Betashares Australian Bank Senior Floating Rate Bond ETF

ASX: QPON

Quarterly Report - September 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)	0.32%	1.37%	2.75%	5.12%	1.85%	2.36%
Growth Return	-0.07%	0.31%	0.73%	1.35%	-0.05%	0.36%
Income Return	0.39%	1.06%	2.02%	3.77%	1.90%	2.00%
Index Return	0.29%	1.33%	2.71%	5.01%	1.94%	2.50%

Past performance is not a reliable indicator of future performance.

[1] As at 30 September 2023. Returns are calculated after fees & expenses have been deducted and distributions have been reinvested.

[2] Inception date for the Fund is 1 June 2017.

Investment objective

The Fund aims to track the performance of an index (before fees and expenses) that provides exposure to a portfolio of some of the largest and most liquid senior floating rate bonds issued by Australian banks.

Responsible entity

Betashares Capital Ltd

Distribution frequency

Monthly

Suggested minimum investment timeframe

At least one year

Fund facts	
Inception Date	1-Jun-17
Fund Size	$1205.61m
Historical Tracking Error (annualised)	0.08%
ASX Code	QPON
Bloomberg Code	QPON.AU
IRESS Code	QPON.ASW

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

Investment strategy

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

In order to be eligible for inclusion in the Index, each bond must be a senior floating rate debt security denominated in AUD and issued by an eligible Australian bank. In addition, eligible bonds must have amounts outstanding of at least $500 million and a term to maturity ("TTM") of between one to five years. Current eligible banks are classified into two bands as follows:

- **Band 1**: ANZ Bank, Commonwealth Bank of Australia, National Australia Bank, Westpac
- **Band 2:** AMP Bank, Bank of Queensland, Bendigo & Adelaide Bank, Macquarie Bank, Members Equity

Eligible bonds with the longest TTM are selected with up to two bonds selected from each Band 1 bank, and one bond from each Band 2 bank. Bonds from Band 1 are given a total weight of at least 80% based on market value, with each bond equal weighted. Bonds from Band 2 are given a total weight of up to 20% based on market value, with each bond equal weighted (with no Band 2 bond allowed to have a weight in excess of 5%).

Top 10 exposures[1]	%
Commonwealth Bank AUST FRN Jan-28	9.9
AUST & NZ Banking Group FRN Mar-27	9.9
National Australia Bank FRN May-28	9.8
National Australia Bank FRN Nov-27	9.8
Commonwealth Bank AUST FRN Aug-28	9.6
Westpac Banking Corp FRN Feb-28	9.6
Westpac Banking Corp FRN Sep-28	9.4
AUST & NZ Banking Group FRN Sep-28	8.7
Bank of Queensland Ltd FRN Jan-27	5.4
Bendigo and Adelaide Bank FRN Jan-27	5.0

[1] As at 30 September 2023

Global macro and rates

The September quarter of 2023 witnessed notable turbulence in global bond markets with benchmark sovereign yields once again surging, led by real yields on a combination of fundamental and technical factors. Market narratives shifted, with the previously favoured "soft landing" perspective reverting to the "higher for longer" view. Changing views are attributed to ongoing US economic resilience, with activity data continuing to exceed expectations and headline inflation pressures starting to re-remerge alongside strength in energy prices.

The 10-year US Treasury yield closed the quarter at 4.57%, the highest level in 16 years, dragging the Bloomberg Global Treasury index's average yield 34 basis points higher. In contrast to previous bouts of Treasury weakness, the latest move was characterised by a bear steepening of both real and nominal yield curves, with long-term yields repricing much higher and short end yields only rising modestly (due to 2024 and 2025 rate cut expectations being unwound). This was in fact the third largest quarterly 2s10s steepening in history outside a recession. Similarly, US real yields also reached post-GFC highs, while inflation breakevens and other market-implied inflation expectations were largely unchanged despite the gains in crude prices. Technical dynamics were likely a major contributor, including a greater volume of issuance than expected from the US Treasury, US political gridlock producing negative ratings actions (with Fitch downgrading the US rating to AA+ and Moody's guiding towards a similar move), and intervention activity from central bank reserve managers to counter broad US dollar strength.

Although policy rate expectations were less of a driver during this round of bond weakness, central bank actions were still in focus. The Fed increased rates by 25 basis points at the July FOMC but paused in September. The latest Summary of Economic Projections (SEP) from the

Fed displayed optimism for the US economy, with GDP growth and Fed Funds forecasts ("dot plot") revised upwards, although Chair Powell clarified in the press conference that a soft-landing was not his base case. The much anticipated Jackson Hole symposium in August offered no major revelations. The topic of "R-star" and any upward revisions in the Fed's "neutral rate" estimate was front of mind among economists and strategists and may have contributed at the margin to the steepening of the curve, although the FOMC dot plot estimate for the long-run Fed Funds rate remained at 2.5%.

In contrast to the Fed, the European Central Bank (ECB) raised rates in both its meetings, amidst somewhat lacklustre Euro area activity data, marking the 10th consecutive rate hike. While inflation rates moderated across the Euro area, they remained above the ECB's 2% target. The Bank of Japan was also in focus. Adapting to elevated domestic inflation pressures, the BOJ incrementally eased its yield curve control (YCC), indicating a move towards policy normalisation, with nascent rate hike expectations for 2024 now embedded in market pricing. Meanwhile, the People's Bank of China, contending with credit market challenges and a slow economic restart, opted for policy accommodation, making it an outlier among major central banks.

In Australia, the 10-year bond yield dragged 46 basis points higher by US Treasuries to finish the quarter at a fresh cycle high of 4.49%. Like in the US, the move was characterised by an aggressive steepening of the curve led by higher real yields, with inflation breakevens largely unchanged. The RBA remained on hold during all three Q3 meetings, shifting to a data-dependent mode of operation. In the August Statement on Monetary Policy, the RBA made only marginal revisions to its economic forecasts, with core inflation expected to return within the target band of 2-3% in December 2025. Market pricing for the cash rate over the medium term was relatively stable, with gyration in the 10-year yields largely reflecting global developments rather than domestic policy expectations. Over the quarter, Australian economic data tended to surprise to the downside, with the trajectory of surprises deteriorating. Although the "mortgage reset cliff" failed to have the detrimental effect on household consumption many had forecast, broader economic growth remained under pressure with Q2 GDP printing below-trend. Inflation data also came in below expectations, with headline and trimmed mean CPI and wages data moderating in absolute terms. This helped stabilise market pricing for 2023/24, despite the long-end selloff.

Credit markets

Global credit markets remained stable for most of the quarter, even amid the stress in rates. However, a shift towards risk-aversion was evident towards September's end, especially as equities began to face pressures.

Credit spreads on 5-10 year USD investment grade corporate bonds largely held steady over the quarter. Any initial tightening of these spreads was later reversed, mainly due to a surge in corporate bond issuance and increased risk aversion into quarter-end. The USD primary market witnessed significant activity, with financials issuing approximately US$500 billion and non-financial corporates adding another US$321 billion of gross issuance. This level of issuance mirrored the activity seen in the first two quarters and marked the second significant issuance wave post-Covid.

US high yield credit spreads followed a similar trajectory, with the gains in energy prices likely supporting oil and gas issuers, who remain a large weight of the broad index. Spreads ended the quarter about 430 basis points above equivalent Treasuries, with liquidity conditions still generally supportive despite the policy tightening, and no imminent refinancing cliffs to pose major concerns. The first major high yield maturity wave is not due to arrive until 2025. Emerging market sovereign US dollar credit spreads largely mirrored these movements. However, there was notable regional dispersion, likely stemming from increased political risks in Latin America.

