# Western Asset Australian Bond Fund

WESTERN ASSET

## Performance Review

The Bloomberg Ausbond Composite Index returned 0.31% in a volatile quarter for bonds that initially saw yields continuing on the downward path beginning the previous quarter, before bottoming out in mid-August then retracing higher to finish a little lower than where they began, on average, with a steeper yield curve.

Interest-rate strategies added value, having gradually extended a small underweight duration position as yields fell through July and August, which initially underperformed, but eventually became a positive contributor as bonds sold off through the latter part of the quarter. Positioning for a steeper yield curve also contributed at the margin.

Sector allocation added value despite spread widening across corporate, semigovernment and supranational, sovereign and agency (SSA) bond sectors where portfolios held spread duration overweights. The offset came from carry, particularly via the large corporate sector overweight. A small allocation to inflation-linked bonds was closed out during the quarter, having provided the portfolio with incremental returns.

Security selection enhanced returns through a range of issuers including REITs General Property Trust, Mirvac Group, Australian Prime Property Fund and Stockland Group. Semigovernment issuer NSWTC added value as did some banks and non-bank lenders such as CBA and Liberty Financial. Airport operator Heathrow also contributed with the removal of social restrictions in the UK.

## Market Review

- Covid made a resurgence in the form of the delta variant in Australia's two most populous states, where the elimination strategy was eventually abandoned.
- Improved domestic supply of vaccines enabled a significant rise in vaccination rates around Australia, particularly in the most affected states.
- Covid-related supply-chain disruptions continued to feed into inflation figures internationally with forecasts baking in some persistence.
- Central banks increasingly sought a path of gradual removal of emergency policy settings and a lift off in rates while the Reserve Bank of Australia (RBA) maintained guidance for no lift until 2024.
- The Australian Prudential Regulation Authority (APRA) announced an end to authorised deposit-taking institutions' (ADI) reliance on the Committed Liquidity Facility (CLF).

The quarter started with Sydney in a lockdown to try to combat the case numbers of the highly infectious Covid delta variant, which had spread to many other parts of the world. The quarter ended with both Sydney and Melbourne having spent most of the quarter in lockdown, abandoning their respective elimination strategies in favour of ramping up vaccination rates as vaccine supply improved. Jobs and job advertisements declined through the quarter as expected with heavy Covid restrictions in place; however, the unemployment rate continued to fall, dropping from 5.1% to 4.5% as the participation rate dipped by 1%. The headline Consumer Price Index (CPI) rose to 3.8% for the year to June, but core inflation remained around 0.3% below the lower bound of the RBA's target band. The RBA reaffimed its expectation that core inflation would improve only gradually and extended its Bond Purchase Program until at least February 2022, although it reduced the rate of purchases to A$4 billion per week and maintained the April 2024 bond for its yield-curve control program rather than extending to the November 2024 bond. The RBA also reiterated that it does not expect to raise the cash rate until at least 2024, when it expects inflation and employment targets will eventually be met. Despite the lockdowns, house prices and housing loans continued to grow, prompting increased discussion from the regulators around macro-prudential measures to curb potential financial stability risks. During the quarter a number of other central banks either commenced or made progress towards tapering their own asset purchase programs as a growing chorus of commentators from both outside and within central banks voiced concerns that inflation may not be as transitory as expected, due to the persistence of supply-chain issues.

Bonds were heavily influenced by international developments. Bond yields declined through the early part of the quarter as some economic data softened and the delta variant of Covid spread across the world. Yields then reversed course, shifting higher on forward guidance from various central banks, particularly the US Federal Reserve, on the scale-back of emergency policy settings.

Risk sentiment waned globally, as Covid constraints and supply-chain disruptions continued to feed into inflation data with some persistence being built into forecasts. Headwinds emerged from China around Evergrande and regulatory matters, which saw Chinese demand for iron ore decline substantially. Domestically, APRA announced that ADIs were expected to eliminate their reliance on the CLF for their liquidity ratios by the end of 2022. This had potential implications for spread-tightening for semigovernment bonds, which qualify as high-quality liquid assets (HQLA) under regulatory liquidity provisions and spread-widening in bonds of the major Australian banks (non-HQLA permitted through the CLF). Spread sectors widened in general with corporate and SSA sectors faring worst at around 5-6 bps wider and semigovernment spreads around 2-3 bps wider, on average. Asset-backed securities tightened over the quarter.

