Antares Inflation Linked Bond Fund

Monthly Investment Report
February 2024

Fund Performance

Period Ended 29/02/2024	1 Mth %	3 Mths %	1 Yr %	3 Yrs %	5 Yrs %	7 Yrs %	Since Inception %pa[1]
Portfolio	-0.182	2.25	5.27	2.32	2.84	2.95	3.82
Bloomberg Govt Inflation Index 0-10	-0.104	2.42	5.23	2.20	2.67	2.80	3.68
Difference	-0.078	-0.16	0.04	0.12	0.16	0.15	0.14

Valuation at month end was $31.40M
Portfolio returns are expressed before investment management fees and taxes; The difference in returns between the Fund and the benchmark may be out due to rounding.
1. Since Inception 07/06/2011

Expected Return Objective

The Antares Inflation Linked Bond Fund aims to outperform (before fees) the Bloomberg AusBond Inflation Government 0-10 Yr Index over an interest rate cycle.

Portfolio Review

The portfolio generated a -0.18% return for the month, with the annual rate moderating to 5.27%. The excess return for the month was -7.8bps. The portfolio continued to see a reduction in short real rate duration relative to its benchmark.

The portfolio ran a long barbell positioning (long the short and long end bonds and short the belly), which led to a performance drag resulting primarily from the underperformance of the ix25s.

Attribution:

- BEI: -2bps (-4bps BEI x 0.2yr long)
  Curve: -1bps (-5bps x 0.2mdc)
- Duration: -3bps (c.3bps rally x 0.2yrs delta adjusted short duration)
- T costs: 2bps tracking error between index and portfolio price sources

Key Characteristics at 29/02/2024

	Fund	Benchmark
Real Interest Rate Duration (yrs)	4.01	4.12
Active Nominal Duration	+0.09	-
Running Yield (Real %)	1.38	1.22
Semi Spread Duration (yrs)	0.69	0.31
Weighted Avg Credit Rating	AAA	AAA

Excess Return Attribution

Description	Dec BPs	Jan BPs	Feb BPs
Duration	-6.0	3.0	**-3**
Curve	-8.0	2.0	**-1**
Sector	-	-	**-**
BEI	-	3.0	**-2**
ZCS	-	-	**-**
Yield Enhancement	-	-	**-**
CPI Accrual	-	-	**-**
Other (t-costs, pricing tracking error)	-3.0	-	**-2**
Total	-17.0	8.0	**-8**

Portfolio Strategy and Positioning

Following limited supply of government bonds over December and January, issuance picked up in February in both nominal and linker issuance. The hiatus in linker issuance was particularly notable, with the market coming under immense strain with little broker inventory to meet ongoing demand. The AOFM issued $150m of ACGB 2050s, which was preceded by the 2040s.

Like earlier tenders, the 2050 tender introduced material duration into the market, with strong demand evident with bids coming 2-3bps inside. In the end, the 2050 was issued at an approximate yield of 1.90%, equating to a BEI of 2.47%.

Supporting the AOFM's decision to issue in the long end has been strong demand for long end real yields, with the real curve flattening from ix25s onward. The longer dated bonds rallied approximately 10bps over the month, while the ix27s rallied approximately 5bps. The flattening in the real rate curve owes itself to several factors including, most notably the disinflation impulse currently running through the domestic economy.

With moderating domestic inflation, the carry provided by shorter dated bonds reduces, helping to compress the spread between the ix25/ix50. This spread narrowed over the month by more than 10bps with yields on the respective bonds moving in the opposite direction over the month.

After very strong carry in 2023, total running returns (inflation + real yield) remain elevated despite the softer Q423 CPI. Our expectation is for running returns to stay strong into 2H24, with returns of 5.1% expected for the first part of the year. Currently, this comprises a 10y real yield of 1.55% and inflation accrual of 3.55% paid from Feb-May. In 2H24 running returns are expected to moderate in line with further moderation in inflation.

A drop-off in the inflation accrual rate is also likely given the rolling-off of larger CPI numbers. It should be noted that the RBA is forecasting inflation of 3.2% for 2024, with risks around this forecast. The global evidence more recently points to fading goods disinflation and continued stickiness of services inflation.

Weaker economic growth and particularly softer domestic household consumption provide some cause for inflation optimism on the domestic front. In per capita terms, Q423 GDP declined while sequential growth for the quarter rose 0.2%. Growth continues to be underpinned by government spending, strong net export performance, and some improvement in capital investment.

Improving capital investment outside of the mining sector is viewed as a positive development for productivity, with marginal gains in productivity evident in the last GDP report. However, improvements to labour productivity are coming mainly from lower working hours as the unemployment rate inches up further.