AUD credit spreads narrowed throughout the quarter and were largely insulated from the bout of risk aversion hitting global credit markets towards the end of September. However, AUD IG spreads still trade well above USD equivalents, broadly in line with historical norms. The AUD financial sector maintained strong issuance activity in Q3, recording around A$34 billion. Meanwhile, non-financial corporate issuance slowed down, with only A$1.5 billion coming primarily from the communication sector.

Outlook

The shift from the *bear flattening* seen in 2022 to the *bear steepening* observed this past quarter underscores the evolving macro narrative. The Fed, nearing the end of its rate hikes, now places emphasis on the duration of these heightened rates – the final dimension of this tightening cycle outlined by Powell last year. The long-term impact of maintaining such restrictive rates can significantly influence the longer end of the yield curve.

Should we witness a sustained period of these rates, it might further unwind some of the rate cuts anticipated in the medium term. Furthermore, if the US economy continues to demonstrate resilience against these restrictive policy measures, we might need to revise our estimates of the so-called neutral rate, as higher real rates would be required to keep inflation expectations anchored around the current 2% target. If growth and inflation were to be more volatile in the future, then the bond market would likely demand a higher “term premium” as well, which would further steepen both the nominal and real yield curves. In addition, were the BoJ to continue its normalisation and fully remove YCC and start raising rates, it would remove what’s become de facto YCC of G7 sovereign bonds more broadly, and potentially force global curves steeper to match JGB yields on a JPY-hedged basis to stem a wave of repatriation.

While it’s easy to envisage further bond market turbulence, some perspective is needed. The US's current economic strength does not exempt it from the long-term effects of a tightening cycle. Monetary policy has historically worked with a long and variable lag. Given the extensive refinancing activities and debt maturity extensions in 2020 and 2021, we might expect these effects to be more prolonged. As we venture further into the refinancing cycle and grapple with escalated policy rates and bond yields, the private sector might soon feel the pinch.

In Australia, the anticipation was for a swifter pass-through from rate hikes, given the dominance of floating rate debts among households and corporates, and elevated household debt levels compared to other advanced economies. However, while growth is now printing below trend, discretionary spending has not fallen anywhere near as much as expected. A plausible explanation could be the significant savings amassed during the pandemic, cushioning households against the rising debt servicing costs. Yet, with the RBA taking a more measured stance after its aggressive rate hikes in 2022 and a fresh bout of Australian dollar weakness, there looms the possibility of renewed core and imported inflation pressures, potentially forcing the Bank to start catching up with its more hawkish peers.

The hawkish catalysts notwithstanding, it's important to draw a line between cyclical and structural factors and not to extrapolate the current cyclical resilience too much or conflate it with a new secular regime. Some dynamics, like the much more expansionary US fiscal policy, may have simply protracted the economic cycle but haven't necessarily redefined foundational drivers like growth, inflation, productivity, and neutral interest rates. If yields continue their upward trajectory, they may soon start imposing real stress upon the real economy, particularly as the refinancing cycle starts to accelerate. Such a scenario could hasten the end of this credit cycle, intensifying the financial squeeze and magnifying the looming recessionary threats. Yields might need to rise further to reflect the current economic strength, but they also sow the seeds of future economic weakness.

For asset allocation, the implications of these rising interest rates are significant. With a fresh surge in real yields likely to pressure nominal growth over the current quarters even further, combined with an easing US fiscal impulse could weigh on cyclical exposures. Furthermore, the repricing in real interest rates and yields only raises the required returns of credit and equities at a time of elevated uncertainty with respect to margins and corporate earnings. Although risk premiums have largely been immune to the surge in bond yields this cycle, this is not an unusual late-cycle development. Whilst risk assets are generally forward-looking, the realities of the early 2000s recession, the GFC, and the Covid-19 recession only became apparent in credit spreads and equity multiples during the recession itself.

The outlook remains highly uncertain, not least because of the relative disconnect between asset classes. Although government bonds remain highly volatile as we enter Q4, these higher starting yields not only offer higher levels of income, but also positive long-term real returns, in addition to larger recession hedging potential if a rate cutting cycle were to commence. At this point, it's likely a large number of investors could hit their long-term nominal and real return targets without taking on additional credit risk or equity risk, relative to any other point in the past decade.

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

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

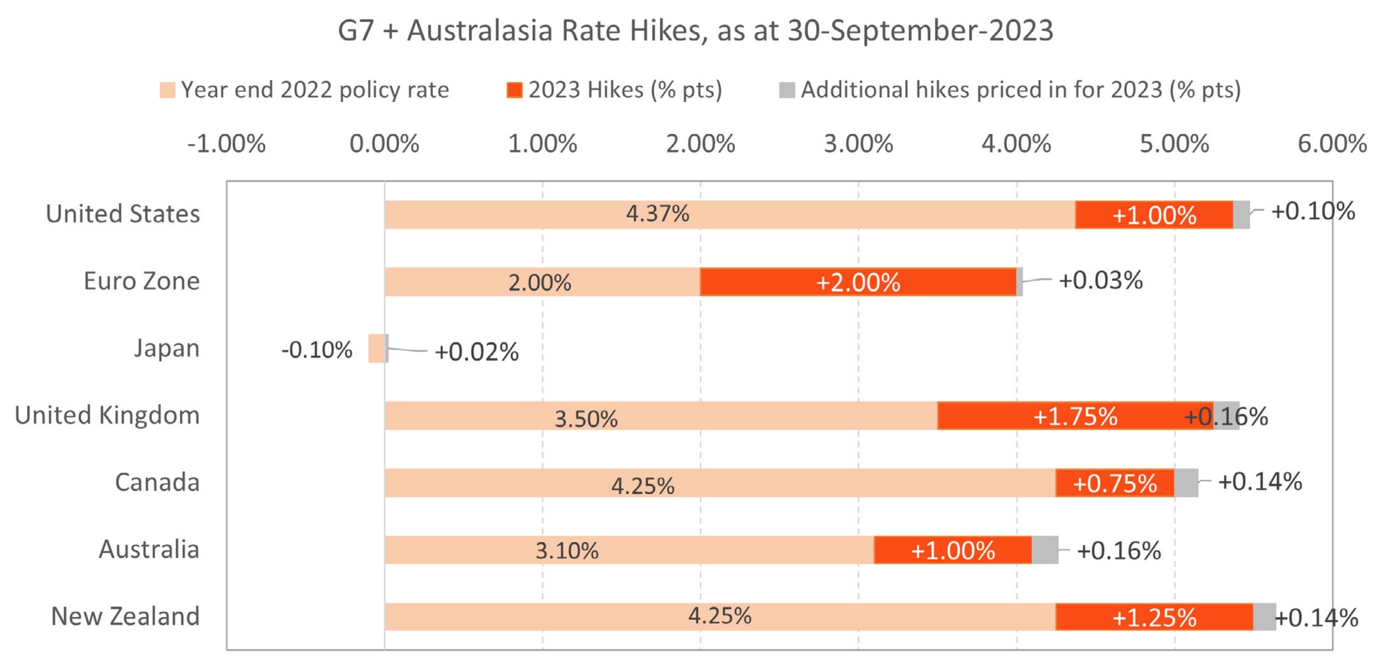

Chart 2: AUD Corporate bonds issuance, as at 30-September-2023; Source: Bloomberg

