

BTIM Income
& Fixed Interest



Australian Quarterly Update

April 2018



Tim Hext
Portfolio Manager

Rates Outlook

Whilst Australia is not booming...

It is now a decade since the Bear Stearns collapse of March 2008 and the Global Financial Crisis that ensued shortly after. In Australia the hit of 2008 and early 2009 was short but sharp. Of course we narrowly avoided recession, with massive stimulus here and in China meaning we powered out of the dip.

Australia was a success story, but that success dragged forward our prosperity to relative global levels not seen since the 1950s wool boom. With the Australian dollar reaching \$1.10 in July 2011, wage growth of 4% and unemployment at 5% (the US was at 9%) there was much to crow about. In June 2011 Governor Stevens even said “a proverbial pet-shop galah can by now recite the facts on Australia’s trade with China and our terms of trade, which are at a level not seen in over a century”.

So by 2011 Australia was rich, very rich for its size, with per capita GDP of USD \$67,000.

It is a level that was only surpassed by Luxembourg, Norway, Qatar and Switzerland. Something had to give to restore some semblance of competitiveness and there were two ways this could happen. Fortunately we did not go down the wealth destruction sharp reversal route of the early 1990s and that other countries experienced in 2008/09. Rather we went down the path of let’s stand still and let the rest of the world catch up. Six years later the currency has adjusted to close to long term averages, unemployment is still not far from 5%, there has been no real wage growth and ultimately Australia is in a far more competitive position.

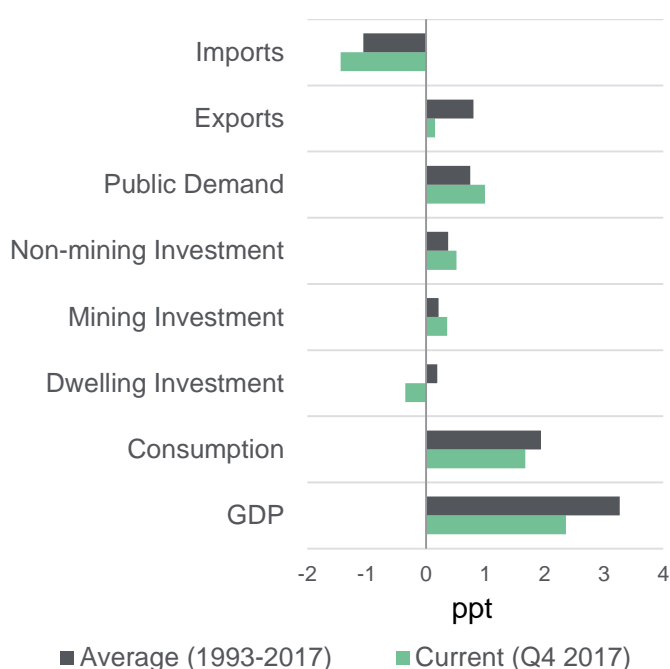
How far we’ve walked down this path of adjustment is crucial to understanding where Australia’s economic and monetary policy settings are heading into the next five years. Will we continue to stand still in real or per capita terms or can productivity improvements drive living standards, and interest rates, higher once again?

It is now reaching more balanced growth

Global economic growth has picked up in the last year. Having dipped to almost 3% in early 2016, it is now pushing 4%, with our major trading partners closer to 4.5%. This has helped Australian GDP hit potential of around 3%. It also contributed to upgrades for consensus growth forecasts last year. As one factor in our economic models, this signalled a bias to higher Australian bond yields. However this has been moderated by more marginal upward revisions in recent forecasts.

Importantly the composition of that 3% is not reliant on very strong numbers in any one particular sector, such as mining investment or housing, which are both roughly flat as visible in chart 1. This puts the economy in a solid position to benefit from a further global upswing.

