



Betashares Australian Government Bond ETF

ASX: AGVT

Quarterly Report - June 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)	-2.76%	-4.05%	2.56%	1.28%	-5.69%	-3.04%
Growth Return	-3.04%	-4.82%	0.93%	-1.75%	-7.40%	-4.62%
Income Return	0.28%	0.77%	1.63%	3.03%	1.71%	1.58%
Index Return	-2.75%	-4.03%	2.63%	1.50%	-5.52%	-2.87%

Past performance is not a reliable indicator of future performance.

¹ As at 30 June 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	2.44%
Yield to Maturity (% p.a.) ²	4.29%
Average Maturity (Yrs) ³	9.04
Modified Duration (Yrs) ⁴	7.92
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 30 June 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	\$434.78m
Historical Tracking Error (annualised)	0.15%
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 Government 1% Nov-31	6.86
Australian Government 1.5% Jun-31	6.59
Australian Government 1.25% May-32	6.52
Australian Government 1% Dec-30	6.51
Australian Government 4.5% Apr-33	5.34
Australian Government 1.75% Nov-32	4.99
Intl Finance Corp 1.5% Apr-35	4.62
Intl BK Recon & Develop 1.1% Nov-30	4.40
Australian Government 3% Nov-33	4.01
Australian Government 3.75% May-34	3.57

¹ As at 30 June 2023

Sector exposure ¹	Fund Weight %	Index Weight %
Australian Government	47.1	47.3
Australian State Governments	27.5	27.5
Supranational Banks	16.9	17.3
Government Development Banks/Agencies	8.0	7.8
Regional Authorities	0.0	0.0
Cash	0.5	0.0
TOTAL	100.00	100.00

¹ As at 30 June 2023

Global macro and rates

The second quarter of 2023 saw a continued focus on policy tightening, with central banks worldwide grappling with persistent inflation pressures amid robust labour markets. Global bond yields climbed as fears of banking stress, which stemmed from the collapse of several US regional banks and the government-brokered takeover of Credit Suisse in Q1, unwound. Surprisingly strong US economic data further contributed to the rise in yields. 10-year US Treasury yields closed the period 37 basis points higher, with 2-year yields spiking by 87 basis points to approximately 5% - a level last seen before the banking crisis.

Similar movements occurred elsewhere; UK gilts saw the most significant repricing across major bond markets, as 2-year gilt yields jumped 183 basis points, surpassing their peak during the September 2022 fiscal crisis. These increases occurred amidst strong inflation and wage growth. Despite a global yield jump, interest rate volatility measures moderated, providing marginal support to risk assets.

Inflation remained a primary concern throughout the quarter. Although most economies' core and headline inflation tended to surprise on the downside, the overall levels remained worryingly high, particularly given the backdrop of strong nominal demand. US economic activity was especially robust, with the Citi US Economic Surprise Index maintaining positive momentum as data consistently exceeded expectations. In contrast, Eurozone activity saw a marked deterioration, with real GDP recording two consecutive quarterly contractions.

Central bank meetings were a key driver of broader narratives. The Federal Open Market Committee raised the Federal Reserve Funds target range in May and held rates steady in June, ending the quarter at 5.00%-5.25%, the highest policy rate since 2007. The updated Summary of Economic Projections (SEP) revealed a significant development, as the median Fed Funds rate projection for year-end was lifted to 5.625%, up 50 basis points from the March "dots". The SEP's release coincided with upward revisions to US growth and core inflation for the year, and lower unemployment forecasts. This development solidified the notion of a potential "6-handle" Fed Funds rate, previously hinted at by some Fed officials before the Q1 banking stress.

The European Central Bank (ECB) raised rates in April and June and hinted at another potential hike in July, as Euro area inflation proved slow to moderate. This ongoing focus on monetary policy culminated in the highly anticipated ECB-hosted Forum on Central Banking in Portugal, where the heads of the Fed, ECB, Bank of England, and Bank of Japan (BoJ) shared the stage. Of note, the new BoJ Governor, Ueda, hinted at a potential 2024 policy shift, contingent on upward movement in inflation expectations. This would mark a significant departure from Japan's prolonged zero/negative interest rate policy, especially as Japan's core CPI surpassed 4% for the first time in over 40 years.

Global liquidity remained a key focus, with the most substantial central banks all contracting their balance sheets. Despite this apparent liquidity drain, risk assets were largely unaffected, with the anticipated squeeze following the passage of the US debt ceiling bill failing to materialise. Following the bill's passage, it had been expected that the surge in Treasury bill issuance to rebuild the Treasury General Account would struggle to be absorbed. However, with the reverse repo facility growing well above US\$2 trillion, it became clear that significant inflows to money market funds since March provided ample demand to absorb much of the T-bill supply.

In Australia, the Reserve Bank of Australia (RBA) tackled inflation pressures similarly to its peers, executing surprise rate hikes in May and June, bringing the cash rate target to 4.10%, with the data tending to surprise on the upside during the quarter. These hikes followed a pause in April, catching the rates market off-guard in discerning the RBA's intentions. The repricing during the quarter was dramatic, with terminal rate pricing based on cash rate futures rising over 100 basis points to end around 4.5%, with Commonwealth bond yields experiencing similar moves across the curve to close the quarter above 4% for all maturities.

Other significant domestic developments during the quarter included the release of the RBA Review, which is anticipated to lead to the appointment of a new Governor at the end of the current term in September, with external appointments being the most likely candidates. An increase in longer-term Australian market-implied inflation expectations was another notable development, with both long-term (e.g., 5y5y forward) inflation breakevens and inflation swaps rising to fresh cycle highs. One reason attributed to this rise has been increased demand for inflation-linked bonds (ILBs) following news that the Government has selected the Bloomberg AusBond Master and not the AusBond Composite as the preferred domestic fixed interest index under APRA's Your Future, Your Super benchmarking framework. The primary difference is that the Ausbond Master includes both ILBs and credit floating rate notes. The decision has already received some criticism from fund managers due to the patchy liquidity in the ILB market and the AOFM's previous reluctance to proactively increase issuance in that sector.

Credit markets

Throughout the quarter, credit markets proved resilient despite further rate hikes, ongoing macro uncertainty, and the shadow cast by the previous quarter's banking crisis. The anticipated credit tightening from the US commercial banking sector did not materialise to the extent many had expected, with overall financial conditions not appearing particularly restrictive, as evidenced by the broad-based compression in credit spreads.

In the US, investment-grade spreads in the 5–10-year maturity bracket compressed by around 10 basis points, finishing the quarter at approximately +140 basis points over Treasuries. Concurrently, high-yield spreads narrowed by an average of 50 basis points to around +400 basis points, with the final level of spreads largely consistent with a soft-landing outcome.