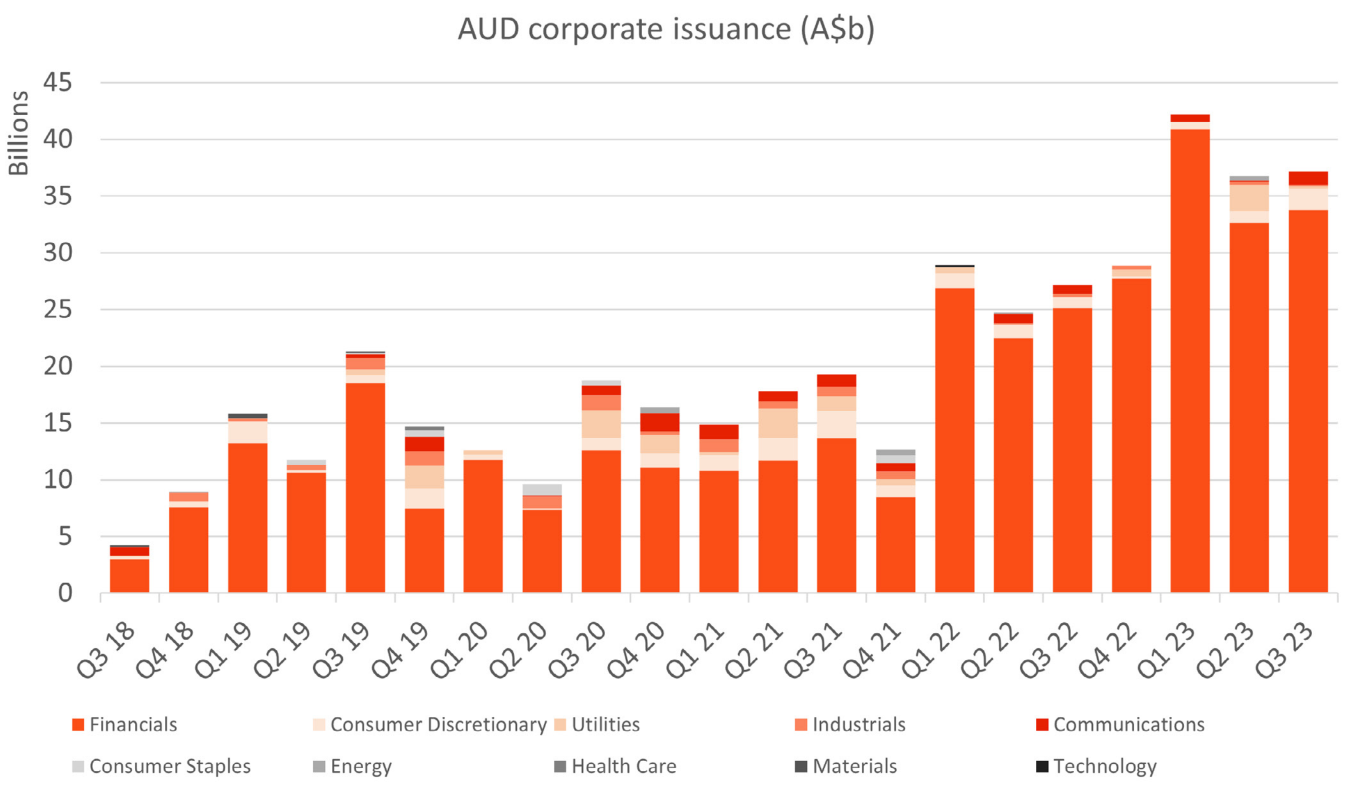

Chart 3: USD Corporate bonds issuance, as at 30-September-2023; Source: Bloomberg

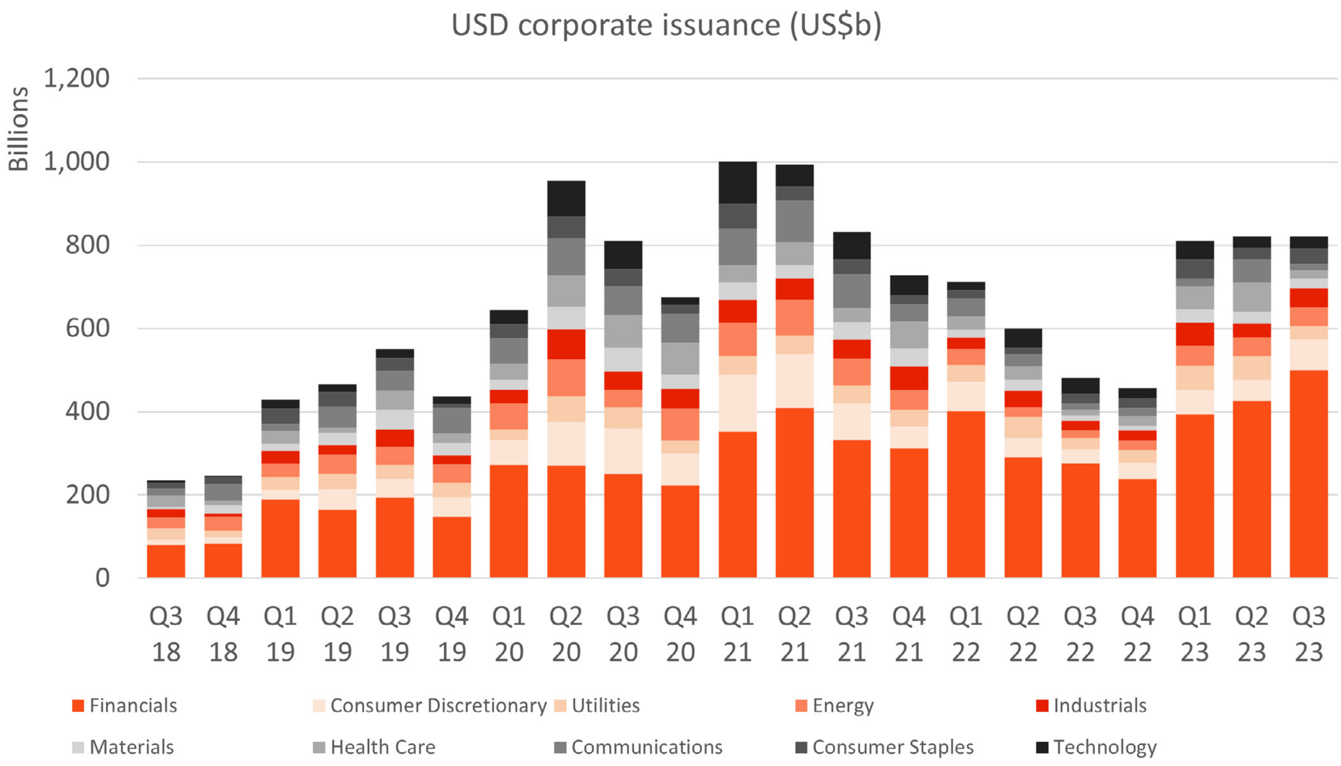

Chart 4: 10-year Government bond yields, as at 30-September-2023; Source: Bloomberg

