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Managed Income Portfolio Service (MIPS)

Interim Update – December 2018 & extended update – February 2019

Welcome. This report is the completed report for MIPS investors following the abridged update in December 18. Detailed publication of quarterly reports will resume in March. The report contains a snapshot of information relevant to the fixed income markets and the major influences impacting the price of the assets and the performance of our portfolios.

MIPS Investment Returns

The average gross returns for MIPS Investment Programs are contained in the table below.

Table 1: Gross returns to 31st December 2018

Total Gross Returns to 31 December 2018	3 months	6 months	1 year	2 years Annualised
Income Plus	1.47%	2.45%	4.67%	5.19%
Core Income	1.09%	2.01%	3.68%	4.82%
Conservative Income	1.20%	1.98%	3.54%	4.07%

During the quarter, all MIPS investment portfolios performed in line with the broader market as the quarter returns are comparable to similar market indices.

Table 2: Index returns for quarter end 31st December 2018

S&P/ASX Australian Bond Index	Quarter End Return
BBB Rating Bond	1.43%
(All Maturities & Credit Grade) Fixed Interest	2.39%
Bank Bill	0.48%
Corporate Bond 0-5 Year	0.92%

**Notes: Indices represents asset universe marked-to-market with zero fees. The "all maturity" index has a duration of > 5.00 years, whilst the 0-5 year Corporate is < 2.50 years and the Bank bill index is 0.25 (or 3 months) in length.*

Table 3: Key (Net) yield metrics of each MIPS investment Program

Investment Program	Running Yield	Total Yield	Estimated Qtly Cash flow*
Income Plus	5.22%	4.22%	$6,525
Core Income	4.12%	3.86%	$4,825
Conservative Income	3.84%	3.57%	$4,463

**per $500,000 invested*

Economics, Interest Rate Direction and Credit Margins

Readers of our prior quarterly report, and also those who attended our 2018 portfolio reviews (on the east coast), will be aware of the consistent theme applied since June 2018. Noting the (US) Federal Reserve is tightening and Australia's economic position is improving, albeit slowly, we have invested client capital short on the yield curve within a diversified pool of the highest yielding assets within each of the Investment Grade (IG) and Non-I G sectors. Key sub themes have been to maximise diversity in the Unrated (UR) sector, build portfolio weightings higher in subordinated debt for the IG component, and slightly higher (but strictly capped) in the Asset Backed Securities (ABS) / Residential Mortgage Bond Securities (RMBS) sector.

In the December quarter, following the release of a lower than expected 3rd Quarter Australian GDP figure, our duration positioning has been tested. Evidence of weaker economic activity than forecast (0.4% lower than treasury estimates) cannot be ignored. Equally, the decline in East Coast Property prices and implications for consumer confidence cannot be ignored. Given these conditions, the RBA is likely justified in holding monetary policy lower 'for longer' and subsequently the yield curve could be expected to rally and flatten. Additionally, careful weighting of exposure in corporate credit is warranted, given lower economic growth could reduce profitability and credit margins could push wider. The late December employment report was actually quite good, with solid employment growth but all in part-time work, and with participation climbing the unemployment rate popped out to 5.10%. And whilst the US Federal reserve tightened in December, as expected, and indeed was dovish regarding future policy action, the US Treasury yield curve rallied heavily, and equity indices fell sharply.

The global players in markets are voting with their asset allocations and forecasting a decline in global growth and lower interest rates for longer. Given this environment, portfolio rebalancing activity by the portfolio management team (PMT) across all MIPS accounts involved slight duration extension, moderation of credit exposure by an increased allocation to IG sector assets, a watch and wait approach on RMBS margins, choosing not to deploy capital to the (lower) cap maximum set. Subsequently, target portfolio yields as at the end of the quarter have fallen, as described in Table 3.

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Concurrently since November, bank margins started and continued to widen (see Table 4). Subsequently there was reason to dilute credit exposure, especially in the unrated sector. However, this is somewhat offset by new supply issues, so unrated asset margins mostly held ground.

Table 4: Bank Bond Investment Program Analytics

Bank Bond (FRN) Investment Program (BBIP) Outlook				
Bank Bond (FRN) Investment Program & Average Metrics for quarter period end	30 Sep		31 Dec	
	Average Credit Margin	Expected YTM	Average Credit Margin	Expected YTM
1. Major Bank Senior	0.76%	3.02%	0.88%	2.88%
2. Major & Minor Bank Senior	0.87%	3.18%	0.99%	3.02%
3. Major Bank Senior & Subordinated	1.05%	3.30%	1.24%	3.25%
4. Major & Minor Bank Senior & Subordinated	1.34%	3.59%	1.51%	3.52%

Summary conclusions

Global uncertainty has resulted in increased volatility and an environment underscored by more questions than answers.

