FIIG Australian Bond Fund

September 2024 Quarterly Report

Introduction

Welcome. This Quarterly Report (QR) is written by Mr Kieran Quaine, Head of the FIIG Securities Investment Management Team (IMT). It contains summary information relevant for investors in the FIIG Australian Bond (FAB) Fund. The QR references the domestic and international fixed income market, informing readers of the major influences impacting the price of the assets from which the performance of the FAB Fund is derived.

Macroeconomics, base interest rates and investment strategy commentary

Quarter on Quarter (QoQ) inflation in Australia to June 2024 maybe in the 'mid 3's (%)' but the most recent Month on Month (MoM) data suggests it is below 3.00% annualised .... so why, unlike many peers, has the Reserve Bank of Australia (RBA) not eased the official cash rate?

Key Global monetary policy changes during the quarter

Official cash rates @ September quarter end and changes made:

- UK (BoE): down 0.25% @ 5.00%
- Europe (ECB): down 0.25% @ 3.50%
- AUS (RBA): unchanged @ 4.35%
- Canada (BoC): down 0.50% @ 4.25%
- New Zealand (RBNZ): down 0.25% @ 5.25%*
- USA (Federal Reserve): down 0.50% @ 4.875%

** and post September down a further 0.50% to 4.75%*

QoQ inflation in Australia to June 2024 maybe in the 'mid 3's (%)' but the most recent MoM data suggests it is below 3.00% annualised .... so why, unlike many peers, has the Reserve Bank of Australia (RBA) not eased the official cash rate?

Yes, the RBA did not tighten as much as other western nations ... but that is hardly relevant when the impact of tighter monetary policy has softened the economy so dramatically.

The Investment Management Team suggests, not unlike we suggested in late 2021 and through to mid-2022, that the RBA is again 'behind' the curve ....

From our March 2022 Quarterly Report: "The RBA, despite mounting (core) inflationary evidence to the contrary, have persisted with forecasting inflation to mean revert to within the 2.00% to 3.00% inflation tolerance band, subsequently exercising 'patience' and holding monetary policy stable at the emergency levels of 0.10% initially set during the onset of the Covid-19 health crisis. They are now appearing to be the lone wolf cut away from the global central banking pack.

Key Observations

- FIIG Australian Bond Fund delivers a 'stellar' first year performance
  - 8.15% (Gross) and 7.53% (Net of fees)
  - +1.03% (Gross) and +0.41% (Net) over Benchmark Index
- RBA holds 'tight' as the domestic economy slides and inflation falls
  - GDP flat, spending subdued and unemployment climbing
  - Impending easier monetary policy expected by the market
- US Federal Reserve joins the easier monetary policy club
  - But (possibly) in 'no hurry' to ease further
- **But wait ... the Middle East theatre of conflict expands**
  - Are global inflation gains about to be reversed ... again?

And again, paraphrasing from our June 2022 Quarterly Report: "The RBA falls on its bloody sword" ... raising "the official cash rate three times in the June quarter" ... (now) predicting ... "inflation peaking next year at an (annualised) 7.00% for the June 2023 quarter.

Historically it is clear they were too slow to raise ... and now they appear too slow to ease.

Having previously expressed dismay within our QR series, at former RBA Governor Phillip Lowe holding policy (too) low for too long in 2021 (and into 2022), it should be no surprise that, consistent with our forecasts, we express a similar difference of opinion to the RBA currently. They appear to be making the same mistake in reverse, by now holding policy too high for too long.

Have they not learnt from Lowe, who infamously expressed confidence (in late 2021) that according to RBA forecasting there was no reason to see cash rate rises anytime soon (this side of 2025), only to reverse tack given their forecasting was overly optimistic? The RBA is not paying attention to the bond market. It is not paying attention to aggressive capital movements, both globally and domestically. As any Bond Trader worth their salt was selling duration in late 2021 and into 2022, so too have they been buying in late 2023 and into 2024. And whilst long dated bond yields in Australia have rallied a full percent in the last year, inflation has fallen like a stone, GDP is flat, unemployment has risen aggressively, and all key global Central Banks have eased ... the RBA is somehow scared that easing policy domestically will reignite domestic inflation.

Up until geopolitical tension in the Middle East elevated (2nd October Iran missile strike), that (domestic assumption) would appear incorrect and unlikely, given the factors that drove inflation higher are dissipating continually:

- Oil prices declined following OPEC increased supply
- Global supply chain repair continued
- The Ukraine conflict is somewhat closer to a resolution
- The Federal Government is reigning in excessive spending
- The US isolationist policy overhang (of Trump years) has been reversed
- China is in an economic hole and initial policy stimulus has not ignited demand
- Large domestic corporates are under the microscope of the competition watchdog
- Domestic mortgage holders under stress (arrears rising) and discretionary expenditure is suppressed.