Chart 1: Growth less dependent on a single sector than in the past



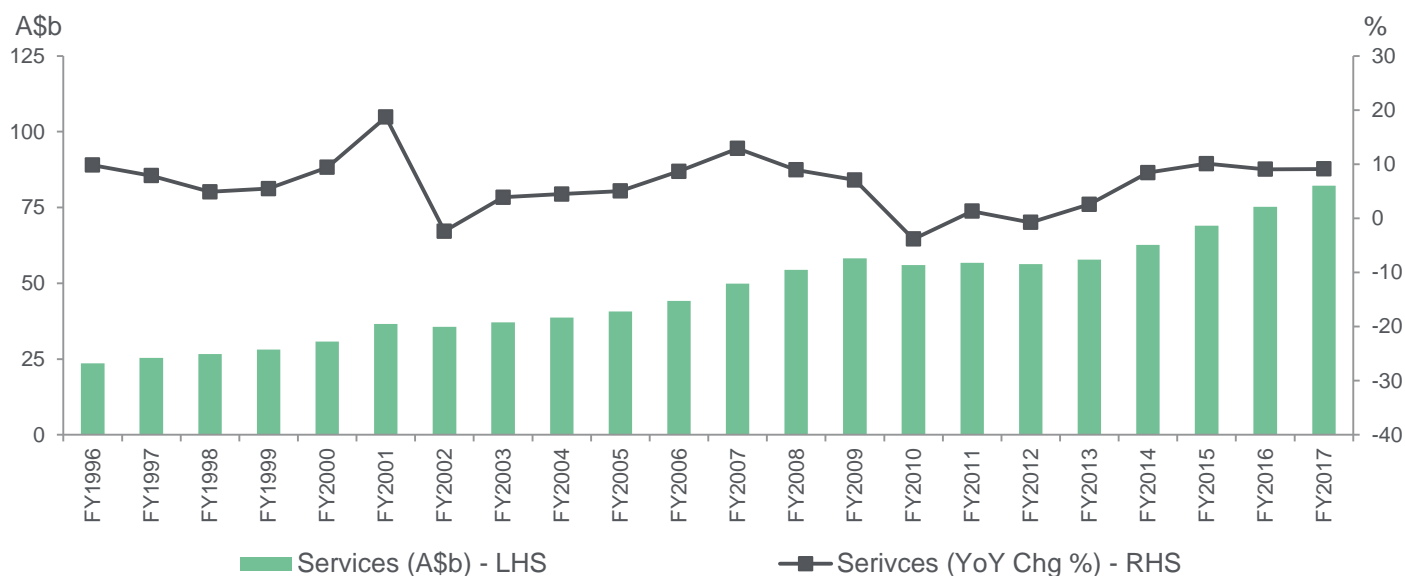
Source: ABS

The more balanced picture suggests there are reasons for optimism that the adjustment is largely over. Non-mining investment was up 9.5% last year and public investment 12.9%. Both are catching up from a long period of underinvestment and are likely to stay strong. This provided a strong tailwind for Australian state budgets, which saw us overweight semis (mainly Western Australia) through 2017. However, global credit concerns caused us to reduce exposure to a neutral level in January.

Consumption is unlikely to rebound strongly but should be able to keep pace with wage growth, a bit above 2%. The more encouraging story is the boom in service exports, which have added around 0.5% to GDP. As illustrated in chart 2, service exports have been growing at around 10% every year for the last four years, with no signs of slowing. This will put service exports near \$100bn by 2020. China, which accounts for a third of our goods exports, now also makes up a quarter of our travel services exports and is climbing fast.

Tourism and education exports combined are now almost the size of iron ore exports, and more importantly have a far higher requirement for labour.

Chart 2: Services growth a bright spot



Source: ABS

The RBA now more science than art

So given an economy at potential GDP (estimated to be around 3%) why does the RBA have its cash rate 2% below its neutral rate of 3.5%? The short answer is that excess labour means benign wage growth. Also a low inflation rate, driven by tradeables, allows them to sit tight.

As such, while our economic and market models have suggested a more constructive economic growth outlook over the past year, our rates view has been balanced by expectations for persistent subdued inflation. This has been reflected in our inflation models that have suggested low inflation will remain in the near-term. It has also influenced our bias to take on little inflation risk in our portfolios.

The low inflation picture is similar to the one faced by the Federal Reserve in 2013-15. For the US Federal Reserve moving rates off historic lows was a very drawn out event. After the false start of the taper tantrum in 2013, the Fed adopted a data driven path towards higher rates. Lift off finally happened in December 2015 with another whole year before the second rate hike. All through this period the Fed spoke of being gradual and data dependent. The hurdle rate was high, despite many accusing the Fed of falling behind the curve.

The RBA would never publicly comment on the Fed, but Governor Stevens words of 2010 that “it is important that monetary policy not overstay a very expansionary setting once it was clear that the danger of a really serious downturn in economic activity has passed” (Opening Statement to House Economics Committee, November 2010) means they were likely surprised by the Fed’s caution.

