

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report May 2021

Performance ¹	1 month	3 months	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	0.14%	0.65%	3.60%	4.51%	5.57%	5.45%	4.22%	4.26%
Benchmark ²	0.20%	0.70%	3.58%	2.92%	1.63%	1.78%	1.64%	1.85%
Excess Return	-0.06%	-0.05%	0.02%	1.59%	3.94%	3.67%	2.58%	2.41%

¹ Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures. Past performance is not a reliable indicator of future performance.

² The Fund benchmark is the Australian Consumer Price Index.

Source: Fidante Partners Limited, 31 May 2021.

Fund Features

Unique 'relative value' investment strategy: The Fund adopts a relative value investment strategy to access a range of fixed income return sources that are independent of interest rates.

Tight risk control: The Fund specifically targets low volatility returns by using a range of risk management strategies

Diversification benefits: The Fund offers significant diversification benefits when combined with conventional bond, credit and equity investments in an investment portfolio

Capital preservation: The Fund prioritises capital preservation by only investing in high quality government bonds, related derivatives and cash like investments. However, the Fund is not guaranteed.

Protect long term purchasing power: The Fund explicitly targets a return exceeding Australian inflation rates to protect long term purchasing power.

Daily liquidity: The Fund only invests in the most liquid segments of global fixed income markets.

Experienced and stable investment team: Ardea's investment team has decades of experience across global fixed income markets. Majority employee ownership of the Ardea business fosters team stability.

Fund Facts

Portfolio Manager	Ardea Investment Management
Investment Objective	The Fund targets low volatility returns exceeding cash rates and inflation, by investing in a global portfolio of high quality government bonds that prioritises capital preservation and liquidity.
Inception Date	20 July 2012
Fund Size	\$8.6bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	72%
Government - State	28%
Total	100%

Rating Exposure	
AAA	70%
AA	30%
Total	100%

Region Exposure*	
Australasia	50%
Europe	3%
N. America	47%
Total	100%

Interest Rate Duration (years)	
12 month average	0.5
Since inception average	0.2

* Australasia = Australia, New Zealand, Japan; Europe = France, Germany, UK ; N. America = USA, Canada

Source: Ardea Investment Management, S&P Ratings

How are we positioned?

The portfolio return in May was positive.

Performance is driven by strategies that target specific ‘relative value’ (RV) mispricing between closely related fixed income securities. These strategies are implemented in a way that isolates the RV mispricing from broader market movements, maintaining minimal interest rate duration exposure and excluding all credit investments. For this reason, the performance of RV portfolios, over time, has a low correlation to broader bond market and macro themes.

The portfolio is constructed with many modestly sized and diverse RV strategies that collectively contribute to overall performance. We outline performance based on our broad attribution categories. As there are a large number of individual positions, the commentary below focuses on a small subset of noteworthy RV themes and examples of positions.

The strategy suggested investment horizon is two years. Over short periods of time, like one month, performance variability commensurate with the portfolio’s volatility budget is to be expected.

Drivers

- **RV bond vs derivative.** These strategies exploit pricing inconsistencies between government bonds and closely related interest rate derivatives by taking a ‘long’ position in one vs. a ‘short’ position in the other, such that the overall trade is duration neutral. Combinations of AUD and EUR bond vs derivative positions added value over the month, although movements were not substantial. Long AUD bond positions in the 10y and longer maturity part of the curve outperformed swap hedges. The relative underperformance of swaps was underpinned by hedging flows and bond demand has stabilised, helped by ongoing RBA quantitative easing (QE) and contained issuance expectations. In EUR, ultra-long semi positions continued to drift slightly tighter relative to swap hedges. Other markets made smaller contributions over the month, such as long positions in relatively cheap UST 20y bonds vs futures (these RV opportunities are impacted by shifts in issuance, investor segmentation and QE considerations).
- **Inflation.** The portfolio maintains structural inflation protection through exposure to inflation-protected securities. These positions in AUD added modest gains over the month. Early in May Australian inflation pricing followed the US market higher, after an historically large upside surprise in the monthly US CPI report. While the highest levels for breakevens and inflation swaps weren’t sustained later in the month,

many market participants remain wary about the risk that post-COVID pressures don't prove as transitory as the consensus of economists expects (see our market commentary and recent research note for more details).

Detractors

- **Volatility.** The portfolio is positioned long interest rate volatility. These positions are implemented based on RV considerations and provide the portfolio with risk balance. After driving significant positive performance during a large sell-off in bonds in Q1, the subsequent fall in market volatility as global rates stabilised has weighed slightly on performance over the last two months. USD swaption positions were the largest component of this small drag.

Portfolio Commentary

Notable events for the quarter are summarised below and more detailed discussions of topical market themes are available here - [Ardea's market insights](#).