This compression in spreads occurred despite an uptick in US corporate bankruptcies, which reached their highest levels since 2010. In addition, corporate issuance remained robust during this period, with gross investment-grade sales reaching US\$320 billion, a 12% increase from Q2 of the previous year (Bloomberg), and high-yield issuance showing similar resilience. Despite the growing incidence of credit stress and robust volume of issuance, risk sentiment towards credit markets remained positive,

bolstered by buoyant equity markets and moderating interest rate volatility.

In Australia, credit spreads reflected the robustness of their USD equivalents, with Investment Grade spreads compressing by around 20 basis points on average. This was supported by a compression in AUD swap spreads as Commonwealth government bonds lost their scarcity premium due to the ongoing unwinding of the effects of Quantitative Easing and speculation around the prospect of accelerated balance sheet run off emerged. AUD corporate issuance picked up over the June quarter, and while issuance among banks remained strong, the most notable development was the flurry of non-financial corporate issuance, with utilities and automakers returning to the market in size.

Outlook

As we step into Q3, bond yields across developed markets have hit or are nearing fresh cycle highs. This adjustment is driven by two realisations among market participants. Firstly, a “pause” in rate hikes, as exemplified by the RBA and Bank of Canada, does not necessarily signal the end of hikes, a fact that the Fed’s guidance also underscores. Secondly, the current policy setting, and overall financial conditions may not be tight enough to promptly impact economic activity and inflation pressures. This may necessitate terminal rates climbing above 5% in Australia, 6% in the US, and 7% in the UK. Labour market strength across developed economies will be a key determinant of these terminal rates. So far, despite the tightest monetary policy in a generation, we have yet to see major disruptions in employment or wages growth.

Market narratives remain fluid. The once prominent recession/hard landing perspective has now been replaced by both the “soft-landing” and “no landing” themes. Underlying these shifts, however, is a growing concern about economic growth relative to inflation fears, as evidenced by the resurfacing negative correlation between stocks and bonds. The tension between softening leading indicators and the strength of hard economic data will likely continue to steer these narratives. It is, however, notable that with respect to economic resilience, the rates market, rather than central banks,

was furthest behind the curve. The banking stress of Q1 emboldened recession expectations, with the Fed’s own dot plot in March seen as overly hawkish. Yet, it has been central bank guidance, which continues to be revised in an ever more hawkish direction, that has been vindicated, with the rates market having to play catch up, with all the 2023 cuts now priced out of the market and most of the 2024 cuts being removed. The fact that some rate cuts are still priced in for next year remains a risk to the US bond market going forward, and arguably the biggest bearish catalyst might not be where terminal policy rates get to, but rather prolonged economic resilience justifying higher long-term neutral rate estimates.

Just how tight the financial conditions currently are is an ongoing question, but there is a compelling argument that they are still too accommodating. This is evidenced by the mechanical easing in financial conditions indices following the strength in risk assets and the compression of implied volatility and risk premiums. Further evidence includes robust corporate issuance that has persisted throughout much of the year and the resilience of labour markets and the housing sector, despite much higher interest rates. The counter to this view is that we simply need to allow for the “long and variable” lags of policy cycles to unfold. Lags have always been a feature of policy cycles, but there’s a strong case that the lag might be even longer this time around. This is due to the terming out of corporate and household debt in the US in the immediate post-Covid period. The Fed’s multi-dimensional view of the tightening cycle—comprising speed, level, and duration—implies that even if the hiking cycle ends soon, the effective tightening might continue well beyond the peak in rates.

Finally, on the topic of asset allocation, discretionary managers started the year with a conservative stance due to perceived US recession risks. However, a combination of better-than-expected data and the resurgence of equities has led to the unwinding of recession trades. Yet, with real yields reaching fresh cycle highs in both Australia and the US, investors now have viable alternatives to equities, especially considering the aim of the current global tightening cycle is effectively to undermine nominal demand, which by extension should translate to weaker corporate profits.

