

Altius Green Bond Fund (Retail Units)

Fund Update 29 February 2024

The Green Bond Fund's purpose is to invest in green, sustainable and social bonds, with the primary aim of targeting investments that contribute to lowering carbon emissions. It is aligned with Australian Unity's values to create positive impact.

Performance as at 29 February 2024

	1 mth %	3 mths %	1 yr %	Since inception % p.a.
Gross total return	(0.23)	2.78	4.00	(2.30)
Net total return	(0.26)	2.68	3.58	(2.69)
Benchmark	(0.30)	2.59	3.51	(2.32)
Excess to benchmark	0.04	0.09	0.07	(0.37)

Inception date for performance calculations is 28 June 2021.

Gross total returns are calculated before fees and expenses and assume the reinvestment of distributions. Past performance is not a reliable indicator of future performance.

Net total returns are calculated after fees and expenses and assume the reinvestment of distributions. Past performance is not a reliable indicator of future performance.

Benchmark is the Bloomberg AusBond Composite 0+Yr Index.

Excess to benchmark is calculated on Net total return.

Portfolio Performance and Activity

February saw markets move away from the soft-landing narrative to growing concerns that the economic data would remain strong coupled with very sticky inflation. The narrative change saw a repricing of the expected easing cycles for most developed markets. This was particularly the case in the US which saw cash rate futures move from pricing 1.46% of cuts by December 2024 to 0.85% and pushing out the timing of the first cut to the June meeting. The move in the domestic market was less pronounced with pricing moved from 0.65% of cuts in 2024 to 0.44%, with the first cut not priced until September 2024. The large change in policy expectation led to domestic three- and 10-year bonds pushing higher to 3.74% and 4.19% respectively, 0.15% and 0.12% higher over the month. Portfolio interest rate risk was largely unchanged finishing the month at 5.15 years after starting at 5.22 years.

As widely expected, the RBA left policy rates unchanged at the first meeting of 2024. The Board's statement emphasized that ongoing inflation risks and not the recent slower growth and the labour markets remain the key focus, noting "returning inflation to target within a reasonable timeframe remains the Board's highest priority". In the press conference the Governor articulated that while the risks to the outlook are broadly balanced, the costs are not. Coupled with the release of the monetary policy decision was the Statement of Monetary Policy (SOMP). The Statement held some significant changes to the RBA forecasts, GDP outlook was revised lower driven by the softer consumer and weaker dwelling investment, offset by slightly stronger public and business spending. These changes lead to a softer employment outlook with unemployment forecast to rise to 4.4% by Mid-2025 and inflation not expected to fall to 3% until June 2025.

Key data releases over the month included employment, quarterly wage data, and retail sales. Unemployment surprised to the upside,

moving from 3.9% to 4.1%, driven by a very large fall of 106k in full-time jobs. Fourth quarter wages data printed on expectation of 0.9% down from 1.3% but led to a slight increase of the yearly number to 4.2%. The wages data will be keenly watched by the market and the RBA as a guide to inflation expectations. Finally, after an extremely weak retail sales number in December, markets expected a strong rebound in January. While the number did rise by 1.1% it was below expectations of 1.5%, again highlighting the cost-of-living pressures customers are facing.

The repricing of US cash rate expectations was driven by both stronger-than-expected economic data and the pass back by US Federal Reserve officials on the timing of any interest rate cuts. The month started with a strong employment release with 353k new jobs created, well above the 185k expectation and upward revisions to the previous two months. This was followed by the ISM Manufacturing printing at 15 month highs. But even as growth remained strong, there were further upward surprises on inflation, raising concern that inflation would take longer to get under control. US core inflation for January printed 0.4% which pushed the 3-month annualized number to 4%. The strength in data supported the consistent commentary from all US Fed officials throughout February that market pricing of policy was incorrect and the timing of the first cut was more likely in the second half of 2024. By the end of month markets had pushed the timing of the first interest rate cut from the March to the May meeting.

Credit markets opened with a strong bid tone which was retained throughout February. Primary issuance volumes highlighted the strong technical backdrop driving credit spreads tighter over the month. Locally, Heritage and People's Choice kicked the month off with \$400m of 8/2/27 at a margin of 1.60%. The deal generated \$650m of support leading to a 0.05% price lowering. This was quickly followed by a \$2bn 10NC5 NAB deal with \$3.1bn of interest which pushed the initial margin from 2.10% to 1.95%. This strong support was a catalyst for bank-subordinated spreads to narrow

around 0.15% over the month. Later in the month saw Macquarie Bank issue \$1.2bn of 10NC5 Tier 2 at a margin of 1.95% with a large book size of just under \$5bn, again highlighting the strength of markets. Other notable transactions included Newcastle Greater Mutual Groups \$400m 5-year and inaugural deals by the ASX, issuing \$275m to 2027 and Perth Airport \$300m 2031 transactions. By the end of the month, senior financial and industrial spreads had contracted 0.04% and 0.03% to finish at 0.90% and 1.02% respectively.