So now its 2018, the Australian economy is doing well, the Fed is consistently raising rates but the RBA is on hold. So where was the level where the Fed finally thought unemployment was low enough to start hiking? By December 2015 US unemployment had reached 5%. This is also the current RBA estimate of full employment, albeit with caveat it may be lower. Of course now the US economy is through full employment, rates are rising more regularly but with low inflation there is still caution.

Assistant RBA Governor Luci Ellis said in September 2017 that “waiting until you are 100 per cent sure things have changed means waiting too long”. However, the RBA seems happy to wait a long time until the case is very clear. Like the Fed in 2013-15 there is clearly no room in this rate cycle for the RBA being pre-emptive. The right direction is encouraging but clear evidence and hitting targets is needed. Better to be cautious as you can always play catch up later. It is a central bank focused on science, not art and as investors we must take note.

Combining Quant & Qual

Our models primarily use forward-looking activity data to generate rate signals. For Australia, the NAB Business survey is historically the most important signal. However, the RBA's greater emphasis on employment indicators has reinforced the importance of our qualitative view and the value from using our judgement based on years of experience, rather than being reliant purely on our quantitative models.

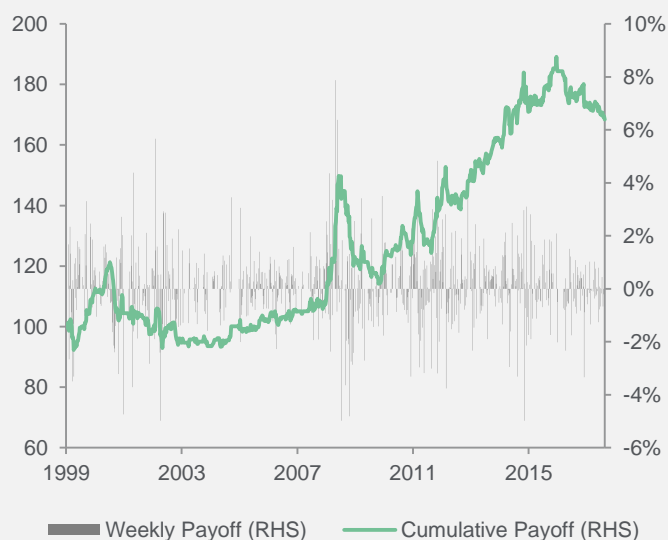
To this point, alongside the swings in its components, our long-term Australian rates fundamental model has demonstrated below average performance over the past year. This is illustrated in the chart below. In contrast, its US counterpart has more consistently pointed to higher rates and has enjoyed much stronger performance.

Charts 3 & 4: Our Australian rates model has offered mixed signals over the past year

10Y Signals



Cumulative Payoff



Unemployment not the full story

Of all the labour market indicators we must follow, unemployment is arguably the most important. The number of jobs created is crucial, but so is the participation rate. As we discovered in 2017 you can have very strong job growth (almost 400,000 jobs and three quarters of them full time) but if that demand is met by new supply, whether its immigration or new domestic workplace entrants, the unemployment rate may not shift.

Chart 5: Higher participation limiting unemployment rate decline



Source: Bloomberg

Without the surge in the participation rate in 2017, we would currently be around the RBA target of 5%. Also employers may have needed to bid up wages to attract those already in the workforce. The rising participation rate contrasts with the US recent experience where participation rates are near four decade lows, pushing the unemployment rate lower with strong employment.

