

Western Asset Conservative Income Fund

JUN 2022 | Commentary

Investment objective

The Fund aims to achieve a before-fee-and-tax return in excess of the Bloomberg Ausbond Bank Bill Index over rolling one year periods.

Performance (%)

	1 mth	3 mths	1 yr	3 yrs pa	5 yrs pa
Fund (net)	-0.08	-0.31	-0.71	0.45	1.12
Benchmark	0.05	0.07	0.10	0.33	0.95

Calendar year performance (%)

	2021	2020	2019	2018	2017
Fund (net)	0.20	0.94	2.03	1.95	2.43
Benchmark	0.03	0.37	1.50	1.92	1.75

Fund details

Inception date	June 2001
Benchmark	Bloomberg AusBond Bank Bill Index
ISIN	AU60SSB01312
APIR	SSB0131AU

Monthly review

What happened in the market?

Volatility in the fixed-income market remained high as yields continued to push upwards in early June after the Reserve Bank of Australia lifted the cash rate by 50 basis points to 0.85%, and many central banks continued to forecast accelerated rate hike trajectories including the European Central Bank's guidance on its first rate hikes in more than a decade. Bond yields then gapped higher after the US Consumer Price Index release and continued the momentum with the Federal Reserve's 75 basis point rate hike. However, markets soon began to ponder the increased likelihood of a global economic downturn induced by the pace and quantum of monetary tightening, and yields retraced a substantial part of the moves from the first half of the month to finish higher in the 10-year key rate with a substantial flattening of the curve between the 10-year and 30-year tenors. While Australia's economic data was broadly solid, including strong consumer spending, jobs growth and job vacancies, some data in Europe, the UK and US undershot expectations and reinforced concerns that aggregate demand was already rolling over.

Credit issuance was light in June as most issuers preferred to avoid deals in such turbulent markets. There were several consumer asset-backed security deals from relative newcomers to the Australian fixed income market including an inaugural deal from Angle Finance. Pepper brought a residential mortgage-backed security deal to the market under the banner of a social bond. Corporate deals were limited to banks while credit demand was soft and spreads continued to move wider, mostly on the back of wider swap spreads and on the growing expectation of a recession.

The Australian dollar lost more ground in June, being considered a commodity currency whose fortunes during an economic downturn are expected to take a larger hit than most. The currency lost 3.8% versus the US dollar, 1.5% versus the euro and 0.4% to the pound sterling while gaining 1.4% versus the yen and 0.3% versus the New Zealand dollar to finish 1.3% lower on its trade-weighted index.

What happened in the Fund?

The Fund was down 0.08% (net of fees) during June, in comparison the benchmark as measured by the Bloomberg AusBond Bank Bill Index was up 0.05% in June. The negative absolute return was largely attributable to interest rate positioning, where a small long duration position underperformed as yields rose during the month. The portfolio's Asset Backed allocation also detracted at the margin as spreads widened.

We tactically added to our duration overweight mid-month after yields gapped higher, then removed that addition to the overweight towards the end of the month as bonds rallied on growing fears of a recession. We retained our overall duration overweight due to our assessment that the increasingly aggressive monetary policy track being priced in for the major central banks created a greater likelihood of either an economic downturn or a moderation in policy setting projections. In either scenario, market yields would need to come down from the high levels priced in. As always, we will keep our interest-rate positioning nimble and seek to take advantage of volatility and yield-curve shape.

What is the outlook?

Most economists are also expecting a 50-bp rise in August after which there is a reasonable spread of expectations that include 25 bps and even 50 bps in each of the remaining meetings of the year, while others have the RBA pausing from September to assess the impact. Expectations for the cash rate at the end of the year therefore also have a wide distribution between 2% and 3.5%. We think that it is more likely to end the year around the 2% mark or marginally higher due to the likely pressure the pace of rises will put on consumer demand as consumer sentiment continues to slide, despite the household saving ratio remaining at elevated levels. There are other signs of tough times as construction firms face cost overruns due to supply chain delays and a significant rise in the cost of material inputs that has put a substantial squeeze on the profitability and solvency of those firms. With the overwhelming majority of mortgage holders still repaying floating-rate loans in highly leveraged households, the impact of rising rates is direct and immediate. Therefore we think that while a number of central banks are discussing very accelerated normalisation paths this year the RBA is likely to pause around the 2% level to assess the progress of its policy settings on the inflation target as well as economic conditions generally.

The Australian dollar remained under pressure, particularly versus a strengthening US dollar, which paradoxically gained both due to the swift rise in relative policy rates and due to the dive in risk sentiment brought about by the rise in rates. The RBA's policy trajectory is unlikely to make ground relative to the fed funds rate, so the Australian dollar is likely to rely on relative economic gains and commodity prices to stabilise at high levels, in order to support the currency and lift it back above the US\$0.70 mark in coming months.

Highlights

- Invests in a portfolio of Australian short duration credit, cash and cash-like securities
- Seeks to protect capital and deliver returns in excess of the cash rate
- Designed to capture relative value opportunities in duration management as well to identify securities with attractive yield characteristics

About us

Franklin Templeton

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Western Asset

Western Asset Management is one of the world's leading fixed-income managers. With a focus on long-term fundamental value investing that employs a top-down and bottom-up approach, the firm has nine offices around the globe and deep experience across the range of fixed-income sectors. Founded in 1971, Western Asset has been recognized for an approach emphasizing team management and intensive proprietary research, supported by robust risk management.



Ratings

Quantitative



The Western Asset Conservative Income Fund received an overall rating of 3 stars out of 39 Australian Short Term Fixed Interest funds as of 30 September 2021.

Qualitative



For enquiries, please contact Investor Services Team on 1800 673 776, email auclientadmin@franklintempleton.com or visit franklintempleton.com.au.

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