

BETASHARES AUSTRALIAN BANK SENIOR FLOATING RATE BOND ETF

ASX: QPON

Quarterly Report - March 2021

| Performance ¹ | 1 Month % | 3 Months % | 6 Months % | 1 Year % | 3 Years % p.a. | Inception ² % p.a. |
|--------------------------|--------------|---------------|---------------|-------------|-------------------|----------------------------------|
| Fund Return (net) | 0.11% | -0.08% | 0.72% | 3.77% | 2.59% | 2.64% |
| Growth return | 0.04% | -0.27% | 0.37% | 2.99% | 0.75% | 0.74% |
| Income return | 0.07% | 0.19% | 0.35% | 0.78% | 1.84% | 1.90% |
| Index return | 0.12% | -0.03% | 0.81% | 3.96% | 2.82% | 2.83% |

Past performance is not a reliable indicator of future performance.

¹ Returns are calculated after fees & expenses have been deducted and distributions have been reinvested

² Inception date for the Fund is 1 June 2017

Investment objective

The Fund aims to track the performance of an index (before fees and expenses) that provides exposure to a portfolio of some of the largest and most liquid senior floating rate bonds issued by Australian banks.

Responsible entity

BetaShares Capital Ltd

Fund Facts

| | |
|---------------------------|----------|
| Inception Date | 1-Jun-17 |
| Fund Size | \$672.7m |
| Historical Tracking Error | 0.09% |
| ASX Code | QPON |
| Bloomberg Code | QPON.AU |
| IRESS Code | QPON.ASW |

Distribution frequency

Monthly

Fees

| | % p.a. |
|----------------------|--------|
| Management fees | 0.19 |
| Recoverable expenses | 0.03 |

Investment strategy

The Fund will generally invest in a portfolio of bonds that comprise the Index in proportion to the weightings of these bonds in the Index.

In order to be eligible for inclusion in the Index, each bond must be a senior floating rate debt security denominated in AUD and issued by an eligible Australian bank. In addition, eligible bonds must have amounts outstanding of at least \$500 million and a term to maturity ("TTM") of between one to five years. Current eligible banks are classified into two bands as follows:

- **Band 1:** ANZ Bank, Commonwealth Bank of Australia, National Australia Bank, Westpac
- **Band 2:** AMP Bank, Bank of Queensland, Bendigo & Adelaide Bank, Macquarie Bank, Members Equity

Eligible bonds with the longest TTM are selected with up to two bonds selected from each Band 1 bank, and one bond from each Band 2 bank. Bonds from Band 1 are given a total weight of at least 80% based on market value, with each bond equal weighted. Bonds from Band 2 are given a total weight of up to 20% based on market value, with each bond equal weighted (with no Band 2 bond allowed to have a weight in excess of 5%).

| Top 10 Exposures ¹ | % | | % |
|-------------------------------|------|----------------|------|
| NAB FRN Jan-25 | 10.1 | ANZ FRN Jan-25 | 10.0 |
| WBC FRN Aug-24 | 10.0 | WBC FRN Apr-24 | 9.9 |
| CBA FRN Jan-24 | 10.0 | NAB FRN Jun-24 | 9.8 |
| ANZ FRN Aug-24 | 10.0 | BOQ FRN Feb-23 | 5.1 |
| CBA FRN Aug-23 | 10.0 | BEN FRN Dec-25 | 5.1 |

¹ As at 31 March 2021

Global macro and rates

It was a tumultuous quarter for global rates, with domestic and global government bond benchmark indices suffering their largest drawdowns since 1994 and Australian and U.S. 10-year yields both rising over 80 basis points over the period. On the surface, the dramatic rise in yields and steepening of curves was driven by higher growth and inflation expectations, owing to increased optimism around vaccine rollouts, confirmation of a Democratic sweep in Congress and the passage of additional U.S. fiscal stimulus. Drilling down a little further, we also saw a large repricing of policy rate expectations, with the sell-off originating at the long-end before migrating to intermediate tenors, despite ongoing insistence from global central banks of prolonged accommodation.

The move was also compounded by several structural factors, both in Australia and the U.S. The RBA's implementation of yield curve control (YCC), which pinned the 3-year yield around 0.10% arguably resulted in a disproportionate steepening as the longer tenors were forced to bear the brunt of the global duration sell-off in late February, triggering increased asset purchases from the central bank during the quarter to help stabilise the market, particularly in the 4-7 year sector. Similarly, a marked increase in U.S. Treasury issuance also contributed to some degree of duration indigestion, culminating in a very poorly received 7-year auction in late February. Furthermore, the ending of the exemption of U.S. Treasuries and reserves in the Supplementary Leverage Ratio (SLR) calculation also created fears of forced selling of Treasury securities into quarter end, although those fears were likely overblown.

