

BETASHARES AUSTRALIAN INVESTMENT GRADE CORPORATE BOND ETF

ASX: CRED

Quarterly Report - March 2023

Performance ¹	1 Month %	3 Months %	6 Months %	1 Year %	3 Years % p.a.	Inception ² % p.a.
Fund Return (net)	2.76%	6.93%	7.40%	-0.24%	-1.50%	1.91%
Growth return	2.39%	5.71%	4.97%	-4.17%	-5.64%	-2.11%
Income return	0.37%	1.22%	2.43%	3.93%	4.14%	4.02%
Index return	2.82%	6.88%	7.46%	-0.07%	-1.29%	2.31%

Past performance is not a reliable indicator of future performance.

¹ Returns are calculated after fees & expenses have been deducted and distributions have been reinvested.

² Inception date for the Fund is 31 May 2018.

Yield and portfolio characteristics

Running Yield (% p.a.) ¹	3.59%
Yield to Maturity (% p.a.) ²	5.63%
Average Maturity (Yrs) ³	7.15
Modified Duration (Yrs) ⁴	6.12
Average Credit Rating ⁵	BBB+

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 6 years implies that a 1% rise in the reference interest rate will reduce the value of the portfolio by 6.00%.

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. Yields shown do not take into account CRED's management costs of 0.25% p.a.

Investment objective

The Fund aims to track the performance of an index (before fees and expenses) that provides exposure to a portfolio of investment grade fixed-rate Australian corporate bonds.

Responsible entity

Betashares Capital Ltd

Distribution frequency

Monthly

Fund Facts

Inception Date	31-May-18
Fund Size	\$509.41m
Historical Tracking Error	0.37%
ASX Code	CRED
Bloomberg Code	CRED.AU
IRESS Code	CRED.AXW

Fees	% p.a.
Management fees	0.22
Recoverable expenses	0.03

Investment strategy

The Fund will generally seek to invest in a portfolio of bonds that comprises of the Index in proportion to the weightings of these bonds in the Index.

The Index is designed to provide exposure to corporate bonds in Australia, with each bond having a minimum investment grade credit rating. In order to be eligible for inclusion in the Index, each bond must be a senior, fixed rate, investment grade debt security denominated in Australian dollars, issued by companies listed on the ASX or other eligible entities. In addition, eligible bonds must have amounts outstanding of at least \$250 million and a term to maturity ("TTM") of between 5.25 to 10.25 years.

Eligible bonds are ranked by yield above benchmark (being a Commonwealth Government bond of similar maturity), with up to a maximum of 50 bonds selected, with each bond assigned an equal weight as at each rebalance date. To aid with issuer diversification, no single issuer shall have a weight in excess of 7% at each rebalance date.

By selecting bonds based upon expected returns rather than debt outstanding, the Index methodology seeks to avoid shortcomings of traditional debt-weighted indices and provide relatively higher returns.

Top 10 positions	%		%
NBN Co Ltd 2.2% Dec-30	3.0	Lendlease Finance Ltd 3.7% Mar-31	2.5
GPT Whl Office Fd No1 3.222% Nov-31	2.7	Australia Pacific Airpor 3.763% Nov-31	2.5
Emirates Nbd Bank Pjsc 6.1% Feb-33	2.7	NSW Electricity Networks 2.543% Sep-30	2.5
Westconnex Finance Co Pt 3.15% Mar-31	2.6	Verizon Communications 2.65% May-30	2.5
Wesfarmers Ltd 2.55% Jun-31	2.6	Optus Finance Pty Ltd 2.5% Jul-30	2.5

¹ As at 31 March 2023

Sector exposure	Fund Weight % ¹	Index Weight% ¹
Financial	37.0	35.4
Communications	12.7	14.6
Consumer, Non-cyclical	12.0	12.5
Utilities	17.3	14.6
Industrial	12.2	12.5
Consumer, Cyclical	8.9	10.4
Technology	0.0	0.0
Basic Materials	0.0	0.0
TOTAL	100.10	100.00

¹ As at 31 March 2023

Global macro and rates

The first quarter of 2023 saw yet more turbulence across global bond markets as interest rate volatility surged on the back of an increasingly uncertain policy backdrop. Amid the combination of ongoing hawkish central bank policy, persistent inflation pressures, and the emergence of acute banking stress in the US and Europe in the latter part of the quarter, global benchmark yields ended the quarter lower after "higher for longer" narrative faced its toughest test. The benchmark US 10-year Treasury yield fell 41 basis points in a bull steepening move, with the 2-year yield the epicentre of the extreme volatility, trading in a 150-basis point range over the period in some of the most violent gyrations since the 1987 crash. Consistent with the extreme moves at the front-end, the MOVE index of US Treasury volatility reached its highest level since the GFC.

The collapse of three US regional banks and the forced takeover of Credit Suisse by UBS (brokered by the Swiss government) on the back of widespread deposit flight was arguably the most impactful development during the quarter.

Global macro and rates cont.

This escalation of financial stability risks catalysed an aggressive repricing lower in policy rate expectations across the globe as central banks were forced to unveil emergency liquidity programs, with the most notable being the Fed's Bank Term Funding Facility (BTFF) – a program designed to mitigate systemic liquidity risks around forced sales US government securities in the event of further depositor flight. Due to the speed of the rate hikes, deposit rates across the US are still lagging yields on Treasury bills and money market funds and with many banks simply unable to offer competitive rates due to having locked in low investment yields on fixed rate assets, the risk of further deposit flight from regional banks to G-SIBs and money market funds remains.

Consistent with the “higher for longer” narrative that characterised much of the quarter, the Fed reiterated its resolve in fighting ongoing inflation pressures, raising the Fed Funds target range by a cumulative 50 basis points across the February and March meetings (to 4.75-5.00%), with the latest “dot plot” of member estimates largely unchanged from the December projections amid little material change to the economic forecasts. However, the emergence of banking stress forced a recognition of these new risks at the March FOMC. Specifically, Chairman Powell acknowledged the stress in the banking system and highlighted the swift actions taken by authorities, including the provision of liquidity facilities for banks and the commitment to preventing future episodes. Key for market pricing, he also noted that the banking events might lead to tighter credit conditions, potentially making ongoing rate increases no longer necessary, depending on the stress's impact on inflation and overall financial conditions. In Europe, the ECB raised its key policy rates by 100 basis points over the quarter (consecutive +50bps hikes in February and March, taking the deposit rate to 3%), while the Bank of England raised the official Bank Rate by 75 basis points (to 4.25%; the pace decelerating from +50bps to +25bps in March), with both central banks presenting a more dovish outlook following the banking sector developments.

Banking stress notwithstanding, the economic data coming out of the US and Europe remained robust, with economic surprise indices remaining in positive territory, although in absolute terms, a moderation in activity was notable. Inflation data continued to moderate, although at a modest pace, with stickier components within services still showing ongoing inflation pressures. Market-implied inflation expectations rose in the US and Europe in the early part of the quarter before reversing sharply but remain at or above targets.

