMONWEALTH OF) 0.25 21-NOV-2024 Reg-S	3.6
AUSTRALIA (COMMONWEALTH OF) 2.25 21-MAY-2028 Reg-S	2.6
AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2027 Reg-S	2.5
QUEENSLAND TREASURY CORPORATION NONDMUNI 1.75 21-AUG-2031 Dual 144a|Reg-S	2.2
AUSTRALIA (COMMONWEALTH OF) 2.75 21-MAY-2041 Reg-S	2.1
AUSTRALIA (COMMONWEALTH OF) 4.75 21-APR-2027 Reg-S	1.7
AUSTRALIA (COMMONWEALTH OF) 3.25 21-JUN-2039 Reg-S	1.7
AUSTRALIA (COMMONWEALTH OF) 2.75 21-NOV-2029 Reg-S	1.6
TREASURY CORPORATION OF VICTORIA 1.5 10-SEP-2031	1.5

Investment Option Commentary

A dramatic repricing of fixed income occurred over the quarter, as markets factored in sharp central bank rate increases in response to the unfolding inflation shock, which was further accelerated by the war in Ukraine. Both the magnitude and pace of the repricing were notable. Over the quarter, the Fund underperformed the benchmark, despite holding cautious views on the outlook.

Largest contributors

Few fixed income assets were spared in the repricing. Fixed income portfolios that did (relatively) well either held short positions or were otherwise positioned in outperforming (but still negative returning), parts of the universe. The Fund's short duration positioning in US rates and positioning for the US yield curve to flatten on increased cash rate expectations proved to be Schroder's most effective insulation from negative returns. Schroder also maintained exposure to Australian inflation linked bonds, which outperformed significantly. Schroder's caution on credit spreads proved correct, however Schroder's positioning to be overweight higher-quality investment grade and underweight lower quality high yield, and to reduce exposure via derivative hedges, was not effective enough.

Largest detractors

In their Core Plus approach Schroder utilise a broad opportunity set to enhance return and help manage risk. In the quarter the Fund's reduced allocations to emerging market sovereign debt and Asian corporate securities detracted value, as despite relatively attractive valuations, these assets continued to underperform. In addition, Schroder's core holding in Australian investment grade credit underperformed, noticeably against both US investment grade and US high yield in risk-adjusted terms.

Market Commentary

Global bonds suffered their worst ever quarter on record, as markets priced in aggressive interest rate increases by central banks, sending short-dated bond yields significantly higher. Additionally, corporate bonds underperformed government bonds with credit spreads widening on a combination of higher geopolitical risk and central bank tightening fears. The key issue is inflation, which rose to multi-decades highs of 7.9% in the US and 7.5% in Europe, supported by the largest quarterly increase in commodity prices since 1973 (+25%). The Ukraine war in Ukraine created additional volatility but ultimately turbo-charged the inflation and bond story by creating more supply-side shortages in key energy and agricultural commodities.

Outlook

Now that central banks are (belatedly) responding to the inflation threat, the key cyclical question is whether they can 'stick the landing', i.e. can central banks engineer lower inflation without sending economic growth plummeting? The US interest rate market is skeptical – the yield curve is beginning to invert, implying rate increases will need to be reversed – and the historical evidence is not good; typically, central banks over-tighten policy, and leading to a recession. This suggests that, while perhaps not just yet, good cyclical value in bonds will emerge as we move through the tightening cycle and the balance of risks shifts from higher inflation to lower growth.

At face value, Australian bonds look attractive on a relative basis as it seems unlikely the RBA will be able to raise official rates by more than the US Fed, as is currently priced into the yield curve. This unlikeliness arises from the greater sensitivity of the Australian economy to the cash rate –- our household debt being much larger, and largely in variable rate form. However, Schroder expect Australian bonds to continue to either trade in lockstep with, or even further underperform, US bonds until this distinction in the policy cycle becomes more apparent.

If we do enter a higher inflation regime, this has two serious implications. The first is that the bond bull market spanning the last 4 four decades, underpinned by disinflation, is likely over. That's not necessarily a bad thing for bond investors as higher yields set up better future returns, but it will mean the positive disinflationary tailwinds are a thing of the past. The second is that bond-equity correlations may move back to positive, as has been the case historically in environments where inflation has been higher than 4 or 5%. Again, this is not necessarily bad for bond investors, but it will cause a rethink on multi-asset portfolio construction techniques, including the traditional 60/40 balanced portfolio and risk parity approaches.

The yield premium on corporate bonds over government bonds is also undergoing a readjustment, primarily related to central bank tightening. The first element is that not only will central banks lift cash rates, they will also sell down the assets accumulated through their quantitative easing (QE) programs. While this may not involve active selling of the bonds purchased, it may simply take the passive form of not reinvesting the proceeds of maturing assets. In either case the central bank will be withdrawing liquidity from the market. To the extent that central bank balance sheet expansion has supported risky assets of all forms, liquidity withdrawal is likely to have the opposite effect. In Schroder's estimation, anticipation of liquidity withdrawal has been, alongside funds flow driven by concern over rising rates, the primary driver of wider spreads this year.

The second element impacting corporate bonds is that over-tightening by central banks, in an effort to rein in inflation, may trigger recession. Recession drives credit spreads wider as profitability and ability to service debt drops, increasing risk of default. Schroder does not think the move wider in credit spreads so far this year reflects this risk, evidenced by the outperformance of high yield credit which are is more vulnerable to recession. Schroder's models are not suggesting imminent recession, but Schroder expect indicators of recession risk to begin flashing soon.

Drawing these points together, fixed income is clearly better value now than several months ago, by virtue of the rise in bond yields and the widening in corporate credit spreads. However, the outlook remains challenging. The tightening cycle is just starting, it is unclear whether the actual delivery of the interest rate increases will be able to tame inflation, and for lower quality corporate credit, the risks remain skewed to downside at least until valuations cheapen further. Given this assessment, Schroder's approach is to remain patient. The worst of the repricing is perhaps behind us. However, opportunities will arise as the repricing continues., and Schroder will look to take advantage of those with more constructive positioning that will set up stronger returns from fixed income.

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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