

BT Index Defensive Fund

Monthly report – 31 January 2023

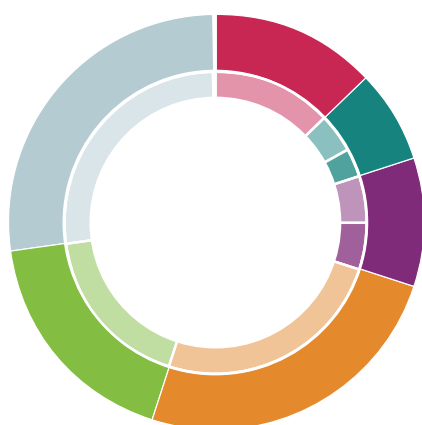
Fund overview

Inception date	1 August 2016
APIR code	WFS0588AU
Fund size (AUD millions)	\$239.86
Investment objective	To provide investors with predominantly income and some growth returns, with a low probability of loss over the short term which tracks the overall return of a diversified portfolio of underlying investments.
Recommended investment timeframe	3 years
Minimum initial investment	\$500,000
Distribution frequency	Quarterly
Management costs (%) pa¹	0.34
Buy/sell spread (%)	0.06 / 0.06

Performance review²

Period ending 31 January 2023	1 month	3 months	1 year	3 years	5 years	Since inception
	%	%	%	% pa	% pa	% pa
Total return	3.05	3.61	(2.68)	0.31	2.90	2.91
Growth return	3.05	3.06	(6.31)	(3.19)	(0.57)	(0.42)
Distribution return	0.00	0.55	3.63	3.50	3.47	3.33

Actual asset allocation %³



- **Equity – Australian Listed – 13.01%**
 - BT Australian Shares Index Fund – 13.01%
- **Equity – International Listed – 7.18%**
 - BT International Shares Index Fund (Unhedged) – 4.09%
 - Blackrock Index Hedged International Equity Fund – 3.09%
- **Property – International and Australian Listed – 10.08%**
 - BT Property Securities Index Fund – 5.09%
 - Blackrock iShares Global Listed Property Index Fund – 4.99%
- **Fixed Income – Australian – 24.89%**
 - BT Australian Fixed Interest Index Fund – 24.89%
- **Fixed Income – International – 17.90%**
 - BT International Fixed Interest Index Fund – 17.90%
- **Cash – 26.95%**
 - Advance Cash Multi-Blend Fund – 26.95%

Market update

With 2022 behind us, we saw a strong start to global listed markets over the month of January, aided by the re-opening of China and an ever more hawkish consensus that we are nearing both peak inflation and interest rates. However, we still need to be watchful of the mixed economic data across global economies with opposing signals from job markets, consumer confidence, and productivity reads across both Developed and Emerging regions.

Australia

Consumer sentiment started 2023 on a positive note, rising to 84.3 in January, an increase of 5.0% in the month.

Sentiment is at its highest level since September, though still deeply pessimistic as the mood among consumers is downbeat among higher interest rates and elevated cost-of-living pressures. Encouragingly, consumers are slowly becoming less pessimistic about the future.

The weak consumer sentiment is expected to flow through to a slowdown in household spending. However, this is taking time as spending has been supported by robust household savings, an unleashing of pent-up demand, and a tight labour market. These factors are expected to fade as we move through 2023.

The December quarter's headline inflation read came in at 1.9%, to be 7.8% in annual terms. This annual rate is the highest in nearly 33 years, though was under the RBA's forecast of 8%. Goods inflation is showing some signs of easing, though this may be happening too slowly for the RBA's liking. More troubling for the RBA is that price pressures have broadened and inflation in the services industry has accelerated to 5.5% p.a. - its highest rate since 2008. This was driven by the hospitality industry with consumers seemingly blasé by the 10.9% quarterly increase in the price of holiday travel and accommodation.

The producer prices index (PPI), which measures prices from the perspective of businesses, eased in the December quarter to increase by 0.7% - the smallest increase since June 2021. In annual terms, producer prices increased by 5.8%, which was lower than the record pace of 6.4% recorded in the September quarter. PPI excludes subsidies and taxes which impact consumer prices (measured by the Consumer Price Index (CPI)). Interestingly, PPI in the USA peaked one quarter before the CPI. But in Australia, PPI and CPI move simultaneously. The unwinding of both electricity rebates and the halving of the fuel excise looks to have delayed the peak in CPI inflation by one quarter.

An intensifying challenge for the RBA is that the longer inflation is elevated, the stickier it becomes and the tougher it is to manage. It runs the risk of inflation becoming embedded in wage-setting processes.