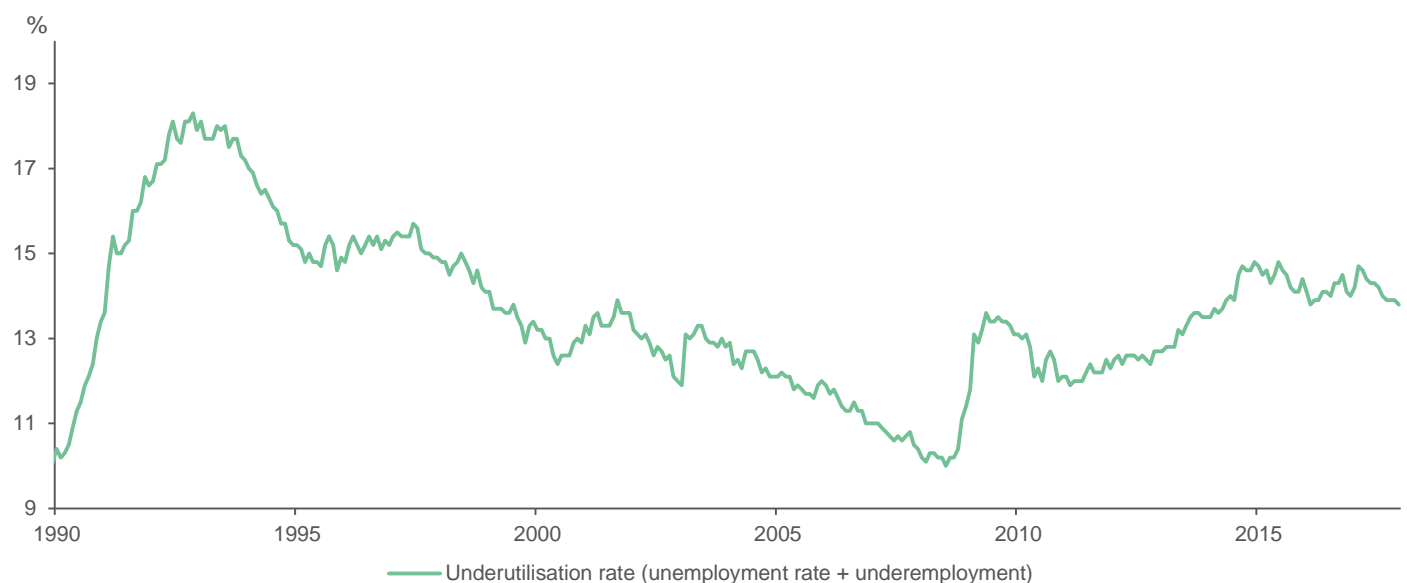
In Australia the surge in participation has been broad based, as potential workers have been encouraged by the surge in employment. As demonstrated in chart 5, a falling unemployment rate generally lifts participation but recently it has been stronger than historic

relationships suggest. Of course this is overall a good thing, but existing workers do lose their pricing power that a shortage of workers might bring. The RBA in their own forecasts have GDP growth of 3.5% by mid-2019 but unemployment only falling to 5.25%. They anticipate the increase in employment will again be met by an increased pool of labour, meaning improved economic prospects will not translate to significantly higher wages. Capital rather than labour will again be the primary beneficiary of strong growth. The RBA also doesn't expect inflation to move above 2% till 2020. It all adds up to a central bank firmly on hold.

What could get unemployment down to 5%?

There are many things to watch when trying to get a handle on employment. Forward indicators such as the NAB Monthly Business Survey suggest the employment outlook remains healthy. There are pockets of labour shortages appearing in IT and the project management sides of construction. As presented in chart 6, the Labour underutilisation rate (unemployment plus underemployment), the rise of which was mentioned by the RBA as one reason for tepid wage growth, has been falling, but not very fast.

Chart 6: Underutilisation remains elevated



Source: Bloomberg

The simple maths of it shows that to get to 5% unemployment this year, assuming an unchanged participation rate and 1.5% working population growth, we need to create around 65,000 jobs for the current unemployed (i.e. 10% of the current unemployed find jobs) and around 200,000 jobs for new entrants. Jobs growth of 265,000 a year, or 22,000 a month, is achievable, as 2017 showed. In fact the NAB survey suggests this will occur. The RBA is also looking for around this pace but also forecasts that the participation rate will continue to climb, hence their forecast of a 5.25% unemployment rate with still some spare capacity in the labour market.

The real test for the RBA will come if we were to get near 5% later this year with inflation and wages around current levels. Then the decision whether to hike or not will likely be swayed by other considerations, such as the currency, global rates and the performance of housing. Perhaps then it will again become part art, part science.

What this all means for rates

Our view of no rate change this year remains, but it is one which needs close watching. As indicated earlier our Australian fundamental models have indicated a stronger growth outlook with the potential for higher yields; however, our inflation scorecard and qualitative view suggests rates at the short end will be relatively contained. In contrast, the global picture gives us greater conviction for higher rates in economies like the US, which may lead Australian rates more at the long end.

