FIIG | The fixed income experts

Managed Income Portfolio Service (MIPS) Quarterly Report

March 2018

Welcome. This report contains a selection of summary information relevant to the fixed income market, informing readers of the major influences upon the prices of the asset universe from which the MIPS team select exposure, and therefore derive performance, for all customised accounts and the three investment programs under management: Conservative Income, Core Income and Income Plus.

Key Observations

- The US Federal Reserve tightens monetary policy to 1.625%.
- The RBA maintains monetary policy at a record low of 1.50%.
- Bank wholesale funding costs are on the rise.
- Base yield curve volatility is low currently and credit margins appear to have troughed.

Economic Summary and Outlook

Within the United States:

Key developments during the quarter are headlined by the US Federal reserve increasing the official cash rate to a mid-point of 1.625% following their March meeting. This is the sixth increase since the tightening cycle began and even more significant given the concurrent end to quantitative easing. The meeting communications to the broader market disclose the reserve members intentions to tighten two more times in 2018, with the very real possibility that a third hike could occur if one more member had voted in that direction.

Clearly the path of the Federal Reserve is set.

The key drivers are a combination of the current excellent US economic performance and momentum, and the forecast consequences (read inflation) should the 'easy money' of the excessively low interest rate environment have continued as significant employment growth continued. An extended cycle of non-inflationary economic growth is their clear goal. Faced with significant stimulus in the form of tax cuts and spending initiatives approved by congress in late 2017 and early 2018, and a very strong labour market as evidenced by a forecast unemployment rate of 3.60% for year-end 2019, they have chosen to tighten somewhat aggressively.

Their forecast for inflation to hold at near the 2.00% target throughout the cycle is testament to the confidence they have in their monetary policy strategy.

And subsequently, so far, the market would appear to back that confidence. The rise in the US 10 Year Treasury Note yield from the lows of below 1.40% in 2016, to the current ~2.80% (at time of writing) has met resistance to further climbs, having recently peaked during the quarter at ~2.95%.

Within Australia:

Conversely, the Reserve Bank of Australia has noted in their minutes of the April 3rd meeting that a stronger level of economic growth, intimated at GDP above 3.00%, will be required to change a number of outcomes. Firstly, Australia's unemployment rate is stubbornly higher than the optimal sub 5.00% level, and likely not to threaten wages growth and therefore (secondly) have any foreseeable immediate impact upon inflation.

MIPS Investment Returns

The MIPS investment returns net of fees, are contained in the table below. These returns are the averages across all individually managed accounts on an actual basis.

Total NET Returns to 31 March 2018	3 months	6 months	12 months
Income Plus	1.06%	1.93%	3.61%
Core Income	0.71%	1.93%	3.77%
Conservative Income	0.55%	1.82%	2.76%

Thirdly, but no less importantly, the RBA continually acknowledges the high level of gearing of the average household balance sheet, and the subsequent reliance upon real wages growth before debt levels concurrently subside and discretionary expenditure increases.

Subsequently the RBA has retained the official cash rate at a record low of 1.50%. There has now been no monetary policy change for a record 19 moths, the last being the easing in August 2016.

Globally:

Whilst further economic commentary from the Eurozone is relevant, the significance is trumped by geopolitical concerns in two key regions, and for two different reasons.

Firstly the tension in the middle east is mounting and as at time of writing conflict in Syria is real. Historically, conflict of this nature (Iraq and Afghanistan as examples) has delivered a short lived bearish tone to western equity markets with minimal disruption to western interest rate volatility.

Secondly, the growing trade tension between the US and China, and China's bullish infrastructure expenditure in support of maintenance of trade routes, labelled the 'One belt, One road' strategy. In summary, we believe that US tariff policy will have a minor impact, being a micro economic or industry specific impact that is insignificant in comparison to the macro economic effects of cheaper global trade facilitated by massive infrastructure expenditure on trade route development. As I read in a Financial Review headline today: Beijing has a higher trade pain threshold than Washington. We subsequently perceive such activity as bullish for interest rate direction as all other things being equal, it reduces inflation. Globally, consumers will benefit from mass product production and distribution from China.

Key Contributors to March quarter end returns.

All investment programs retained a "short duration" and "long (short dated) credit exposure" position. As evidenced by the minimal change in the shape of the yield curve during the quarter, as shown in Chart 1, duration positioning (i.e. capital gains or losses within the portfolio generated from a rally in base interest rates) contributed minimally to total returns.

March quarter end returns were therefore dominated by, and attributable to, credit exposure that delivered an accrual advantage (a higher rate of return) that was neither increased upon due to a contraction in credit margins or diluted significantly as a function of deteriorating credit margins.