The labour market remains incredibly tight, which was echoed in the sentiment survey. The unemployment expectations index fell by 8.4% in the month to 108. This indicates that fewer people expect the unemployment rate to increase over the next 12 months.

With the lowest unemployment rates seen in decades across the developed world, a disconnect has emerged when it comes to wages growth. In developed economies like the USA, UK, Canada and NZ, wages growth has picked up strongly and there's a real risk emerging of a wage price spiral. In these countries, wages growth is inconsistent with their respective inflation targets and central banks have had to respond aggressively.

Meanwhile in Australia, the latest Wage Price Index read of 3.1% p.a. suggests that wages growth continues to be in line with the RBA's 2-3% inflation target.

The key question is whether we are lagging what's happening overseas and that it's only a matter of time before wages growth accelerates to levels that are inconsistent with the RBA's inflation target? Or is Australia different in that we can get through this period of elevated inflation without recording excessive wages growth? Many consider that wage setting features in Australia's labour market reduce the risks of excessive wages growth. While wages growth may very well continue to accelerate, Australia's wage setting system provides the RBA with the best chance to navigate the narrow path ahead and achieve a soft landing.

Compared to the other countries mentioned, Australia has a much higher portion of wages (employment) contracts on 'collective agreements' - called Enterprise Bargaining Agreements and Awards - rather than 'individual agreements'. This effectively means that Australia's wage setting mechanism is slower to respond to market movements and inflation pressures, because individual agreements:

- have more frequent wage renegotiations,
- allow workers with strong bargaining power to put their best foot forward, and
- are prevalent in more highly skilled areas where there tend to be acute skills shortages.

Retail trade fell by 3.9% over December 2022 – the sharpest fall since August 2020. Though over the December quarter, retail trade grew by 0.9%. However, with CPI increasing by 1.9% over the quarter, this suggests that retail trade over the quarter was, in reality, negative after adjusting for prices changes. It can therefore be drawn that the spending impulse from pent up demand has likely come to an end.

There are now clearer signs that spending is slowing, and the RBA's interest rate hikes are reducing demand. The full impacts of the rate hikes from last year are yet to fully flowthrough to consumers. It can be expected that retail trade will ease over 2023 as consumers adjust to higher interest rates, higher rents, and the higher cost of living.

New residential building approvals rose a surprise 18.5% in December, partly unwinding a 21% fall in the monthly rate of new approvals between August and November 2022.

Although December's strong result looks like a sign of better things to come, it may not be. The real underlying weakness in approvals in December was masked by a sharp rise in high-rise apartment approvals in NSW and VIC.

The rate of new private sector dwelling approvals is still steadily declining from a peak in early 2021, falling 2.3% in December. New house approvals have tumbled 37.5% since their March 2021 peak and are running below the average rate of the past decade. Surging material and labour costs in the construction sector have combined with rising interest rates to erode demand for new housing.

Private sector multi-density (apartments) approvals surged 56.6% in December. Despite the monthly spike, multi-density approvals are not immune to the headwinds facing new housing demand. The 3-month moving average reveals a gradual slowdown has also been underway for multi-density building approvals since peaking in May 2021.

The slowdown is likely to persist for some time until some of the headwinds facing the housing sector reverse. However, the rapid resumption in overseas migration will lift demand for new housing and

United States

The big political news from the US in January was the much-publicised contention between Democrats and Republicans regarding the debt ceiling. US Treasury began tapping two government-run retirement funds to avoid a default after the debt ceiling was hit, steps that should allow payments to last until early June. Janet Yellen has since urged Congress to boost the borrowing limit.

Signs of slowing in the US economy appear to be broadening and there is growing evidence of inflationary pressures easing. Although the Bank of Canada paused their rate hikes, the market is not anticipating the Fed to go on hold anytime soon.

Inflation appears to have passed a peak in the US, but the Fed is not yet fully convinced inflation will subside quickly and will therefore need a bit more convincing to pause. With a notably tight labour market and the unemployment rate near a record low, it may be difficult for the Fed to achieve price stability without further tightening.

Fed Chair Powell is expected to emphasise that a smaller pace of rate hikes does not mean the job is done. Interest-rate markets are pricing in a peak for the mid-point in the fed funds rate of almost 5% around mid-year.

The producer price index (PPI), a measure of input price inflation for businesses, declined 0.5% in December. This was the largest monthly decline in the PPI since April 2020. Disinflation in food and energy prices play a major role, and the PPI actually rose 0.1% in the month when removing these items. In annual terms the PPI rose 6.2%, slowing from November's 7.3% annual pace. The slow-down in producer prices has now extended for nine months and will continue to flow through to softer goods price inflation.