What Happened?

Markets in a broad holding pattern

Most markets broadly tracked sideways to slightly stronger in May. Equity indices (ex-Japan) finished modestly positive – the MSCI world closed 1.3% higher and the S&P 500 +0.6% higher. Global bond indices added moderate gains – the Bloomberg-Barclays Global Aggregate Index lifted 0.9%. The US 10y yield fell 3bp in May to 1.59%, holding within the 1.50-1.75% range that has held since mid-March. EUR rates underperformed intra-month before finishing little changed. Elsewhere, commodity prices continued their impressive ascent, but at a slower pace than in April (Bloomberg Commodity Index +2.7%). In FX, the USD continued its trend lower in broad terms (DXY -1.6%), while the GBP topped the G10 leader board (+2.6%).

Investor sentiment and asset prices remain broadly supported by the combination of:

- continued solid global growth momentum;
- central banks still providing large scale stimulus; and
- rising vaccinations in developed economies reducing potential damage from Covid.

A wobble as US CPI surge arrives; “temporary” consensus prevails for now

In May there were a few brief challenges to the prevailing bullish narrative in the form of volatile economic data and some underlying concerns about central bank support. Of note, nominal bonds and stocks briefly underperformed amid a large upside surprise in the US CPI report (for April). CPI lifted 0.8% m/m and 0.9% m/m in headline and core terms, respectively. That core increase is the fastest monthly rebound since 1981. The y/y rise in the headline measure of 4.3% is the highest since 2008 and the 3.0% y/y rise in the core measure is the highest since 1996. The data well exceeded consensus expectations and the headline increase was higher than the forecast of all economists surveyed by Bloomberg.

This realisation of higher US inflation helped US Treasury inflation-protected securities (TIPs) to outperform in May and other global inflation-linked markets rallied in sympathy. Breakeven inflation spreads reached touched multi-year highs across the world (see below for more detail).

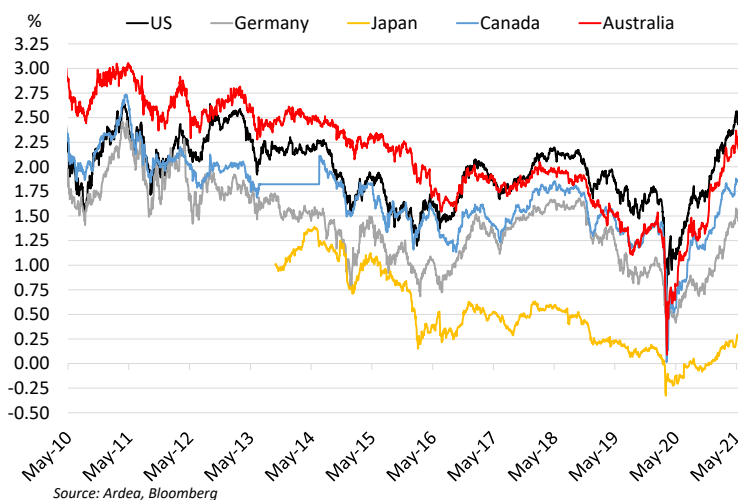
Why is it relevant?

This note is a summary of a more detailed research article on the Ardea website in May: ***Are interest rate markets pricing an inflation problem?*** (see [here](#))

Global rates market pricing for inflation has surged to multi-year highs.

The inflation expectations component of long-term bond yields (breakeven inflation rates or BEIs) have surged higher over the last year, after reaching record low levels at the onset of Covid-19 in March 2020 (for a primer on inflation-linked bonds and how expectations are implied see [here](#)). The bounce back in inflation expectations initially reflected a recovery from extreme economic disruption and liquidity pressures. The repricing has since gone on to eclipse pre-COVID levels and reach multi-year highs across markets. As Chart 1 shows, 10y BEIs in the US and Australia are at the highest levels in eight and six years, respectively.

Chart 1: 10Y Breakeven Inflation Rates



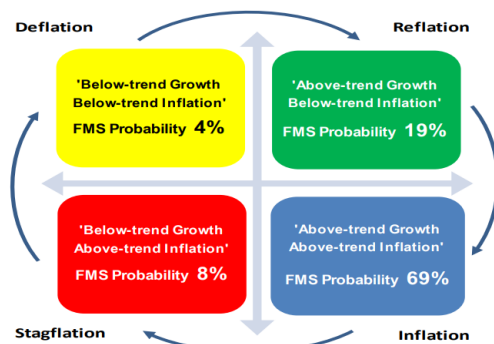
We have previously published a bigger picture note on inflation, which covered some of the distinctions between the shorter and longer run forces at play (see [here](#)).

The market reaction to recent data and survey indicators suggests investors are more worried about inflation risks than many economists.