Australian bonds also experienced considerable volatility during the quarter. Ten-year Commonwealth Government Bond (ACGB) yields made another push towards 4 per cent (alongside a move in terminal cash rate pricing to 4.3 per cent before collapsing amid the global banking stress to end the quarter around 3.3 per cent). This decline was driven by global banking stress leading to a repricing lower on cash rate expectations. The RBA continued its tightening cycle in Q1, raising the cash rate by 25 basis points in both February and March (before pausing in April), taking the cumulative rate hikes for the cycle to +350 basis points. The RBA's official guidance remained focused on returning underlying inflation to the 2-3 per cent target range, with the latest measures of trimmed mean inflation and wages growth still pointing to elevated price pressures. The April meeting acknowledged the global banking developments and due to the much-discussed lags in the policy pass-through, the RBA appears to have adopted a “wait-and-see” posture heading into Q2, with market pricing suggesting a growing likelihood of an easing cycle to commence over the next 12 months.

Credit markets

The emergence of banking stress and the spectre of systemic risk and financial contagion weighed on credit markets in the latter part of the quarter, although beyond selected names and subordinated bank debt, the broader credit market was well behaved. The most notable development stemmed from the UBS takeover of Credit Suisse, where the latter was forced to fully write-down the value of its Additional Tier 1 (AT1) capital instruments to zero despite ordinary shareholders still retaining some residual value from the acquisition, inverting the traditional capital structure, and inducing acute stress across the broader European AT1 complex and subordinated debt more broadly. Once it became clear that this treatment was unique to Switzerland, following clarification from both the Eurozone and UK banking regulators, global bank credit stabilised, with broader investment grade corporate bond spreads ending the quarter largely unchanged. US high yield credit spreads also ended the quarter little changed, although significant sector dispersion was seen in March with a surge in financial spreads offset by a compression in energy. Ultimately, with corporates able to term out their debt in early 2020, a major USD corporate bond refinancing wave isn't likely until 2024/25 and credit markets are still functioning relatively smoothly.

Credit markets cont.

AUD credit markets were influenced by global developments, with the banking stress sending both swap spreads (vs government) and corporate spreads to swap wider. However, overall credit spreads still ended the quarter marginally tighter, assisted by a more dovish outlook for domestic policy rates, which helped compress risk premiums. New issuance picked up during the quarter following a very quiet 2022 (Q1 often sees annual issuance needs front-loaded), with the first maturities of the RBA's term funding facility (commencing in mid-April) acting as a catalyst for a fresh round of senior FRN issuance. Credit spreads across the domestic bank capital structure were well-behaved, with the Australian banking sector seen as world-leading in terms of capital adequacy and liquidity. Consequently, domestic bank credit showed a high degree of resilience in the aftermath of the Credit Suisse acquisition and the European AT1 market gyrations. Within the capital structure, major bank hybrid spreads widened relative to both T2 (subordinated) and senior credit on the back of fresh supply after briefly trading through T2 levels in late 2022.

Outlook

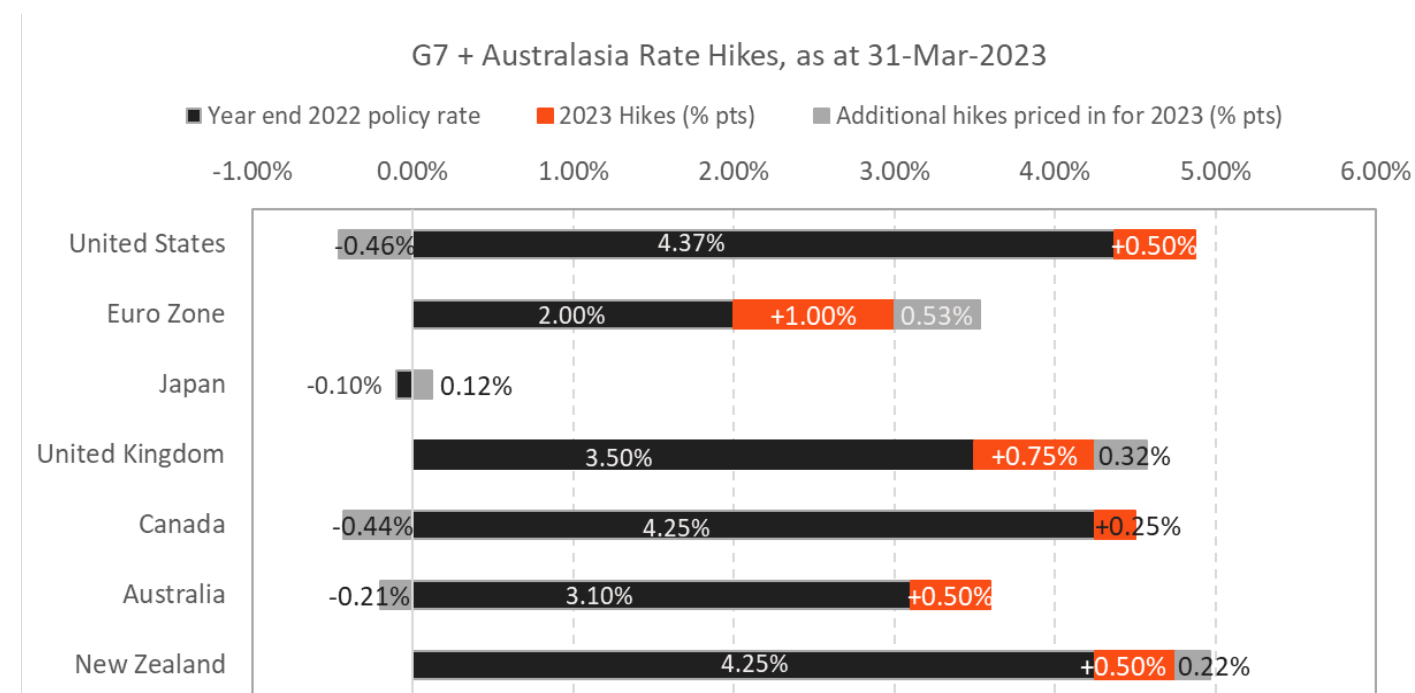
The macro narrative and consensus has shifted from "higher for longer" to a less inflationary outlook, with mixed market signals. Rates and government bond markets indicate a US hard landing, increasing the likelihood of central banks entering a cutting cycle. In contrast, credit and equity markets remain optimistic, supported by a favourable liquidity outlook. The debated "separation principle" distinguishes macroeconomic objectives from financial stability concerns. Liquidity injections can coexist with rate hikes, as demonstrated by the Bank of England and the Fed.

Global liquidity remains a debated topic, with central bank balance sheets growing before recent banking stress. The Fed's actions to support the commercial banking sector raise questions about "stealth QE." However, emergency lending programs differ from traditional QE in intent, duration, and bank funding cost impact. The Fed has stated that tighter credit availability will lessen the need for further rate hikes, indicating that risk assets will be responsible for tightening financial conditions to reduce inflation pressures.

The reduced need for rate hikes due to banking stress has led to aggressive repricing in rates, particularly front-end US Treasury yields. However, short covering may have exaggerated the moves, creating the appearance of a fundamental policy outlook reassessment. The Fed typically engages in cutting cycles only when necessary, and history suggests a pivot is unlikely while inflation, labour market data, and credit spreads are suggesting ongoing economic resilience.