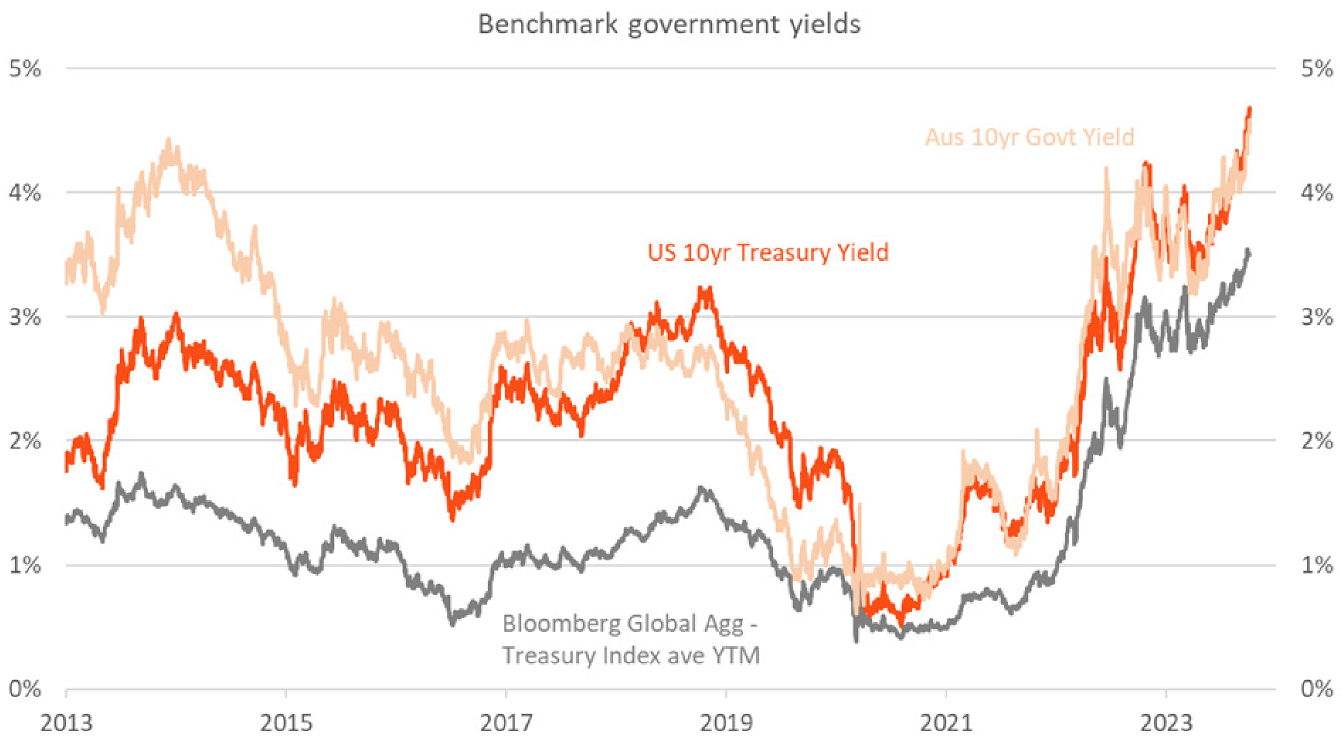

Chart 5: Australian interest rates, as at 30-September-2023; Source; Bloomberg

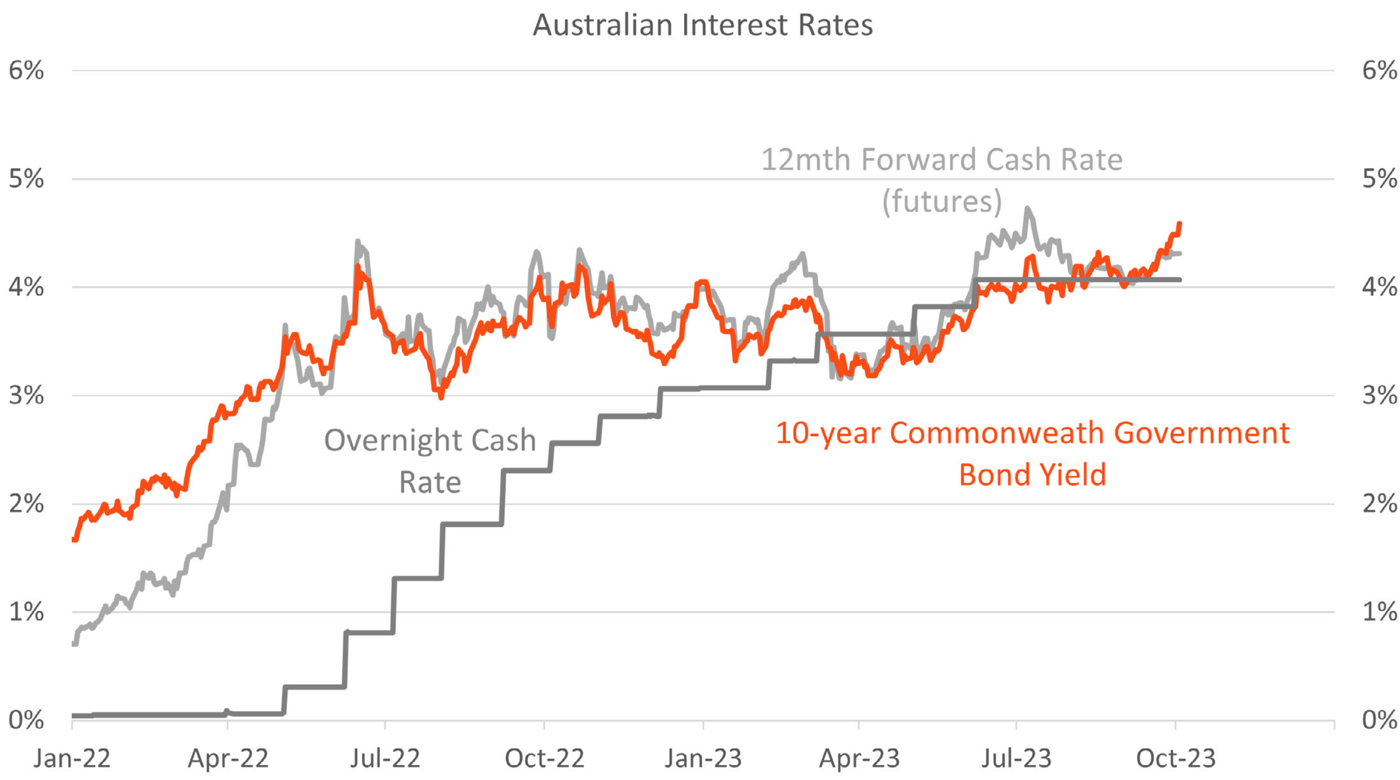

Chart 6: US interest rates, as at 30-September-2023; Source: Bloomberg

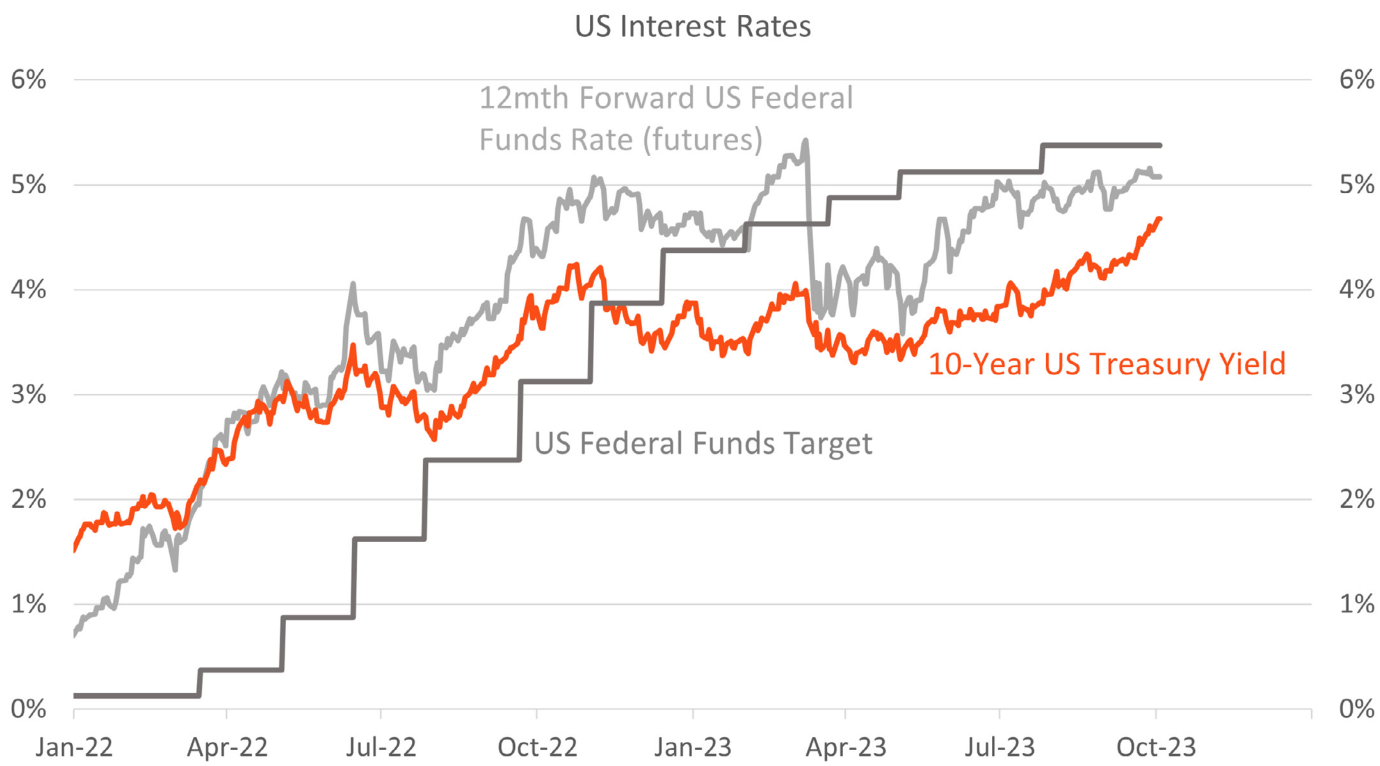

