BT Investment Solutions

BT Index Defensive Fund

Monthly report – 28 February 2023

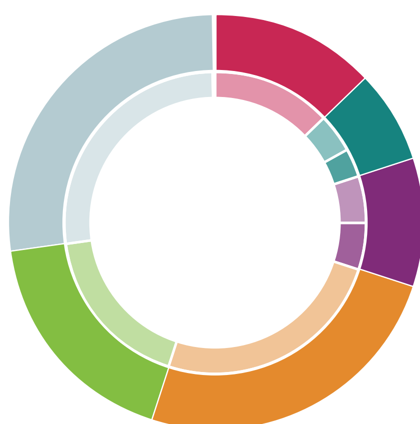
Fund overview

Inception date	1 August 2016
APIR code	WFS0588AU
Fund size (AUD millions)	$233.75
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 (%) pa[1]	0.34
Buy/sell spread (%)	0.06 / 0.06

Performance review[2]

Period ending 28 February 2023	1 month	3 months	1 year	3 years	5 years	Since inception
	%	%	%	% pa	% pa	% pa
Total return	(1.10)	(0.03)	(3.15)	0.49	2.77	2.70
Growth return	(1.10)	(0.56)	(6.76)	(3.02)	(0.69)	(0.58)
Distribution return	0.00	0.53	3.61	3.50	3.46	3.28

Actual asset allocation %[3]



- **Equity – Australian Listed – 12.83%**
  - BT Australian Shares Index Fund – 12.83%
- **Equity – International Listed – 7.03%**
  - BT International Shares Index Fund (Unhedged) – 3.98%
  - Blackrock Index Hedged International Equity Fund – 3.04%
- **Property – International and Australian Listed – 9.97%**
  - BT Property Securities Index Fund – 5.08%
  - Blackrock iShares Global Listed Property Index Fund – 4.89%
- **Fixed Income – Australian – 25.07%**
  - BT Australian Fixed Interest Index Fund – 25.07%
- **Fixed Income – International – 17.95%**
  - BT International Fixed Interest Index Fund – 17.95%
- **Cash – 27.15%**
  - Advance Cash Multi-Blend Fund – 27.15%

Please refer to the end of this report for the footnotes

Market update

After January's strong start to 2023, February shifted into reverse gear with a softer performance across global markets. Central banks continued hiking interest rates despite global inflation prints beginning to show signs of abating. Softening in what has been exceedingly strong labour markets, as rate hikes weigh on confidence and household spending, is a clear indicator. That said, we are not out of the woods yet, as we believe there remains a long path to controlling inflation.

Australia

As mentioned above, the RBA kicked off 2023 with another rate hike of 25bps, taking the cash rate to 3.35%. The policy statement took a more hawkish tone than December's, with stronger language around its resolve to bring inflation back to target. The final paragraph of the statement: 'The Board expects that further increases in interest rates will be needed over the months ahead to ensure that inflation returns to target and that this period of high inflation is only temporary'. This statement implies that there are going to be at least two more hikes in this cycle.

The Statement on Monetary Policy (SoMP) includes updated forecasts for the economy, in which the outlook for economic activity remains broadly unchanged. The RBA is still expecting a soft landing, with the unemployment rate to increase but remain well below where it sat pre-pandemic. What changed was the outlook for underlying inflation (the inflation measure which dampens the impact of volatile items) and wages growth. The RBA is now expecting annual wages growth to be around 0.5% higher in the December quarter of 2022 and the June quarter of 2023. This is feeding into higher underlying inflation expectations, which is now approximately 0.75% higher for the June quarter 2023. By 2025, underlying inflation and wages growth are broadly in line with what was expected in November. These forecasts are based on the cash rate reaching 3.75% in mid-2023, up from the 3.5% expected back in November. In other words, the RBA believes the economy can withstand a cash rate of 3.75% without slowing down too sharply.

Demand-side factors will not only be critical in the future but have had an important role in the trajectory of inflation so far. In February's SoMP, the RBA included modelling results which suggested that supply-side factors accounted for around 0.5-0.75% of the elevated inflation. So, while demand effects are not as significant as supply, they are still sizeable. Going forward, demand will be the key area to watch as supply-side pressures gradually ease. Goods inflation remained very elevated in the December quarter, which was at odds with a more material slowing in goods inflation internationally. The RBA Governor noted that 'the most credible explanation is that demand was very strong here [Australia] during the December quarter'. The Governor also pointed to a few specific categories: 'The price of clothing and footwear in the December quarter was up 2.2% in one quarter. The price of non-durable household goods was up 2.3%. Durable goods prices were still rising strongly in the December quarter. That wasn't the case in many other countries, and it's not the price in global markets.'

