

Ardea Real Outcome Fund

ARSN 158 996 699 APIR Code HOW0098AU

Monthly Performance Report June 2021

Performance ¹	1 month	3 months	FYTD	1 year	3 year	5 year	7 year	Inception
Fund	-0.55%	-0.27%	3.03%	3.03%	5.37%	5.25%	4.09%	4.16%
Benchmark ²	0.20%	0.70%	3.78%	3.78%	1.66%	1.80%	1.65%	1.86%
Excess Return	-0.75%	-0.97%	-0.75%	-0.75%	3.71%	3.45%	2.44%	2.30%

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, 30 June 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	\$9.0bn
Management Fee	0.50% p.a.
Buy/Sell Spread	+0.05% / -0.05%
Distribution Frequency	Quarterly

Sector Exposure	
Government – National	71%
Government - State	29%
Total	100%

Rating Exposure	
AAA	67%
AA	33%
Total	100%

Region Exposure*	
Australasia	34%
Europe	2%
N. America	64%
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

*Physical weights for sector and rating exposure

Source: Ardea Investment Management, S&P Ratings

How are we positioned?

The portfolio return in June was negative.

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 rates.** The portfolio holds a wide range of relative value long and short positions across multiple markets in bonds, swaps, futures and options. These positions require constant rebalancing as market conditions change. The hedging of residual duration risk from RV trades and delta hedging of option positions in USD and AUD markets added modestly to performance over the month. While overall volatility in bond markets was not historically high, there were large movements within yield curves in June.

Detractors

- **Inflation.** The portfolio maintains structural inflation protection through exposure to inflation-protected securities. Over the last year, the overall contribution from these positions has been positive as global markets embraced a reflation theme amid massive policy stimulus and as temporary covid disruptions impacted many key goods and services prices. However, after reaching multi-year highs in May,

through June inflation-linked bonds and swaps underperformed notably, sending market pricing for inflation lower.

This repricing reflected a shift in market thinking on the risk of earlier central bank tightening. This policy shift is still projected to be at least a year away, but it only takes a modest change in the balance of risks to future inflation for market pricing to adjust, especially after a strong run-up. This theme was most prevalent in the US market in June, but also impacted the AUD market.

- **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. RV bond vs derivative strategies have contributed strongly to returns over the last year. Normal volatility within constrained ranges can occasionally cause these positions to collectively be down over short periods of time.

In June, for example, long positions in AUD semi-government bonds underperformed futures and swap hedges. The underperformance reflected changes to supply/demand risks, which weighed on the sector as a whole after earlier positive performance. On the supply side, issuance after budgets was expected to moderate, but in the case of at least one issuer was revised higher. On the demand side, expectations for Reserve Bank of Australia (RBA) quantitative easing (QE) support were generally scaled back, reducing the premium priced into many semi-government bonds relative to futures and swaps.

- **RV micro curve.** These RV strategies exploit pricing inconsistencies between different points on interest rate curves by taking a 'long' position in one point vs. a 'short' position in another, such that the overall trade is duration neutral. Broader yield curve spreads flattened sharply over the last month (both lower long term yields and higher short term yields). Micro yield curve trades are typically well insulated from big macro directional curve changes. However, the much larger macro curve volatility spilled over into temporarily higher volatility within more tightly constrained maturity points. Such conditions tend not to last for long and micro curve positions generally exhibit negligible correlation to broader curve changes.

For example, in the AUD and CAD markets, long positions in the 3-4y part of the swap curve underperformed short positions in the 5y sector as markets priced greater risk of earlier policy tightening. Such changes are normally offset by other RV curve positions. Various USD micro curve positions added value over the month, but over this short space of time did not fully offset the drag from AUD and CAD positions.

Portfolio Commentary

Notable events for the month are summarised below and more detailed discussions of topical themes are available in the [Research](#) section of the Ardea website.

What Happened?

Risk assets grind higher and yield curves twist

The performance of major asset classes was generally positive in June. Global equities posted solid gains, taking the MSCI World (+1.4%) and S&P 500 (+2.2%) to new highs. The macro backdrop remained broadly supportive of risk assets. Global growth indicators suggest continued positive momentum, which is set to become less US-centric in H2 2021. There has been continued progress in Covid vaccinations among developed economies, although risks remain from the delta Covid variant.