Chart 7: Global economic surprises, as at 30-September-2023; Source: Citi

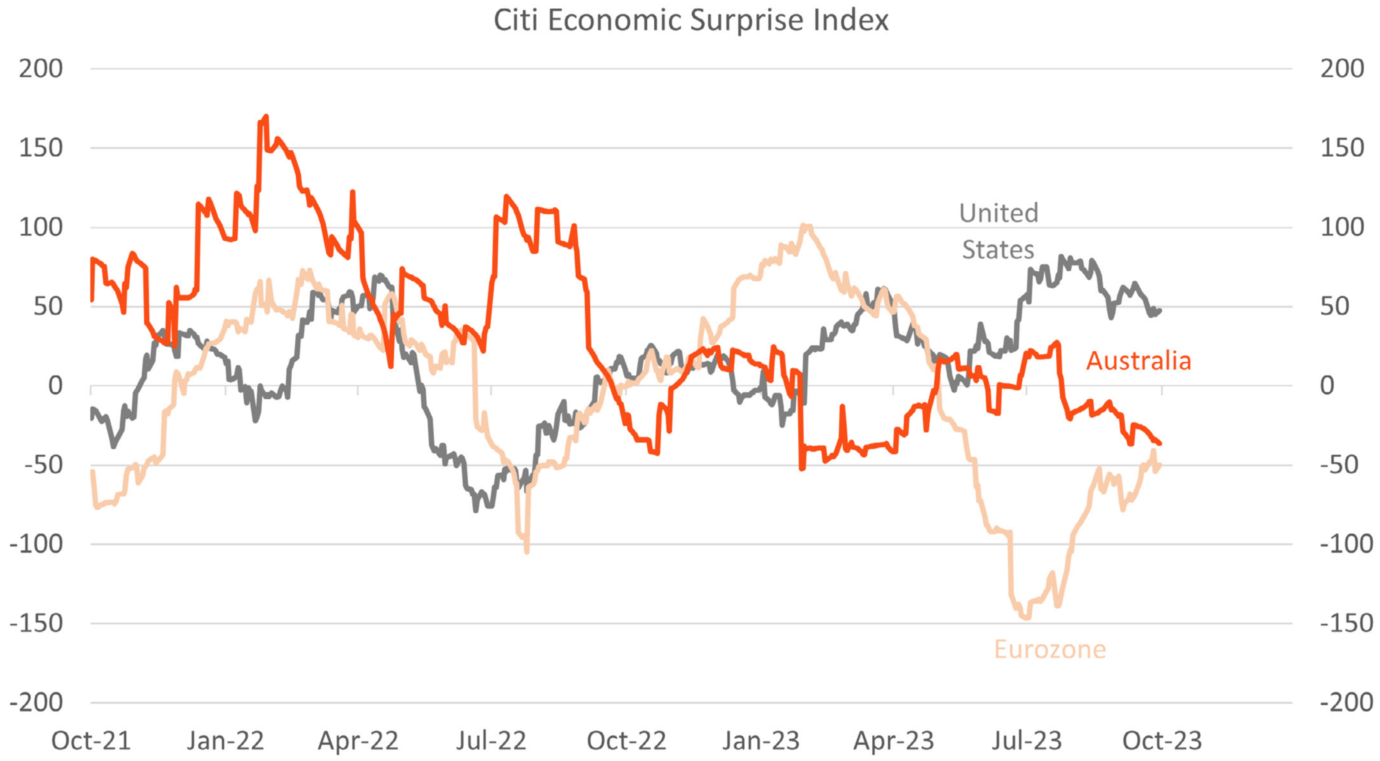

Chart 8: Global inflation surprises, as at 30-September-2023; Source: Citi

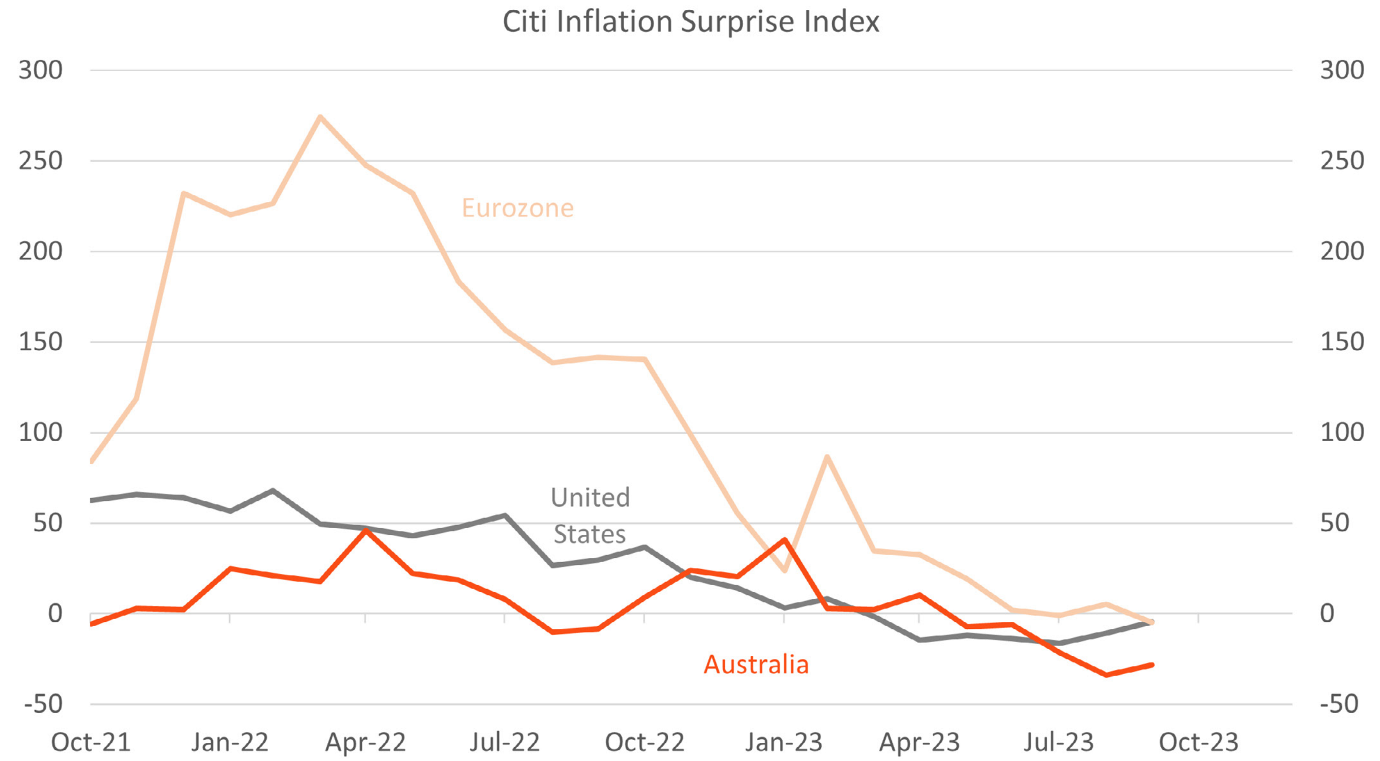

Chart 9: Neutral nominal Fed funds rate estimate, as at 30-September-2023; Sources: Bloomberg