The Australian earnings season concluded in February. Corporates (ex REITs) reported moderately credit-negative to neutral results with financial leverage increasing year-on-year with most guiding a cautious and uncertain outlook. Key themes included a soft consumer and higher cost across the board and the inability to pass on cost increases. REITs remained under pressure reporting negative credit results driven by higher debt costs and further asset devaluations, resulting in a significant increase in leverage. Consistent themes were seen across the Banking sector with slowing credit growth and increased NIM pressure, driven by higher funding costs and mortgage competition. The positive for banks was that while non-performing loans have started to increase, they remain at historical lows.

Several key credit events occurred locally over the month. The Australian Competition Tribunal overruled the ACCC's decision and authorized ANZ's proposal to purchase Suncorp's banking division. The acquisition still remains subject to approval by the Federal Treasurer and an amendment to Queensland Parliament. The announcement saw Suncorp Bank securities compress towards ANZ Bank margins. Bank Australia announced merger talks with Qudos Bank with the member vote expected in late 2024 and completion in early 2025.

The biggest global credit story of the month was the poor Q4 result from the regional US bank, New York Community Bancorp (NYCB). NYCB reported an unexpected \$252m loss, which reignited concerns about US regional bank's exposure to commercial real estate. This saw Moody's cut the Group's rating by 2 notches. While the Regional Bank equity index only fell 1.7% on the announcement, the weakness continued to build through the month. The month closed with NYCB announcing a delayed release of its mandatory annual financial disclosure until March 15th. The delay led to a further 4-notch downgrade by Moody's from Baa2 to Ba3 and resulted in a 25% equity fall. The woes continued for NYCB in early March with Fitch also downgrading the bank and the equity price fell a further 30%. Over the past 12-month NYCB has fallen 73%. While uncertainty about NYCB's future continues the impact on the wider banking market has been minimal.

Socially Responsible Investments in Focus

January 2024 was the warmest January in the ERA5 data record, going back to 1940. The global surface air temperature was 13.14°C, which is 0.70°C above the 1991–2020 average for January and 0.12°C above the previous warmest January, in 2020. Considering the average of the last twelve months, the global mean temperature was the highest on record at 0.64°C above the 1991–2020 average and 1.52°C above the 1850–1900 pre-industrial average.

Samantha Burgess, Deputy Director of the Copernicus Climate Change Service (C3S) noted: "2024 starts with another record-breaking month – not only is it the warmest January on record but we have also just experienced a 12-month period [with a mean global average temperature] more than 1.5°C above the pre-industrial reference period. Rapid reductions in greenhouse gas emissions are the only way to stop global temperatures

increasing."

The average global sea surface temperature (SST) for January outside the polar regions reached 20.97°C, the highest recorded for January and the second highest monthly temperature in the ERA5 dataset for any month, only 0.01°C below the highest, reached in August 2023.

(<https://climate.copernicus.eu/warmest-january-record-12-month-average-over-15degc-above-preindustrial>)

The International Capital Market Association (ICMA) is exploring the possibility of developing market guidance for 'avoided emissions' (estimated savings from low-carbon projects or products), to include in principles for sustainability bonds and loans. These are separate to an entity's scope 1, 2 and 3 GHG emissions, and not usually counted towards decarbonization targets.

A key impediment to growing the use of 'avoided emissions' as an impact measure is the lack of a standardized accounting method for calculating 'avoided emissions', to ensure there is no overstatement of climate impact claims. The development of a guidance together with standardized calculations will help improve the credibility around this concept and orientate financial flows to activities to enable the decarbonization of the economy. (https://www.icmagroup.org/assets/documents/Sustainable-finance/ToR/TF-Green-enabling-ToR_-2023-2024_Member-List-Jan-2024-080124.pdf).

Despite global macroeconomic uncertainty in some key regions, S&P anticipate that GSSSB (Green, social, sustainability, and sustainability-linked bonds) issuance will increase modestly in 2024, building on the near US 1 trillion seen in 2023. Green bonds will continue their dominance, buoyed by increased demand for environmental projects across all geographies, while transition and blue bonds may also gain traction in the GSSSB market in 2024. S&P also see the spread of issuers growing as middle- and low-income countries strive to increase their share of GSSSB issuance given their large unmet funding needs.

Outlook

Global goods inflation has retreated but the tension between activity and employment data, and the trajectory of services inflation is expected to manifest in oscillating market reactions. The lags in effect of interest rate adjustments, timing of data, and of wage responses ensure a degree of volatility. The slow but nonlinear fall in inflation biases yields lower though with reasonably wide ranges.