The USA's fourth quarter Employment Cost Index was relatively benign at +1.0% quarter-on-quarter from the prior +1.2% in the September quarter. This is a further sign that some key inflation risks are moderating.

The Fed's January 'Beige Book', which provides information on current economic conditions across the Fed districts, included some encouraging signs that labour shortages were easing, but that firms are still encountering difficulties in filling positions. Measures of economic growth were lukewarm, with five districts reporting slight to modest increases in economic activity, while six noted no change or slight declines from the previous reporting period.

The University of Michigan's measure of consumer sentiment rose to 64.9 in January from 59.7 in December - the strongest read since April 2022 and was better than the 60.7 expected by the market.

Retail sales fell 1.1% in December, extending on the 1% fall in November. The monthly fall was the largest since December 2021, reinforcing the idea that the economy is losing momentum.

Industrial production slipped 0.7% in December following a 0.6% fall in November. This was the largest monthly fall in production since September 2021, likely reflecting shrinking orders and companies preparing for lower output in the future. This further adds to an increasing flow of data suggesting a softening outlook.

Activity indicators surprised slightly to the upside in January. However, they remained weak and in contractionary territory, continuing to signal a slowdown in economic activity and elevated risks of a recession. January's manufacturing Purchasing Managers Index (PMI) came in at 46.8, the third consecutive month of contraction (a PMI reading below/above 50 indicates contraction/expansion). This was above consensus expectations of 46.0 and was up on the 46.2 outcome in December. New orders were slightly higher while employment slipped into contractionary territory.

Housing starts decreased 1.4% to 1.38 million units in December, totalling a fall of 3% in 2022. The median consensus was that starts would slide to a rate of 1.36 million units in December.

Existing home sales, which are counted when a contract is closed, fell 1.5% to an annual rate of 4.02 million in December. This is the lowest level since November 2010 and marks the 11th straight monthly decline in residential sales, the longest stretch since 1999. In year-on-year terms, existing sales fell 17.8%.

New home sales increased to an annualised rate of 616K in December, the highest value in four months. This was higher than the 617k the market was expecting and the 602k recorded in the month of November. Over the 2022 calendar year, an estimated 644k new homes were sold, 16.4% below the 2021 figure of 771k – a clear sign higher rates were biting.

Asia

The Bank of Japan (BoJ) left its monetary policy settings unchanged on January 18th, which prompted large swings in financial markets. The central bank left its policy rate at -0.1% and didn't alter its 0.0% yield target on the 10-year government bond. While markets were not expecting a change to these policies, there was some speculation that the BoJ would increase how far it would allow the 10-year yield to move beyond its target. Last month, the BoJ surprisingly increased this threshold from 0.25% to 0.50% and markets were positioned with caution in January in case of a similar announcement. In the end, this did not eventuate, instead the BoJ doubled down on its yield target and suggested it would continue to purchase bonds to defend it.

Headline inflation jumped 3.7% in the year to December, which is the highest annual rate since December 1981 when the currency was still experiencing high inflation from the 1979 oil price shock. The core consumer price index, which excludes fresh food but includes energy costs, rose 3.7% in November from a year earlier, also the largest rise since December 1981. Core consumer inflation is expected to slow to the BoJ's 2% target in 2024 as the base effect of past fuel price spikes dissipates and the impact of government subsidies to curb electricity prices take effect from February.

Manufacturing activity remained in contractionary territory in January as exports were weak, parallel to the continued slowdown in the global economy. The manufacturing PMI remained at 48.9, unchanged from December and the 3rd consecutive month of a below-50 reading.

Services activity surprised to the upside as the services PMI came in at 52.4. This beat December's 51.1 reading and was the 5th consecutive month of expansion. The outcomes resulted in the composite PMI moving to an expansionary 50.8 in January from a contractionary 49.7 in December.

The People's Bank of China (PBoC) has reinforced a stance on sustainability, announcing that it will extend the use of three monetary policy tools designed to encourage financial institutions to support green technologies and the logistics sector. The PBoC will continue to offer cheap funding until the end of 2024 to banks which lend to firms that are helping reduce carbon emissions, a policy tool which was first adopted in November 2021. The bank's relending program for clean-coal use will also be extended until the end of 2023.

Europe

December's inflation print for the Eurozone was -0.4%, giving the annual inflation number an unchanged 9.2% from November. This was the second consecutive decline in headline inflation following a peak of 10.6% in October. Core inflation was also unchanged at 5.2% over the year to December.

ECB President Christine Lagarde has warned that inflation figures still remain "way too high" despite optimism that price growth may have recently peaked. Speaking at a panel at the World Economic Forum in Davos, Lagarde reiterated the ECB's plan to bring inflation in the Eurozone back down to its 2% target through aggressive monetary policy decisions. The ECB has increased rates by a cumulative 250bps at its last four meetings.