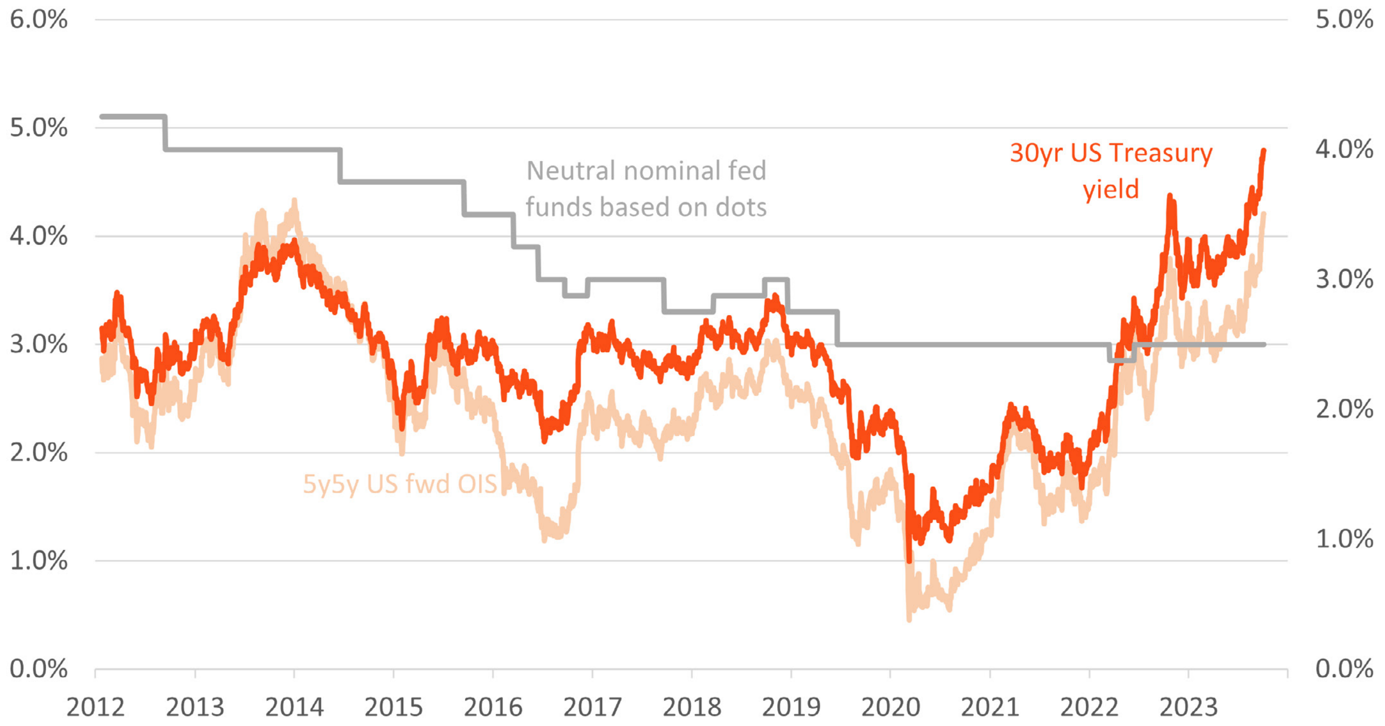

Chart 10: Neutral real Fed funds rate estimate, as at 30-September-2023; Sources: Bloomberg

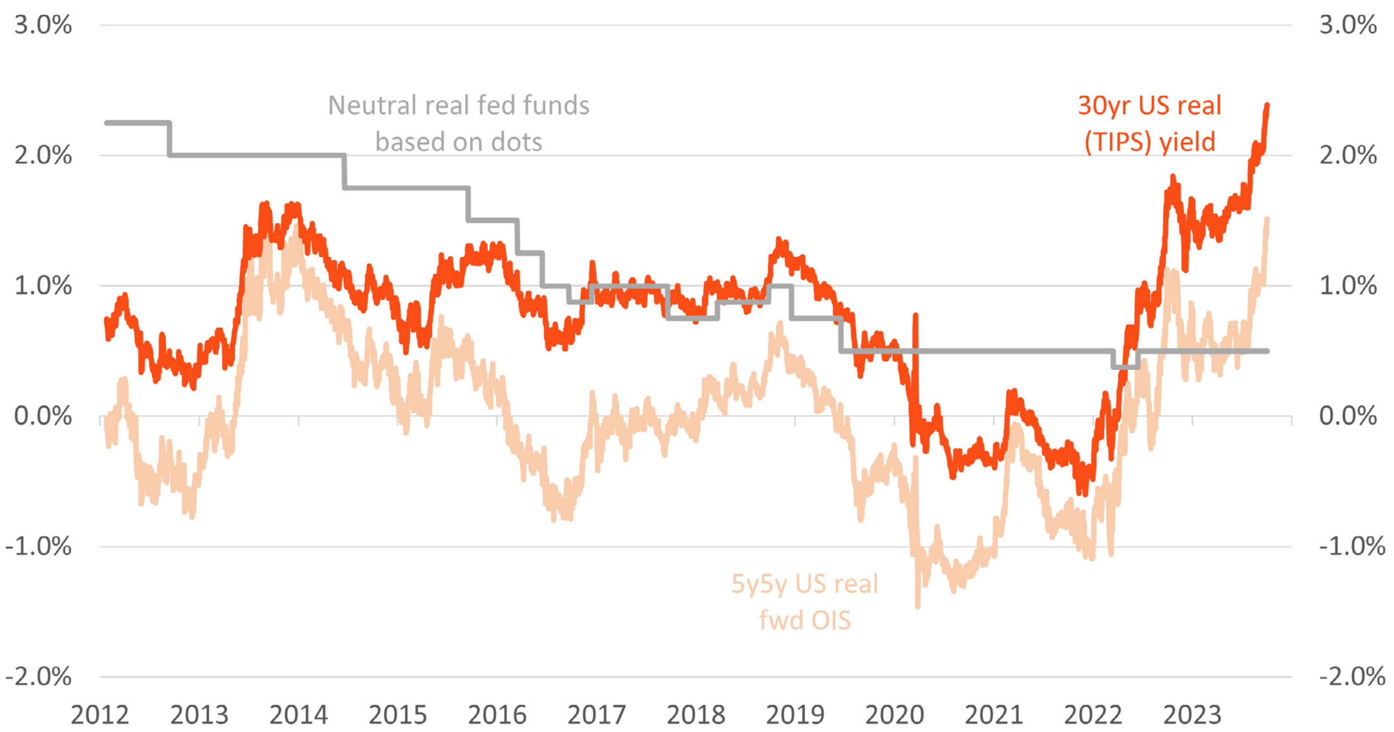

Chart 11: US 10-year real and nominal bond yields, as at 30-September-2023; Source: Bloomberg

