Betashares Australian Government Bond ETF

ASX: AGVT

Quarterly Report - December 2023

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Performance[1]	1 month %	3 month %	6 month %	1 year %	3 years % p.a.	Inception % p.a.[2]
Fund Return (net)	4.21%	5.37%	3.57%	6.22%	-4.90%	-1.94%
Growth Return	4.49%	4.49%	1.88%	2.83%	-6.99%	-3.72%
Income Return	-0.28%	0.88%	1.69%	3.39%	2.09%	1.78%
Index Return	4.26%	5.45%	3.71%	6.44%	-4.72%	-1.76%

Past performance is not a reliable indicator of future performance.

[1] As at 29 December 2023. Returns are calculated after fees & expenses have been deducted and distributions have been reinvested.

[2] Inception date for the Fund is 5 July 2019.

Yield and portfolio characteristics	
Running Yield (% p.a.)[1]	2.56%
Yield to Maturity (% p.a.)[2]	4.18%
Average Maturity (Yrs)[3]	8.95
Modified Duration (Yrs)[4]	7.80
Average Credit Rating[5]	AAA

[1] Average coupon (weighted by market value) of the bonds in the portfolio, divided by the current market price of the bonds. Provides an indication of expected current income from making an investment at market price. This value will vary over time as interest rates change.

[2] Total expected return from the bond portfolio, based on current bond prices and assuming no change in prevailing interest rates.This value will vary over time.

[3] Average (weighted by market value) length of time until the current bonds in the portfolio mature.

[4] A measure of the sensitivity of the portfolio's value to a change in interest rates. For example, a Modified Duration of 7 years implies that a 1% rise in the reference interest rate will reduce the value of the portfolio by 7.00%.

[5] Average credit rating for the bonds in the portfolio. Credit ratings should not be used as a basis for assessing investment merit.

Source: Bloomberg. As at 29 December 2023. Yields shown do not take into account AGVT's management costs of 0.22% p.a.

Investment objective

The Fund aims to track the performance of an index that provides exposure to a portfolio of high-quality bonds issued by Australian federal and state governments, and with a component also issued by supranationals and sovereign agencies.

Responsible entity

Betashares Capital Ltd

Distribution frequency

Monthly

Suggested minimum investment timeframe

At least three years

Fund facts	
Inception Date	5-Jul-19
Fund Size	$612.13m
Historical Tracking Error (annualised)	0.14%
ASX Code	AGVT
Bloomberg Code	AGVT.AU
IRESS Code	AGVT.AXW

Fees	% p.a.
Management fee	0.19
Recoverable expenses	0.03

Investment strategy

The Fund's Index is designed to provide exposure to Australian Dollar denominated fixed rate bonds issued primarily by Australian federal and state governments, and with a component issued by supranationals, sovereign agencies and similar issuers. To be eligible for inclusion in the Index, amongst other requirements, each bond must be an Australian Dollar denominated fixed rate bond, have a term to maturity between 7-12 years and meet a minimum issuance size requirement. Securities are market capitalisation weighted, and will be adjusted at rebalance date to ensure that 75% of the Index is comprised of Australian federal and state government bonds; and 25% of the Index is comprised of supranationals, sovereign agencies, government-related development banks and non-Australian governments/ regional authorities.

Top 10 positions[1]	%
Australian Govt 1% Nov-31	6.0
Australian Govt 1.5% Jun-31	5.9
Australian Govt 1.25% May-32	5.8
Australian Govt 1% Dec-30	5.7
Australian Govt 4.5% Apr-33	5.0
IFC 1.25% Feb-31	4.7
Australian Govt 1.75% Nov-32	4.6
Australian Govt 3% Nov-33	3.8
IFC 1.5% Apr-35	3.7
Australian Govt 3.75% May-34	3.3

[1] As at 29 December 2023

Sector exposure[1]	Fund Weight %	Index Weight %
Australian Government	46.2	46.5
Australian State Governments	29.2	28.3
Supranational Banks	14.7	16.8
Government Development Banks/ Agencies	9.8	8.4
Regional Authorities	0.0	0.0
Cash	0.1	0.0
TOTAL	100.00	100.00

[1] As at 29 December 2023

Global macro and rates

In the December quarter of 2023, the global macro narrative underwent a significant pivot, with global bond yields staging a dramatic round-trip. The US 10-year Treasury yield surged by up to 31 basis points during the first half of the quarter, reaching a 16-year high and briefly touching 5% intraday. However, yields reversed sharply lower in the back half of the period, ending the quarter down 69 basis points and largely unchanged for the year. Similar movements were observed in other developed bond markets, with the average yield on the Bloomberg Global Treasury Aggregate peaking at a 15-year high of 3.65% before sharply falling to 2.92% by year-end – a quarterly decline of 59 basis points and an annual drop of 12 basis points. This reversal in yields was primarily driven by a series of dovish FOMC meetings in November and December, a more muted US Treasury Quarterly Refunding Announcement, in addition to a continued moderation of inflation pressures in the US and most developed economies.

Global macro and rates (cont.)

The November FOMC meeting saw the Fed maintain the federal funds rate at a 22-year peak of 5.25% to 5.50%. Chairman Powell's comments which indicated a view that tighter financial conditions would eventually impact economic activity was interpreted by the market as a 'dovish hold'. This sentiment was reinforced at the December meeting, where the Fed held the rate steady and recognised a slowdown throughout the US economy, which was also reflected in economic surprises also trending on the softer side of expectations throughout the quarter. The dovish shift was only affirmed with the updated 'dot-plot' projections, now forecasting 75 basis points in rate cuts over the subsequent years through to 2025 and 2026. Powell's press conference remarks also suggested a readiness to initiate rate cuts before reaching the 2% inflation target, aligning with the view of other FOMC members that cuts would be required to prevent real rates from rising excessively as inflation falls.

Like the Fed, the ECB maintained unchanged policy, albeit with an attempt to project a hawkish bias. However, weak economic data across the region led to a dramatic market shift towards expectations of rate cuts within a year, with longer-term yields largely following US Treasuries' path. Elsewhere, Q4 also saw further indications of the Bank of Japan's intent to normalise policy, largely via the domestic financial press. However, despite significant market speculation, no major policy announcement emerged from the December meeting, although the market is still pricing in a hike cycle to begin in Japan in 2024, which would end an 8-year period of negative policy rates.