Chart 1: G7 + Australasia Policy Rates, as at 30 June 2023; Source: Bloomberg

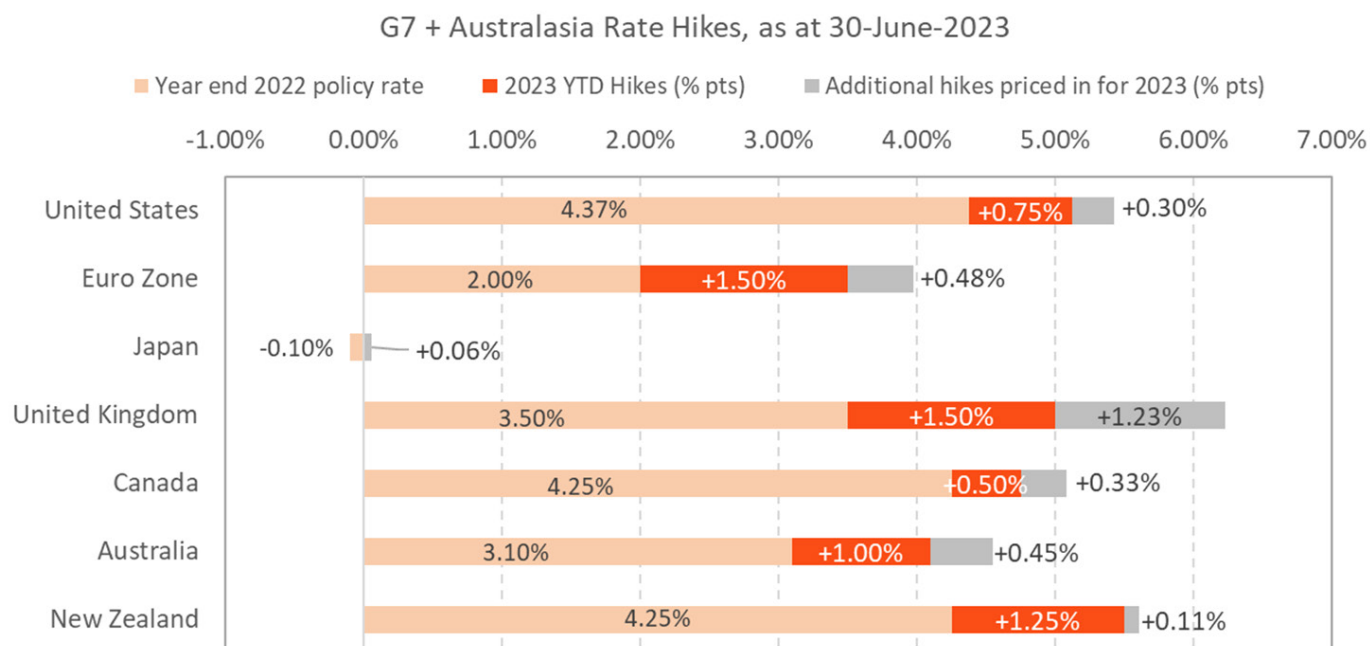


Chart 2: Global economic surprises, as at 30 June 2023; Source: Citi

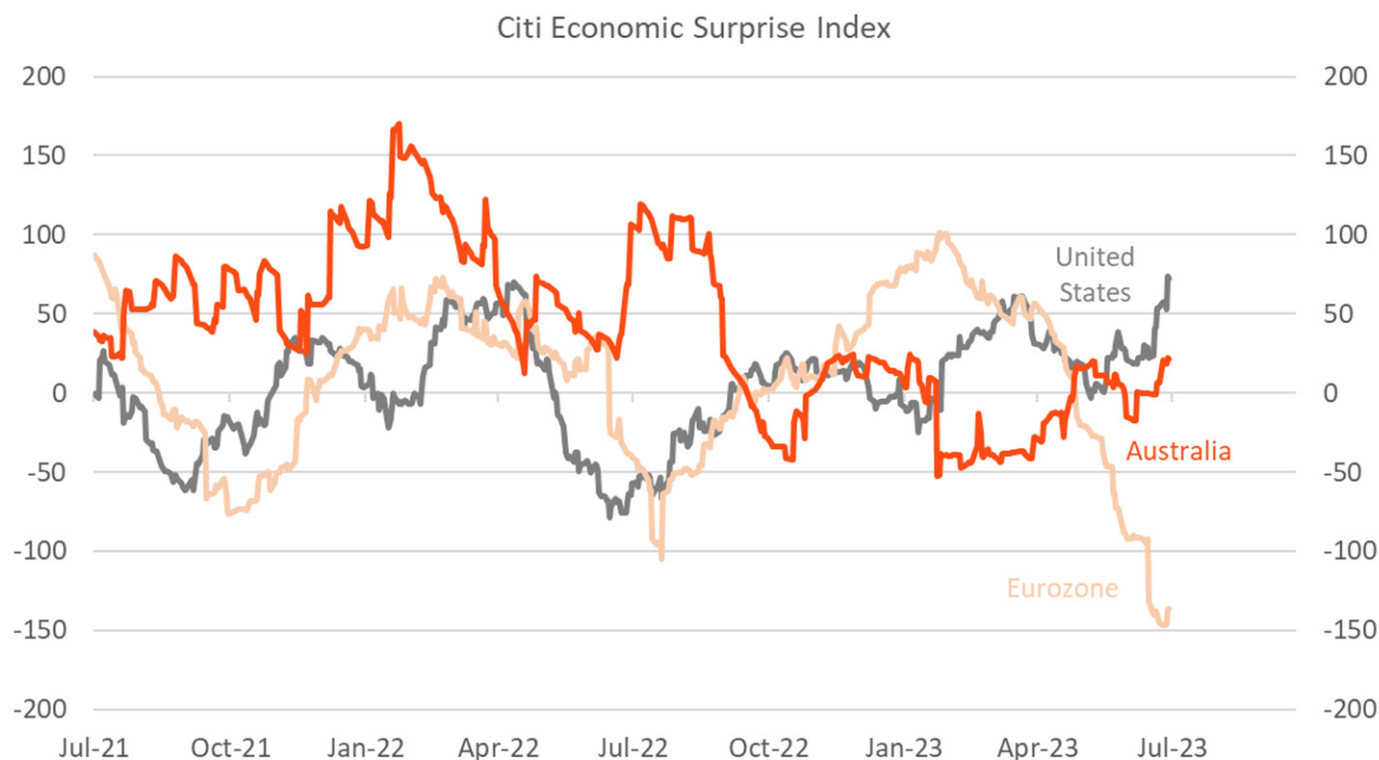