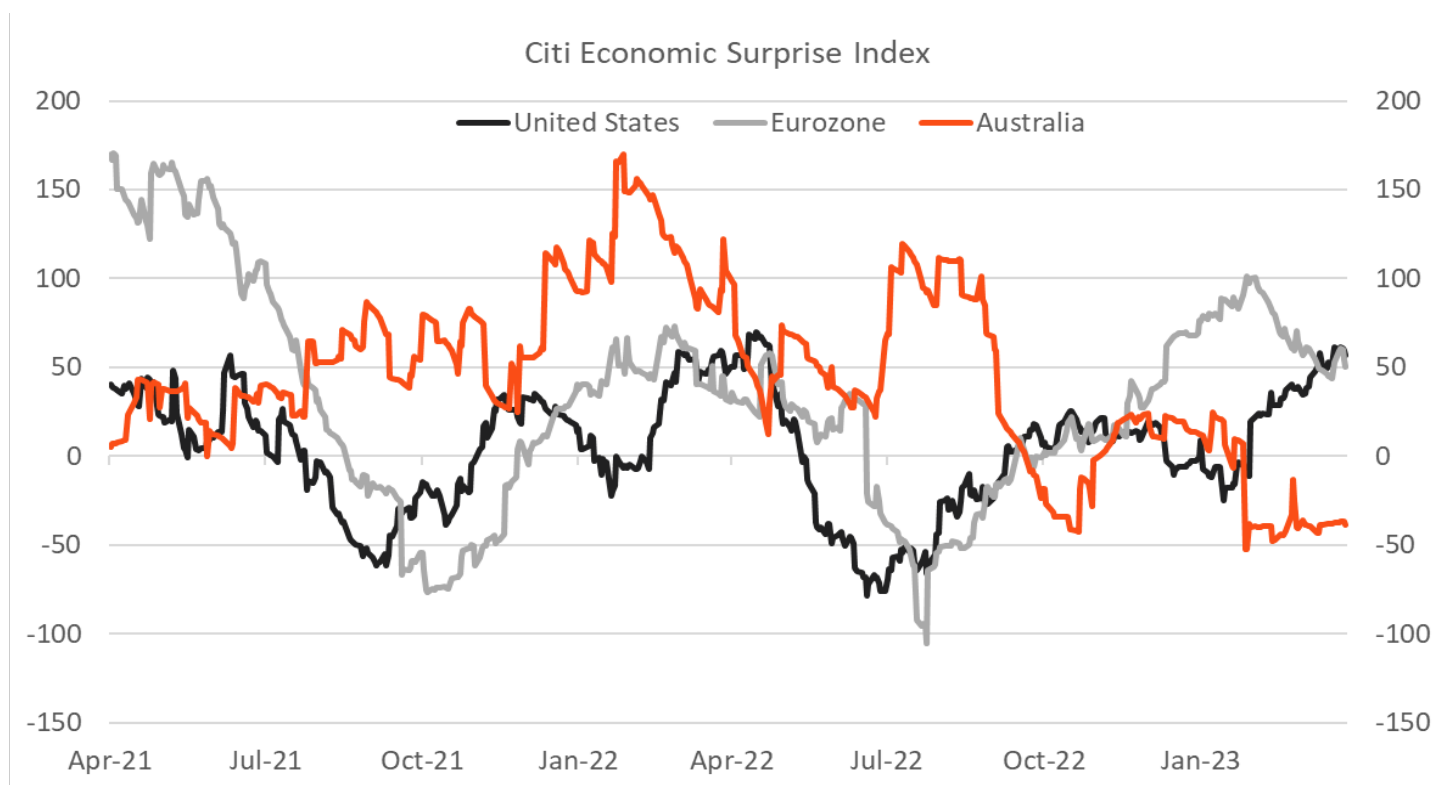
With government bond markets pricing in a recessionary outlook, adding duration to portfolios adding duration to portfolios is not without risk, particularly as interest rate volatility remains elevated. Widening AUD swap spreads over the past 12 months have driven ACGB yields below OIS and other risk-free benchmarks, raising the bar for duration to outperform cash and floating rate exposures. However, spreads in state government bonds and AAA-rated supranationals still offer value, especially if the domestic hiking cycle has ended. US Treasuries remain compelling in a recession, but the distribution of outcomes is bifurcated. Either rapid economic deterioration forces the Fed into an aggressive cutting cycle, or stress dissipates, and the resilient US economy leads to a "long pause" or further policy rate increases. Due to lags and the rate hikes already done, the corporate profit and risk asset outlook remains precarious, particularly as the refinancing cycle gathers momentum over the coming quarters, and investors should consider skewing asset allocations towards high-quality, liquid, defensive assets.

Chart 1: G7 + Australasia Policy Rates, as at 31-March 2023



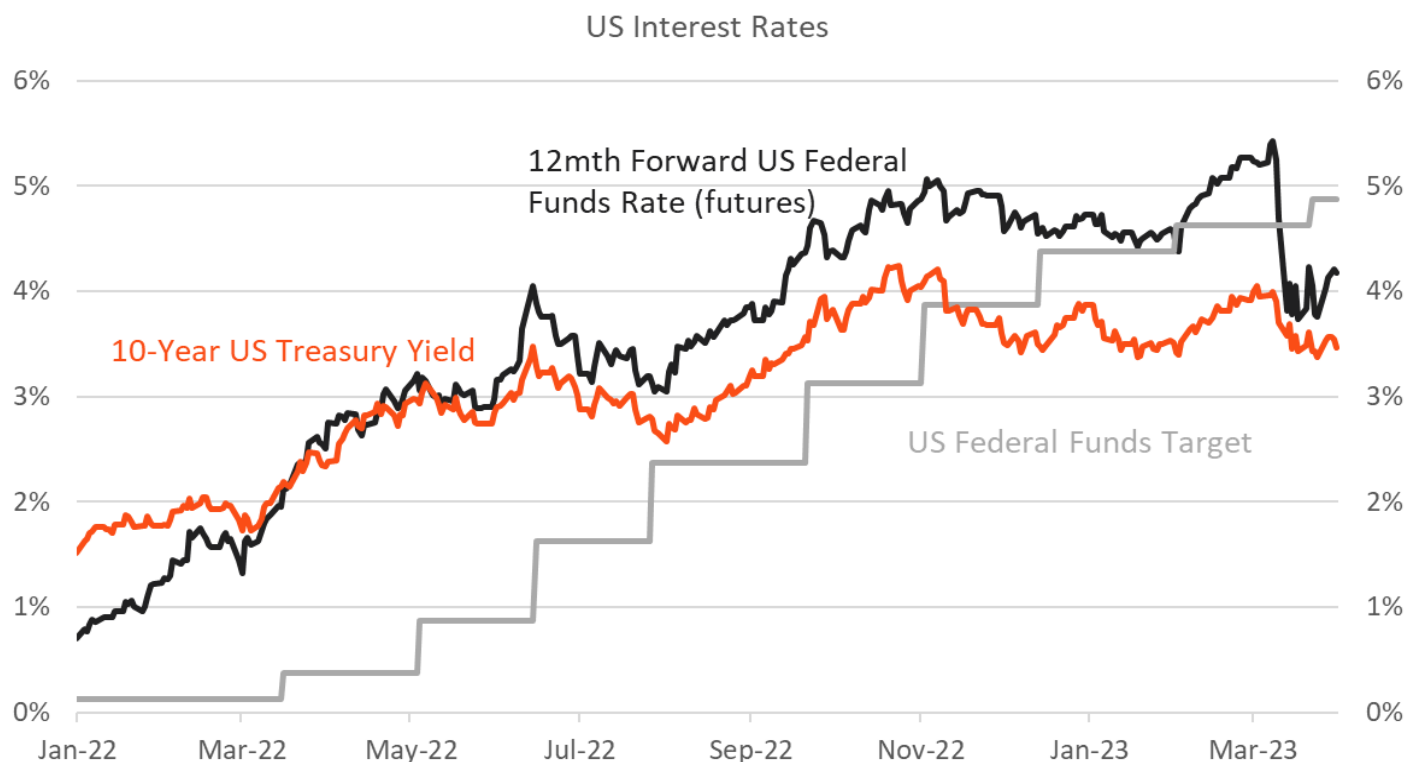
Source: Betashares, Bloomberg.