In Australia, gyrations in Commonwealth Government yields largely mirrored those of US Treasuries, although domestic factors also played a role. The benchmark 10-year yield ended the quarter 53 basis points lower and 9 basis points lower over the year. Following a higher-than-expected Q3 CPI print, the RBA raised the cash rate target to 4.35% in November, prompting an upward revision in medium-term inflation forecasts. Despite this hike, the statement adopted a cautious tone, highlighting the policy lag, mortgage channel impact on household balance sheets, and global headwinds, including weaker-than-expected Chinese economy activity. The dovish posture continued into the December meeting, with the cash rate remaining unchanged.

Credit markets

Global credit markets remained robust over the quarter, with spreads compressing further amid optimism around a dovish Fed pivot. The quarter began with an expansion in credit spreads as benchmark yields reached new highs, reflecting greater policy uncertainty amid the economic strength. However, as the quarter progressed and the Fed's dovish pivot became evident, a significant compression in spreads occurred. This tightening in credit spreads was accompanied by a noticeable easing in broader financial conditions and a reduction in interest rate volatility, suggesting a recalibration of risk perceptions and a reassessment of the credit landscape amid an expanding 'soft landing' window.

5–10-year USD investment grade corporate bond spreads compressed 31 basis points over the quarter and 43 basis points for the year. US high yield spreads experienced even greater compression, with the broad index's option-adjusted spread narrowing by 72 basis points for the quarter and by 145 basis points over the year. This trend was supported by the growing consensus around a soft-landing scenario and reduced rate volatility. Another notable aspect was the anticipated liquidity drain from the Fed's quantitative tightening (QT) program proving to be overstated, with the size of the Fed's reverse repo facility acting as a buffer against net new issuance.

AUD corporate bond spreads largely mirrored the global trend, albeit with less day-to-day volatility. These spreads continue to trade above USD equivalents, primarily due to AUD swap spreads remaining usually wide by global standards. However, there was notable compression from late 2022 highs, primarily driven by the swap spread channel, with only modest compression in corporate credit spreads versus swap. This trend was also evident in senior bank credit, where discount margins versus BBSW continued to trade in a very narrow range as supply weighs at the margin. Of note, there was approximately AU$28 billion of financial issuance in the domestic bond market, including $4 billion of senior FRNs from NAB alone. In contrast, issuance in the domestic non-financial corporate space remained subdued, with only AU$3.7 billion issued in total across a handful of deals.

Outlook

As we look ahead, the landscape for bond markets remains complex and fluid. The apparent shift in the Fed's policy stance potentially marks a major inflection point, with major implications for asset returns for 2024. However, uncertainties persist, and it's possible the market has become overly aggressive in anticipating the next easing cycle, with six cuts priced into US forward rates for 2024 by year-end. Caution is advised for several reasons. Firstly, a similar pivot narrative emerged in late 2022, peaking during the regional banking stress in March 2022, but was unwound over the remainder of the year amid sustained US economic strength and elevated Treasury issuance. Given the post-pandemic budget deficits in much of the developed world, high Treasury issuance, particularly in the US, should be expected to continue. Additionally, much of the recent fixed income rally may have been amplified by short covering in the rates space, given extended short positioning from trend-following and similar systematic strategies.

Furthermore, while US inflation continues to moderate, much of this stems from the goods channel as global supply chains normalise. Beneath the surface, 'super core' measures (i.e., core services excluding housing) remain stubbornly high, and the fixed income rally hinges on where the stickiest parts of the CPI basket settle. As of the November CPI report, such measures are still well above the Fed's 2% target both annually and on a month-on-month basis. In the US, there is also now a real risk that easing financial conditions could be counterproductive, potentially reigniting demand-driven inflation if the wealth effect and 'animal spirits' spurred by the asset rally re-accelerate demand.

In Australia, although moderating, inflation continues to exceed the RBA's target, and wages growth appears sticky, suggesting similar risks of inflation bottoming out at too high a level. However, given the faster pass-through and shorter policy lag, below-trend growth is likely to persist, as the RBA predicts, potentially curbing demand-side price pressures. This could justify a shift to a more neutral policy setting by the RBA, which might justify a modest easing cycle, as the market is now currently pricing in. However, it's also important to remember that central banks' perceptions of 'accommodative', 'neutral', and 'restrictive' rates depend on their estimate of the so-called "neutral rate", which is very difficult to know in advance. Post-pandemic structural changes may argue for higher neutral rates than previously thought, but might not know for years, due to the long and variable lag of policy.

In this environment, asset allocation should play a crucial role. While the likelihood of a US soft landing has increased, several markets have already compressed to reflect this. Given that base interest rates and yields are around the highest levels in a decade, there appears to be a greater role for high-quality investment-grade credit, both fixed and floating rate, in balanced portfolios. Elsewhere, cash still offers optionality with minimal opportunity cost and is a valid tactical or duration lever. In contrast, the lowest quality, and least liquid segments of the credit market, including traditional high yield and alternative lending arguably command an insufficient premium to justify the US soft-landing scenario not coming to pass. Investors might find more favourable return asymmetry in taking such cyclical exposures through equities.

There are risks associated with an investment in AGVT, including interest rate risk, credit risk, market risk and index tracking risk. For more information on risks and other features of AGVT, please see the Product Disclosure Statement.