Fixed income performance was mostly positive. While the Global Aggregate (-0.9%) index finished the month down, US Treasury (+0.6%), Australian government (+0.8%) and Australian composite (+0.7%) indices posted gains. Broad US and European Investment grade credit indices finished the month tighter. Yield curves flattened notably as expectations for policy tightening were pulled forward after the June Federal Reserve meeting. However, longer term rates expectations and inflation pricing actually fell over the month, supporting longer duration bond performance (more details below). Well contained long term bond yields are providing a tail wind for risk assets.

Elsewhere, oil prices outperformed most other assets (Brent +8.4%, WTI +10.8%), on the favourable growth outlook and contained supply expectations. The USD index outperformed (+2.9%) following hawkish Fed comments.

Why is it relevant?

Yield curve implications of the Fed's hawkish shift

In June, the US Federal Reserve (Fed) raised the prospect of tightening policy earlier than previously expected. Rather than a broad rise in yields, the shift in policy rhetoric drove a sharp flattening of the US yield curve. Popular reflation curve trades were hit hard and inflation pricing moderated. The Fed's message followed some other central banks in recent months flagging the unwinding of highly accommodative monetary policy over the next one to two years.

In early July, the RBA modified its QE program and didn't extend its yield curve control target. Markets and economists are calling for rate hikes in Australia as soon as late 2022, well ahead of the RBA's signal of 2024 at the earliest.

Fed signals risk of QE tapering and earlier rate hikes

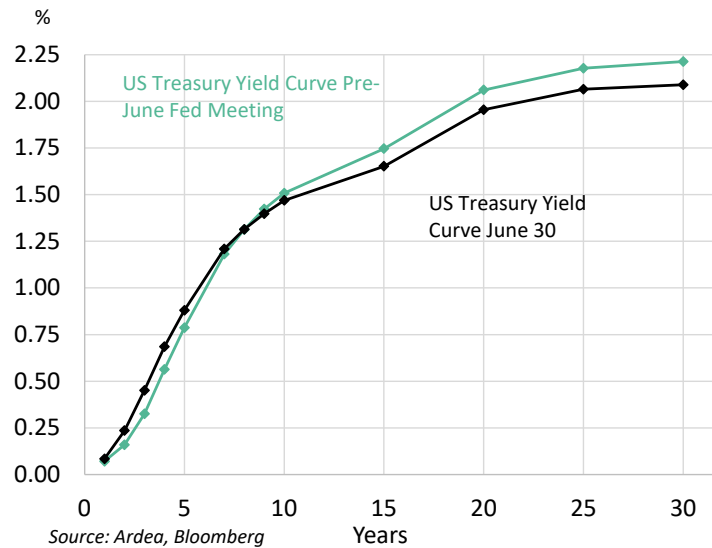
The June Federal Open Market Committee (FOMC) meeting surprised markets with its hawkish message. The prospects of an earlier tapering of QE purchases and earlier rate hikes followed changes to the Fed's published forecasts and comments in the post-meeting statement by Fed Chair Powell:

- The median Fed governor's "dot" projection for the Fed Funds rate now implies two rate hikes by the end of 2023, compared with zero in the March statement.
- 7 FOMC participants see a rate hike by the end of 2022, up from 4 in March.
- Economic forecast changes were not as dramatic but showed an uplift in near term inflation expectations and for unemployment to be 3.5% and core personal consumption expenditure (PCE) inflation to say above 2% in 2023.
- In the press conference Fed Chair Powell said they are "a ways away" from the "substantial further progress" required for tapering, however progress is underway and this discussion is ongoing at "upcoming meetings".

Rates reflation trades under pressure

The reaction in interest rate markets to the Fed's hawkish tilt has been severe within the yield curve, although moves in outright yield levels and broad measures of implied volatility have been remarkably well contained. The yield curve flattened via a combination of both higher short term and lower long term yields.