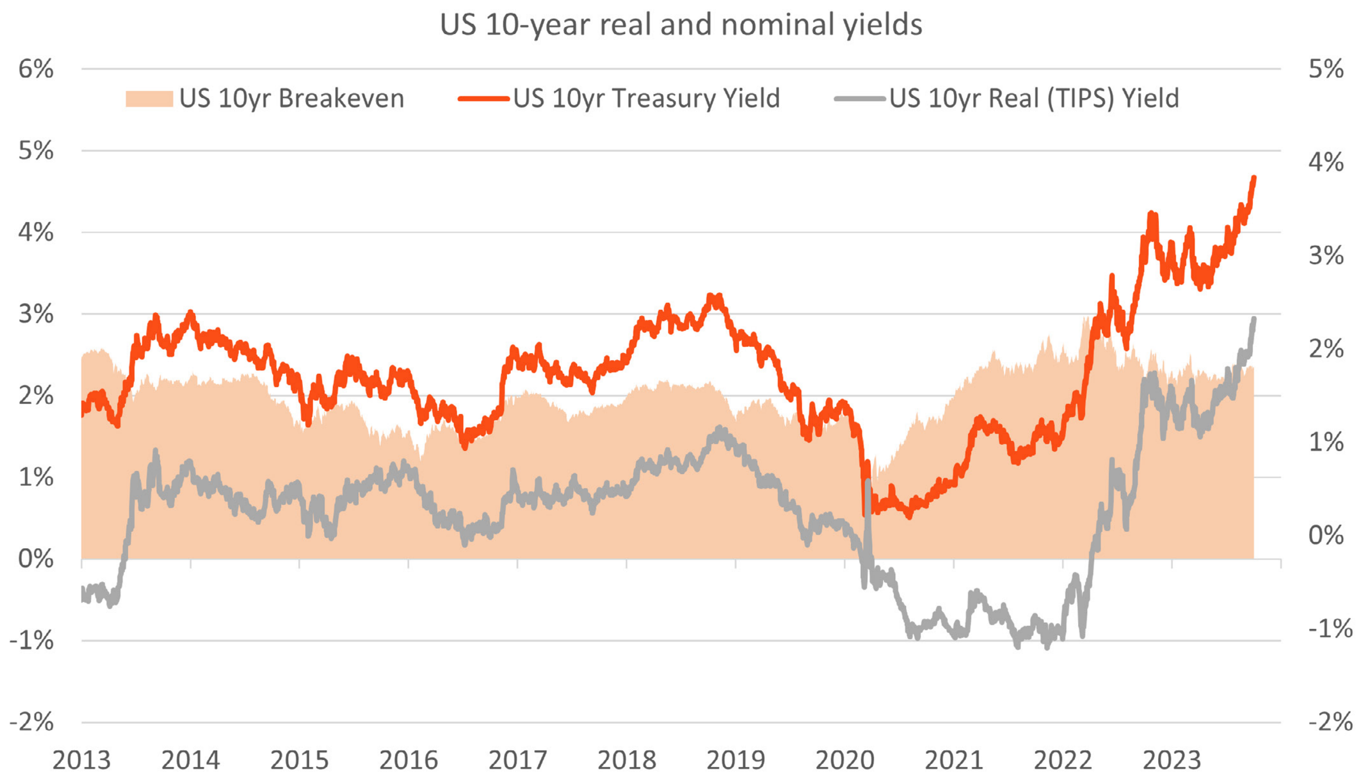

Chart 12: AU 10-year real and nominal bond yields, as at 30-September-2023; Source: Bloomberg

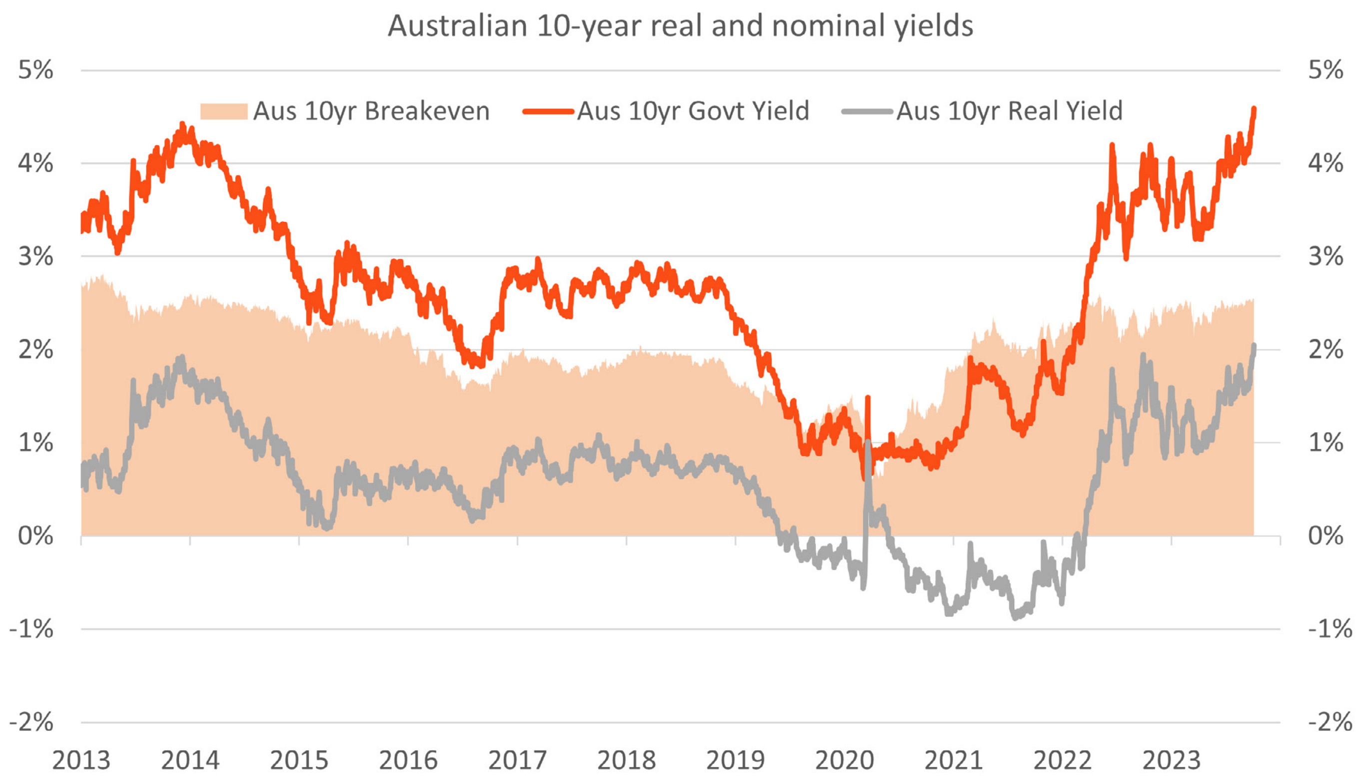

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Chart 13: Corporate bond spreads; as at 30-September-2023; Source: Bloomberg