Chart 3: US interest rates, as at 30 June 2023; Source: Bloomberg

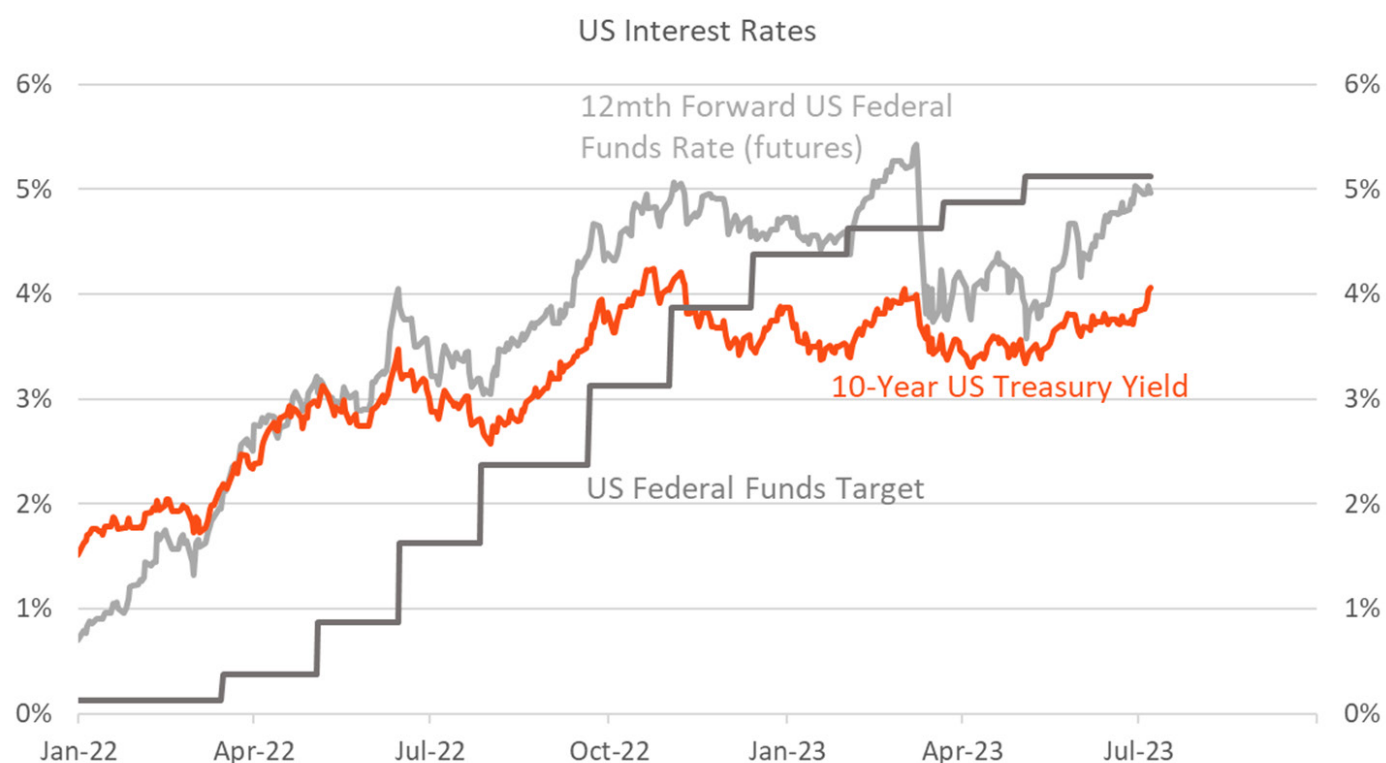


Chart 4: Australian interest rates, as at 30 June 2023; Source; Bloomberg

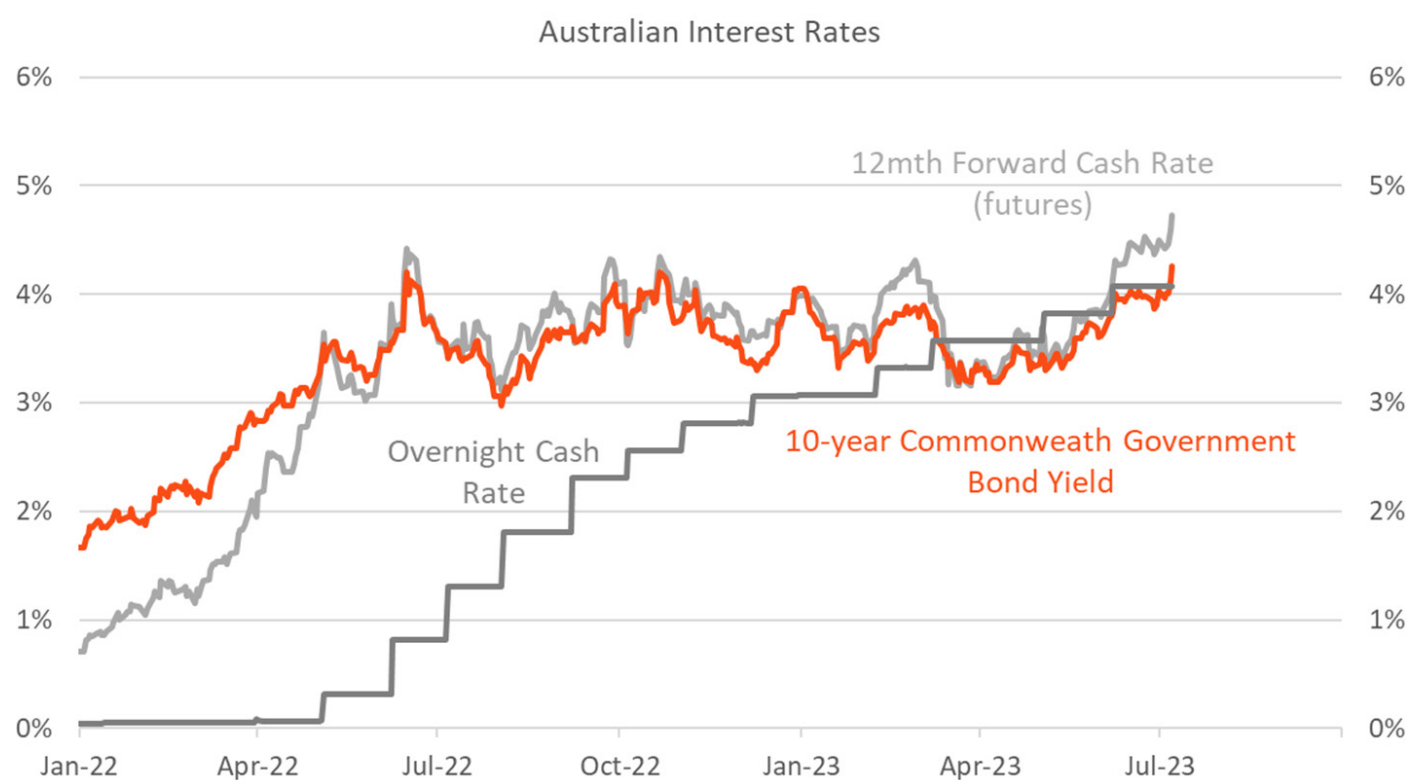


Chart 5: Corporate bond spreads, as at 30 June 2023; Source: Bloomberg