The tale of the tape effectively shows that credit exposure outperformed during the quarter. The BBB index, with a similar tenor length to the Corporate Bond 0-5 year index, outperformed.

The longer duration all maturity index (> 5 years average duration) did not quite match the BBB index.

S&P / ASX Australian Bond Index	Quarter End Return
BBB Rating Band Index	1.10%
(All Maturities & Credit Grade) Fixed Interest Index	0.99%
Bank Bill Index	0.42%
Corporate Bond 0-5 Year Index	0.74%

Interest rate outlook.

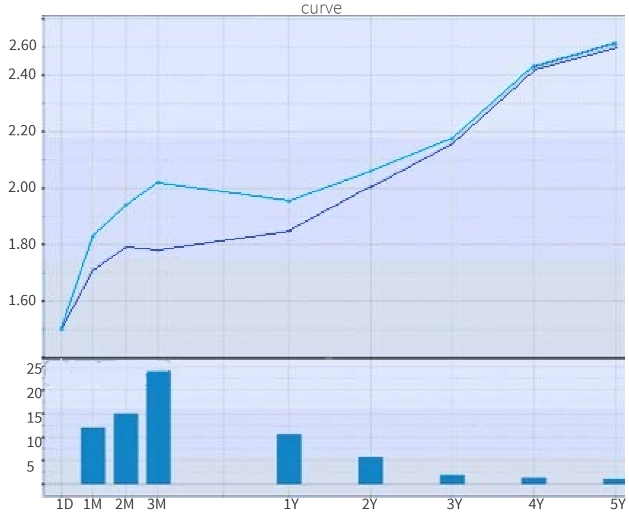
As evidenced by the change in the shape of the Australian yield curve (Chart 1), the market has forecast the next move by the RBA is a tightening. Yields for longer dated product, having predominantly climbed since August 2016, have now stabilised and exhibited low volatility during the quarter. It would appear for many investors and traders that there is not enough clear economic evidence of immediate wage or price pressure to encourage the bond bears, nor would it seem, sufficient evidence in the other direction to encourage bond bulls. Subsequently in response, the longer dated yield curve has been very stable. Volatility has been extremely low.

However, the influence of the US market rate moves is not subsiding. As discussed in our last report, a breakdown in the correlation between the moves in longer dated rates has emerged, as evidenced by the tabled history of the correlation of the 5 year notes.

What is seemingly more important now is the cost of short dated funds in the Australian market climbing significantly during the tail end of the quarter. Three month (90 day) bank bill rates, being where major banks can borrow short term money, have climbed in the order of 0.25% in the quarter. Significantly, banks are now paying close to 2.10%, or 0.60% above official cash, a significant premium not seen for a very long time.

But of additional importance, this increase in the short term base interest rates will increase the running yield of FRN's and reduce the gap between the running yield of FRN's and longer dated (steeper curve) fixed rate assets.

Chart 1 - Quarter on Quarter % change in the Australian Interest Rate Swap yield curve



Source: Bloomberg; Key: X axis = Tenor, Y axis = Mid Price YTM

Note: for the quarter ended March 2018, the short term tenor (3 month bank bills) experienced the largest basis point change in rates on the base Australian interest rate (swap) yield curve.

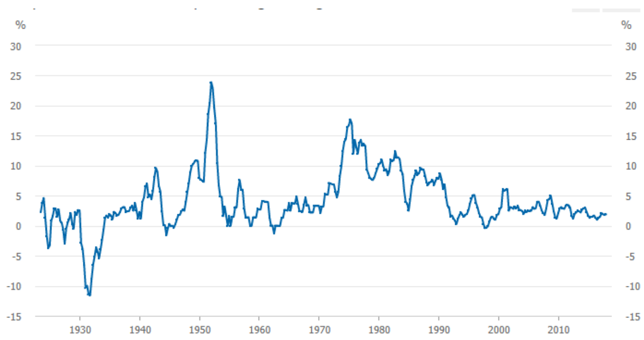
In summary, the MIPS Portfolio Management Team will be extending duration for the first time since August 2016. The economic evidence suggests the RBA will hold monetary policy at the current levels for longer. The next move is still predicted as up, but given the market has priced in a move of significant enough magnitude, and the curve is steep enough to entice investment longer on the curve, duration will be increased. The move will be minimal, probably initially a 0.25% of a year longer, but will be increased on any weakness (higher longer term rates).

Inflation Outlook.

Our inflation expectations in Australia are unchanged this quarter and remain below the lower boundary of the RBA's 2.00-3.00% tolerance and target band. Global economic conditions have improved with manufacturing data continuing to exceed expectations. The RBA has acknowledged in particular in their most recent meetings, that weak domestic and international wage growth will, in the near term, likely keep core inflation low.