Chart 1: G7 + Australasia Policy Rates, as at 31-December-2023; Source: Bloomberg

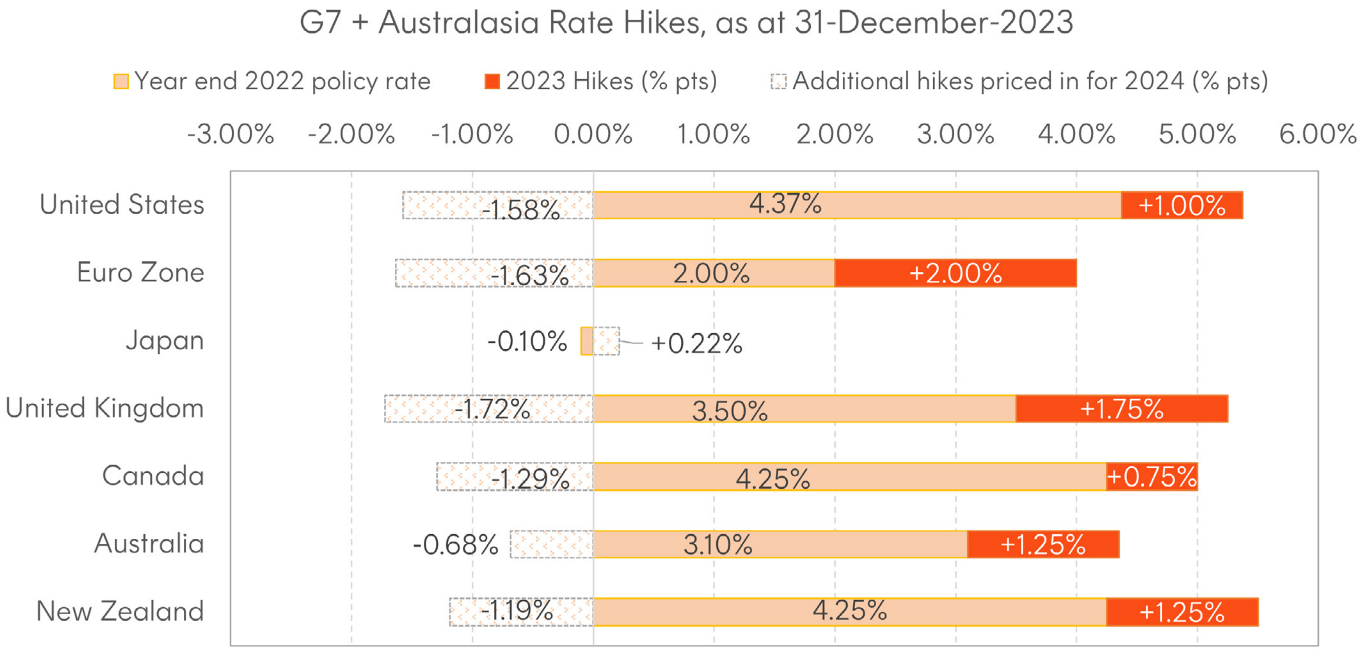

Chart 2: 10-year Government bond yields, as at 31-December-2023; Source: Bloomberg

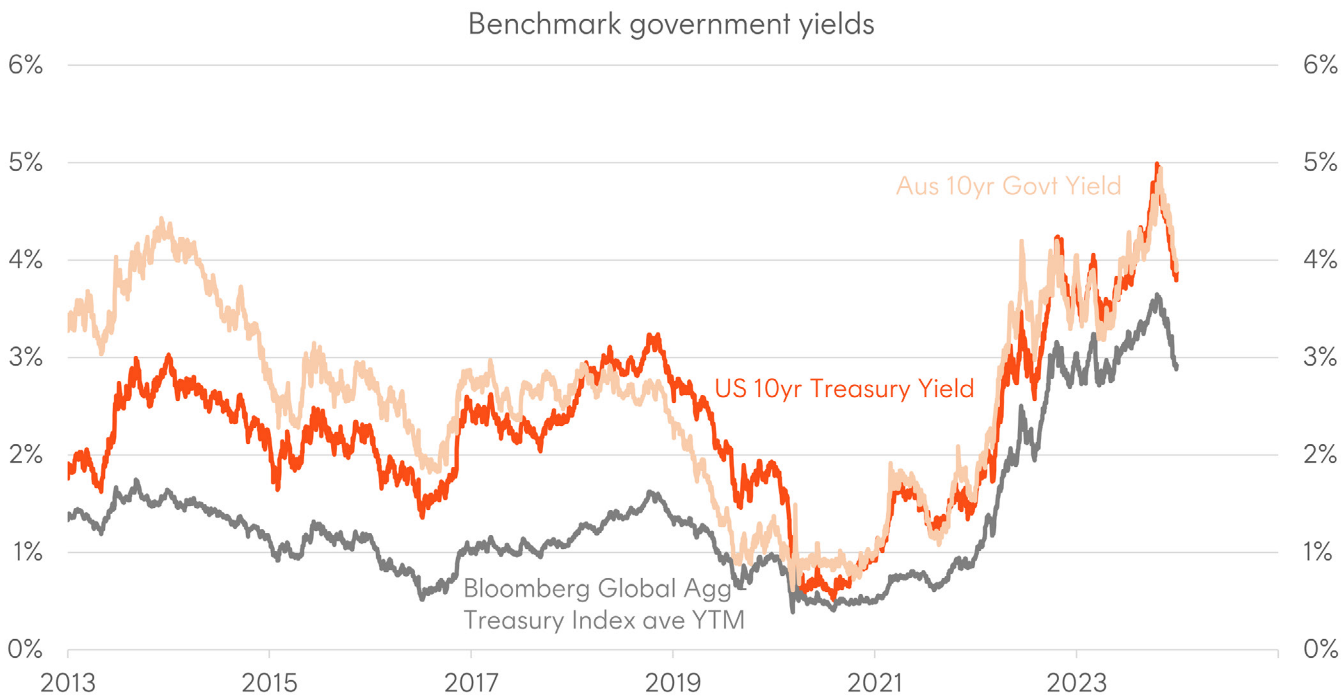

Chart 3: USD corporate bond issuance, breakdown by BICS sectors, as at 31-December-2023; Source: Bloomberg