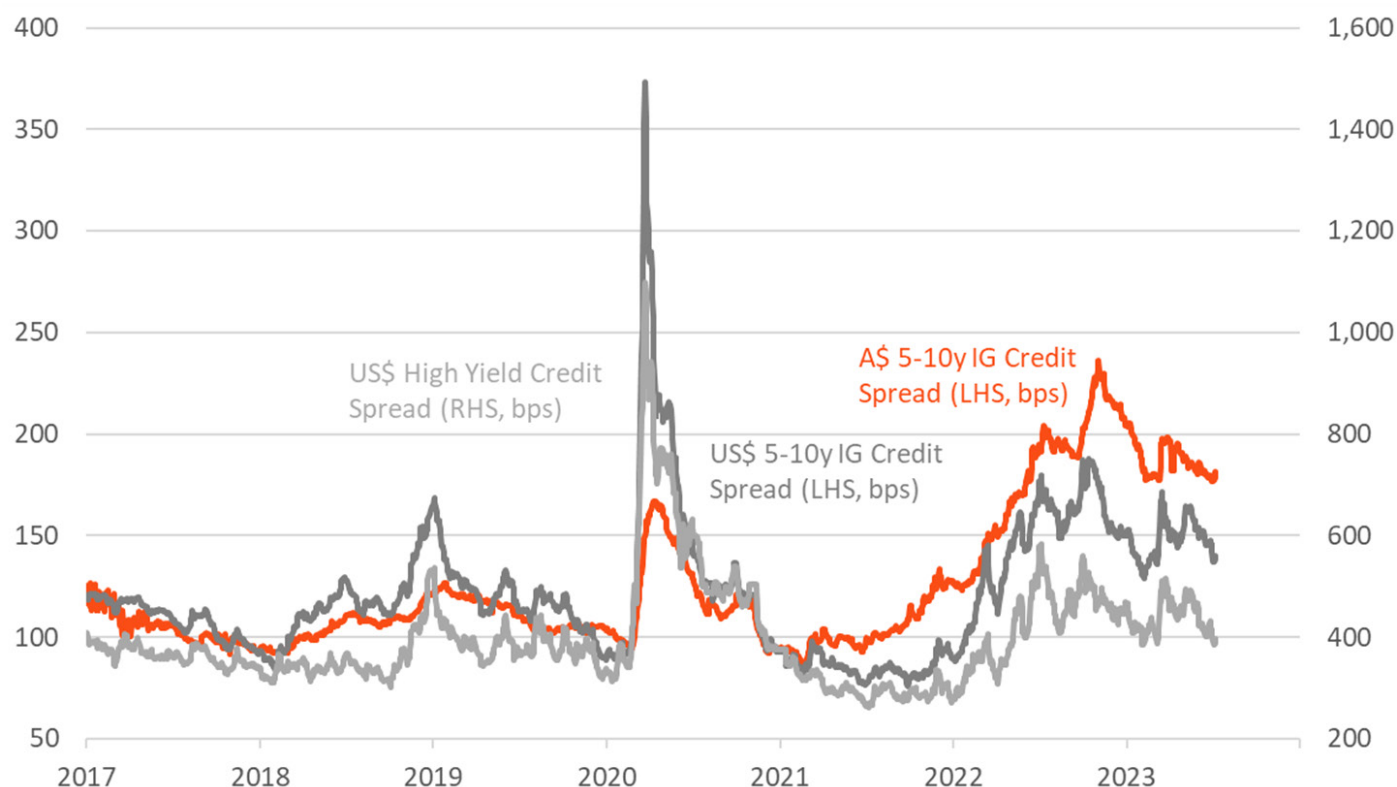


Chart 6: USD gross corporate bond issuance (US\$b), as at 30 June 2023; Source: Bloomberg

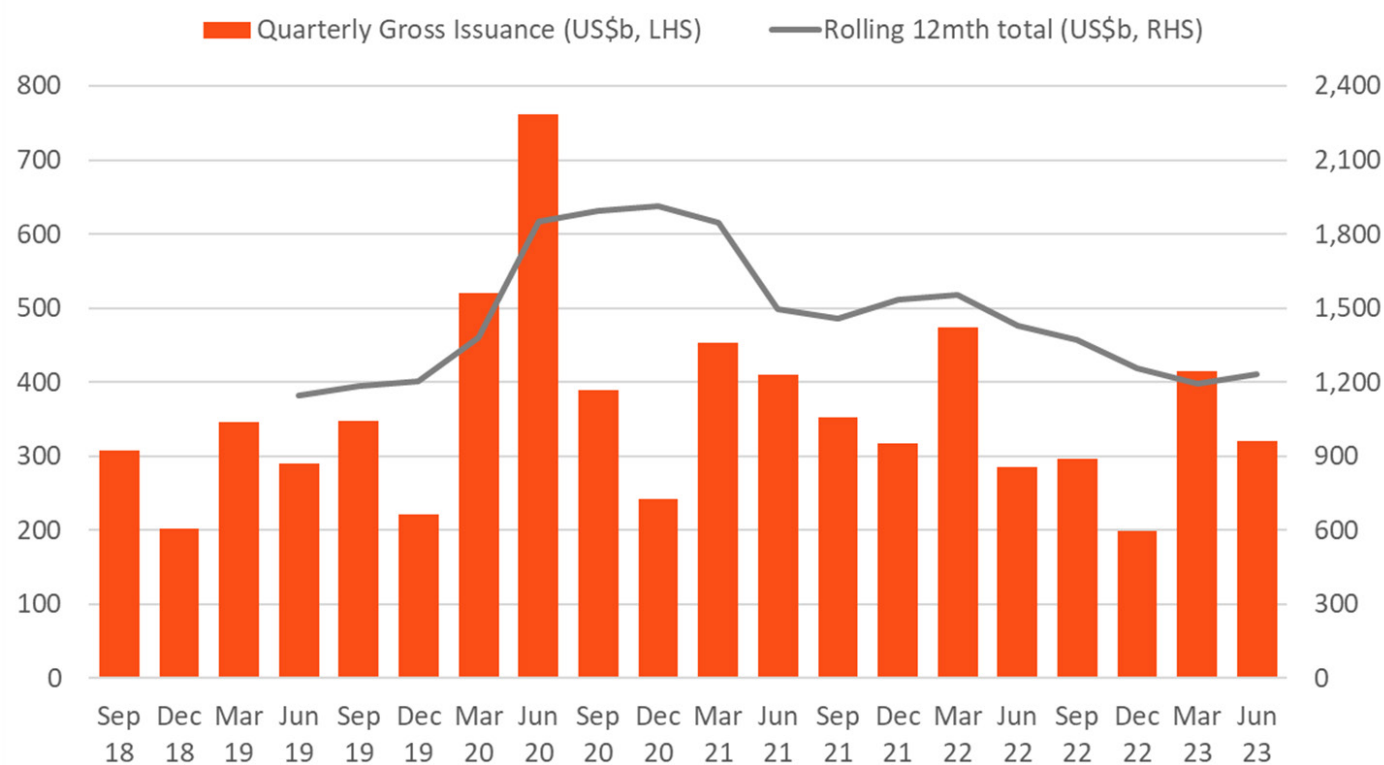


Chart 7: AUD gross corporate bond issuance (A\$b), as at 30 June 2023; Source: Bloomberg

