Schroder Absolute Return Income Active ETF (CBOE: PAYS)

Portfolio Review

The Schroder Absolute Return Income Active ETF delivered a return of 0.8% (net of fees) for December and 6.4% (net) over the 12 months to December, which is 2.0% over the RBA cash rate for the past year. Over 3 years and 5 years the Fund has returned, net of fees, 3.6% p.a. and 2.8% p.a. which is 0.4% p.a. and 0.8% p.a. over the RBA cash rate, respectively.

Largest contributors

The largest contributor to the month's performance was our interest rate strategy overlay (+0.30%), where we positioned for outperformance by Australian shorter maturities and European short end rates (where yields fell) and underperformance from US longer dated maturities, where yields increased. Australian credit exposures, particularly investment grade corporates and subordinated bank debt (+0.25%) continued to add value via higher carry. Foreign currency exposure, particularly to the US dollar, also added.

Largest detractors

There were no major detractors to performance over the month

Market Review

Most equity markets sold off in the second half of December, after the US Federal Reserve (Fed) delivered a hawkish 0.25% cut to the Fed Funds rate, and signalled a more uncertain path for rate cuts ahead in 2025, with inflation expected to be stickier than previously expected. The Fed 'dot plots' which had previously indicated four 25 basis point rate cuts for 2025, were unwound back to two cuts, whilst the longer run dot plots beyond 2025 also moved higher. Fixed income markets were more mixed, with bond yields generally moving higher, most notably in the US long end. Australia was an exception to this, as there was a more dovish tone from the Reserve Bank of Australia (RBA). In its December meeting, the RBA indicated a greater confidence that inflation is moving back towards target, and acknowledging mixed growth signals, opens up the possibility of a potential rate cut in the first quarter of 2025. In Europe, there remains a high degree of political uncertainty, with the French government unable to pass a budget for 2025, and forced to adopt a stopgap measure, whilst a collapse of the German government sets up a federal election for February 2025. Meanwhile, in China, the People's Bank of China shifted its stance on monetary policy to be 'moderately loose', and emphasised that it would prioritise 'the role of interest rate adjustments' over 'quantitative objectives' for loan growth.

Global developed equity markets fell by 1.9% over the month, being primarily driven by a weaker US equity market. Australian equities underperformed global equities over the month, with a return of -3.2%, while emerging markets were broadly flat over the month in US dollar terms. That said, there were some equity markets that still delivered positive returns during December, with the Euro Stoxx index returning 1.4%, while Japan was the standout performer, with the TOPIX index returning 4%.

Over the quarter, Japan was also one of the best performing markets, returning 5.4% through Q4, while global developed equity markets returned 2.0%, Australian equities fell by 0.8%, and emerging markets was the biggest underperformer, with a return of -8% in US dollar terms. Within credit, there were divergent moves across different sectors, with spreads tightening at the margin in Australian investment grade and emerging market debt, while in the US, high yield spreads widened by just over 20 basis points over the month. Over the quarter, spreads tightened moderately across all major markets.

Bond yields typically moved higher over the month, with Australia being the exception. A more hawkish pivot from the Fed, saw US 10-year bond yields jump by 0.4% to finish the year at just under 4.6%, while Australian 10-year bond yields were broadly flat over the course of December, finishing the year at 4.36%. Australian 3-year bond yields fell by 0.09% down to around 3.8% as the market moved to price in more rate cuts from the RBA. German 10-year bond yields also sold off, moving higher by almost 0.3% over the month, while Japanese yields saw a more modest increase of 0.05%. Over the course of the quarter, US 10-year bonds also saw the largest increase in yields, jumping by over 0.8%, while German 2-year yields outperformed, remaining broadly flat over the quarter.

Within FX, the US dollar continued its recent rally, with the broad DXY index rallying by 2.6% over December. The US dollar rallied about 5% against both the Australian dollar and Japanese yen, while also rallying by over 2% against the Euro. Over the quarter, it was the same story, with DXY index up by over 7.5%, with the Australian dollar being a notable underperformer, falling over 10% relative to the US dollar. Commodities delivered a 1% return over the month, with stronger returns in energy, being partially offset by weaker performance from Gold. Over the quarter, commodities returned -0.4%.