Investor concerns about inflation were heightened in May amid an historically large jump in the US April CPI report (0.8% m/m and 0.9% m/m increase in headline and core CPI, respectively). Economists and Fed governors pointed to temporary distortions, but for markets it still raised the risk inflation could rise further and be more sustained than the consensus thinks. Evidence of this investor concern is also reflected in surveys. A monthly Bank of America Survey asks global fund managers to list the biggest tail risks facing markets. Since March the answer has been higher inflation or a “bond tantrum” for the first time in a decade and inflation displaced Covid as the biggest risk for the first time in a year. The same survey showed a record high 69% of participants listed “above-trend growth and above-trend inflation” as the most likely outcome for the global economy over the next 12 months, well above expectations for deflationary and trend inflation outcomes (Chart 2).

Chart 2: BofA Global Fund Manager Survey (May 2021)

Which of the following do you think best describes the global economy in the next 12 months?



Source: BofA Global Fund Manager Survey

Inflation curves, however, reflect expectations for only temporary inflation pressures and show large cross-market differences.

A simple gauge for whether the market is pricing an inflation problem is to compare inflation swap rates with central bank targets (Table 1). The market is clearly pricing above the target level in the US in the short term. However, the Fed’s revised approach to policy – formally agreed last year – explicitly allows for a temporary overshoot of the inflation target. The longer-term measure of inflation pricing – the 5y forward, 5y inflation swap rate – is around 40bp above the 2% target. There are, however, some technical nuances with the US pricing. The swap rate is based on CPI, while the Fed is arguably more interested in the core PCE inflation measure, which has averaged around 30bp lower than CPI over the last 20 years. After accounting for this measurement difference, the market is expecting inflation to roughly average around the Fed’s target in the long run (and there are also normal tolerances for so-called inflation risk premia, which are affected by the insurance value of inflation securities, liquidity and other factors).

Table 1: Central bank target and inflation pricing in the US, Europe and Australia*

	Central Bank Target	2y Inflation Swap	5y5y Inflation Swap
US	2.00	3.05	2.42
EUR	1.90	1.72	1.55
AUS	2.50	2.28	2.53

Source: Ardea, Bloomberg (28-May-21)

* The ECB targets "close to, but below 2.0%"

The RBA targets a 2.0-3.0% range

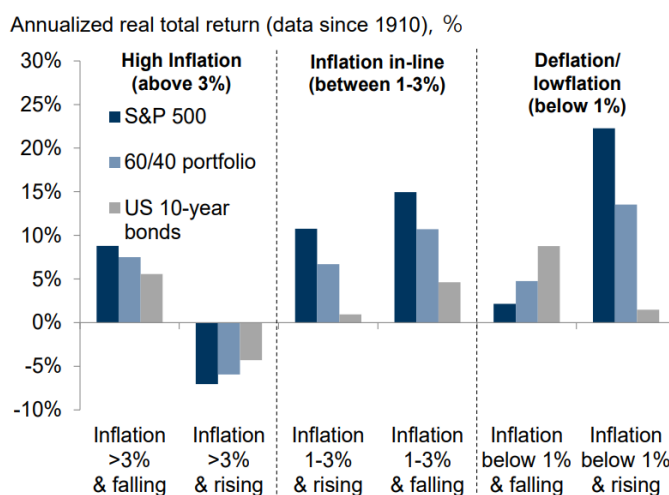
Longer term forward inflation pricing levels are below levels that would typically signal a problem for multi-asset investors.

At what point should multi-asset investors be worried? Identifying the tipping point whereby inflationary pressure cascades into materially higher bond yields and weaker risk assets is tricky, since it involves controlling for the range of other forces at play. A basic historical observation is that US equity bull markets tend to end when the business cycle rolls over, rather than at a specific level of actual or market-implied inflation or at a time when growth is accelerating as it is at present. The link with inflation is historically better viewed through Fed policy settings. Significant Fed policy tightening amid rising (or anticipated) inflation have typically preceded downturns, although the timing and magnitude is inconsistent over time.

The level, speed and drivers of higher inflation and bond yields are also important. Low but rising inflation tends to be the best macro backdrop for US equities and a 60/40 portfolio. Over the very long-run, Chart 3 from Goldman Sachs research highlights the danger-zone for equities and 60/40 portfolios tends to be

inflation above 3% and rising - a level priced into only the very front end of the US inflation curve. With the Fed and market viewing this rise as temporary, the risk for multi-asset investors is a more prolonged rise in inflation or a market belief that the Fed is significantly behind the curve. This credibility question is a key risk, as investors are just coming to grips with the Fed's average inflation targeting framework and even temporary price pressures could quickly become uncomfortable for bond markets.