Chart 2: Global economic surprises, as at 31-March-2023



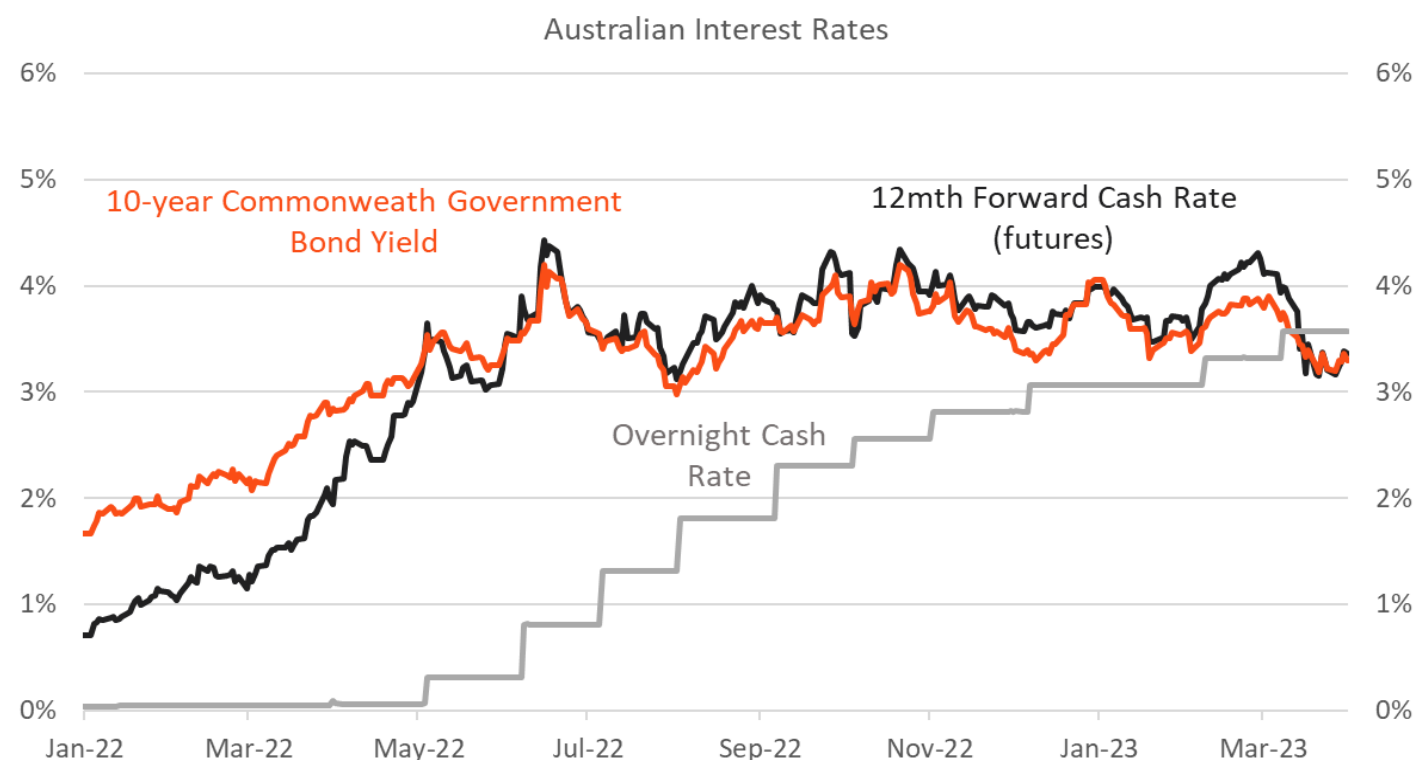
Source: Citi.

Chart 3: US interest rates, as at 31-March-2023



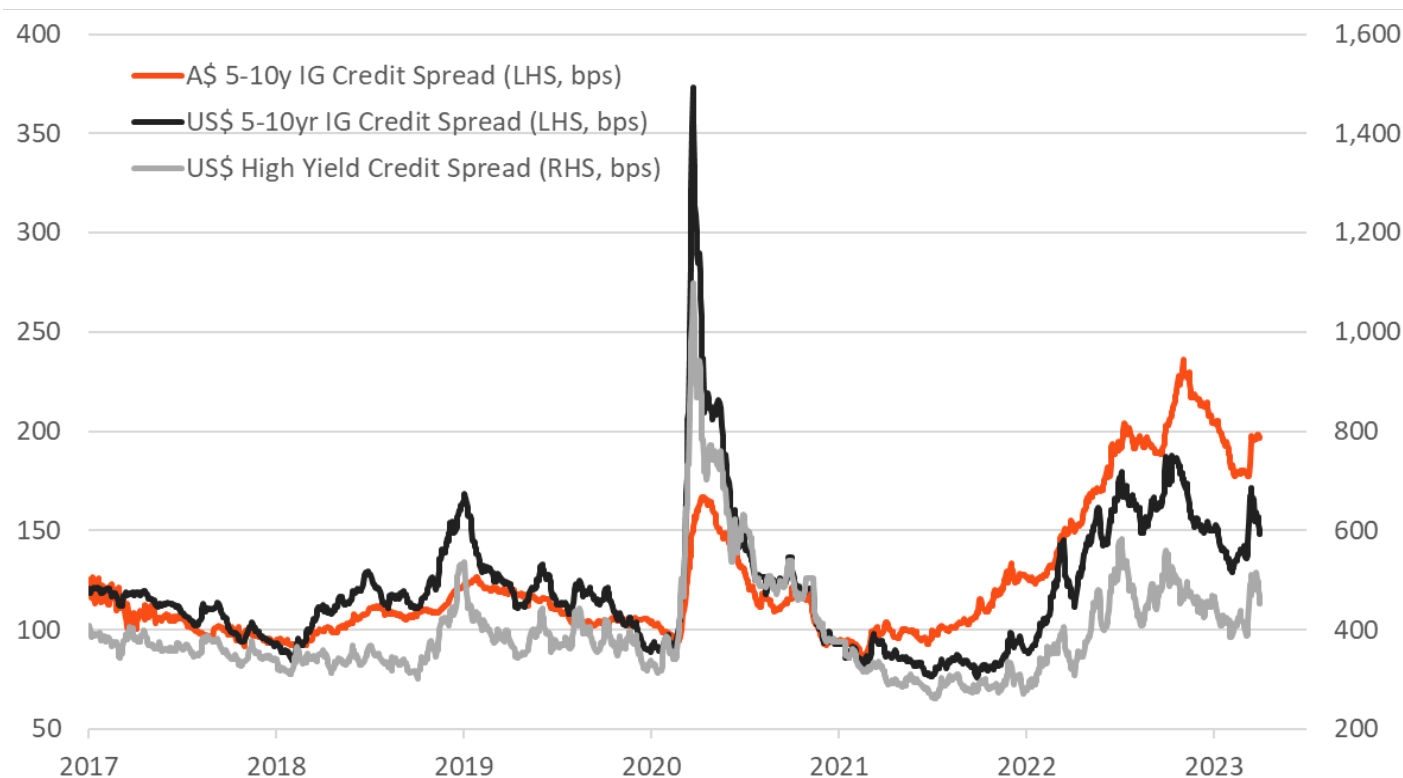
Source: Bloomberg.