The PMT expect inflation will remain at the lower end of the RBA band at near 2.00%, with a gradual pick up as the economy strengthens, but also tow the RBA line, believing it will take a step up in growth to deliver a fall in unemployment first.
As discussed at length in the last quarterly report, significant competitive forces in on-line retail product distribution will benefit consumers with lower prices, but will also be at the detriment of traditional distribution systems, resulting in a future lower trend inflation. Changes in product distribution are continually facilitating cost reduction and the consumer can be expected to continually benefit.

Chart 2- The Year-end percentage change in Consumer Price Inflation



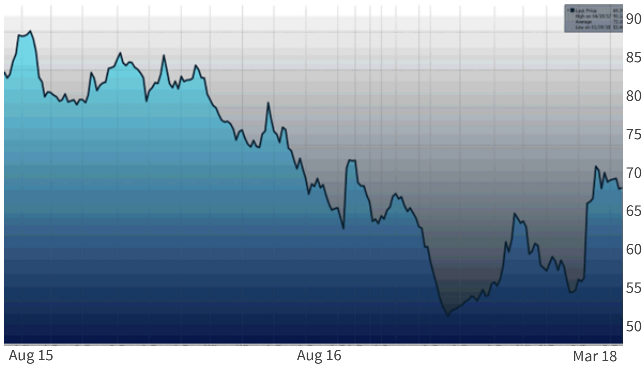
Source: ABS, 31 January 2018

Credit (margin direction) outlook.

The credit margin widening experienced by major banks in the short end is a catalyst for change. And as evidenced by the Chart 3 below, that change has commenced. The lion's share of the lift in bank bill rates above official cash occurred late in the quarter, in March. Not coincidentally, the beginning of the reversal in credit spreads, as evidenced in Chart 3, commenced concurrently over the same period. It has and will subsequently have a widening influence for longer dated and lower rated credit. If banks need pay more margin (excess or higher interest rates above benchmark rates) then those corporations who are funded by the banks, or compete for wholesale funds in the bond market, can expect to pay more if they borrow for longer and/or have lower credit ratings.

Collectively, this move in short term base rates (bank short term credit rates) makes it easier to hold a short duration position and ratifies the choices made for MIPS portfolio construction that comprises a high percentage of FRN's and short dated fixed assets in a diversified list of high quality Investment Grade (IG) and Non-Investment Grade (NIG) credits.

Chart 3 - History of the Australian credit index: 'ITrax' (from August 2015)



Source: Bloomberg, April 2018; Key: X axis = Price, Y axis = Time

In summary, combining both the duration and credit strategy, the PMT will extend portfolio duration in only the highest grade IG assets, given the view that credit spreads are under pressure. Those higher rated assets should outperform lower rated assets in that sector of the yield curve. Otherwise, the predominant credit exposure strategy, especially in the NIG sector, is to hold short dated credit with high accrual advantages.

(Credit) RMBS Strategy:

Our specific and most note-able strategy with regards to credit exposure implementation includes a significant increased exposure (to 20% target in Income Plus) to the Residential Mortgage Bond Sector (RMBS) and junior (lower rated) notes within that sector.

The PMT decreased exposure to IG debt, especially IG subordinated debt that had up to CYE 2017 performed significantly. This freed investment capital to allocate to the RMBS sector.

The PMT are 'bullish' junior RMBS notes despite what some investors might believe are key reasons for under performance. Firstly, credit margins generally, as described above appear under pressure. Secondly there is a high likelihood of significant volume in RMBS to be delivered in 2018 and thirdly, as has been covered infinitum in the press, East Coast Australian residential property is 'overvalued' significantly and is experiencing the first of what many economists believe is the start of a prolonged fall.

The PMT believe the RMBS sector will outperform corporate credit. RMBS margins have lagged the compression in credit that corporates lending in senior and subordinate structural form have benefited from. Additionally, residential mortgage lending standards have improved. Pool diversity and LVR's of course need review for credit approval to meet MIPS investment criteria but standardisation of this process to deliver IG rated outcomes and subordination support are positives.

We suggest that the sector will constantly surprise on the volume upside, and be supported by large funds that will otherwise be earning less investing in corporate unsecured credit as the large increase in migration develops constant demand for more housing.

Bond Market New Issuance – Supportive credit markets.