ECB member Knot was also hawkish, saying "our president has already announced that most of the ground that we have to cover we will cover at a constant pace of multiple 50bp hikes...it will not stop after a single 50bp rate hike - that is for sure...core inflation has not yet turned the corner in the euro area". Knot called for 50bp hikes in both February and March, reiterating that the time to slow down is still far away.

The Eurozone's annual pace in the M3 measure of broad money supply (currency in circulation, deposits with a maturity of up to two years, deposits redeemable at notice of up to three months and repurchase agreements, money market fund units, and debt securities up to two years) continued to decelerate. In annual terms, money supply grew 4.1% in December, following growth of 4.8% in November and double-digit growth in early 2021.

January's Eurozone manufacturing PMI came in at 48.8, matching expectations. Fourth quarter GDP for the area was encouragingly above estimates with a minor 0.1% quarter-on-quarter expansion, which beat the market consensus for a 0.1% contraction. Despite some unsettling national-level releases, notably from Germany with a 0.2% quarterly GDP contraction, the risk of an EU recession may have been averted.

Business activity surprised to the upside in January as services activity shifted back into positive territory. The services PMI moved from 49.8 in December to 50.7 in January. This was the highest reading since July 2022 and followed five consecutive months of readings in contractionary territory.

The trade deficit narrowed to €15.2bn in November from the €28.1bn recorded in October. The outcome was much better than the €21.1bn trade deficit expected by the market and was driven by a 3.8% decline in imports. This outcome is consistent with the easing, though still elevated, energy prices and slowing domestic demand.

The three confidence indicators released for the euro area each improved in January, with all three also beating consensus forecasts. The economic confidence index rose 2.8 points to 99.9, the industrial confidence index rose 0.7 points to 1.3, and the services confidence index lifted 3 points to 10.7.

Politically, UK / EU negotiators are close to resolving their long-running dispute over post-Brexit trading arrangements in Northern Ireland. Last week they agreed a deal on real-time trade data and are also nearing agreement on customs aimed at reducing frictions between Britain and Northern Ireland. Hopefully, this is the start of a post-Brexit easing of hostility between London/Brussels.

In the UK, the consumer price index (CPI) rose 0.4% in December, matching November's pace. This was marginally above consensus expectations for a 0.3% gain. In annual terms, inflation rose 10.5%, slowing from a 10.7% increase over the year to November. This was the second consecutive monthly decline in headline inflation following a peak of 11.1% in October. However, core inflation, which removes more volatile items such as food and energy, remains sticky and was unchanged at 6.3% over the year to December. Markets had expected a modest fall to 6.2%.

The UK's Bank of England (BoE) meets soon after the Fed's decision (on 2 February 11pm AEDT). The BoE's Monetary Policy Committee (MPC) is likely to hike by 50 basis points to take the policy rate to 4.00%. Whilst this outcome is widely expected, markets will again be focussed on how much more the MPC has left to do, especially after last week the BoE Governor said the path towards lower inflation would be "easier" than previously thought given lower prices for gasoline and supply-side pressures easing.

However, the annual growth rate of headline inflation remains in the double digits; December's print for consumer price inflation was 10.5%. Whilst it is off the peak rate of 11.1% in October, the lift in wage inflation to 6.4% in the three months to November would also be worrying the BoE.

Further, core inflation has stayed stubbornly above 6% for the past six months even as headline inflation has started to wane.

2022 insolvencies in the UK hit their highest level since 2009, and roughly 60% higher than in 2021. The number of UK companies in critical financial distress increased by 36% in the last quarter of 2022 according to figures from insolvency firm Begbies. Alison Rose, chief executive of NatWest, said that while the lender hasn't yet seen widespread company failures, they are concerned that firms are unable or not confident enough to invest for the future, which will affect growth.

UK's CBI released their January Retail Sales survey which showed a notable slowing, with the total index slipping to -22 from -5. Retailers saw declining volumes with expectations of a further, but less severe, fall for February, though this was "in line with seasonal norms".

UK house prices also fell for a 5th month running as rate hikes take effect on the population's for taking on or maintaining mortgages.

Footnotes

- 1 The Management Costs included in this fact sheet are inclusive of the Management Fee and any Performance Fees and includes the effect of GST (net of RITC). They do not include other indirect costs. Refer to the Product Disclosure Statement and online disclosures for further information.
- 2 Past performance is not a reliable indicator of future performance. Performance returns are calculated net of management fees and costs. Growth and distribution returns may not equal the total net return due to rounding.
- 3 Allocations may not equal 100% due to rounding.

For more information

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