Some relief from the tightness in the labour market should be welcome. The productivity improvement has been accompanied by further rises in unit labour costs, which highlights the RBA's inflation challenge. This risk speaks to flattening pressure on the nominal curve, which also supports the flattening trade in the real yield curve.

In line with the dissipating inflation, short tenor BEIs have pulled back from their previous highs. The ix25 BEI fell 18bps over the month to 2.49% after having reached 3.1% as recently as November 2023. Longer tenors have also seen BEIs fall, with the 10yr BEI grinding 4bps lower over the month to 2.50%. The long end continues to remain well anchored, with little prospect of a breakout of BEIs in the near term. Nevertheless, long BEI positioning is justified given the tension between (weaker) growth and elevated inflation and the likelihood that the peak in financial conditions is behind us.

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Market Review

Bond yields rose in February off the back of stronger than expected economic data and central banks pushing back on market pricing of rate cuts for 2024. Various Fed members highlighted the need for caution and patience to have more confidence that target inflation would be achieved and sustained before easing monetary policy.

The US economy continued to show resilience, with economic data largely surprising to the upside. Labour market, productivity, home sales, ISM manufacturing, services, and prices paid data all printed stronger than expected. Markets responded by paring back rate cut expectations from 5.8 rate cuts at the end of January to 3.4 cuts by the end of February to be more in line with the Fed's DOTS plot projections of 3 rate cuts for 2024.

The Australian economy is showing signs of slowing, with softer economic data over the month from building approvals, retail sales, and the labour market. Markets responded by paring back rate cut expectations from around 2.5 cuts at the end of January to around 1.7 cuts at the end of the month.

Macro Outlook

For a while now, markets and central banks have been diametrically opposed in their rate cut expectations, with markets pricing in rapid rate cuts and central banks being cautious and hawkish around their forward guidance. This month, that changed.

Markets pared back their rate cut expectations to be more in line with central banks in recognition of the risks around a goldilocks outcome. There are risks on both sides of that outcome, and markets are struggling to form a directional view right now.

The longer central banks wait to start rate cuts, the higher the risk of a negative growth outcome. There is evidence that the Australian economy is starting to slow, but the RBA still needs to see more evidence of inflation coming back towards target before easing.

Conversely, the US economy continues to show resilience and provides little reason for the Fed to pivot to an imminent easing cycle, especially if reinflation risks increase.

As inflation moves closer to target, it will also get more difficult for central banks. The disinflation trend to date has largely been driven by supply chains normalisation and base effects. The hardest challenge lies ahead to reign in sticky services inflation and to ensure unit labour costs are maintained.

If market's aggressive rate cut expectations have contributed to the economic resilience we have seen, then perhaps the recent paring back of those expectations may start to feed into a slower economic outlook ahead.

Antares Scenario Analysis

The Antares Scenarios table reflects the interplay between growth, inflation, and bond yields, and how they will drive the level and shape of yield curves in the different scenarios.

Antares Scenarios - Growth & Inflation - Latest Market Yields

	Scenarios	AU GDP	AU Inflation	1YR	AU 3YR Bond	AU 5YR Bond	AU 10YR Bond	AU 30YR Bond	US 10YR Bond	iTraxx	Probability Weighting
1	Strong Growth	5.00%	4.50%	6.53%	6.98%	7.43%	7.88%	8.38%	7.88%	150	0%
2	Above Trend	4.00%	3.50%	5.22%	5.28%	5.79%	5.91%	6.41%	6.13%	151	4%
3	Trend	3.00%	2.50%	3.50%	4.00%	4.39%	4.54%	5.04%	4.25%	152	24%
4	Below Trend	1.50%	1.50%	2.03%	2.30%	2.40%	2.63%	2.93%	2.40%	153	28%
5	Recession	-2.00%	0.50%	1.25%	1.50%	1.75%	2.25%	2.75%	2.00%	154	12%
6a	Stagflation Light...Growth & employment softens but inflation sticky	1.50%	3.50%	4.55%	4.55%	4.73%	4.90%	5.20%	5.44%	155	26%
6b	Stagflation...Growth & employment fall sharply but inflation still elevated	-1.50%	3.25%	3.25%	3.58%	3.90%	4.23%	4.73%	4.23%	156	6%
	Market Yield Latest	15/03/2024		4.15%	3.74%	3.79%	4.13%	4.51%	4.28%	60.6	

In February, Antares continued to reallocate probability weighting away from Antares' "Stagflation Scenario" (6b) which has negative/recessionary growth but still elevated inflation.

The resilience in the economic data seen in January and February, particularly in the US, has seen Antares probability assessment shift towards Antares' "Trend Scenario" (3) and Antares' "Below Trend Scenario" (4).