There may be sufficient evidence that global growth is set for a decline in such a manner as to justify a significant bond rally.

The PMT has previously held the opinion that the slight uplift in average weekly earnings, alongside the sharp decline in unemployment domestically, was reason enough for our yield curve not to rally. There now appear stronger forces at play and we subsequently responded as advised. During this uncertain period, the performance derived should be evidence to the effectiveness of the "short credit spread duration" strategy, which is applied across all MIPS investment programs.

Whilst we are always data dependent, we suggest now that we will extend duration more aggressively on any yield curve weakness and are more reluctant to invest lower on the credit curve than we were in 2018.

Extended discussion – February 2019

Given the significance of both local and global economic developments in the period over early January 2019, when the 'interim' quarterly update was released, it would be of little benefit for readers if we opined on irrelevant historical data and estimates of the December 2018 Quarter end period. Subsequently, the following discussion advises of our current fixed income investment strategy given the most important local economic data releases of January 2019, global influences of significant note and the subsequent interpretation of the RBA meeting notes and especially RBA Governor Lowe's subsequent address to the National Press Club.

In summary, economic data releases domestically have been weak, the US Fed has halted the planned tightening progress (although the latest employment data is very strong) and whilst the RBA did not move officially to a 'neutral' monetary policy bias, Governor Lowe subsequently made it clear they were revising economic growth forecasts down and the case for the next move in policy was 'evenly' balanced. The 'lower (rates)' for '(even) longer' story is developing legs and subsequently the yield curve has rallied.

Australian Economic Data releases

Retail Sales: Weak. The November figures (January release) were +0.40% MOM, followed by December's fall of -0.40%. The quarter end December 2018 figure was up a meagre 0.10% and YOY up only 1.60%.

Westpac-Melbourne Institute Index of Consumer Sentiment: Weak. Fell 4.70% in January.

Westpac-Melbourne Institute Lending Index: Weak. Fell -0.27% in November.

Housing Finance: (Extremely) Weak. The November figures (January release) showed a decline across owner occupier and investor categories (all ex-refinancing) of 0.60% MOM and 10.00% YOY and 4.50% and 23.60% YOY respectively.

NAB Business conditions and confidence. Extremely weak. The largest monthly fall since the GFC, down 9 points.

Consumer Price Index: A slight 'upside' surprise (off a low base). December Quarter CPI, released late January, printed at 0.50% to be 1.80% YOY. Whilst slightly higher than anticipated (0.30%) average estimated, it is not testing the RBA tolerance band of 2.00% to 3.00% anytime soon.

The Core Logic home value index: Weak. The index, which measures average values across 8 major cities, fell 1.20% in January following December's 1.30% decline. Prices are down 6.90% YOY and 7.80% from the peak (September 2017).

The US Federal Reserve

The path paved by the US Federal Reserve was for a series of rate hikes, likely three more times in 2019, is no longer one they feel comfortable walking down. The picture is now more 'dovish'. The extended Government shut down of December and January, enforced by President Trump as a failed methodology to get passage of the Mexican border wall funding, will not help economic activity measures. But there is no doubt that the coincident equity market weakness in the order (S&P index) of down 7.50% net (but down as much as 20.00% from prior peak to trough), contributed heavily. The latest FOMC (Jan 31) statement indicated that while the current state of the US economy is still positive, recent developments "warrant patience" and the picture is "somewhat contradictory".

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We suggest that despite the subsequent strong US employment data for January (early February release), being the creation of 304,000 new jobs, it will take some time, and further justifiable and consistent economic evidence, for the Fed to resume upon the prior path. For the moment our assessment is that the Fed, whilst holding a tightening bias, will not move monetary policy for the next six months at least.

The RBA and Governor Lowe speech to the National Press Club

Following their February meeting, the RBA left monetary policy on hold at 1.50% for the 30th successive month. And despite lowering their growth forecasts (marginally) and recognising downside risks to economic activity, their concluding statement was the same as prior releases. The market, expecting a softer or more dovish rhetoric, was surprised and fixed rates along the yield curve rose slightly. The benchmark 4 year fixed interest rate swap rose from 2.03% back up to 2.09% and the $A rallied.