The Governor also spoke about the rise in services inflation: 'The other surprise that we saw in the December quarter was that the prices of many services were rising strongly. The prices of restaurant meals were up 2.1% in the quarter. The prices of domestic travel and accommodation were up 7.5% in the quarter. When trying to understand why that is, it's because there's strong demand. Australians could go on holidays for the first time in years, people could go out with family and friends at restaurants, and prices are going up. While the supply-side factors have been important drivers of inflation, the outcomes in the December quarter had a very strong demand element as well.'

Forward-looking 12-month consumer inflation expectations declined in February, falling to 5.1% in the month, as reported by the Melbourne Institute (down from 5.6% in January). Despite this 0.5% fall, inflation expectations remain elevated and were above the 4.6% reading from the same time last year.

Business confidence jumped 6 points to +6 in January, the first reading above zero since September, and back around long-run levels. This was stimulated by the reopening of China and resilience in the US and Europe providing reason for optimism in January. Business conditions rose 5 points to +18. Conditions have receded from the peak of +24 in September but remain elevated, underpinned by strong summer trading conditions.

Demand appears buoyant despite retail data suggesting that conditions are starting to soften. Capacity utilisation, which measures the extent to which businesses are exhausting their resources, rose to a near-record high of 85.7%. Forward orders also picked up.

Meanwhile, cost pressures reaccelerated after a marked slowdown over the second half of 2022. Purchase costs (3.2%), labour costs (2.7%) and final produce prices (1.7%) all rose in quarterly terms but remain below their peak from the middle of 2022.

Consumer sentiment tumbled 6.9% in February to 78.5 and was only just above November's cyclical low of 78.0. You would need to go back to the depths of the pandemic or all the way back to the 1990's recession to find a lower reading.

Views on household finances relative to a year ago deteriorated sharply as pressures on household budgets continue to build. Adding to the gloomy disposition, households do not expect to be out of the woods anytime soon. Future expectations for family finances also declined materially, with 53% of respondents expecting a further 1% increase in the cash rate.

The 'time to buy a major household item' sub-index (a proxy for spending intentions) deteriorated considerably to 78.0, the 4th lowest on record. Similarly, housing market sentiment tumbled to its lowest level since 2008 – back when the cash rate reached 7.25%.

The weakness in household finances and sentiment serves as a coherent sign that budgets are being stretched due to rising rates and an elevated cost-of-living. As a result,

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spending is likely to taper off sharply this year, though sizeable savings buffers will provide some resilience. However, not all will benefit as savings are more concentrated among the older and wealthier households.

The unemployment rate increased to 3.7% in January 2023 – the highest rate since May 2022. The number of people unemployed jumped 22k over January and by 30k over the past two months. Other labour market indicators are also showing signs of slowing, with the share of the working age population employed declining by 0.2%, the share of full-time employment and the participation rate both creeping lower, and youth unemployment increasing to 7.9% from 7.7%. At the same time, population growth continues to accelerate. In January, there was a 41k person increase in the Australian working age population. In economic theory, a growing labour supply should act as a pressure relief valve for the tight labour market – we are seeing this situation play out.

National dwelling prices recorded a 0.1% decline in February, their tenth consecutive monthly fall. A striking feature of February's data was that the decline of 0.1% was the smallest fall since May when the RBA began hiking rates (i.e. the fall in prices is slowing). Sydney prices rose 0.3% over February, the first rise in thirteen months. Dwelling prices across other major cities continued to fall though, although at the slower mentioned pace. The national decline in dwelling prices since the peak in April 2022 is now at 9.1%, the steepest fall since pre-1980s.

Approvals for houses declined across all states and territories too. The reduced demand for new housing is being driven by elevated material and labour costs in the construction sector alongside rising interest rates. The weakness is likely to persist for some time, putting upward pressure on rents as surging demand from high migration outstrips the inelastic housing supply. Higher interest rates will delay the supply-side's response compared to other periods where we have experienced strong population growth. ABS data show that average rents across Australia increased by almost 5% in the year to January 2023. Newly-advertised capital-city rents increased by a whopping 11.6% in annual terms to the end of February 2023 – the highest on record (since the early 2000s). Eventually, higher rents will entice property investors to return to the market, which will theoretically halt the fall in values.

United States

CPI increased by 0.5% over January, in line with market expectations, and is an acceleration on the 0.1% increase recorded in December. CPI has grown by 6.4% in annual terms, down from the 6.5% recorded in December. Stripping out energy and food prices, the core CPI was unchanged from December, increasing by 0.4% over January. This was also in line with market expectations. In annual terms, core CPI increased by 5.6%.