We suggest Monetary Policy, both domestically and internationally, has done its job and so we now repeat what we said in March 2022 ....

"They (the RBA) are now appearing (yet again) to be the lone wolf cut away from the global central banking pack". The short-term RBA response to a weak economy, via adjustments to the official cash rate, is of minimal relevance now. That is because fixed rate bond investors have all benefited from the market revaluation of bond yields lower. The Investment Management Team has been 'long' and FIIG investors have benefited. Bond Traders do not wait for a Central Bank to ratify their decisions. Performance is ratification. For floating rate investors, a higher official cash Rate has delivered a higher BBSW return, and investors (in our Individually Managed Account Menu of opportunity) have benefited from higher accrual returns ... but a lower performance than was otherwise available through fixed rate product investing (via the Fund).

However, as I write this report, the gains made in the bond market in late 2023 and to date in 2024 are slipping back under the pressure of a strong US labour report and the broad concern about the elevated risk in the Middle East with Israel and Iran now exchanging missile fire.

We suggest that it is the latter, and not the former (US labour report) that has the capacity to upset the inflation apple cart. An expanded theatre of conflict in the Middle East could impact oil prices and re-disrupt global goods supply chains, re-igniting inflation yet again.

Domestically, the annualised CPI headline rate fell to 3.80% (June QoQ release) but to 2.70% (August MoM release). But the CPI Core (ex-volatiles) sat at 4.10% (June QoQ) and 3.40% (August MoM). The RBA is focused on the core outcome and is especially focused on avoiding the short-term noise created by the government energy rebates distributed as part of the 'cost of living' assistance, that have contributed to the recent (large) CPI decline. The RBA will also focus on QoQ numbers will not likely be swayed by MoM figures, although they too support obvious trend direction and MoMentum to lower CPI. Apart from the contention (mostly from the RBA) of the gains made in fighting inflation, the balance of economic news points continually to a softer economy and is subsequently supportive of the rally in fixed interest rates to date.

Unemployment is rising as the economy barely grows and retail sales are subdued as consumers reign in their discretionary expenditure. And iron ore prices are falling, correlating positively with the outlook for the Chinese economy. Mining corporation revenue and profitability reductions will negatively impact government tax receipts.

Ex the elevated Middle East conflict outcome, we have doubts that inflation is really 'sticky' (at above 3.00%) at all. There is an improbable, but not impossible chance that a Melbourne Cup Day easing could still occur ... if for example September Quarter inflation prints lower than expected and the next MoM figure does the same. In the history of RBA monetary policy moves since 1991, a pre-Christmas move, and especially in the November month, figures more highly than all other periods. Central Banks have a habit of jawboning. Historically it is often best to pay attention to what they do, not necessarily what they say. Remember the 4th quarter bond rally of 2023 came on the back of continual jawboning by the US Federal Reserve Chairman, Jerome Powell. Maybe Bullock is doing the same.

We suggest policy will be eased eventually, likely by February 2025 at the latest, commencing incrementally with a small (0.25% or 0.35%) move, followed by the expectation of further small moves based upon subsequent positive data releases. The RBA would otherwise be faced with the likelihood of larger cuts down the track as the economy softens further under the weight of retained high policy settings.

MIPS Investment Returns

Average Gross Fund and Individually Managed Portfolio (IMP) performance per Investment Program

Total GROSS Returns to 30 September 2024	1 mth	3 mths	6 mths	6 mths annualised	1 yr p.a.
FIIG Australian Bond Fund	0.37	3.22	2.44	4.94	8.15
Bloomberg AusBond Composite 0+ Yr Index	0.31	3.02	2.16	4.37	7.11
FIIG Australian Bond Fund Excess Return	0.06	0.20	0.28	0.57	1.04

Whilst the RBA has determined (to now) that the evidence is not sufficient to ease the official cash rate, the bond market has, since October 2023 been rallying, with a few steps 'back' along the way. The Investment Management Team has captured the lion's share of the rally, best described by the change in yield for the 10-year Commonwealth Government Bond from a decade high of 5.00% in October 2023.

The IMT wrote, within their June 2024 QR that ..."The RBA is treading carefully, fearful that any early move to ease policy in response to inflationary gains that may not be sustainable may well ignite inflation again" ... but that, despite this, our Investment Strategy application remains consistent, for we will continue to ... "extend duration upon given any price advantage offered by the market, or confidence that inflationary numbers will improve yet again.