Chart 4: Australian interest rates, as at 31-March-2023



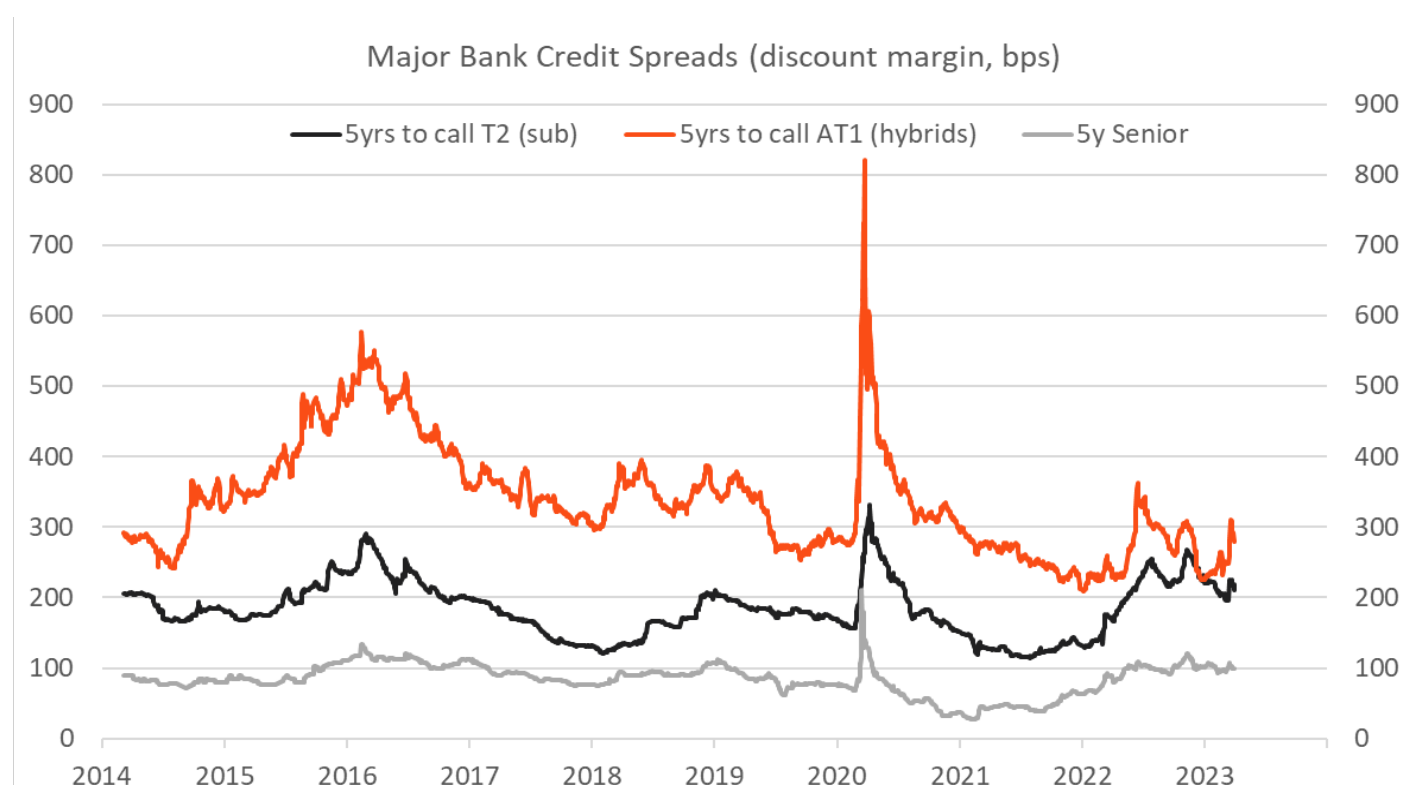
Source: Bloomberg.

Chart 5: Corporate bond spreads; as at 31-March-2023



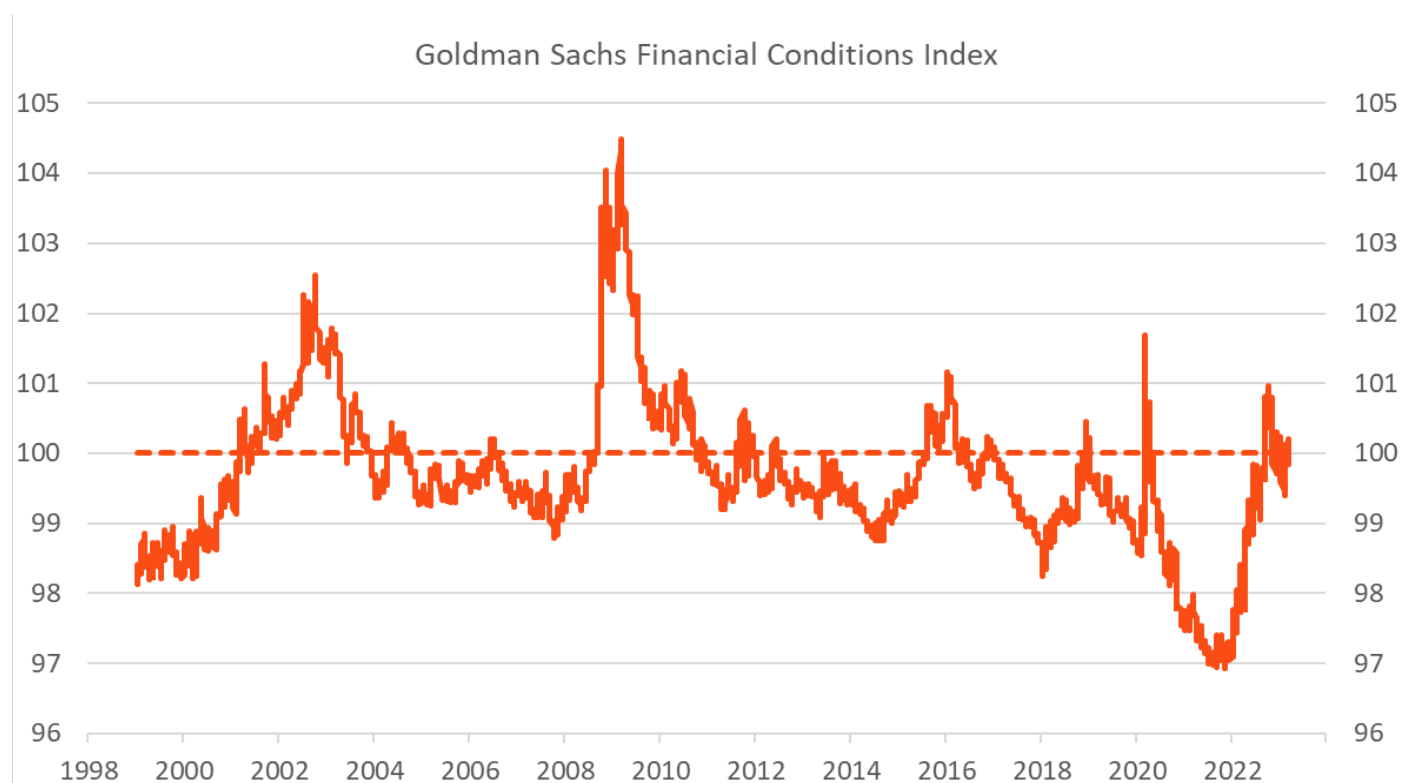
Source: Bloomberg.