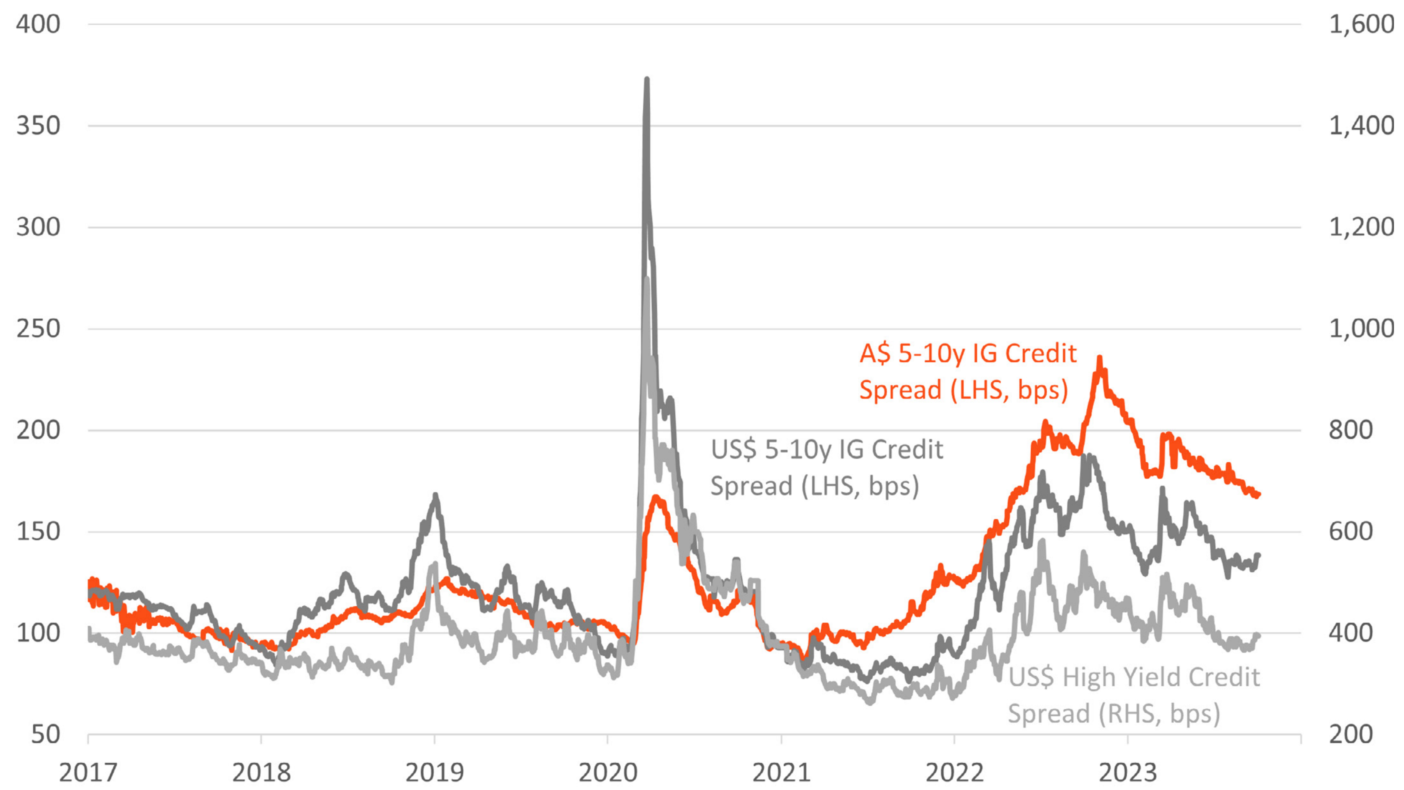
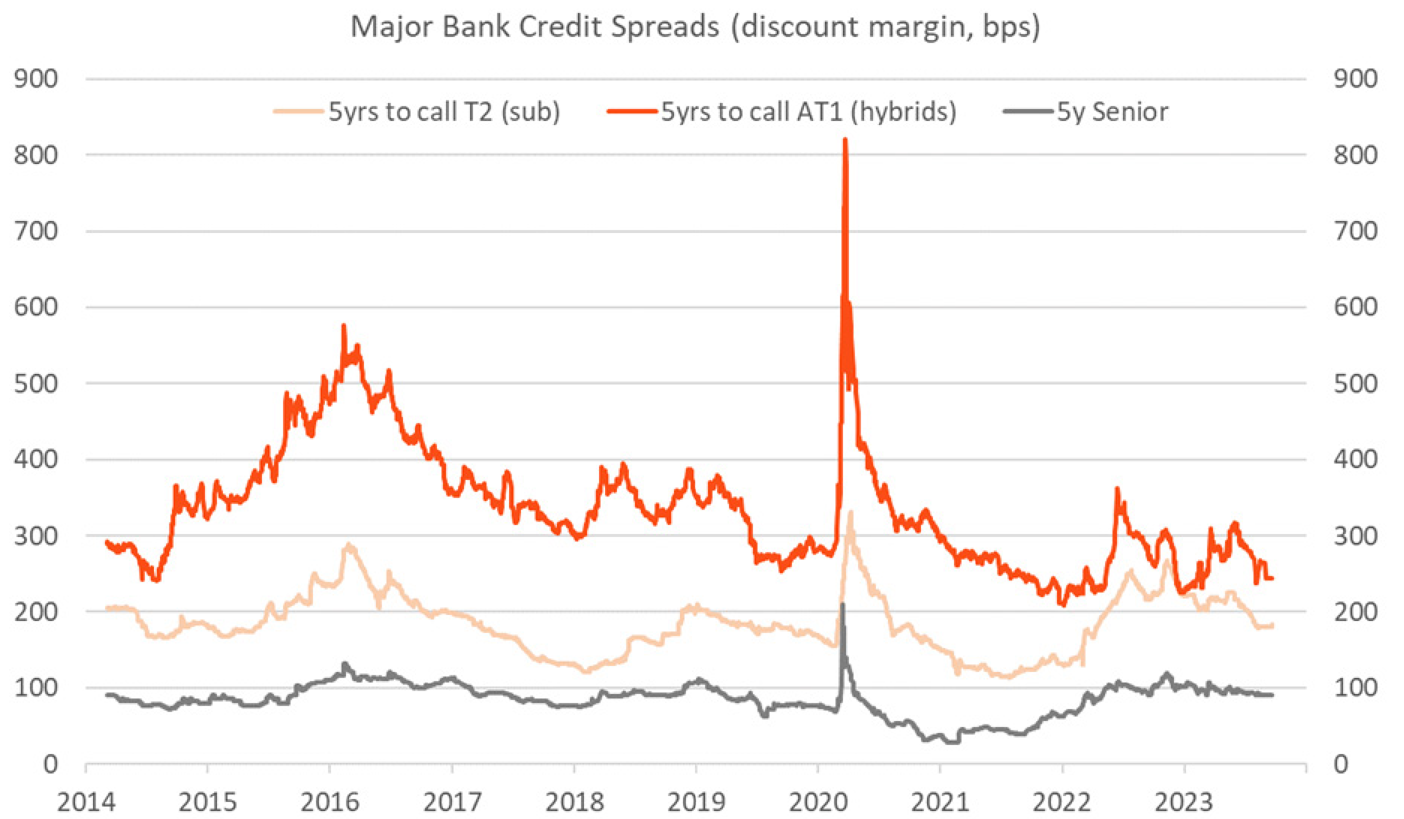


Chart 14: Australian major bank credit spreads history, as at 30-September-2023; Source: Bloomberg



Important

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