Late last year, oil fell 28% as OPEC and non-OPEC (largely Russia) increased production. The effects of this flow, with a lag, provided a disinflationary pulse that hit official inflation data. This contributed to financial markets factoring in the expectation of significant rate cuts, starting in the US and Europe as early as June.

Attacks on container ships passing through the Red Sea have contributed to a 35% lift in shipping container costs over the first quarter. Key trade routes have extended by up to three weeks and specific shipping insurance costs have increased up to ten-fold. If this is ongoing, estimates suggest a 0.4% to 2% lift inflation, depending on jurisdiction.

Growth is expected to be uneven and weaker in sectors reliant on discretionary consumer activity. But as long as unemployment remains toward 50-year lows, and inflation is above target, the RBA's inflation mandate remains the greater focus for monetary conditions.

In Australia, housing makes up 22.25 percent of the CPI, with the

big ticket items being rents, new dwelling purchases, and maintenance. Australian "asking rents" are tracking at 8.4 percent - higher than measured rents currently in the CPI. The significant population growth and shortage of housing supply mean rents will have an upward bias to the CPI going forward, noting the rental subsidy effect was temporary.

Domestically, the Commonwealth Rental Assistance program added to the disinflationary pulse by temporarily dampening rents; an otherwise consistent source of Australian inflationary pressure. This allowed the RBA to resist the need for a follow-up rate increase. Moreover, it translated into markets factoring in RBA rate cuts as early as the second quarter.

The disinflation pulse is unlikely to be repeated in the current quarter. This is consistent with Altius view that fall in inflation to central bank targets will be elongated and non-linear. We expect mini cycles that reflect the uneven nature of the global economy and reaction functions.

The crude oil spot price is about 18% higher in Australian dollar terms than where it was at end of December and the average only a little below the average price of the previous quarter.

We expect lower headline inflation and a less supply-constrained labour market to allow more modest wage growth in aggregate compared to last year. The cumulative negative 7.5% real wage growth of the last three years likely sees wage negotiations attempt to claw back the loss of disposable income. Wage increase pressures should remain elevated – though not acute – over a longer time horizon.

Fed Governor Powell articulated that the Fed won't wait until inflation reaches 2% before easing interest rates. Real cash rates are as tight as any time over the last 30 years. As long as there is sufficient evidence that the expected immediate bounce in inflation is temporary and modest, the trimming of cash rates can occur with while keeping monetary settings slightly restrictive. The one hundred basis points fall in long-dated US Treasuries has already eased monetary conditions.

Australia's real cash rate is not tight by historical standards. We expect Australian cash rates to be eased during the fourth quarter. This reflects the higher starting point and more gradual decline of inflation. The commencement of a gradual US easing cycle in the middle of the year introduces a disinflationary bias through the currency channel and influences the RBA's reaction function.

The range on Australian long-dated bonds is expected to oscillate around a midpoint in 10-year Australian sovereign bonds of 4.0% with the expected evolution of inflation to allow long bonds to move lower to around 3.75%. The portfolio strategy is to actively manage duration settings; incrementally increasing duration above 4.0% or decreasing duration accordingly.

With cash rates above 4% over the immediate investment horizon, there is a significant benefit of attractive accrual across the yield curve and capital gains from roll down on fixed-rate corporate bonds. The expected low volatility environment correlates bullishly with higher-yielding corporate bonds converging with sovereign bonds.

The portfolio maintains on overweight credit exposure with a preference for financials, including senior and subordinated securities.

A further measure of value that we find in the high-grade corporate market is related to the yield on the Australian Corporate Index is higher than the dividend yield of Australian stocks as defined by the ASX 200. To illustrate at the time of writing, the CBA dividend yield is around 3.8%. By comparison, the higher-

ranking CBA (10-year) subordinated bond yields above 6%.

Sector Profile

Asset Class	Portfolio %	Benchmark %
Supranationals	20.18	8.05
Industrials	14.04	4.40
Financials	14.44	4.49
Asset Backed	2.86	0.00
Agencies	10.47	1.24
11AM	7.30	0.00
Cash at Bank	1.54	0.00
Semi Government	29.17	30.01
Sovereigns	0.00	51.81

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	6.90	2.72
AA	47.07	30.65
AAA	32.71	63.70
BBB	13.32	2.93

Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	4.26	4.24
Running yield (%)	3.03	
Modified duration (years)	5.10	4.94

Fund snapshot

APIR code	AUS9041AU
Inception date	28 Jun 2021
Distribution frequency	Quarterly
Minimum initial investment	\$5,000
Fund size (net asset value)	\$197.88m
Management fee*	0.40% p.a. expressed as a percentage of the net asset value of the Fund
Buy/Sell spread	0.05%/0.05%

*Refer to the Fund's Information Memorandum for more details on the Fund's management costs which also include recoverable expenses and indirect costs. Total management costs may vary.

Ratings / Awards





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