John Williams, President of the New York Fed branch, endorsed a peak in the Fed funds rate of 5.00%-5.25% as appropriate. However, Williams noted that if the labour market remains too tight or if financial conditions ease too much, the Fed will need to do more. Governor, Lisa Cook, also commented on the tightness of the labour market but cautioned reacting to a single data release (referencing the January labour report). Cook maintained that inflation was too high, and that restrictive policy will need to be sustained for a prolonged period.

In early February, applications for unemployment benefits rose for the first time in 2023 but remained near the historical low, which highlights the hardiness of the job market. Initial unemployment claims rose by 13k to 196k in the first week of February.

Consumer sentiment rose in February to the highest level in a year as near-term inflation expectations began to retreat. The University of Michigan's sentiment index increased to 67, the highest since January 2022. This result highlights resilience despite a backdrop of slowing economic activity. One year inflation expectations rose to 4.2% from previously recorded 3.9%. However, 5-10 year forward-looking inflation expectations remained unchanged at 2.9%.

Activity in services was stronger than expected, moving into expansionary territory for the first time since June 2022. The S&P services purchasing managers' index (PMI) jumped to 50.5 in February, up from 46.8 in January and well above expectations of 47.3. The gain reflected a stronger employment outcome, which rose to 51.5 in February from 50.8 in January. In what would likely be a consideration for the Fed, prices charged rose in February to their highest level since October. The higher-than-expected February outcome narrows the previous gap between the S&P services PMI and the ISM (Institute for Supply Management) services PMI, which surprised to the upside in January at 55.2.

US S&P Flash February PMIs were firmer with Services rising to 50.5 (est. 47.3, prior 46.9), Manufacturing 47.8 (est. 47.4, prior 46.9) and so the Composite rose to 50.2 (est. 47.5, prior 46.8).

The National Association of Home Builders (NAHB) housing market index rose to 42 in February from 35 in January. This was the second consecutive monthly improvement after a 12-month string of declines. Though conditions remain weak as elevated interest rates weigh on demand for new housing.

The US manufacturing sector contracted for the 4th consecutive month in February as higher interest rates continue to dampen demand. The ISM index, which tracks factory activity, crept up to 47.7 in February from January's 47.4 reading, roughly in line with forecasts, however, remains in contraction territory.

Employment was higher, at 52.6 in February versus 50.3 in January. Output also rose versus the prior month and increased to the highest level since October. New applications for unemployment benefits fell below 200k for the 7th straight week to the end of February, highlighting the resilience in US labour markets in the face of higher interest rates attempting to combat and inflation and cool the jobs market.

The New York Fed empire manufacturing survey improved dramatically in February, though remains in negative territory. The index surged to -5.8, from the historical low of -32.9 in January. This trumps consensus expectations which forecast a reading of -18.0. Despite the improvement, the index continues to indicate contraction in the sector amid higher costs and weaker demand.

The Philadelphia Fed business outlook index dropped sharply to a three-year low of -24.3 in February. This was well down on the -8.9 outcome from January and the -7.5 outcome expected by consensus.

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Asia

Japan's current account surplus narrowed to ¥33.4bn in December from ¥1.8tr in November, falling short of expectations for a ¥112.0bn surplus.

Core consumer prices jumped 4.2% in January from a year earlier, rising at the fastest pace since September 1981 on higher energy and food prices. Excluding volatile fresh food items, the core consumer price index was above the Bank of Japan's 2% inflation target for the 10th straight month.

Services activity accelerated in February with the services PMI rising to 53.6, up from 52.3 in January. This was the 6th consecutive month of expansion and the highest reading since June 2022. Contrary to this, manufacturing activity fell deeper into contractionary territory. The manufacturing PMI landed at 47.4 in February, down from 48.9 in January. This was the 4th consecutive month of contraction. New orders declined, while output recorded its 8th consecutive month of contraction – dropping to the lowest level since July 2020.

China is showing signs of a stronger economic rebound after COVID restrictions were abandoned, with services and manufacturing PMI data posting its biggest improvement in more than a decade. The CPI rose 2.1% over the year to January, accelerating from a 1.8% annual increase in December. The inflation outcome met expectations as the economic recovery gathers momentum and demand heats up. However, inflation in China remains well contained compared to other major economies.

Perhaps a sign that these tempered inflationary expectations will continue, the producer price index (PPI), which measures input price pressures for businesses, declined by more than expected. The PPI declined 0.8% in annual terms to January, following on from a 0.7% annual decline in December. January's reading marked the 4th consecutive decline in annual PPI inflation.