As such, our bias is to buy short end duration on any good selloffs given our domestic outlook and sell long end duration on any good rallies given our global outlook. We will be keeping a close eye on any signs that the RBA may need to question their outlook sooner than expected. Also, as happens from time to time, global events can overwhelm our open economy. Given we expect the US to remain strong but China and Europe to weaken the global risks are not all one way.

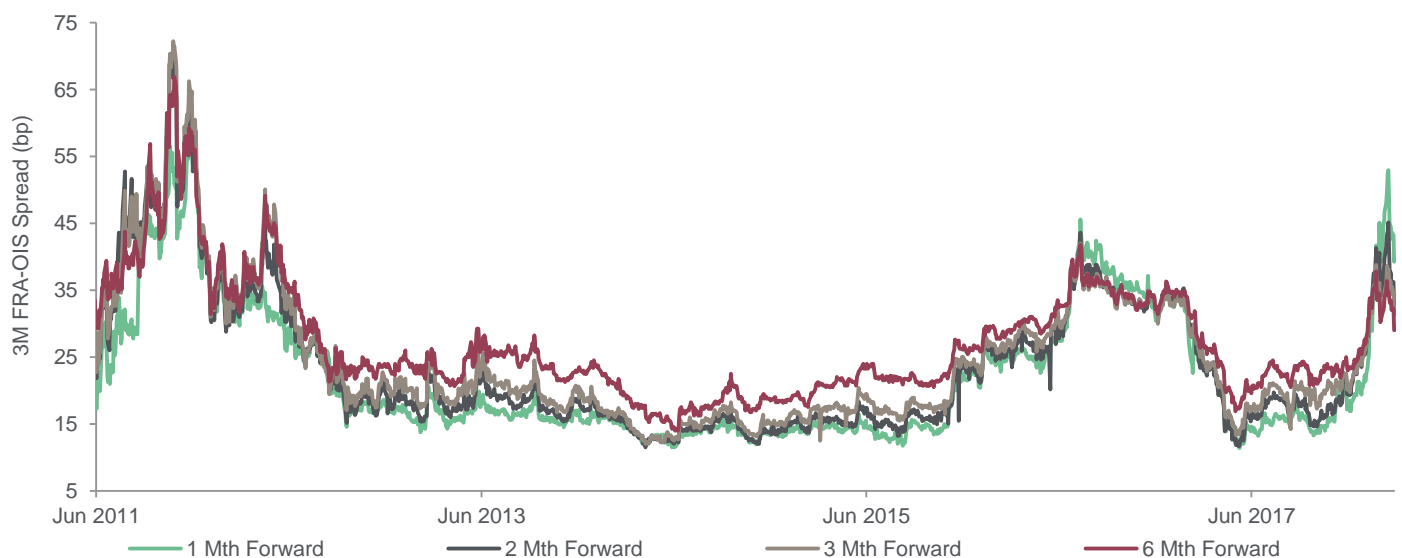


Steve Campbell
Portfolio Manager

Cash Markets

With the RBA likely to remain on hold for some time, one would expect the Australian bank bill market to be quiet. This has certainly not been the case! Developments in the US market are driving moves domestically, resulting in bank bill yields selling off and the curve steepening. So what has happened in the US? The following graph shows the spread between 3 month Forward Rate Agreement (FRA) and overnight index swaps (OIS) of various tenors. The graph below shows spreads since the Eurozone debt crisis. Two episodes caused sharp widening. In late 2011 it was credit concerns due to deteriorating European bank credit. In 2016 it was money market reforms in the US affected spreads.

Chart 7: Spreads at the short end have spiked to the highest since the Eurozone debt crisis



Source: Bloomberg

The recent move wider has been predominately driven by a tidal wave of US Treasury bill issuance with US\$300bn of issuance expected in the first quarter (the repatriation tax and base erosion & anti-abuse tax will also have an effect – but that is a subject for another day). This supply is providing short term investors with additional options on where to invest their cash.

It is also putting pressure on US commercial paper issuers, which include the Australian banks, who now face additional competition when it comes to sourcing funding. The only real response they have against this increase in supply is to cheapen their price if they want to maintain US short term funding.

The other option available is using alternate markets – if the US market is proving too expensive for Australian banks they can issue more in the Australian market. This also comes at an increasing cost for the banks; however, it may relatively look more attractive than the US commercial paper market currently.