The Australian dollar underperformed the stronger US dollar and Japanese yen by around 3.5%, the New Zealand dollar by almost 2.5%, and it lost a little more than 1% to the euro and pound sterling as iron ore prices continued to come off their peaks due to a drop in Chinese demand and also as Covid lockdowns hit the local economy.

## Investment Outlook

Some guarded optimism has emerged regarding the flattening of the global daily infection curve for Covid as vaccination rates reach levels that assist in curbing its spread and ameliorate its health impact for those infected. The approaching northern hemisphere winter will be something of a litmus test regarding whether the worst is now behind us for this pandemic.

The sharp rise in the vaccination rate in New South Wales (NSW) appears to have contributed to a significant decline in daily new cases from a peak of more than 1,500 in early September to fewer than 1,000 over the final days of the month and a definite downward trajectory. This bodes well for a significant reopening of Australia's largest state economy before the end of the year, albeit with some residual social restrictions. By contrast, Victoria's daily infection rate rose from little more than 100 to more than 1,400 over the month of September and was still on a rising trajectory as authorities played catch-up on vaccinating the population. Assuming new infection rates do eventually subside, as in NSW, once a critical mass of vaccination is achieved Victoria is likely to be two to three weeks behind NSW in terms of substantive removal of social restrictions and so will likely continue to drag on economic activity through a good part of 4Q21. The opening of Australia's internal borders may take longer than that, as all the other states that continue to live Covid-free remain reluctant to throw open the doors until 80% vaccination of the eligible population is achieved in all states—in some states an even higher threshold has been touted. This will continue to be a drag for the tourism and hospitality sectors. Likewise, it is hard to see the trans-Tasman travel bubble with New Zealand reopening this year, given New Zealand's shift of focus from elimination to containment of Covid while racing to vaccinate its population.

Most economists agree that an economic contraction in Australia for 3Q21 is a given but it's less clear for 4Q21 and is highly dependent on the success of the vaccination drive, which will determine how far into the fourth quarter lockdowns persist. One query is whether consumers, and indeed businesses, will have lost more wealth during the current lockdowns versus previously under various government Covid-relief programs that have since ended, and therefore whether the resurgence in consumer activity will be as strong once social restrictions are eventually removed. This will make a difference regarding the extent of the economic bounce-back on the other side of the current outbreak, when the majority of the population is vaccinated.

Notwithstanding taper of various central bank asset purchase programs either imminent or already underway, we expect both domestic and global monetary conditions to remain easy for some time as emergency settings are gradually removed, with a keen eye on achievement of policy objectives. We believe such conditions will continue to favour spread sectors, particularly corporate bonds, which have benefited from substantial support. In our opinion, these sectors should be the best performing fixed-income assets. APRA's announcement regarding the phase out of the CLF hasn't, to date, resulted in dramatic swings in spreads for bank and semigovernment bonds, and in our opinion isn't likely to, but we do think we are likely to see spreads for major domestic bank paper leak mildly wider at a time when post-Term Funding Facility (TFF) issuance gets underway with both domestic and offshore markets being tapped. Conversely, we think semigovernment bonds are likely to continue to inch tighter from their recent wides. We continue to seek value in other parts of the corporate and asset-backed sectors and selectively add exposure to credit to take advantage of steeper credit curves. This remains judicious, with the majority of the overweight still focussed on shorter maturities to manage spread risk.

As bond yields continued to rise off six-month lows, we reduced our underweight duration position a little in the 10-year key rate but still retained an overall underweight in anticipation of a further rise in yields. We will keep our interest-rate positioning nimble to take advantage of volatility events and yield curve steepness.

The Australian dollar eased further as prices for iron ore almost halved over the month amid headwinds in China and as the RBA's position on the expected time frame for normalisation of policy rates is beginning to look increasingly at odds with a number of other central banks. Some uncertainties for the global economy and markets are feeding the flight-to-safety trade and giving strength to the US dollar. However, as social restrictions are eventually removed we are likely to see a resumption of upward pressure in the currency as activity regains momentum. Despite a deepening rift with China that has seen a number of Australia's export industries increasingly sidelined and need to find destinations outside China, commodity export prices remain elevated and provide some justification for the currency to return to around the mid to high US$0.70 range.