Yet Governor Dr Philip Lowe subsequently spoke to the National Press Club the following day,and was quite candid – the next monetary price move is effectively balanced evenly between a hike or a cut. The catalyst for a cut would be a rise in unemployment and a concurrent maintenance of inflation below 2.00%. This deviates markedly from even the most recent official release that stated … "the low level of interest rates is continuing to support the Australian economy". Whilst it must be noted that the RBA modified their more "bullish" economic outlook down marginally (growth for FYE 2019 at 3.00% from 3.25%) they steadfastly stated an expectation for further progress in reducing unemployment, forecasting 4.75% from the current 5.00% and inflation returning to target (greater than 2.00%). But now they believe progress in this direction is likely to be "gradual".

Governor Lowe emphasised during his speech that the weak $A and low base monetary policy rate were both conducive to growth and noted the recent (marginal) rise in average labour force earnings. Various commentary regarding the banking royal commission and the impact upon consumer discretionary spending following property price declines was also very relevant. He stated that the property price correction was not the correction "we had to have" but was the correction that we "expected" and is certainly "manageable" and will not threaten their economic growth forecasts. The price correction is simply a market response to oversupply and having not been driven by higher unemployment or interest rates is not a perceived threat, at this stage, to economic growth. However, the RBA was closely monitoring discretionary consumer expenditure response to declining household wealth. Global economic activity, emphasised Dr Lowe, particularly that of China, was far more relevant.

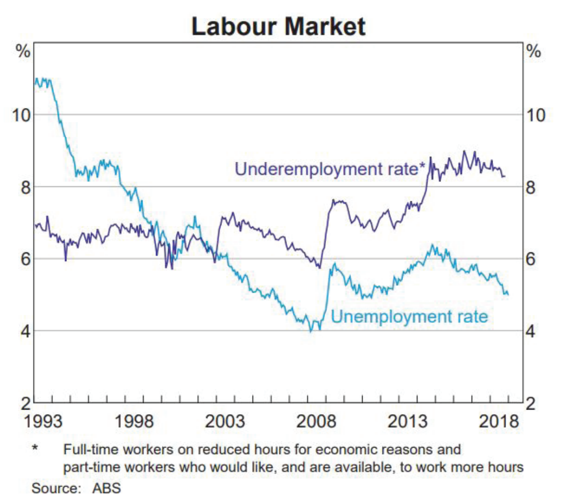
The following statement is perhaps the best focus point: "In the event of a sustained increased in the unemployment rate and a lack of further progress towards the inflation objective, lower interest rates might be appropriate at some point. We have the flexibility to do this if needed."

Fixed rates rallied and the $A weakened following Governor Lowe's statement. The benchmark 4 year fixed interest rate swap fell from 2.09% to 1.99%.

Extended Summary Conclusions

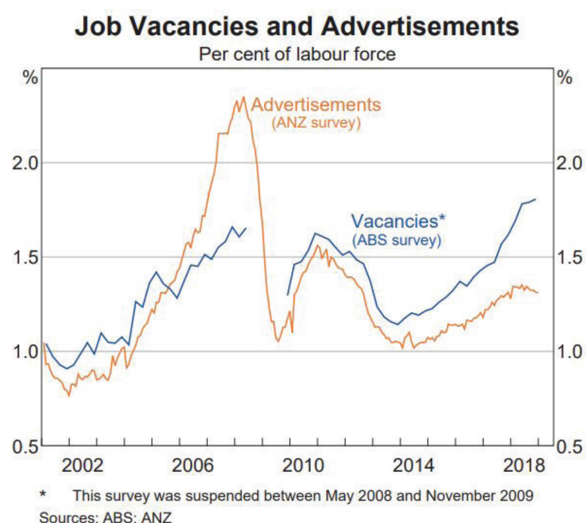
We note our prior summary conclusions, in December 2018, were to extend duration given evidence of weaker (domestic) economic activity, and therefore the RBA likely justified in holding monetary policy lower 'for longer' alongside 'sufficient' evidence that global growth is set for a decline in such a manner as to justify a significant bond rally. Whilst Governor Lowe has described the catalyst for an easing domestically as less likely given their central employment and CPI forecasts, he has certainly moved toward a neutral monetary policy stance. Subsequently our investment strategy will be to extend duration even longer than we intended in late December and do so more aggressively as the opportunity presents.

We will be watching forward indicators of employment, and the unemployment data releases themselves, with keen interest.



* Full-time workers on reduced hours for economic reasons and part-time workers who would like, and are available, to work more hours

Source: ABS



* This survey was suspended between May 2008 and November 2009

Sources: ABS; ANZ

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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. She has been with FIIG Securities for 3.5 years all of which within the Managed Income Portfolio Service.

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 riskreturning 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.

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