Bank bill yields in Australia have risen at the same time as the FRA/OIS spread has widened in the US with 6 month BBSW rising from a low of 1.895% in early February to 2.16% in early April. Short term yields are likely to remain elevated in the near-term.

Chart 8: Opportunities from a higher and steeper front-end curve



Source: Bloomberg

This move is providing our cash funds with increasing opportunities to increase returns. Not only are yields higher but the curve is also steeper. The following graph shows annualised one month holding returns across various tenors on the yield curve.

In turn, the developments in the US market have provided Australian cash investors with an opportunity to increase the return on their Australian dollar denominated investments.

This opportunity can only be monetised however by investing in highly liquid securities such as negotiable certificates of deposit (NCDs).

It is why we avoid illiquid securities such as term deposits – cash should represent the most liquid holding of anyone's portfolio so that opportunities, be it in cash or other asset classes, can be taken advantage of. You can't pay for these with a term deposit that matures at some point in the future.



George Bishay
Portfolio Manager

Credit Markets

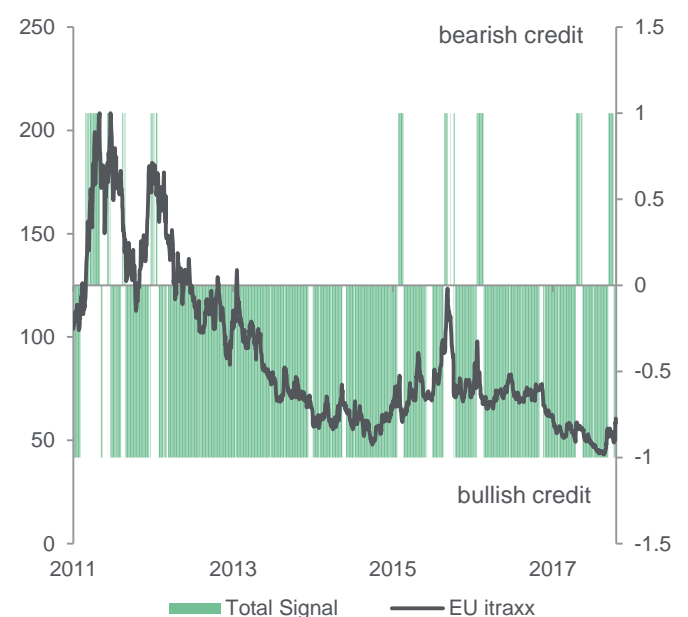
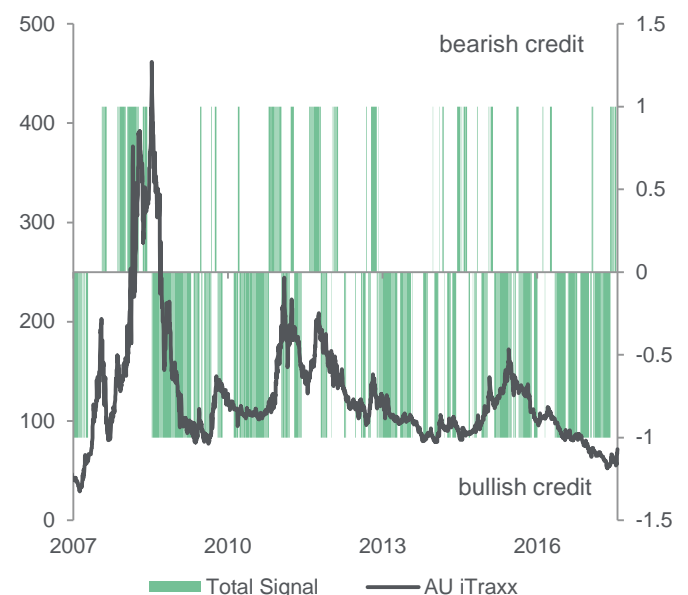
We have moved to a neutral stance on Australian investment grade credit

Our composite funds and enhanced cash moved to a neutral stance on investment grade credit (IG) at the start of February after being positive for a number of years. A number of the positive tailwinds are becoming less clear, with monetary stimulus being removed globally and signs of inflation and wage growth, at least in the US. We believe this concern over where inflation is moving will continue to see volatility in rates and equity markets in the near term.

Concerns around levered corporates in the high yield space having to pay higher interest rates in the future will pressure corporate profitability and credit metrics. This in turn should drive credit spreads wider. We believe investment grade will outperform high yield but credit spreads will also be pushed wider. The risk reward that so often favours being overweight investment grade credit is no longer there in the near-term. Trade war developments add to our concerns here.