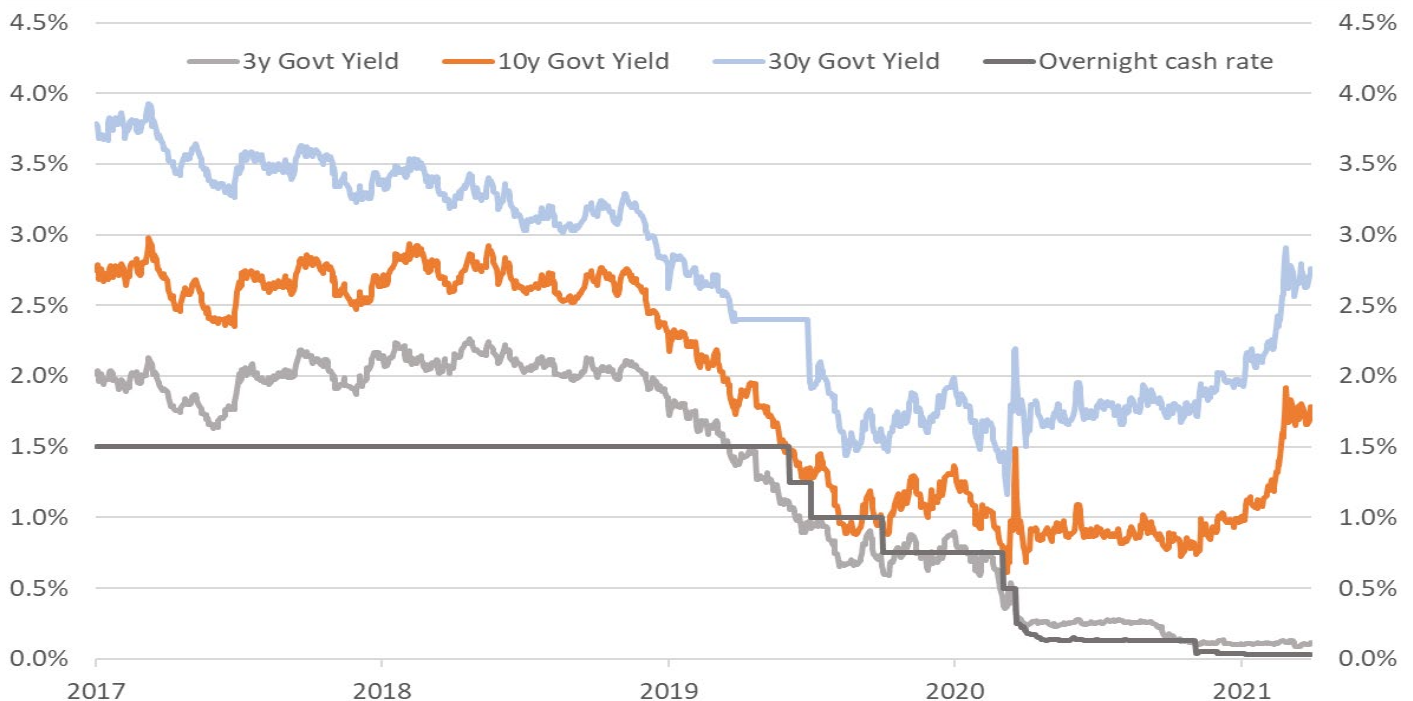
Global economic data continued to improve, with economic surprise indices remaining in positive territory throughout the period and global PMI numbers indicative of a strong rebound in activity. U.S. data in particular was well received, with both the ISM manufacturing and services PMIs recording their highest reading since 1983 and 1997 respectively. When this is combined with a very strong vaccine rollout relative to the Euro area, the complexion of the reflation narrative has moved from a globally synchronised rebound to a U.S.-led recovery, with recent strength in the broad U.S. Dollar also reflecting this narrative change. Further contributing to the recent U.S. Dollar strength has been concerns around policy tightening in China and a deterioration of the Chinese credit impulse, which has been a key driver of global reflation for much of the post-GFC period. Australian data also tended to surprise on the upside, with the domestic labour market rebounding much faster than expected despite the Job keeper support program coming to an end, although core CPI and wage growth remained subdued. Reflecting this improved outlook, both the RBA and Fed revised their growth expectations higher, although left core inflation expectations largely unchanged.