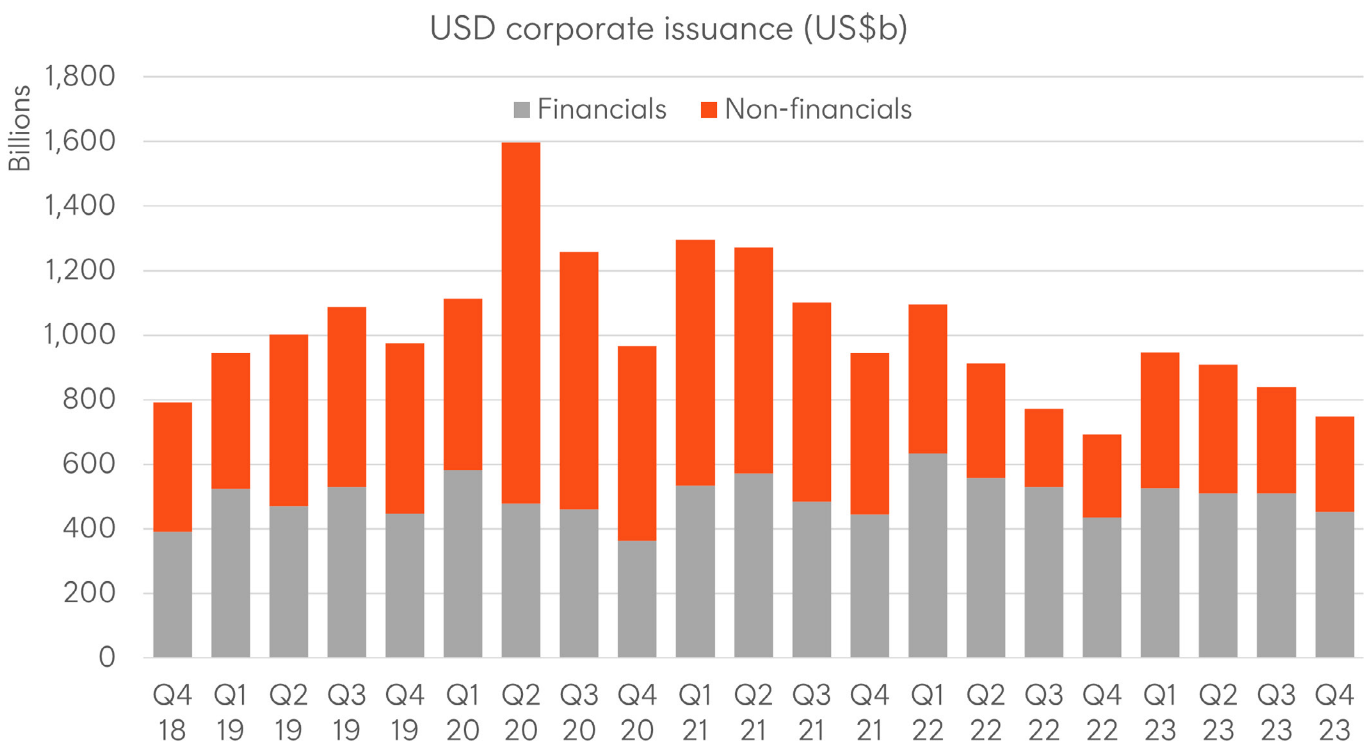

Chart 4: AUD corporate bond issuance, breakdown by BICS sectors, as at 31-December-2023; Source: Bloomberg

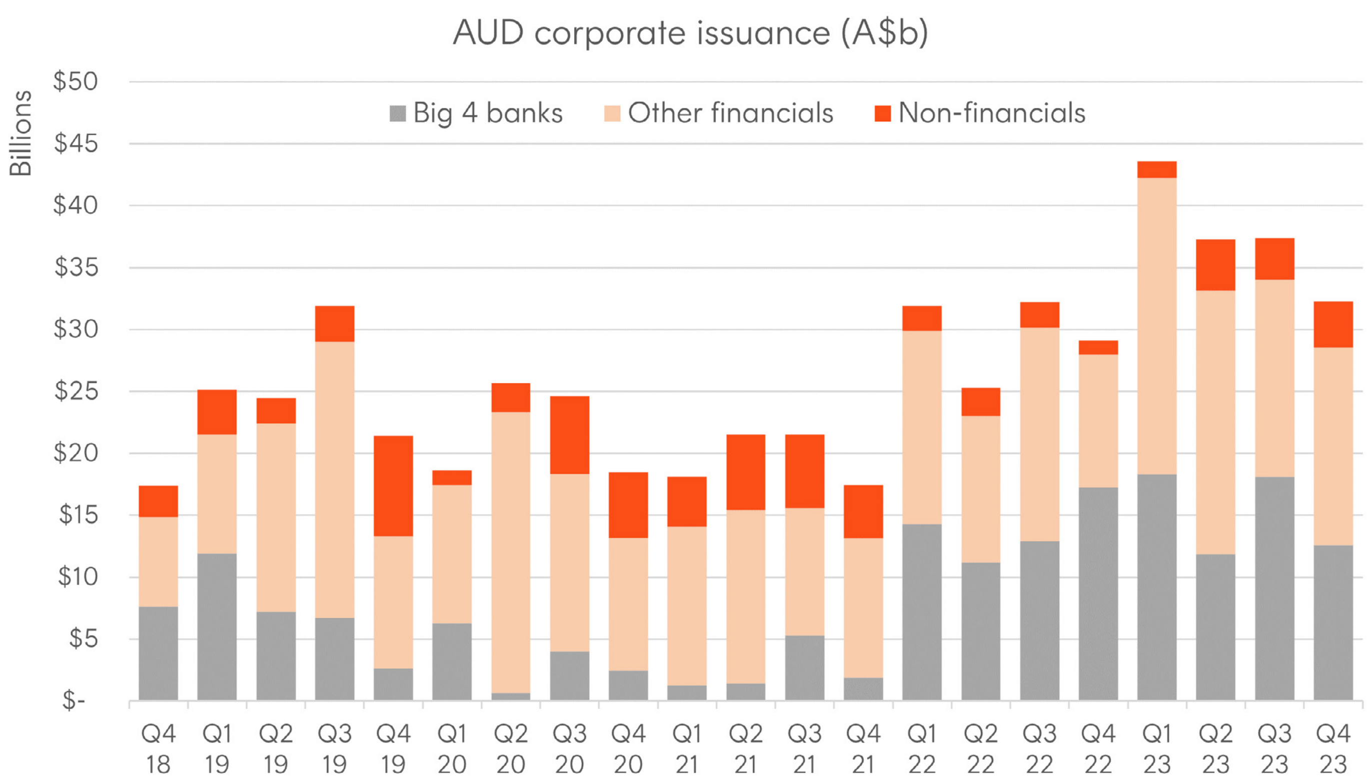

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Chart 5: US interest rates, as at 31-December-2023; Source: Bloomberg

