

BETASHARES AUSTRALIAN INVESTMENT GRADE CORPORATE BOND ETF

ASX: CRED

Quarterly Report - March 2021

Performance ¹	1 Month %	3 Months %	6 Months %	1 Year %	3 Years % p.a.	Inception ² % p.a.
Fund Return (net)	0.14%	-3.63%	-1.05%	4.31%		6.52%
Growth return	-0.17%	-4.50%	-2.49%	0.14%		2.60%
Income return	0.31%	0.87%	1.44%	4.17%		3.92%
Index return	0.23%	-3.44%	-0.70%	4.58%	6.74%	7.08%

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	3.18%
Yield to Maturity (% p.a.) ²	2.74%
Average Maturity (Yrs) ³	7.73
Modified Duration (Yrs) ⁴	6.71
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	\$473.67m
Historical Tracking Error	0.46%
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 35 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		%	
Lloyds Banking 4.25% Nov-27	3.8	Barclays PLC 4% Jun-29	3.5
Vodafone Group 4.2% Dec-27	3.8	Woolworths Group 2.8% May-30	3.5
AGI Finance 1.8152% Nov-28	3.7	AT&T Inc 4.6% Sep-28	3.4
Coles Group 2.1% Aug-30	3.6	Ausgrid Finance 1.814% Feb-27	3.4
Emirates NBD Bank 4.75% Feb-28	3.6	Uni of Technology 3.75% Jul-27	3.3

¹ As at 31 March 2021

Sector exposure	Fund Weight % ¹	Index Weight% ¹
Financial	34.0	34.7
Communications	16.4	11.3
Consumer, Non-cyclical	17.3	17.1
Utilities	16.1	17.2
Industrial	10.0	14.1
Consumer, Cyclical	6.1	5.7
Technology	0.0	0.0
Basic Materials	0.0	0.0
TOTAL	100.00	100.00

¹ As at 31 March 2021

Global macro and rates

It was a tumultuous quarter for global rates, with domestic and global government bond benchmark indices suffering their largest drawdowns since 1994 and Australian and U.S. 10-year yields both rising over 80 basis points over the period. On the surface, the dramatic rise in yields and steepening of curves was driven by higher growth and inflation expectations, owing to increased optimism around vaccine rollouts, confirmation of a Democratic sweep in Congress and the passage of additional U.S. fiscal stimulus. Drilling down a little further, we also saw a large repricing of policy rate expectations, with the sell-off originating at the long-end before migrating to intermediate tenors, despite ongoing insistence from global central banks of prolonged accommodation.