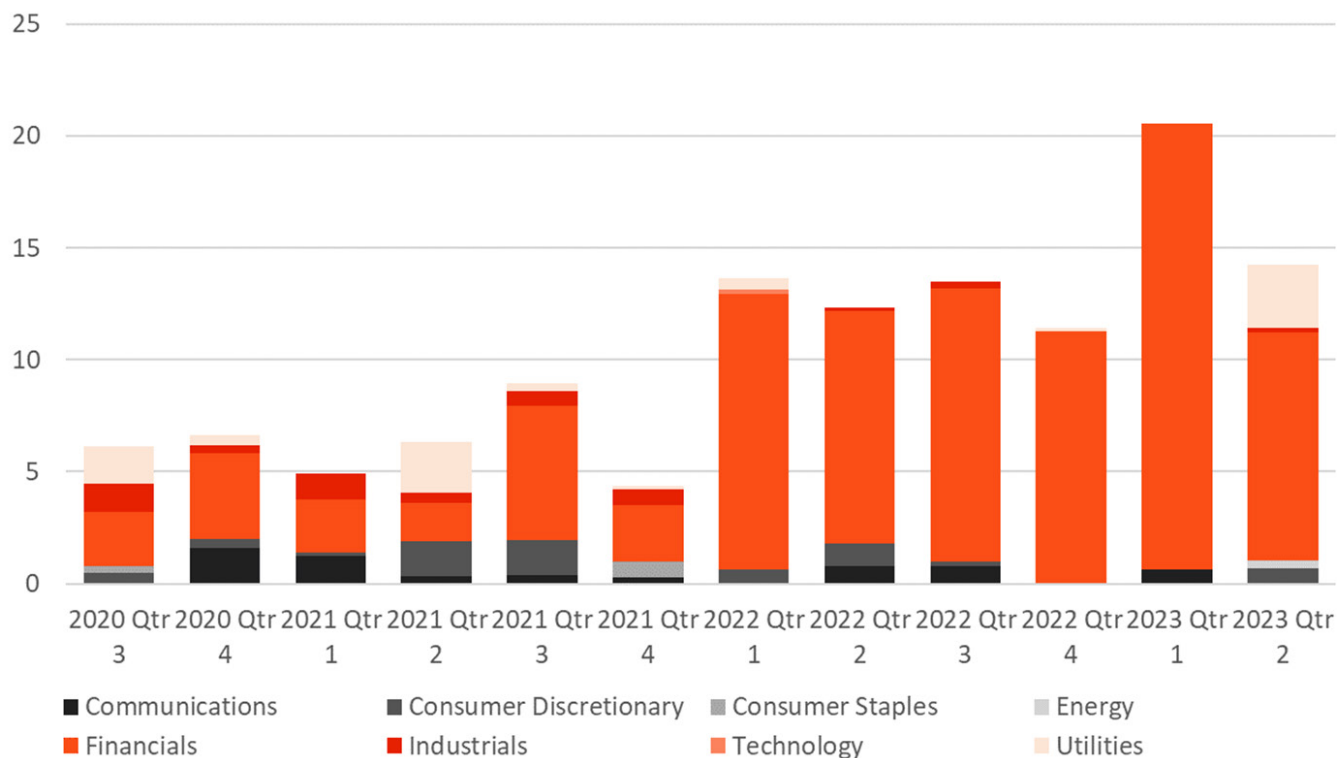


Chart 8: US financial conditions, as at 30 June 2023; Source: Goldman Sachs

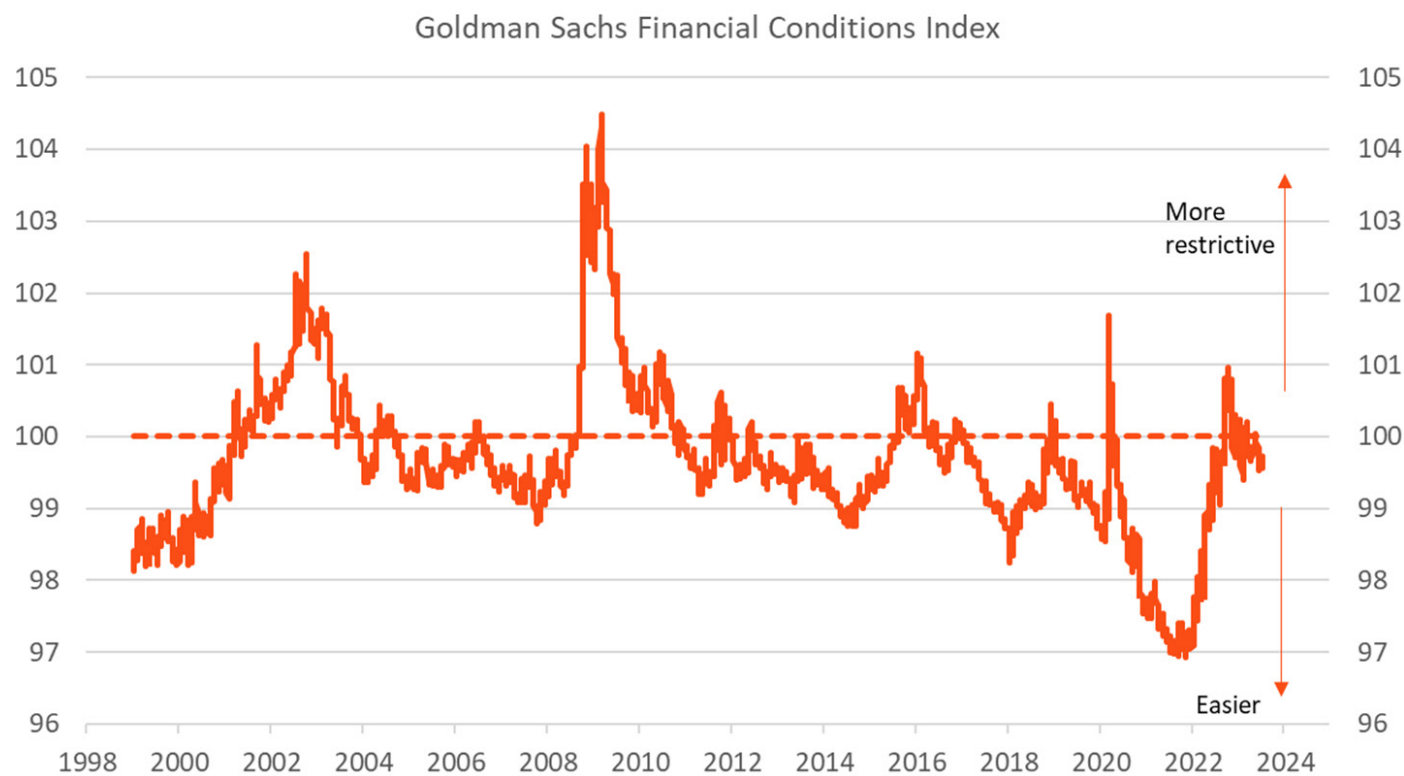


Chart 9: Quarterly change in central bank balance sheets, as at 30 June 2023; Source: Bloomberg