Market Outlook

The minutes from the RBA's December meeting revealed a clear bias to ease monetary policy as board members are gaining confidence that inflation is moving sustainably towards their target, and importantly they have judged that the upside risks to inflation have diminished. If the future flow of inflation and growth data continues on its current trend, then the RBA is very likely to cut interest rates in the first half of 2025 and market pricing has moved quickly to factor in three rate cuts over the course of the year. As we discussed in our last monthly commentary, we had anticipated this change in policy bias and had over the preceding months shifted our interest rate exposure to Australian shorter maturity bonds (less than 5 years), which significantly outperformed longer dated bonds and other developed market rates. Despite the US Federal Reserve cutting rates, US bond yields significantly underperformed with 10-year and 30-year yields increasing 40 basis points over the month as the market focused on the potential inflationary and debt consequences of the new administration's policy agenda.

With three rate cuts priced into market yields, we now need to think about the potential factors or risks that may slow the pace or reduce the number of rate cuts. One factor we have emphasised over the past year is the level of government spending (both federal and state) which has been working against the RBA's monetary policy. The impact of this can be seen in the labour market, where close to 80% of the increase in employment over the past year has been in the non-market sectors (i.e. health care and social assistance, education and public administration), boosting the level of aggregate demand and keeping services inflation sticky. The federal government is due to release their yearly budget in March, just ahead of the most likely timing of the federal election in May. Will the government extend and potentially increase their cost-of-living relief measures in the budget and maintain their loose fiscal policy, with the risk the RBA waits until after the budget (or the election) before considering easing policy. Or is there a potential deal between the Treasurer and the RBA, where the price of RBA rate cuts is the government holds back of further spending measures? Mortgage holders would probably be more receptive to some mortgage relief than extended electricity subsidies. There is also the hurdle of the December quarter inflation data (released in late January) with current forecasts at 0.7%; a result which is critical to confirm the RBA's more optimistic inflation outlook as revealed in the December minutes.

The next question is how low can the official cash rate go; are we looking at a deep or shallow rate cutting cycle? With unemployment at 4% (already below some measures of full employment), inflation on target to fall below 3% by the end of 2025 and no recession, official rates could get to 3.5% depending on how quickly inflation comes down. This level of rate cuts is mostly priced into forward yields with December 2025 bank bill futures trading near 3.5%. Given the uncertainties around government policy (and their fiscal policy preferences versus potential rate cuts coming into an election), we will be looking for opportunities to reduce the Fund's interest rate exposure which remains concentrated in Australian short rates.

The Schroder Absolute Return Income Fund closed the calendar year with strong performance in December to post an annual return for 2024 (before fees) of 6.9%, which was 2.5% above the RBA cash rate return of 4.4%. December's outperformance was due to a combination of 1) our interest rate positioning with most of the exposure in short-dated Australian bonds (which rose in value as yields fell) and short positioning in longer-dated US bonds (where yields increased) and 2) strong performance from our Australian credit exposures, with Australian investment grade credit, subordinated bank debt and Residential Mortgage-Backed Securities all performing strongly. In addition, holding 4% in foreign currency (mostly US dollar and Japanese yen) added value as the Australian dollar depreciated against a strong USD.

In terms of positioning, we increased duration from 1.25 years to 1.5 years by reducing the short USD rates exposure via US 2 year bonds, which at the time of entry were trading at the same yield as US Federal Funds rate, with little further cuts factored into the yields. We also increased exposure to inflation-linked bonds to 8% (by increasing Australian and the US ILBs by 1% each) as the breakeven inflation rate fell to around 2.25%. These bonds will outperform nominal bonds if the inflation rate averages over 2.25% over the next 5 years. In credit, we reduced exposure via buying 4% protection across US high yield and European cross-over in credit default swaps. With less rate cuts now expected in the US, high yield credit spreads are unlikely to compress much below 300 basis points as companies with higher debt burdens may struggle to refinance. Across the continent, whilst the European Central Bank is expected to continue cutting rates, European spreads would be dragged along by higher US credit spreads. In foreign currency, our long Japanese yen call expired out-of-the-money after the Bank of Japan left policy rates unchanged in December. We will look for opportunities to increase the long yen position as we continue to expect the Bank of Japan to follow a rate hiking cycle in 2025.

Important Information