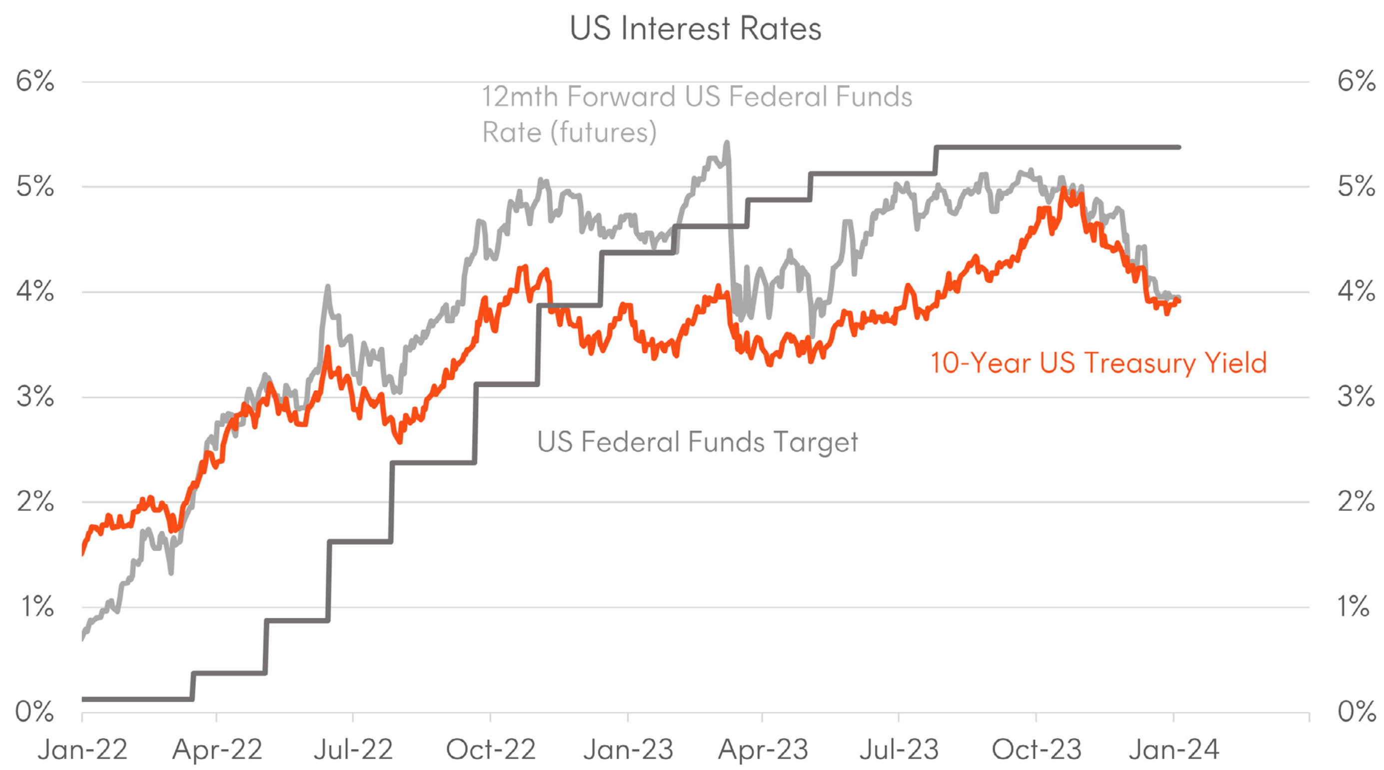


Chart 6: Australian interest rates, as at 31-December-2023; Source; Bloomberg

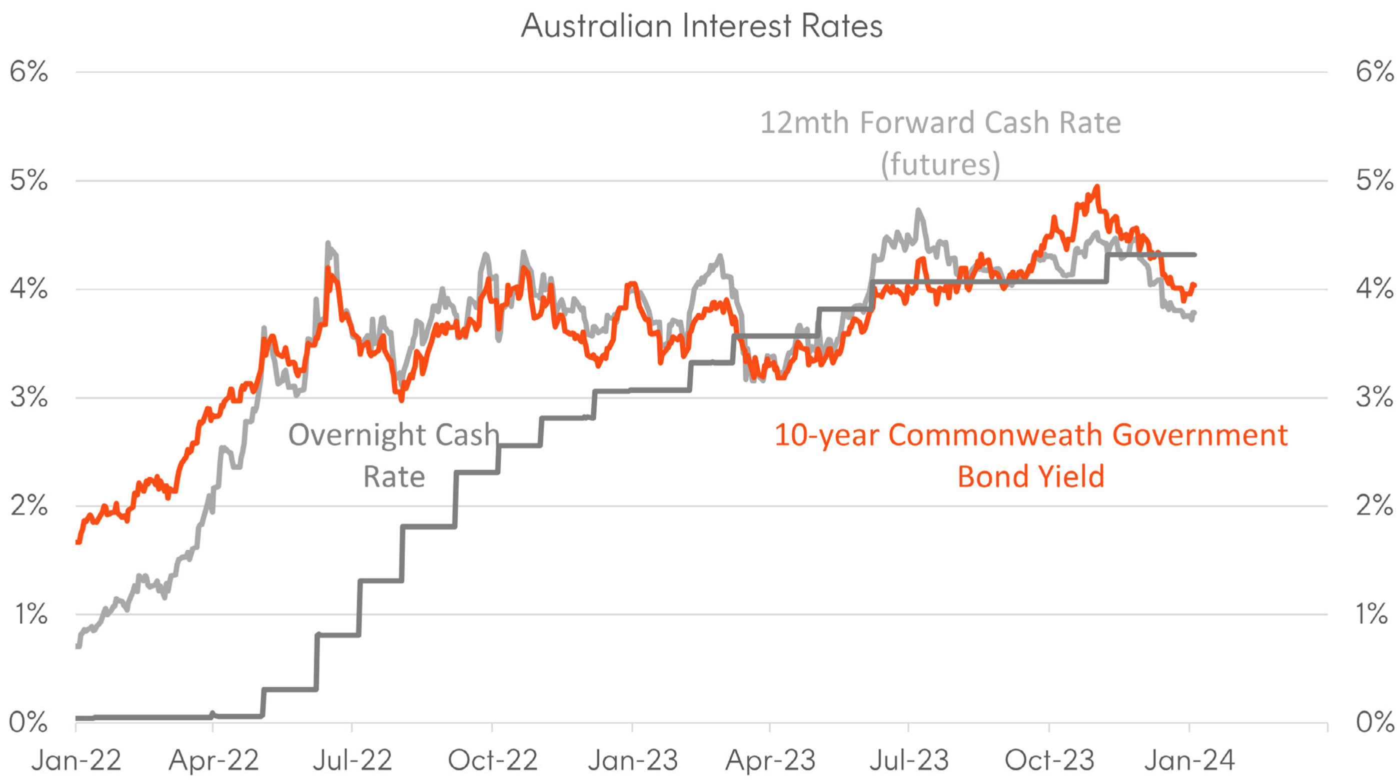


Chart 7: Global economic surprises, as at 