The February PMI points to significant strengthening in conditions alongside the reopening. The Manufacturing PMI rose to 52.6 in February from 50.1 in January – the strongest reading since April 2012. The services PMI also surprised to the upside, jumping to 56.3 from January's 54.4.

The Caixin manufacturing PMI, which surveys small businesses, also advanced rising to 51.6 from 49.2. This was the first read above 50 a year, pointing to a broad-based improvement in conditions. These PMIs are now comfortably in expansionary territory as the economic recovery steams ahead.

Europe

Off the back of the ECB's 50bp hike decision, ECB member Klaas Knot said that the central bank may have to extend its streak of 50bp hikes into May if core inflation doesn't ease by that time. Knot commented that "Once we see a clear and decisive turn in underlying inflation dynamics, I expect us to move to smaller steps."

Consumer confidence came in at -19.0 in February, up marginally from -20.7 in January. The result largely met expectations and marks the 5th consecutive monthly improvement in sentiment since the record low -28.7 in September 2022. However, confidence remains deeply negative by historical standards and well below the long-term average of -10.3.

Economic confidence remained in contractionary territory for an 8th consecutive month in February. The reading of 99.7 occurred despite a milder winter, that gave hope the region would avoid a serious recession. The outcome was below consensus expectations of 101.0 and was largely unchanged from the January's 99.8. Looking at the sub-components, a slowing in confidence was seen across both services and industrial sectors. Services confidence slid from 10.4 in January to 9.5 in February, while industrial confidence was barely in positive territory at 0.5, from 1.2 in January. Both measures were below consensus expectations.

Activity in the services sector was stronger than expected and in expansionary territory (above 50). The services PMI rose to 53.0 in February, the strongest reading since June 2022, up from 50.8 in January. The strength in the services sector shows that the economy is holding up well under the weight of higher rates.

Conversely, activity in the manufacturing sector remained in contractionary territory for the 8th consecutive month and was weaker than expected. February's manufacturing PMI came in at 48.5, slightly lower than the January outcome of 48.8 and below expectations of 49.3.

Germany's inflation rate was helped by government support packages that reduced household energy bills, though remained unchanged at 8.7% in February, which defied expectations for a mild decrease. This adds to evidence that inflation in Europe is proving stickier than anticipated. In monthly terms, inflation jumped 0.8%, slowing from 1.0% in January. Three of the four largest European economies had stronger inflation results than expected in February, pointing to upside inflation risks.

Investor sentiment in Germany, Europe's largest economy, improved for a 5th consecutive month as concerns of a deep recession decline. The ZEW survey of expectations rose to 28.1 in February, above expectations of 23.0 and the highest reading since the Russian invasion of Ukraine. This was up from the 16.9 reading in January, after the measure was in deep negative territory throughout most of 2022.

The IFO Business Climate indicator for Germany increased to an eight-month high of 91.1 in February, from 90.1 in January. Expectations for the coming months were significantly less pessimistic, even while firms' assessments of their current situation worsened. Around 45% of companies complained about supply chain bottlenecks, less than the 48% in January, and the share of those who want to increase their prices has fallen. Across sectors, the mood of businesses in tourism and hospitality has improved.

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As for the UK, the December quarter GDP growth was flat, meaning the UK economy narrowly avoided a technical recession over the second half of 2022. Household and government spending helped keep activity above recessionary levels, while public and private investment also contributed strongly to growth. In annual terms, growth slowed to 0.4% in the December quarter from 1.9% in the September quarter.

The UK government recorded a budget surplus in January as borrowing by the public sector fell by £6.2 billion over the month, following a budget deficit of £24.8 billion in January. This was below expectations though, which centred on a further increase in borrowing of £1.3 billion.

House prices were flat in February following a 0.9% gain in January. In annual terms, dwelling prices were up 3.9% in February, slowing from a 6.3% gain over the year to January.

UK services activity surprised to the upside and moved into expansionary territory in February. The services PMI jumped to 53.3, following a 48.7 read in January, and beating consensus expectations of 49.2. This was the first move into expansionary territory since the 50.0 reading in September 2022 and was the strongest outcome since June 2022. New business rose to 53.8 in February from 49.9 in January, the highest reading since May 2022.

Activity in the manufacturing sector also gave a positive surprise, though it still remained in contractionary territory. The manufacturing PMI rose to 49.2 in February from 47.0 in January, and above expectations of 47.5. The increase was driven by stronger results in output and employment.

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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