Corporate issuance continued to be strong. The large volume of new issuance is being met by investor demand for credit and tenor. Key deals include:

- (UR) Pioneer Credit, $40m, 4 year FRN @ +525bps.
- (UR), Zip Co, $20m, 1.13 year FRN @ +600bps.
- (UR) CF Asia Pacific Group, $65m, 2.65 year Fixed @ 8.35% (+618bps).
- Nissan Financial Services, (A), $200m, 3 year Fixed @ 3.06% (+83bps).
- (UR) Elanor Investors, $20m, 4.8 year Fixed @ 7.10% (+450bps).
- Ausnet Services Holdings (A+), $500m, 10.5 year Fixed @ 4.22% (+ 130bps).
- Victoria Power Networks (A-), $225m, 10 year Fixed @ 4.06% (+113bps).
- GPT Wholesale Shopping Centre Fund (A-), $200m, 10 year Fixed @ 4.49% (+160bps).
- (RMBS) Conquest 2018-1 Trust, $400m in tranches A1-D, 30 year amortising FRN @ +1.03bps - +5.74bps.
- (RMBS) National RMBS Trust 2018-1, $2bn in tranches A1-F, 30 year amortising FRN @ +85bps - +5.75bps.

MIPS Investment Strategy

The MIPS programs performed strongly during the quarter – a period that encompassed a stable interest rate curve and slightly stronger credit margins. Key exposure statistics and changes over the March quarter period end include:

Exposure Category by Program	Income Plus		Core Income		Conservative Income		Bank Bond Program 3	
Date Period	31 Dec	31 Mar	31 Dec	31 Mar	31 Dec	31 Mar	31 Dec	31 Mar
Duration (tenor exposure)	1.61	1.88	2.40	2.65	2.20	2.49	0.14	0.14
Investment Grade Senior	28%	22%	92%	92%	81%	81%	53%	70%
Investment Grade Subordinated	12%	17%	0%	0%	19%	19%	47%	30%
Non-Investment Grade & Unrated	60%	61%	8%	8%	0%	0%	0%	0%

Portfolio Management Team

Kieran Quaine

Head of Managed Income Portfolio Services

Kieran has in excess of 30 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 range of investment mandates. His experience includes roles as a proprietary interest rate trader, debt originator, syndicator and institutional debt sales, with his expertise in the unrated market likely unsurpassed. He has been with FIIG securities for 9 years and is the Head of the Managed Income Portfolio Service.

Megan Romeo

Assistant Portfolio Manager

Megan Romeo has over 8 years' experience in financial market data segment with a focus on the Asia Pacific Fixed Income markets. Prior to joining FIIG, Megan was the Valuations Product Manager at S&P Capital IQ which required local Fixed Income market knowledge and a technical understanding of the asset class in order to tailor a Fixed Income market data solution to participants across Asia Pacific.

MIPS Example Portfolios

Conservative Income Investment Program

Investment objective

This program provides a portfolio that only invests in investment grade securities while investing across the capital structure. Like the fundamentals of the fixed income asset class, this portfolio, or program option, aims to provide investors with strong levels of capital preservation and regular income flow.

Investment Program Limits (selection)	Min/Max
Investment Grade	0/100
Sub Investment Grade/Unrated	0/0
Senior Debt	80/100
Subordinated Debt	0/20
FIIG Arranged Bonds	0/25
Number of bonds	10/no max
Modified Duration	0/5

Core Income Investment Program

Investment objective

This program aims to provide a portfolio that is primarily focused on investment grade securities, investing in the most senior parts of the capital structure. Like the fundamentals of the fixed income asset class, this portfolio, or program option, aims to provide investors with strong levels of capital preservation and regular income flow.

Investment Program Limits (selection)	Min/Max
Investment Grade	0/100
Sub Investment Grade/Unrated	0/25
Senior Debt	100/100
Subordinated Debt	0/0
FIIG Arranged Bonds	0/35
Number of bonds	10/no max
Modified Duration	0/7

Income Plus Investment Program

Investment objective

This program aims to increase the investment return through a larger allocation to high yield securities while still retaining the benefits of a fixed income portfolio. This program allows the Portfolio Management team to invest, with more flexibility along the capital structure and credit ratings spectrum. This additional scope allows the team to identify strong risk-returning investments. This is achieved through extensive credit analysis on both the issuer/ guarantor(s) of the bond as well as the security itself

Investment Program Limits (selection)	Min/Max
Investment Grade	0/100
Sub Investment Grade/Unrated	0/75
Senior Debt	80/100
Subordinated Debt	0/20
FIIG Arranged Bonds	0/60
Number of bonds	10/no max
Modified Duration	0/5

Note: The Investment Programs may contain Asset backed securities including Residential Mortgage Bond Securities (RMBS). RMBS are senior secured assets issued in floating rate note form and are an approved investment within MIPS Investment Programs. Please refer to "Section 3" of the Information Memorandum for more detail regarding the parameters of each Investment program.