31-December-2023; Source: Citi

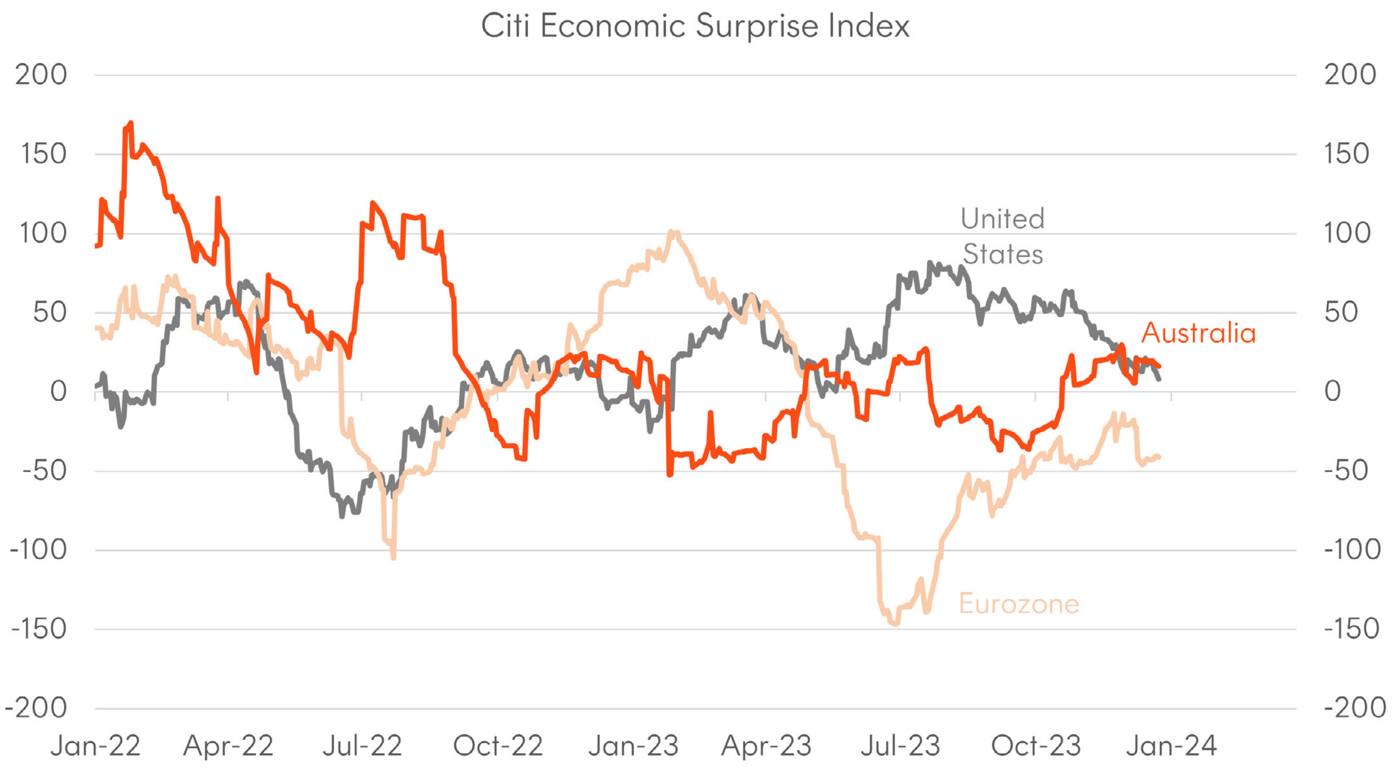


Chart 8: Global inflation surprises, as at 31-December-2023; Source: Citi

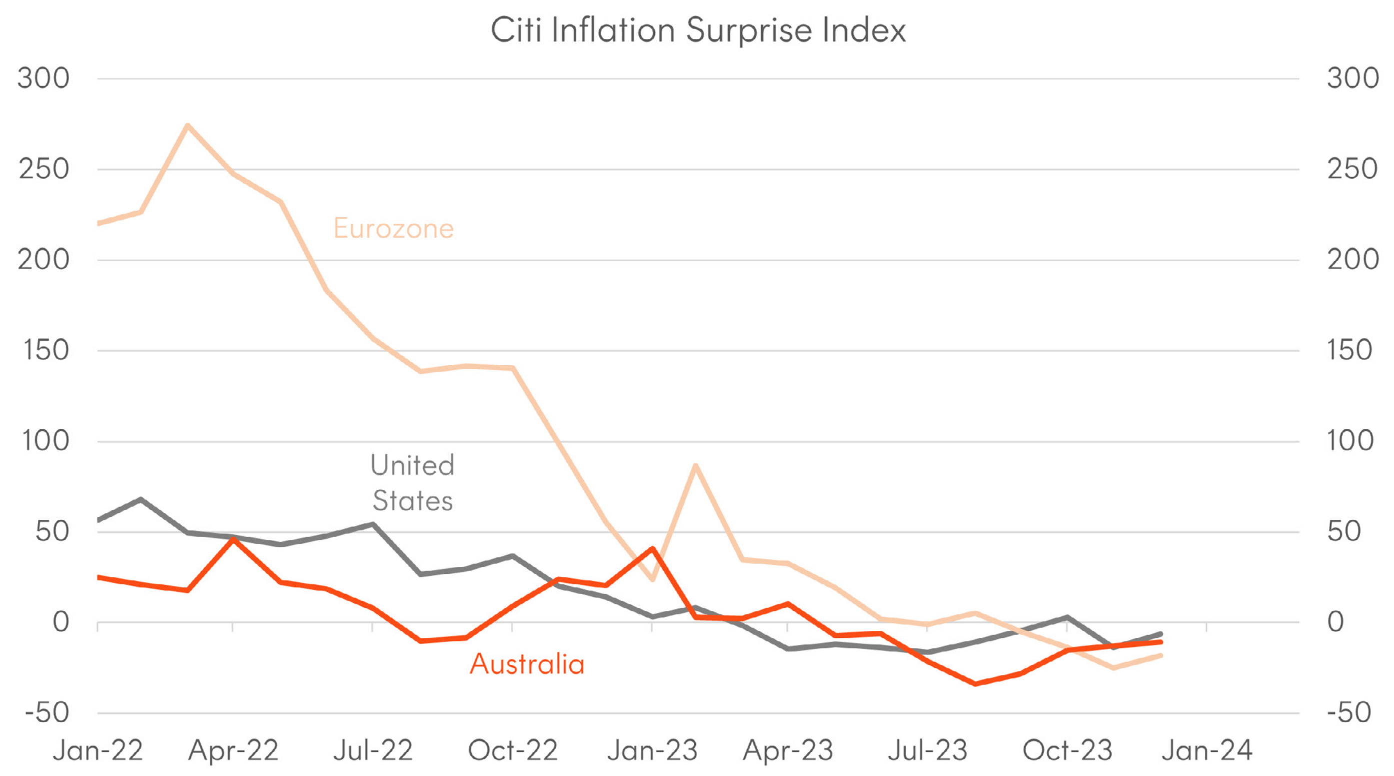