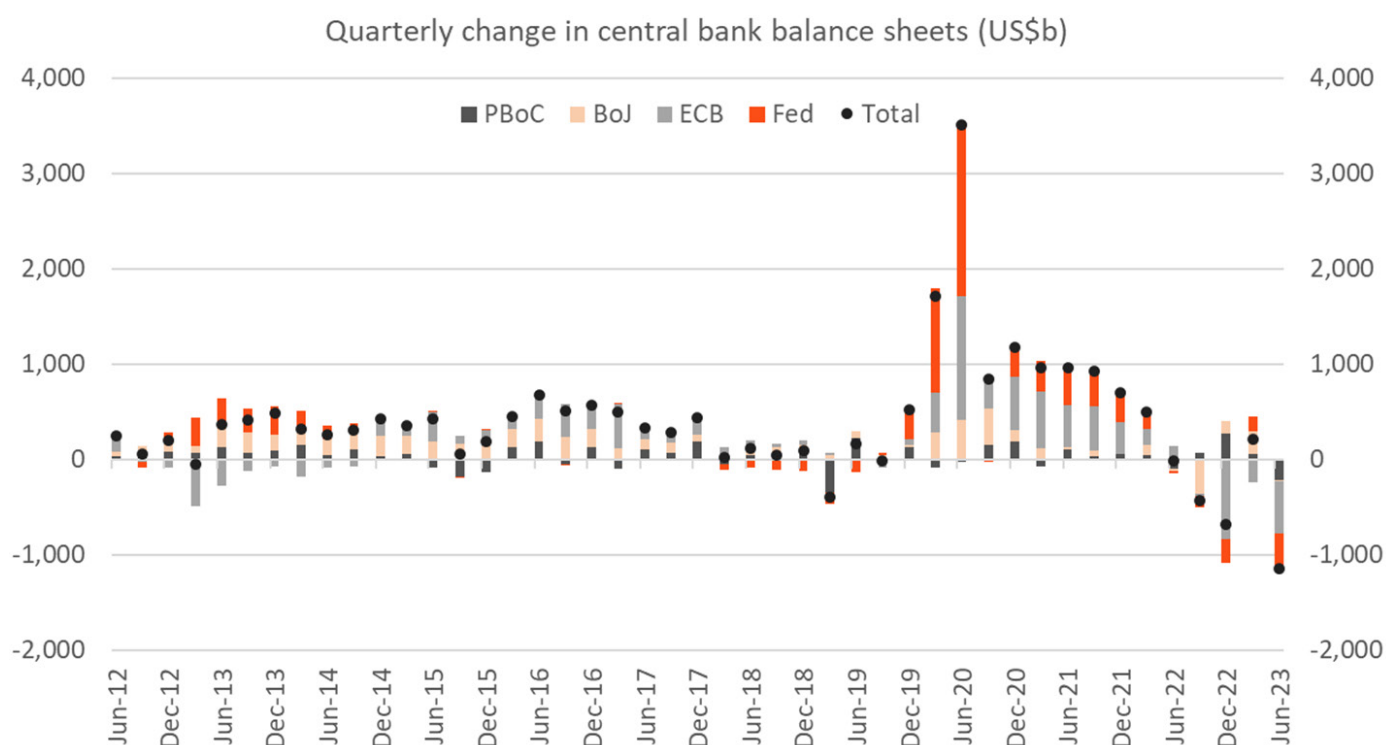


Chart 10: US inflation, as at 30 June 2023; Sources: BLS, Bloomberg

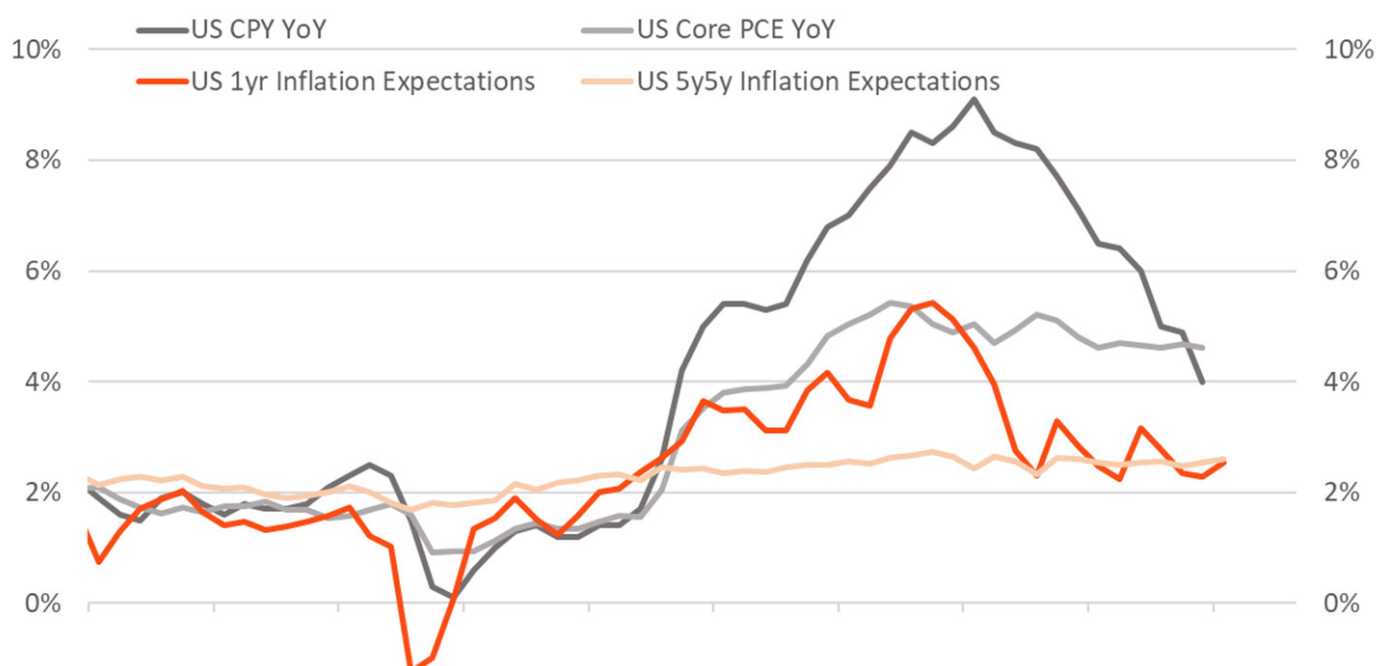


Chart 11: Australian inflation, as at 30 June 2023; Sources: ABS, Bloomberg