The September Quarter saw yields closing 32 basis points lower, reversing the capital losses of the prior quarter significantly. The Bloomberg All Composite Bond Index delivered a 3.02% return for the quarter and the FAB Fund delivered a further 20 basis points (gross) in excess of that.

Summary Outlook

The IMT remains consistently bullish. We expect to extend duration, longer than the benchmark index, as opportunity presents. We forecast the RBA will eventually set the official cash rate lower in response to evidence of lower inflation continuing and would not be surprised to see the official cash rate at 3.25% by EOCY2025. Whilst the bond market has currently priced in an official cash rate of ~3.60%, we suggest once the RBA eases policy the first time, likely now in February 2025^, the market will move to price that rate to move lower again.

^ But not improbable to occur on Melbourne Cup Day (November 5).

Adding to the fray is continuing geopolitical tension.

- Israelis and Palestine, Hamas/Hezbollah, Lebanon and now Iran.
- Russians in Ukraine and continually antagonising NATO
- Trump and Harris and policy differences.
- The possibility of an early (domestic) Federal election.

Yet, political and geopolitical tension will eventually dissipate. Markets have historically taken an initial 'hit' and then recovered. A threat to an oil price rise would negatively impact upon growth and therefore equity markets, and negatively upon inflation and therefore bond markets. Given the expanding theatre of conflict in the Middle East now includes Iran, it is worth noting its position as the sixth largest producer of oil globally and a key member of OPEC. However, the conflict is not necessarily about oil production setbacks. In fact, Iran exports a large proportion of its oil production to China.

The major concern is more about safe passage of oil to global demand via the Persian Gulf. Should we see elevated terrorist activity along transport routes, more likely as a function of the Israeli/Iran conflict, then yes, the current geopolitical tension will likely elevate oil and therefore petroleum prices and that will impact the speed of the fall in inflation, and likely hold bond yields higher in the medium term.

The IMT has determined that current economic evidence warrants a long duration position, and it subsequently expects to extend duration upon given any price advantage offered by the market. However, rather than intending to extend duration 'strategically' and by larger amounts, we are likely to extend 'tactically' and by smaller amounts, because the market has already moved to price a lot in. We envisage that we will continue to 'trade from the long side', but equally envisage that a longer-term outlook for an aggressive rally in long dated bonds will require more convincing evidence that falls in inflation can continue and geopolitical tension will ease.

Performance Commentary

The FAB Fund has delivered significantly high absolute and relative performance, having outperformed its respective index by a significant margin.

- The FAB Fund has delivered an 8.15% gross and 7.53% net in its first full year.

It outperformed the benchmark Bloomberg All Composite Index by 104 basis points (Gross) and 41 points (Net).

The FAB Fund, derived near 100% of duration exposure via exposure to Federal and State Government Bonds. The FAB Fund will commence investing more significantly in Corporate Debt as FUM grows to exceed $50m, whereby it will satisfy diversity scores. Simply put, given that wholesale market parcel sizes are transacted at minimums of $500k, then, given a preferred maximum exposure of 1% of FUM to any singular corporate credit (issue), the manager will require FUM to exceed $50m to satisfy their exposure requirement. The FAB Fund is currently managing $40m of assets.

The FIIG Investment Management Team (IMT)

Extensive and combined experience of in excess of 65 years. Your capital is in safe hands.

Kieran Quaine

Head of Investment Management

Kieran has in excess of 35 years' experience in senior roles in the fixed income market, primarily as a fund manager in charge of investing multiple billions of dollars across a wide and complex range of Investment Mandates. His experience includes roles as a US Investment Bank proprietary interest rate trader, as a debt originator, syndicator and institutional client relationship manager. Kieran has worked at FIIG Securities for over 15 years, including the last 9 years as Head of MIPS, developing the IMA business with Megan Romeo. Kieran has a BA (Accounting) from Canberra University and is a former Chairman of the AFMA Debt Capital Markets Committee.

Megan Romeo

Head of MIPS
Portfolio Manager

Megan has in excess of 15 years' experience in the Asia Pacific fixed income markets. Before joining FIIG in 2015, Megan worked for Standard & Poor's Capital IQ, tailoring technically complex data and algorithm solutions for clients across the Asia Pacific. Megan holds a Bachelor of Science (Hons) in Quantum Physics and a Diploma of Financial Services (Securitisation). Her mathematical and statistical data analysis skillset, and development of trading and allocation algorithms, has been instrumental in the generation high alpha returns within all MIPS products, and the emerging equivalent record for the FIIG Australian Bond Fund.