Amid the improvement in the global economic backdrop, market implied measures of policy rate normalisation were aggressively brought forward, with the Australian bank bill futures and OIS curves suggesting the RBA may hike as early as late 2022, with similar moves seen in the U.S. Expectations of terminal policy rates, as indicated by OIS-implied 5-year forward policy rate expectations, rose to as much as 2.5% in Australia and 2.25% in the U.S., which corresponded to a repricing of over 150 basis points since mid-2020, although the move has since moderated.

Global macro and rates cont.

This repricing of forward rates was largely at odds with prevailing central bank forward guidance, with both the Federal Reserve and the RBA reiterating they are unlikely to raise rates until 2024 at the earliest. The RBA also announced a QE extension in the February Board meeting, with an additional \$100 billion of commonwealth and state government bonds to be purchased beginning in April, noting also that recent statements indicate that another renewal at the end of the year is likely, while rolling the 3-year YCC benchmark from the April-2024 bond to the November 2024 security is also being considered. Central banks globally were largely of the view that the marked increase in inflation expectations is transitory, driven by a combination of base effects and supply chain bottlenecks. Potentially supporting this view is that although 10-year U.S. inflation expectations rose to their highest level in 8 years, the move was driven by shorter dated breakevens, with the inversion in the inflation curve potentially reflecting the outsized surge in commodity prices, particularly WTI crude and gasoline, which may be hard to sustain once supply chain frictions are eased.

Chart 1: Australian benchmark yields



Source: Bloomberg.

Credit

Despite the elevated volatility in sovereign yields, credit markets were largely well behaved, particularly for shorter duration and lower quality segments. Re-opening optimism, abundant liquidity and relatively benign credit impairments helped both investment grade and high yield spreads compress back to pre-covid levels. However, the aggressive steepening in global yield curves did eventually spill over to steeper credit spread curves as all flavours of duration fell out of favour. Domestic credit spreads consolidated over the quarter, with senior bank FRN spreads moving off their post GFC lows amid new 5-year issuance from Suncorp and a more general view that the Term Funding Facility (TFF) will come to an end soon, resulting in more supply going forward. AUD corporate bond spreads also moved off their post-COVID lows into quarter end, dragged wider by the aggressive steepening in both the sovereign and swap curves.

Outlook

Looking ahead, it's likely that government bond yields will consolidate given the disconnect between market implied rate expectations and central bank forward guidance. The end of the Japanese financial year will also likely see foreign buyers return to the Australian and U.S. Treasury market to take advantage of the most generous JPY and EUR-hedged yields in years. Furthermore, net new issuance of Australian government bonds has turned negative, with the RBA maintaining purchases against a reduction in issuance from the AOFM. With Commonwealth and state budget shortfalls likely to be smaller than previously expected, it is possible we'll see a further reduction in government issuance.

Regarding global monetary policy, the FOMC's recent minutes also showed little concern about the rise in longer term bond yields or inflationary pressures, with focus likely to remain on labour market outcomes. Similarly, the RBA has also made it clear in recent months that it believes the economy is still years away from achieving sustained core CPI between 2 and 3 per cent and that full employment and wage growth of at least 3 per cent would be a necessary condition, with the ending of Job Keeper potentially posing a challenge. Despite the robust improvement in employment growth and a larger than expected fall in the unemployment rate, wage growth remains sluggish, leading to suggestions that the RBA's estimate of the natural rate may have fallen from 4.5% to below 4.0%, further raising the bar to policy normalisation.

U.S. inflation concerns will remain an ongoing issue, particularly considering the momentum of the U.S. economic rebound and the proposed Biden infrastructure package. However, base effects will turn against the U.S. economy in the latter part of the quarter and an easing of supply chain bottlenecks as economies re-open should eventually put a damper on price pressures, while significant political obstacles and a lack of bipartisan support stand in the way of any infrastructure bill or further fiscal stimulus being passed. Furthermore, the Q1 surge in nominal and real yields alongside strength in the broad U.S. Dollar have tightened financial conditions at the margin, which may also prove to be a headwind to longer-term inflationary pressures, with the structural disinflationary factors of demographics, debt overhang and technology still present in a post-COVID world.

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