Chart 6: Major bank credit; as at 31-March-2023



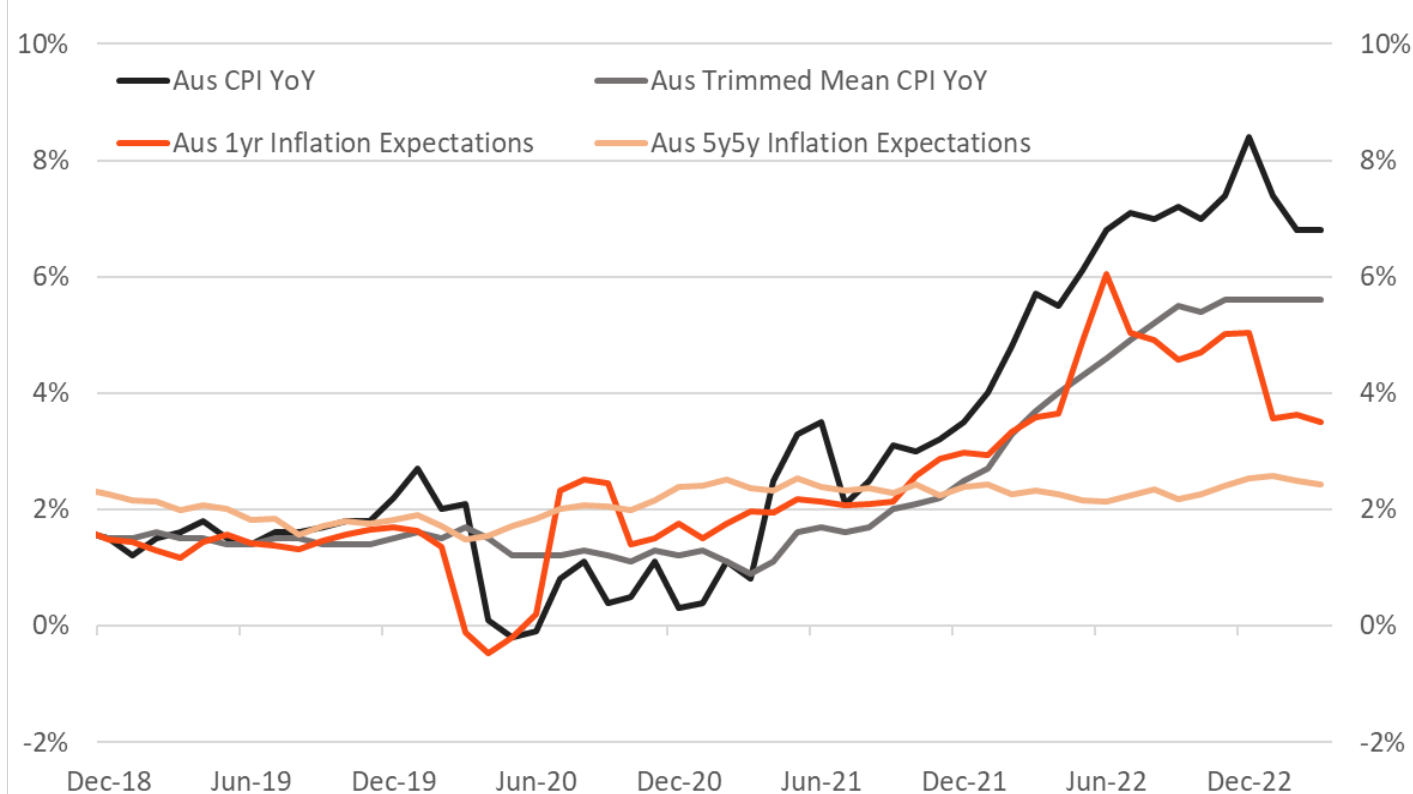
Source: Citi.

Chart 7: US financial conditions



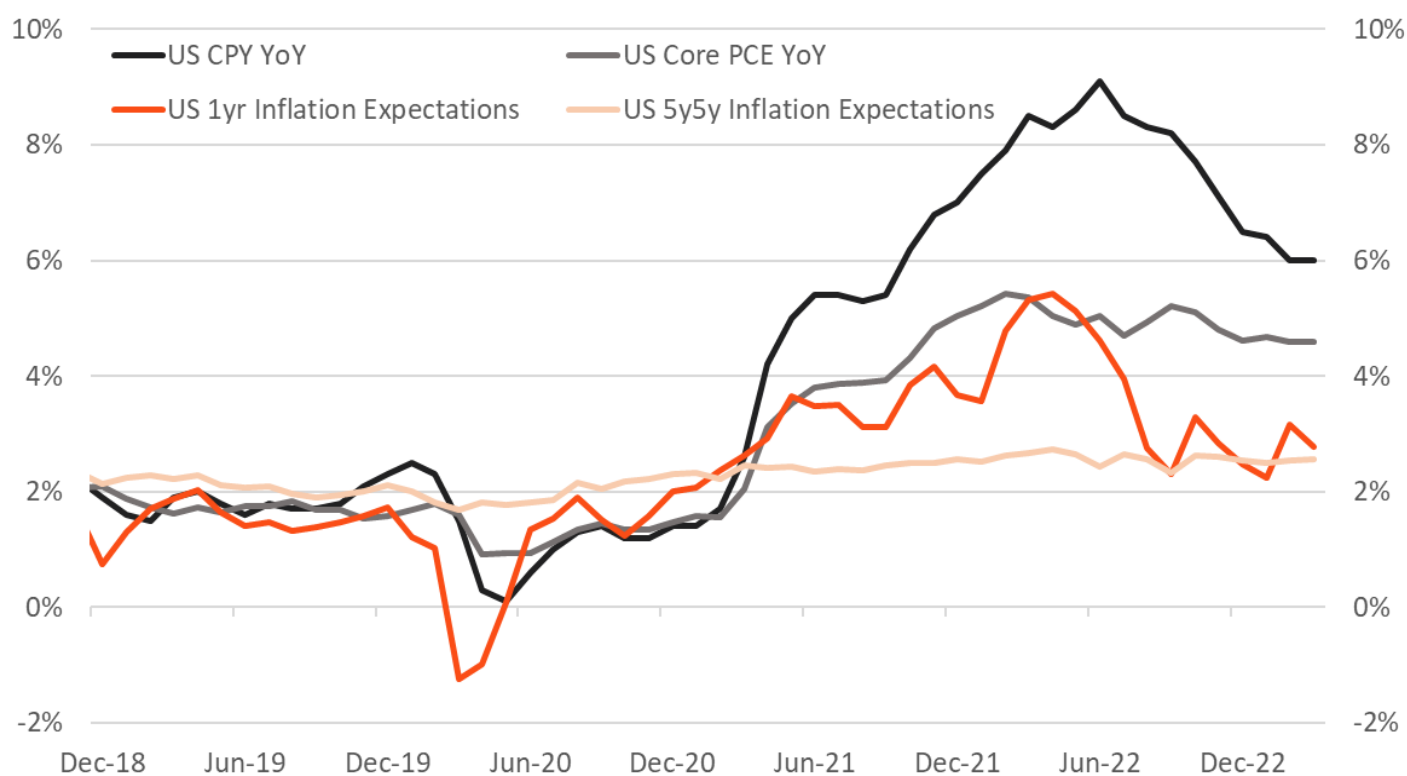
Source: Goldman Sachs.