Chart 9: Corporate bond spreads; as at 31-December-2023; Source: Bloomberg

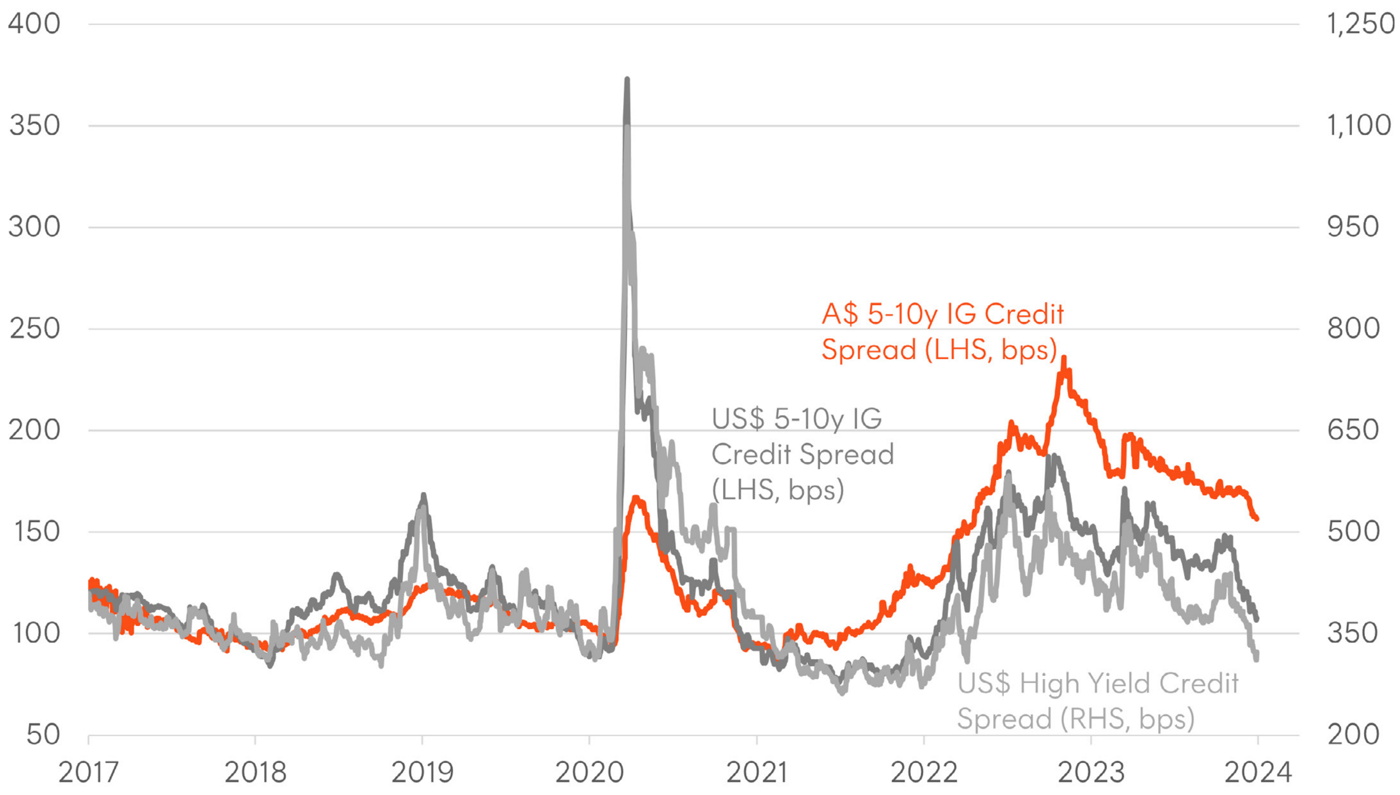


Chart 10: Australian major bank credit spreads history, as at 31-December-2023; Source: Bloomberg