Chart 1: US yield curve before and after Fed shift

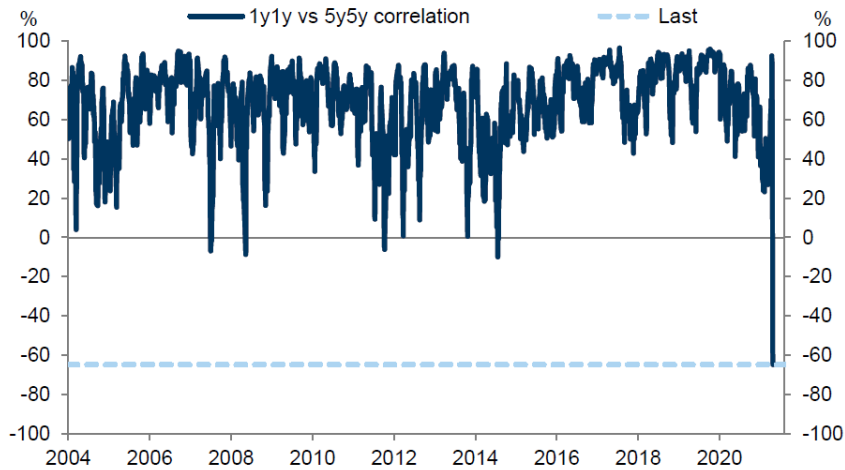


Why has the curve shifted in this dramatic manner? There are four related themes:

- 1) Rate hikes are priced sooner.** The market now sees rate hikes coming sooner and at a faster pace for a few years starting in 2022-2023. This shift in market thinking on timing led to a dramatic underperformance in 2-5 year part of the yield curve.
- 2) The expected terminal rate in the cycle is lower.** This expected earlier policy tightening leads many market participants to believe less overall policy tightening will ultimately be delivered in the cycle, lowering the expected terminal or neutral policy rate implied by longer term forward rates.

Putting 1) and 2) together, Chart 2 (via Goldman Sachs research) shows just how unprecedented the divergence in correlation between curve segments is by long term historical standards. (The chart shows the 1y forward starting 1y swap rate and 5y forward starting 5y swap rate to capture respective near term and longer term Fed pricing).

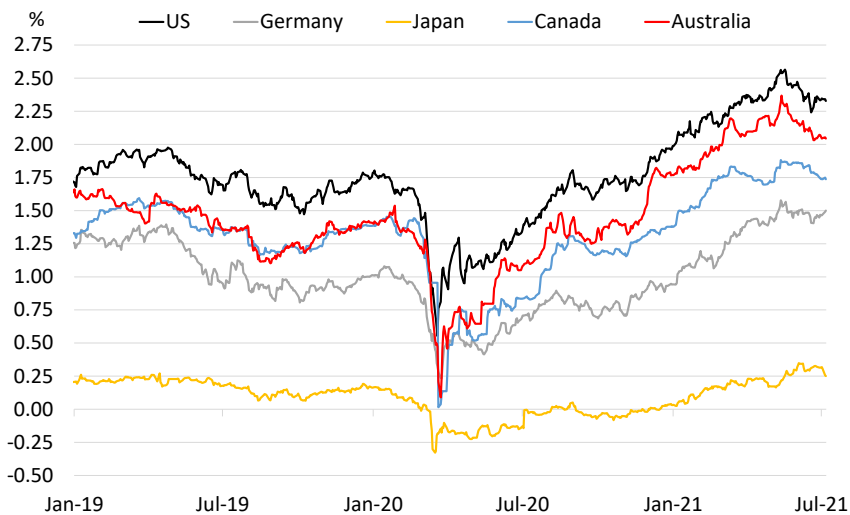
Chart 2: Rolling 21d correlation of daily changes in 1y1y vs 5y5y OIS rates



Source: Goldman Sachs Global Investment Research

3) Lower inflation risk premium. With the Fed expected to be a bit more reactive to the uplift in growth and inflation, the market has wound back inflation risk pricing. The breakeven measures of inflation have fallen over the last month but remain elevated from a longer term perspective. The market continues to price a relatively comfortable scenario where inflation rises only temporarily before settling close to the Fed's target.