Chart 8: US inflation



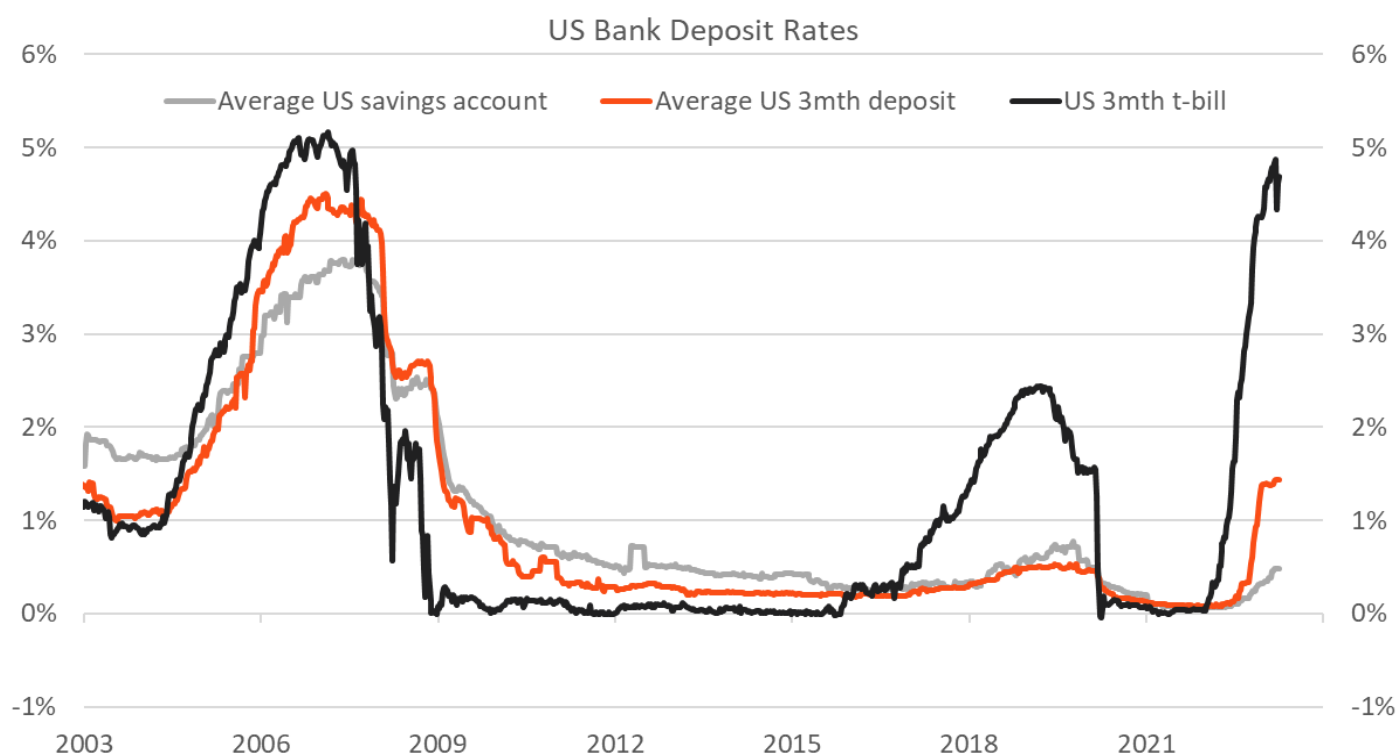
Source: Bloomberg.

Chart 9: Australian inflation



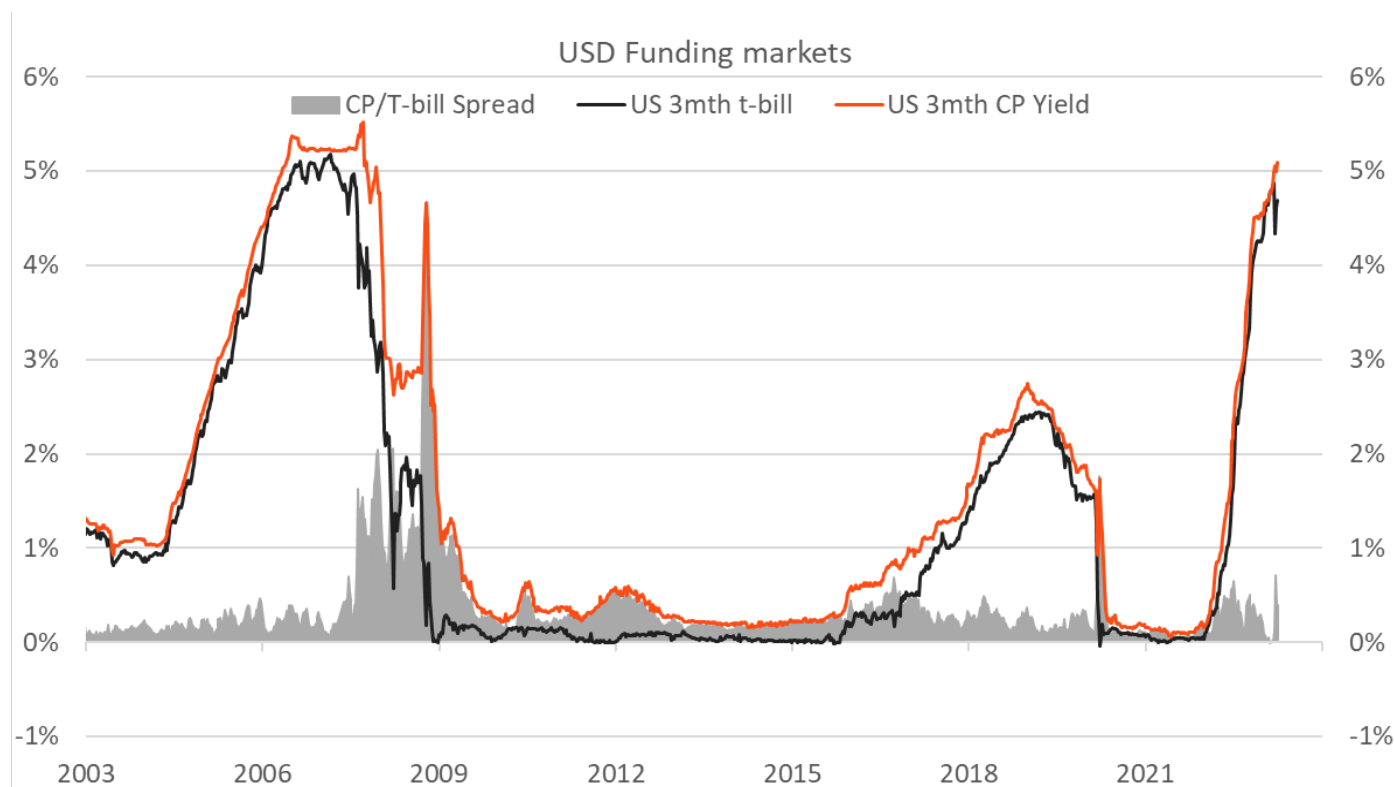
Source: ABS, Bloomberg.