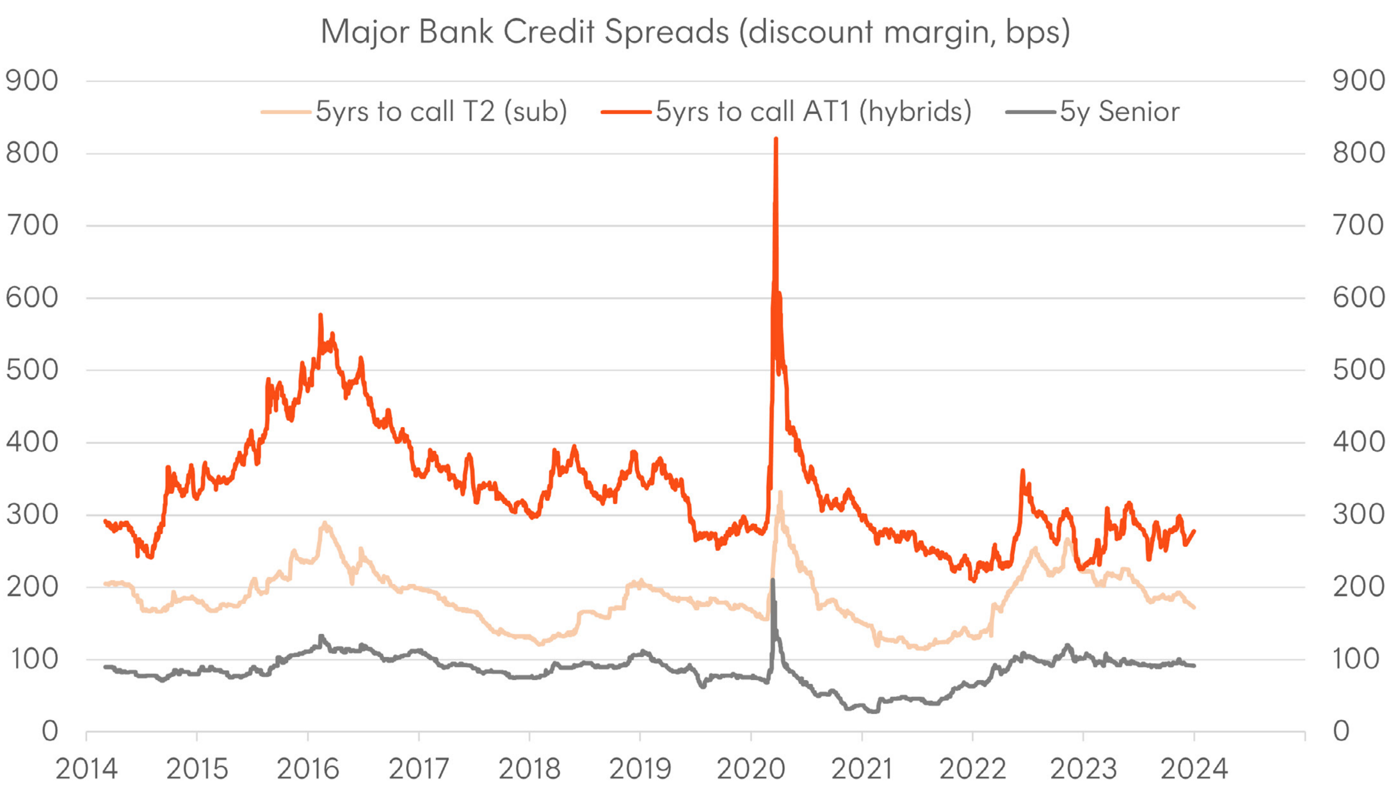
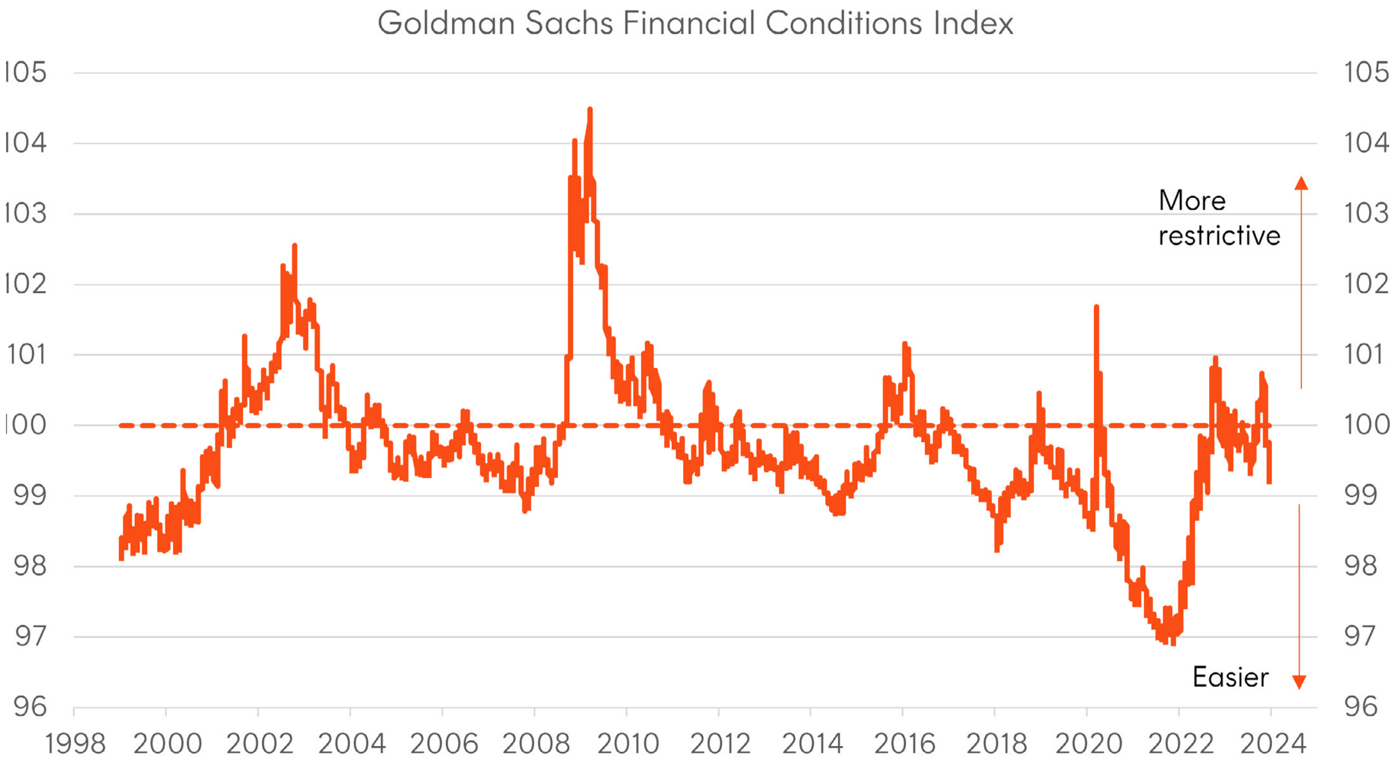


Chart 11: Goldman Sachs US Financial Conditions Index, as at 31-December-2023; Source: Goldman Sachs



Important

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