Chart 3: Global 10y breakeven inflation rates



Source: Ardea, Bloomberg

4) Positioning impacts. Any time an entrenched macro narrative is suddenly challenged, position unwinding can exacerbate price action. June was no exception. Many curve steepening trade combinations had previously benefited from the macro outlook of stronger growth and inflation, slow-to-move central banks and positive carry (such positions benefit if markets remain stable). The US

Treasury (UST) 5s30s curve was a popular expression of this steepening bias and the rush for the exits exacerbated the sharpness of the flattening move in the month (Chart 4).

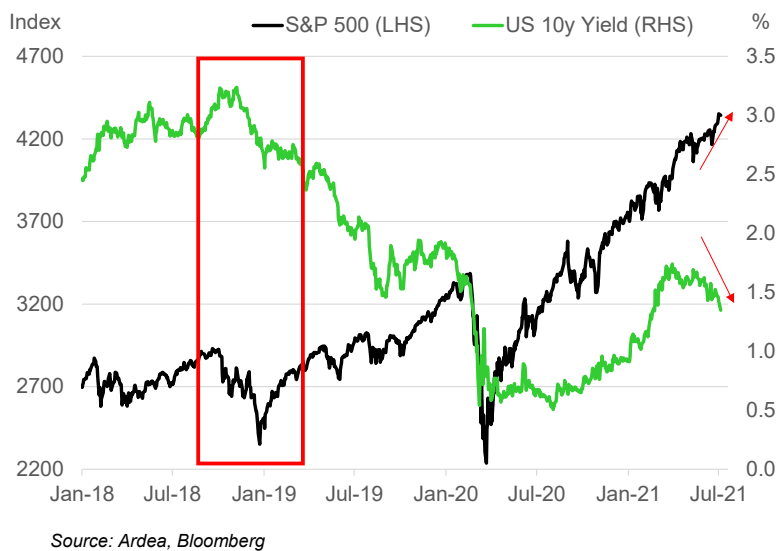
Chart 4: US Treasury 5s30s curve



Broader market implications limited (so far) amid a still long road to unwinding ultra-easy policy

One narrative emerging from the sharp yield curve flattening in June is that the bond market is pricing a type of Fed policy mistake. However, this perspective is inconsistent with the strong positive performance of risk assets, which suggest no real concern of a policy mistake. As Chart 5 shows, equities have continued to make new highs in the face of a decline in longer term yields. One could also read the prospect of earlier Fed action as lowering the odds of a “bad” inflation outcome, thereby supporting the negative correlation between bond yields and equities.

Chart 5: S&P 500 vs UST 10y yield



The current backdrop stands in stark contrast with the late 2018 to early 2019 period, where the Fed was actually in the process of lifting the Funds rate and pressure from tighter financial conditions weighed on equities. Relative to that period, the lack of current vulnerability in risk assets speaks to the fact that financial conditions are still extraordinarily easy. Genuinely tight monetary policy remains years away and

real yields are still near all-time lows (-0.98% for UST 10y), which is supportive for riskier assets.

Notwithstanding recent moves, history shows markets can quickly lose comfort with an outlook for policy “gradualism”. So economic data and central bank rhetoric around QE tapering over the coming months are key risks to watch. Most indicators point to a strong global growth pulse being sustained but broadening beyond the US to other major economies over the rest of the year. The tapering of Fed QE is widely expected to start in Q1 2022 and finish by early 2023, implying there is still around \$800bn of UST and mortgage-backed securities (MBS) purchases to come before the pace even starts to slow. However, markets will start to price the risk of this shift earlier and alongside a strong global growth pulse, new highs in bond yields are still possible.

Finally, as we outlined in a recent [research note](#), the current market set up of a specific path for inflation (a large rise and then moderate fall) factored into yield curves at a time of high forecast uncertainty is arguably out of step with current low levels of implied interest rate volatility. This suggests larger swings in bond yields in either direction remain a key risk, even if over the last month such pressure has been well contained within yield curves.

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