Garreth Innes

Portfolio Manager

Garreth has over 15 years' of extensive experience in financial markets, including portfolio management roles with multi asset class exposure. He has individually managed significant volumes of capital invested in the fixed income asset class across a complex array of Investment Mandates and has lead teams of analysts and junior managers. Garreth has additionally been a member on Tactical Asset Allocation committees and has successfully launched and managed an Australian Dollar Income Bond Fund for Asian Private Bank clients. Garreth holds a Master's Degree in Finance (UNSW) and is a CFA Charter holder.

FIIG The fixed income experts

FIIG Investment Management Product Suite and Summary Investment Mandate limits.

Unitised Trust Fund opportunities

1. FIIG Australian Bond Fund

Provides investors with exposure to a portfolio of longer maturity Australian IG fixed income securities that are benchmarked to the (near) 5-year long (MD) Bloomberg AusBond Composite 0+Year Index. Suits investors with a longer term (3-5 years) investment horizon, who also seek exposure to the tenor, returns, volatility and income delivered by the Australian Bond market, through exposures that include government, semi government bonds, corporate bonds and asset backed securities. The fund aims to deliver returns in excess of the benchmark, net of fees, over a 3-year rolling period.

Investors should read the PDS via, available via the following link: 62932 FIIG AUSTRALIAN BOND FUND PDS

Minimum investment	$1,000 AUD	**Corporate Debt**	Up to 70%	**Asset Backed Securities**	Up to 30%
Investment Grade	Minimum 100%	**Subordinated Debt**	Up to 30%		

2. FIIG Monthly Income Fund

Provides investors with exposure to a portfolio of shorter maturity floating rate and short dated fixed rate securities that are benchmarked to the Bloomberg AusBond Bank Bill Index. The Investment Mandate includes capacity to invest a maximum of 30% of exposure in NIG debt and carry a 10% exposure to unhedged foreign currency debt. Suits investors with a medium term (3-year) investment horizon. The fund aims to deliver returns in excess of the benchmark, net of fees, over a 3-year rolling period.

Investors should read the PDS via, available via the following link: 63281 FIIG MONTHLY INCOME FUND PDS

Minimum investment	$10,000 AUD	**Investment Grade**	Minimum 70%	**Non-Investment Grade**	Up to 70%

Individually Managed Account (IMA) opportunities

1. MIPS Conservative Income (CVI) Investment Program

Provides investors with exposure to a diversified portfolio of risk averse IG Senior and Subordinate fixed income securities, which additionally produce reliable and regular income that can be distributed or retained for reinvestment.

Number of Bonds	Minimum 10	**Subordinated Debt**	Up to 20%	**FIIG Arranged Bonds**	0%, not allowed
Investment Grade	100%	**Asset Backed Securities**	Up to 20%	**Modified Duration**	Up to 5 years

2. MIPS Income Plus (IP) Investment Program

Provides investors with a potentially higher return than the CVI Program through exposure to a diversified portfolio of both IG and NIG fixed income securities, which additionally produce reliable and regular income that can be distributed or retained for reinvestment.

Number of Bonds	Minimum 10	**Non-Investment Grade**	Up to 20%	**Asset Backed Securities**	Up to 40%
Investment Grade	Minimum 80%	**Subordinated Debt**	Up to 20%	**FIIG Arranged Bonds**	0%, not allowed
				Modified Duration	Up to 5 years

3. MIPS Customised IMA Program

MIPS offers the ability to create a bespoke fixed income portfolio solution for clientele seeking specific key investment objectives, that include, but may not limited to, objectives that can encompass return targets, income distribution, liquidity reliance, credit exposure and duration limitations, diversification minimums and Environmental, Social and Governance (ESG) considerations.

Minimum investment	$10,000,000	**Currency**	Australian dollar	**Management Fee**	Negotiated

ABS: The Investment Programs may contain Asset Backed Securities (ABS) including Residential Mortgage-Backed Securities (RMBS). All ABS generate income from pools of loan receivables that are secured over real assets. They are issued in a Floating Rate Note (FRN) structural form. Please refer to Section 3 of the MIPS Information Memorandum for more detail regarding the parameters of each program.

IMP: Individually Managed Portfolio.

FRN: Floating Rate Notes. Gross performance: Total yield earned per relevant program for period pre management and custody fees.

Investment Grade (IG): An asset is IG if it is rated >= BBB- (S&P) or equivalent by one of three internationally recognised credit rating agencies that include Standard and Poor's (S&P), Moody's or Fitch.

Non Investment Grade (NIG): An asset is NIG if it is rated < BBB- (S&P) or equivalent.

Unrated (UR): An asset is UR if it is not rated by any one of three internationally recognised credit rating agencies.