Chart 3: US equities and bond returns under low and high inflation regimes



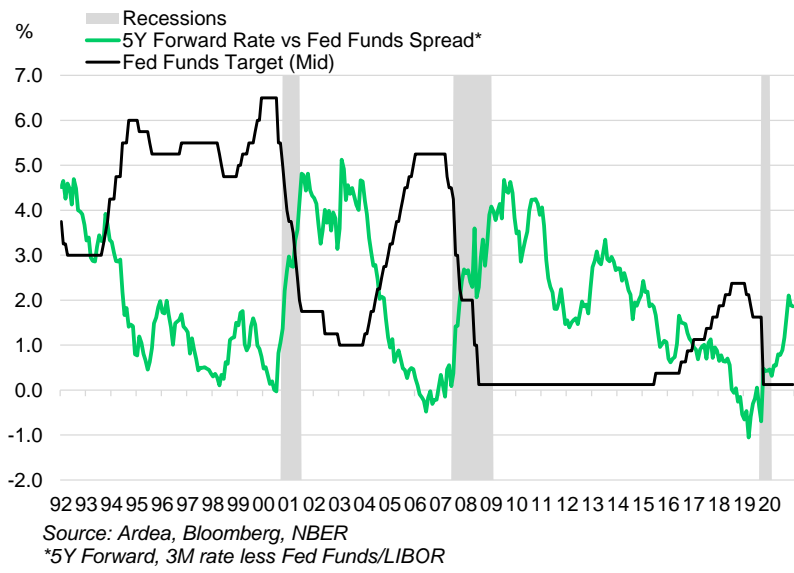
Source: Robert Shiller, Goldman Sachs GIR.

Inflation tail risks – both higher and lower – have grown significantly and could lead to bouts of pressure across markets over the coming months and years.

In the context of much higher than usual inflation uncertainty, inflation markets appear to be priced for perfection. The market expects central bank targets to be met with at worst only a brief overshoot. While risks appear tilted to the upside for inflation based on recent data, the reality is that inflation has become even more difficult to forecast over the last decade and there is a case to be made for much higher or lower outcomes than markets currently assume.

The heightened uncertainty has important implications for the assumed path of central bank policy. In 2021 interest rate markets have dramatically increased pricing for rate hikes in the coming years, even as central banks remain committed to keeping policy rates at the lower bound and in many cases maintaining large asset purchase programs for several years. The US curve is currently priced for around 200bp of rate hikes over the next five years, a large increase on the roughly 120bp of hikes implied at the start of 2021. But that still marks a slow tightening cycle relative to historical episodes of higher inflation and even the last two recoveries from recessions (Chart 4). If instead inflation underwhelms, the 2020 experience shows that there is a long way for this pricing to fall.

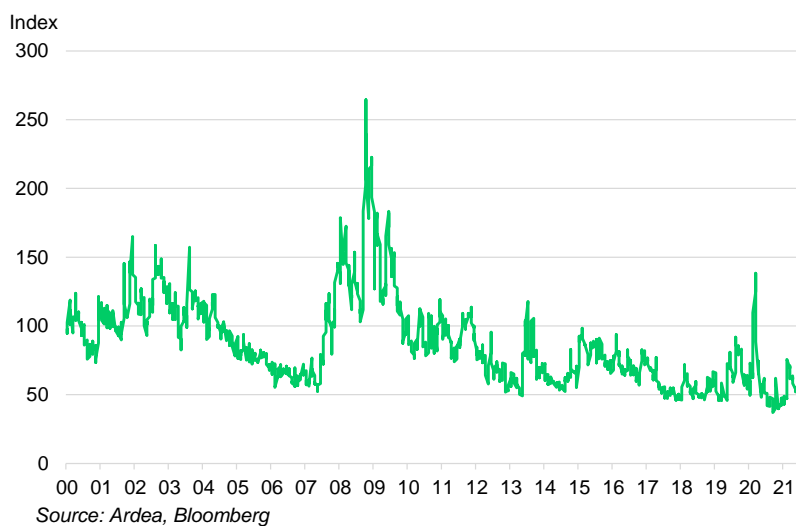
Chart 4: Nominal rate pricing has lifted a long way, but is still low relative to prior recoveries



Interest rate volatility is low despite the wider than usual distribution of inflation risks

The much wider scope for inflation to surprise markets means interest rate volatility has the potential to rise by a lot if either the lower or higher tail risk outcomes come into play. Rising rates volatility, particularly if associated with the higher inflation scenario, could have significant consequences for risk assets and multi-asset portfolios given the benign path currently assumed. Interest rate volatility strategies have an asymmetric payoff if either of these inflation tail risk outcomes eventuates. Current US option-implied volatility is broadly subdued by historical standards (Chart 5).

Chart 5: MOVE Index of US Treasury volatility



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