Chart 10: US deposit rates



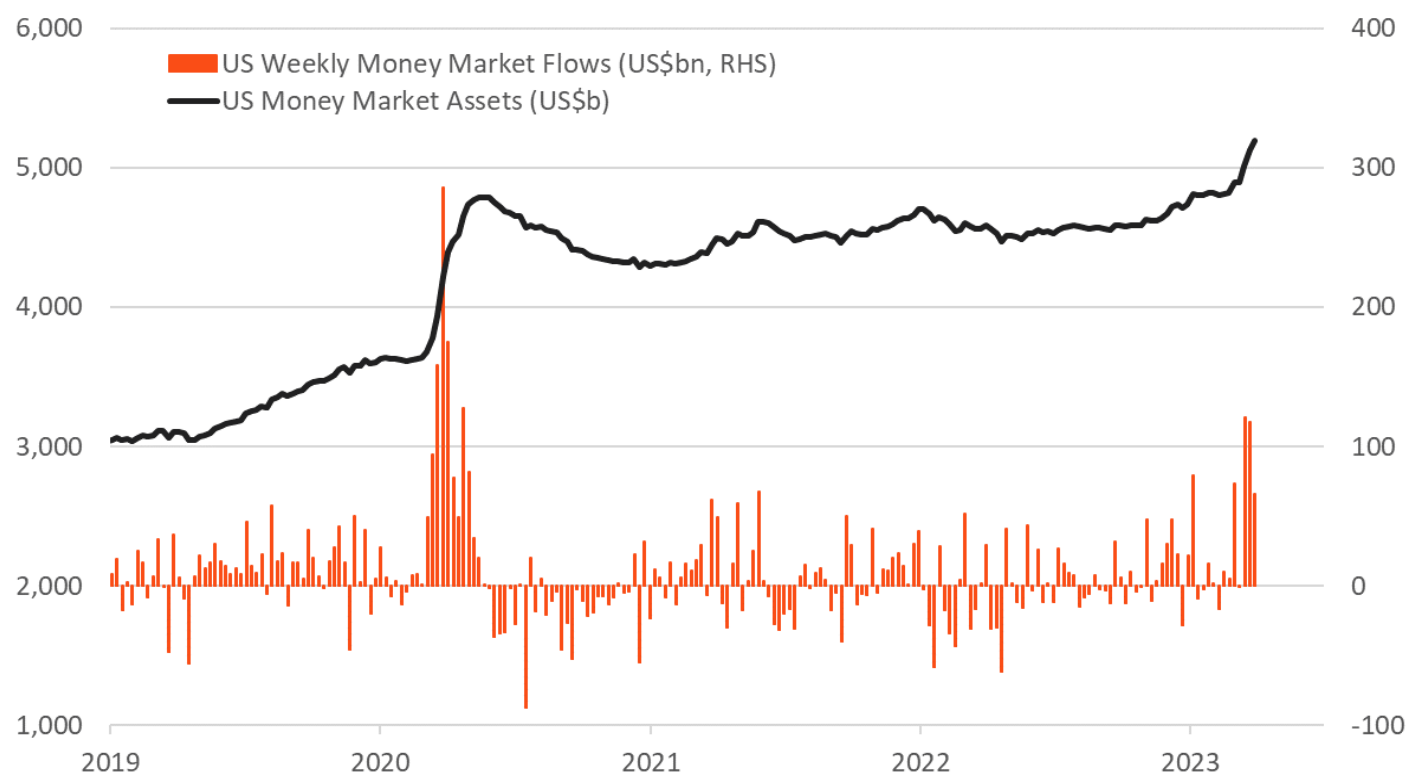
Source: Bankrate.com, Bloomberg.

Chart 10: US deposit rates cont.



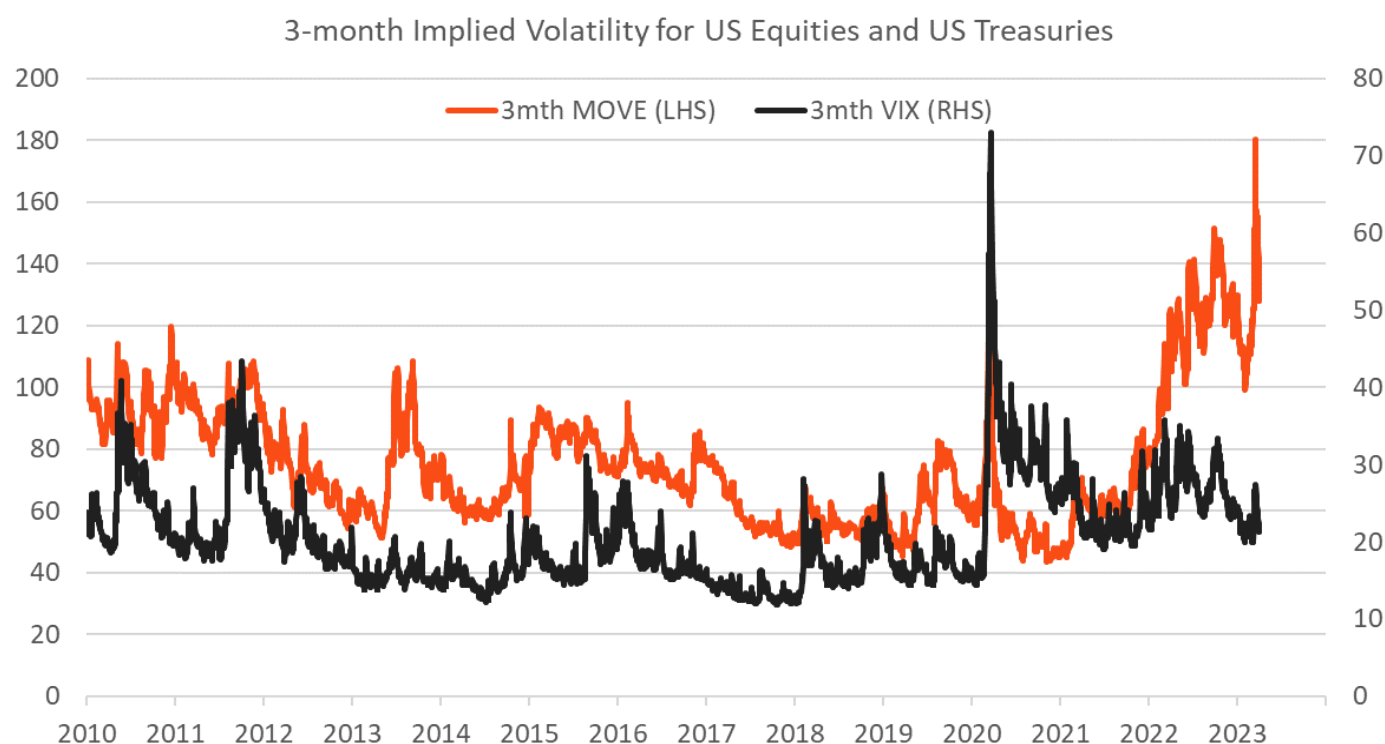
Source: Bankrate.com, Bloomberg.

Chart 11: US money market fund flows



Source: ICI, Bloomberg.

Chart 12: US fixed income and equity implied volatility



Source: Bloomberg.

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