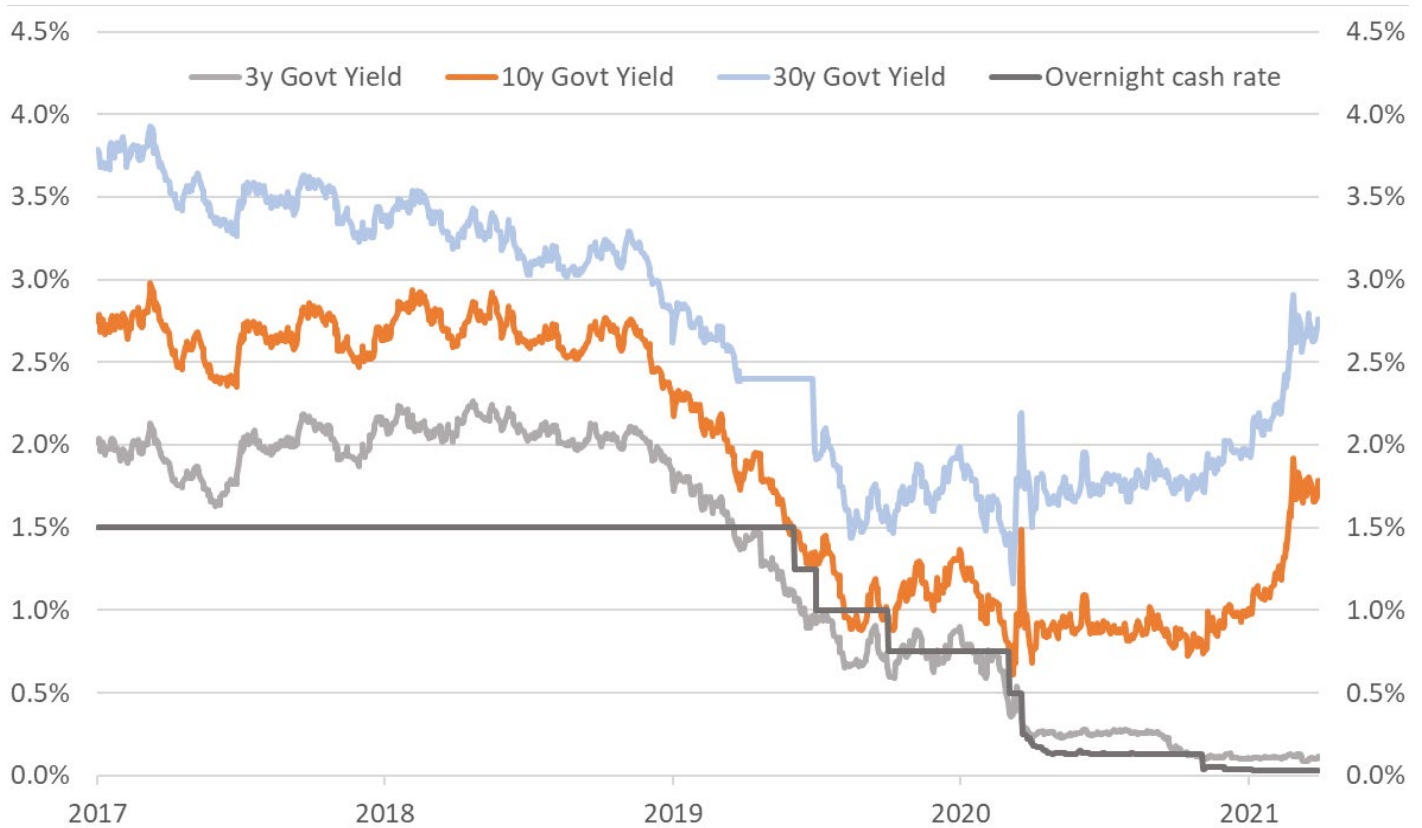
Global macro and rates cont.

The move was also compounded by several structural factors, both in Australia and the U.S. The RBA's implementation of yield curve control (YCC), which pinned the 3-year yield around 0.10% arguably resulted in a disproportionate steepening as the longer tenors were forced to bear the brunt of the global duration sell-off in late February, triggering increased asset purchases from the central bank during the quarter to help stabilise the market, particularly in the 4-7 year sector. Similarly, a marked increase in U.S. Treasury issuance also contributed to some degree of duration indigestion, culminating in a very poorly received 7-year auction in late February. Furthermore, the ending of the exemption of U.S. Treasuries and reserves in the Supplementary Leverage Ratio (SLR) calculation also created fears of forced selling of Treasury securities into quarter end, although those fears were likely overblown.

Global economic data continued to improve, with economic surprise indices remaining in positive territory throughout the period and global PMI numbers indicative of a strong rebound in activity. U.S. data in particular was well received, with both the ISM manufacturing and services PMIs recording their highest reading since 1983 and 1997 respectively. When this is combined with a very strong vaccine rollout relative to the Euro area, the complexion of the deflation narrative has moved from a globally synchronised rebound to a U.S.-led recovery, with recent strength in the broad U.S. Dollar also reflecting this narrative change. Further contributing to the recent U.S. Dollar strength has been concerns around policy tightening in China and a deterioration of the Chinese credit impulse, which has been a key driver of global deflation for much of the post-GFC period. Australian data also tended to surprise on the upside, with the domestic labour market rebounding much faster than expected despite the Job keeper support program coming to an end, although core CPI and wage growth remained subdued. Reflecting this improved outlook, both the RBA and Fed revised their growth expectations higher, although left core inflation expectations largely unchanged.