Our quantitative credit model scorecards, which use economic and market data factors to give a bias for future market directions, have also recently shifted from a bullish to a more neutral bias for investment grade credit. This has been echoed in our technical analysis scorecard signals that have turned bearish.

Charts 9 & 10: Our fundamental signals have shifted

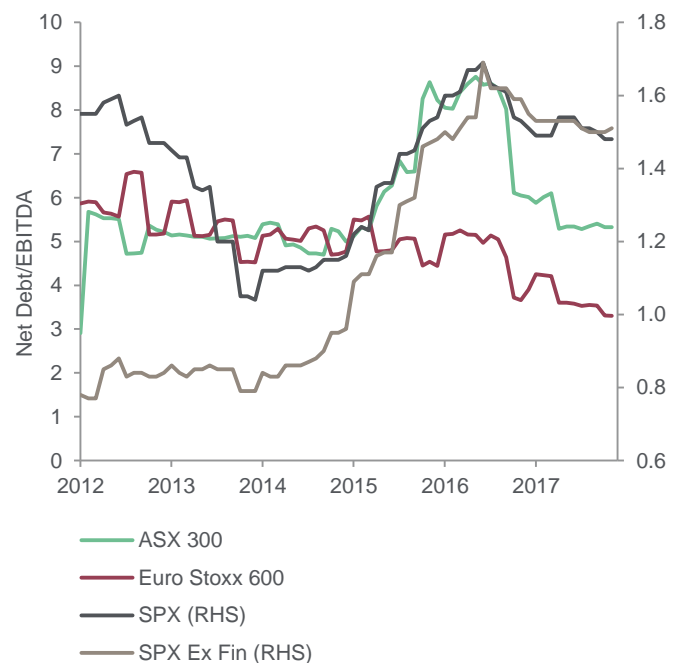
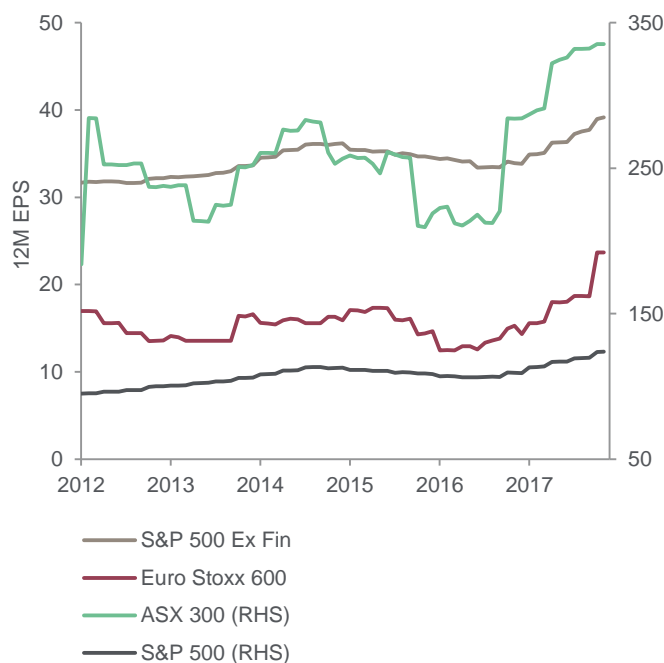


Source: BTIM

However, given the extended period of low inflation in the US, it's difficult to determine when and to what extent inflation will rise and the impact on bond yields and corporate interest expenses/ability to refinance. Given this uncertainty we prefer to be neutral investment grade credit whilst waiting for more economic data for direction.

Increasing volatility remains a significant negative for credit. However at the same time, corporate fundamentals we regularly monitor remain healthy as illustrated in the charts below. Balance sheets are strong and earnings growth is positive. This balances the perceived risks and for now warrants a neutral stance.