Currently Antares probability assessment is equally distributed across three key Antares' scenarios being:
3) Trend – with both growth and inflation tracking towards longer term averages,
4) Below Trend – with both growth and inflation tracking below longer-term averages, and
6a) Stagflation Light – with growth being below trend but inflation still being elevated, i.e., the disinflation trend seen in late 2023 stalls.

Interest Rate & Inflation Outlook

Real yields continued to bear flatten through February following a disappointing Q4CPI print and growing expectations for a new syndicated line. As Australia currently experiences a disinflationary impulse while US inflation surprises to the upside (again), the 10y BEI spread between the two markets continues to compress.

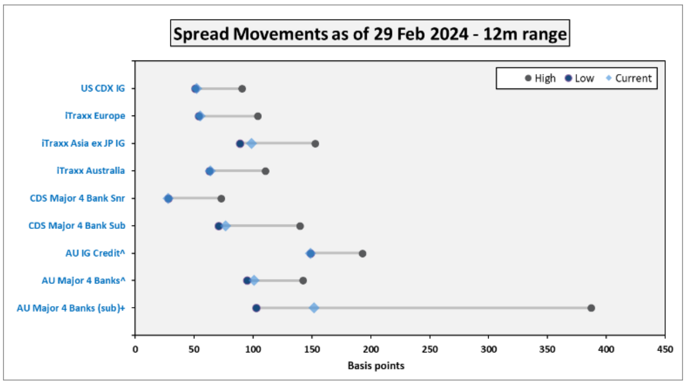
A similar theme has been evident with the outperformance of Aussie nominal yields relative to US bonds, with the latter experiencing a run of positive economic surprises.

More positive economic data in the US may have been buoyed by the Fed's pivot in December. Expectations for Fed cuts have since been pared back significantly, with a little over 3 cuts now expected in 2024. The flow of economic news in Australia stands in contrast to the US, although the domestic economy remains resilient enough to ensure rate cuts are unlikely for the foreseeable future.

Credit Outlook

Credit spreads remained resilient in February despite a continued large volume of primary market supply. Major investment grade indices and synthetic indices were mostly unchanged, while US high yield credit spreads moderately narrowed from already tight levels. There has been a record amount of money flowing into US Investment Grade debt, which is supporting the resilience being seen in credit spreads globally. The markets consensus in a soft landing is supporting this flow. Some of the flow is driven by capital leaving emerging markets due to a loss of investor confidence in the Chinese economy.

The Australian credit market has also been functioning well and absorbing many primary issuances without pressuring credit spreads wider. February was the interim reporting season for Australian corporates, who, on average, reported a resilient result with moderate revenue expansion and flat earnings growth, reversing the negative growth trend experienced in the previous interim. Non-discretionary consumer segments such as supermarkets and insurers did particularly well, expanding both revenue and profit margins.



ESG

Worley Ltd (ASX: WOR) was accused of making a bribe to the Ecuadorian government during a recent tribunal over a contract dispute, and the company had previously not disclosed this issue to the ASX. The company subsequently made public announcements defending its position and denied any corruption or illegality. The individual being accused of bribery was a Worley's subcontractor and Worley has claimed it strictly followed its proper processes and due diligence. When the news came out, we had an internal debate and concluded not to take pre-emptive portfolio actions without further engaging the company. Whilst the incident rings an alarm bell for a potential governance failure, it is difficult at this stage to determine if Worley had participated in a corrupt act or if its internal controls and due diligence processes are weak, noting they do operate in Emerging Markets (EMs). From a credit risk perspective, at this stage, we do not think this issue will have a material impact on Worley given the company is highly diversified across a large number of projects and countries, and noting, EM countries only to constitute a minor part of its operations.

When we first acquired bonds issued by Worley, we were aware that the company operated in many EM countries and that these countries typically have higher exposure to corruption, human rights issues, geopolitical tensions, and sanction risks. We thus assigned a 'moderate' risk score to Worley's ESG score. We continue to monitor and currently accept the EM-related risks for Worley given the company derives only a small portion of revenue from these countries does not have large amounts of capital invested in EM countries. Currently, only portfolios with higher risk/return credit appetite have exposure to Worley. We will continue to monitor and investigate the above issue that has been raised but at this stage do not intend to undertake any immediate action regarding our bond exposure to Worley.

About Antares Fixed Income

Antares Fixed Income (Antares) is a specialist fixed interest manager covering a range of domestic and international securities. Antares has managed fixed interest and cash portfolios for investors since 1990 and currently has over A$25.67 billion* in funds under management across a range of cash management, fixed income and liability driven investment strategies. Antares is focused on delivering performance objectives for our clients within a carefully managed and defined risk framework.

*as at 30 June 2023

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