This repricing of forward rates was largely at odds with prevailing central bank forward guidance, with both the Federal Reserve and the RBA reiterating they are unlikely to raise rates until 2024 at the earliest. The RBA also announced a QE extension in the February Board meeting, with an additional \$100 billion of commonwealth and state government bonds to be purchased beginning in April and recent statements indicate that another renewal at the end of the year is likely, while rolling the 3-year YCC benchmark from the April-2024 bond to the November 2024 security is also being considered. Central banks globally were largely of the view that the marked increase in inflation expectations is transitory, driven by a combination of base effects and supply chain bottlenecks. Potentially supporting this view is that although 10-year U.S. inflation expectations rose to their highest level in 8 years, the move was driven by shorter dated breakevens, with the inversion in the inflation curve potentially reflecting the outsized surge in commodity prices, particularly WTI crude and gasoline, which may be hard to sustain once supply chain frictions are eased.

Amid the improvement in the global economic backdrop, market implied measures of policy rate normalisation were aggressively brought forward, with the Australian bank bill futures and OIS curves suggesting the RBA may hike as early as late 2022, with similar moves seen in the U.S. Expectations of terminal policy rates, as indicated by OIS-implied 5-year forward policy rate expectations, rose to as much as 2.5% in Australia and 2.25% in the U.S., which corresponded to a repricing of over 150 basis points since mid-2020, although the move has since moderated.

Chart 1: Australian benchmark yields


Source: Bloomberg.

Credit

Despite the elevated volatility in sovereign yields, credit markets were largely well behaved, particularly for shorter duration and lower quality segments. Re-opening optimism, abundant liquidity and relatively benign credit impairments helped both investment grade and high yield spreads compress back to pre-covid levels. However, the aggressive steepening in global yield curves did eventually spill over to steeper credit spread curves as all flavours of duration fell out of favour. Domestic credit spreads consolidated over the quarter, with senior bank FRN spreads moving off their post GFC lows amid new 5-year issuance from Suncorp and a more general view that the Term Funding Facility (TFF) will come to an end soon, resulting in more supply going forward. AUD corporate bond spreads also moved off their post-COVID lows into quarter end, dragged wider by the aggressive steepening in both the sovereign and swap curves.

Outlook

Looking ahead, it's likely that government bond yields will consolidate given the disconnect between market implied rate expectations and central bank forward guidance. The end of the Japanese financial year will also likely see foreign buyers return to the Australian and U.S. Treasury market to take advantage of the most generous JPY and EUR-hedged yields in years. Furthermore, net new issuance of Australian government bonds has turned negative, with the RBA maintaining purchases against a reduction in issuance from the AOFM. With Commonwealth and state budget shortfalls likely to be smaller than previously expected, it is possible we'll see a further reduction in government issuance.

Regarding global monetary policy, the FOMC's recent minutes also showed little concern about the rise in longer term bond yields or inflationary pressures, with focus likely to remain on labour market outcomes. Similarly, the RBA has also made it clear in recent months that it believes the economy is still years away from achieving sustained core CPI between 2 and 3 per cent and that full employment and wage growth of at least 3 per cent would be a necessary condition, with the ending of Job Keeper potentially posing a challenge. Despite the robust improvement in employment growth and a larger than expected fall in the unemployment rate, wage growth remains sluggish, leading to suggestions that the RBA's estimate of the natural rate may have fallen from 4.5% to below 4.0%, further raising the bar to policy normalisation.

Outlook cont.

U.S. inflation concerns will remain an ongoing issue, particularly considering the momentum of the U.S. economic rebound and the proposed Biden infrastructure package. However, base effects will turn against the U.S. economy in the latter part of the quarter and an easing of supply chain bottlenecks as economies re-open should eventually put a damper on price pressures, while significant political obstacles and a lack of bipartisan support stand in the way of any infrastructure bill or further fiscal stimulus being passed. Furthermore, the Q1 surge in nominal and real yields alongside strength in the broad U.S. Dollar have tightened financial conditions at the margin, which may also prove to be a headwind to longer-term inflationary pressures, with the structural disinflationary factors of demographics, debt overhang and technology still present in a post-COVID world.

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