Charts 11 & 12: Corporate fundamentals remain healthy



Source: Bloomberg

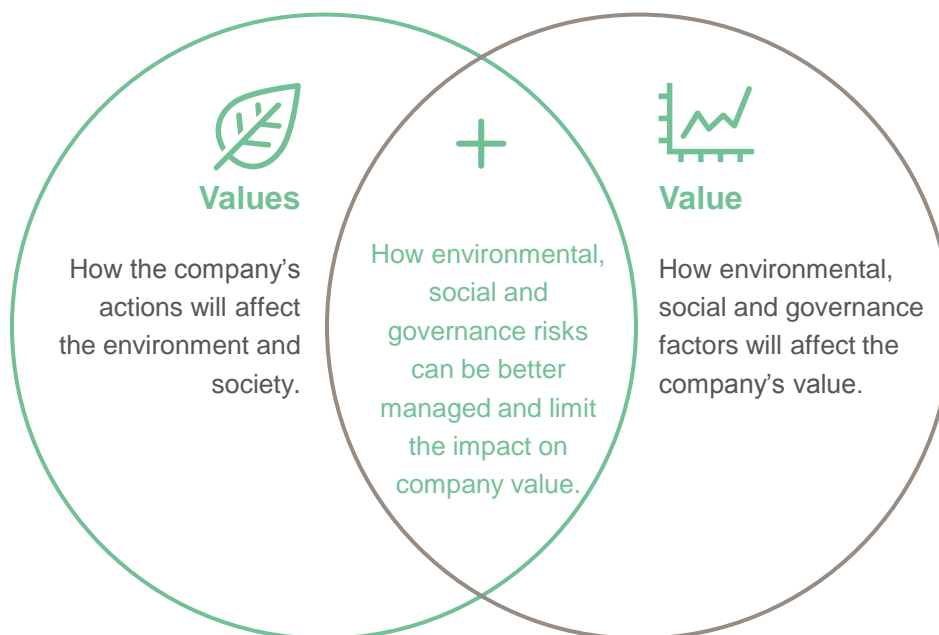


Edwina Matthew
Head of Responsible Investments

ESG

Values v Value

Last year saw significant momentum building around the question of sustainable investments and ESG (Environmental, Social and Governance) criteria. Clearly investors are asking the custodians of their money what, if any, process is there for incorporating ESG into investment decisions. This increased focus is welcomed as an increased awareness of good ESG outcomes at the corporate and investor level can lead to better outcomes for investors and society. BTIM is playing its part by making sure ESG metrics are a regular part of discussions with issuers and form part of the framework for analysing securities that we invest in across all funds.



Source: BTIM

However, there are a number of participants interchanging different concepts in this space. This comes down to whether ESG Values are driving investment, or ESG is only driving value. When asking about ESG, investors should be clear about where they would like to be on the spectrum.

At the Values end of the spectrum is ethical investing, whereby ESG factors provide a hard screen on industries or investments. Different investors request screening different industries or activities depending on their ethical outlook. All companies in these sectors will have a permanent screen.

In the middle of the ESG spectrum are the sustainable funds BTIM runs. These funds have some hard screens, but less than a typical ethical fund. The ESG focus becomes partly Values and partly Value. A company is judged on whether it is exhibiting best of breed behaviour in regard to ESG practices within their industry. BTIM uses Regnan (for ASX 200 listed companies) and MSCI to assist in this process, with a number of companies screened out due to poor ESG practices. Where these poor practices are addressed the screens can be lifted. This process provides a robust foundation for discussion of ESG best practice with companies and seeks to have a positive impact on their behaviour.

At the other end of the ESG spectrum, and the majority of funds who claim they are ESG focused, is where it is used purely for value. ESG metrics are taken into account where these considerations have an effect on financial performance of the asset. Companies should aspire to good ESG practices because it is good for their performance. For example poor governance is a negative for asset price performance and therefore a factor in any analysis.

If an asset is in an industry under increasing regulatory scrutiny, that is also relevant. However, where ESG considerations may have caused an asset to be sold off too heavily they can also lead to buying opportunities. Therefore poor ESG is in itself not a reason to avoid an asset but rather a factor in valuation. So when investors ask for proof of ESG considerations in investing it is a matter of formalising a process of metrics that should already be taking place.

Finally, we are often asked the question that whilst Sustainable Funds are a good thing does the more limited opportunity set mean potentially lower performance? This belief means many investors want to be seen to be ESG focused, asking for proof of consideration of ESG metrics, but not at a cost. The answer to this long and much asked question is frequently debated. It rests on the question of whether the negative of a more limited opportunity set is outweighed by the eligible assets exhibiting stronger corporate responsibility and therefore longer term improved financial performance. Our experience suggests doing good and good performance can exist together.

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