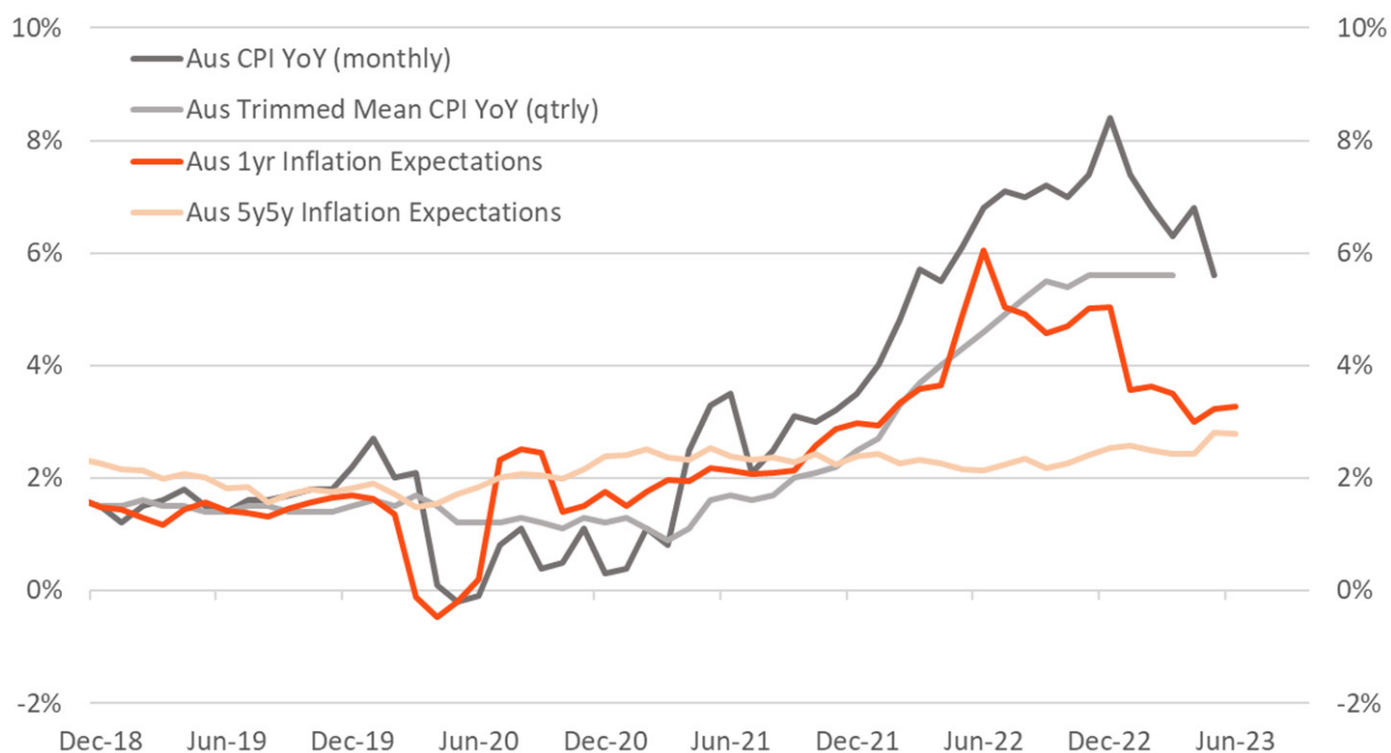
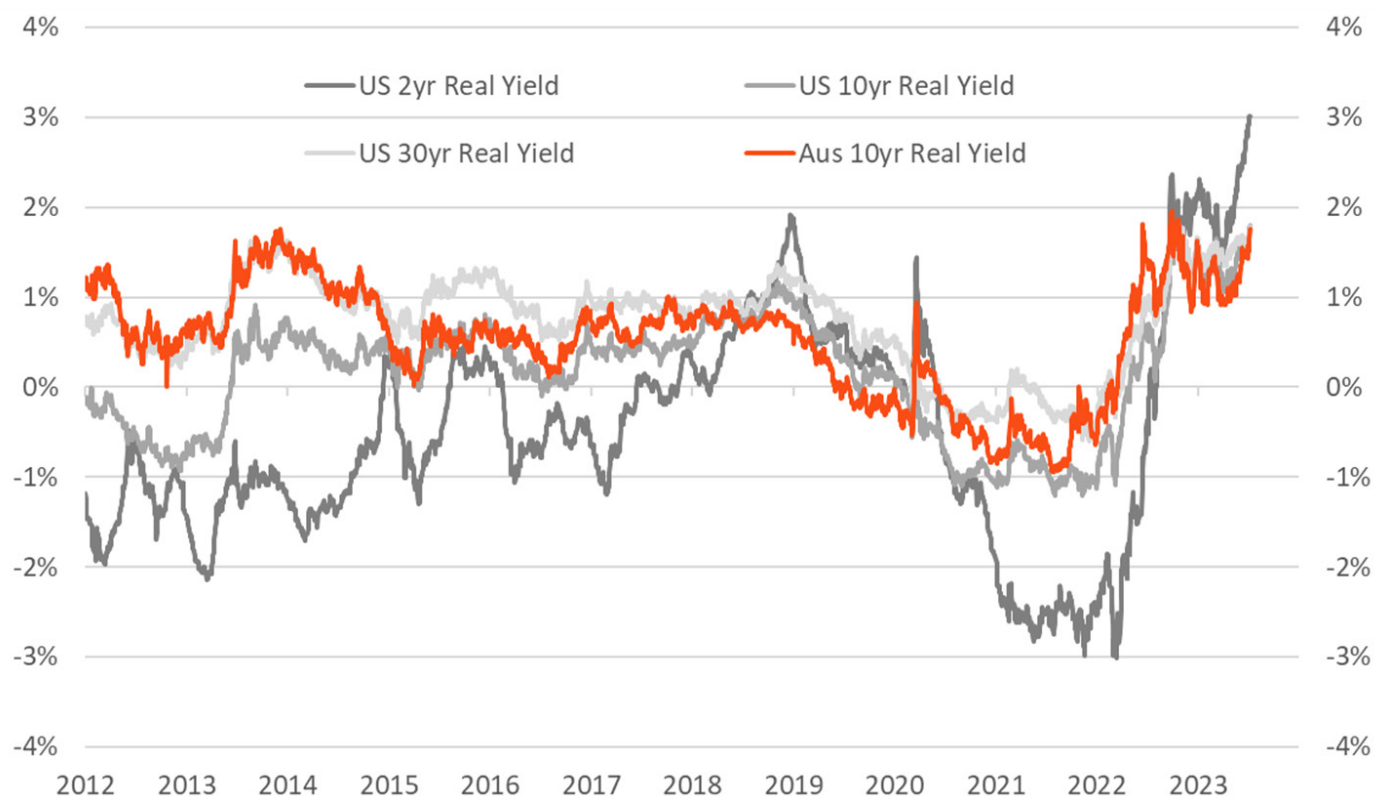


Chart 12: Real yields, as at 30 June 2023; Source: Bloomberg



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