

Nikko AM NZ Bond Strategy

Monthly Update 31 July 2024

Assets are held in the Nikko AM Wholesale NZ Bond Fund. The Nikko AM NZ Bond Fund (retail) invest in units in the wholesale fund, which the commentary refers to.

Market Overview

- NZ bonds had a strong month as yields moved meaningfully lower in July making new year-to-date lows.
- Credit and NZ government bonds remain opposed in terms of supply/demand dynamics with a shortage of credit and increasing supply of government bonds.
- There is now a lot priced in terms of rate cut expectations, and there is some risk the market could again be disappointed in the near term. But we do expect further downside for rates over the medium term.

Fund Highlights

- The fund had a strong month and outperformed its benchmark.
- We have increased duration when bonds have been higher in yield, and locking in higher rates for longer has benefited performance through capital gains as rates have fallen.
- Credit margins have tightened but we like the higher yield of quality credit and expect the demand/supply dynamics to remain supportive.

Performance

	One month	Three months	One year	Three years (p.a.)	Five years (p.a.)	Ten years (p.a.)
Wholesale¹	2.82%	5.41%	9.52%	0.67%	1.41%	3.93%
Benchmark²	2.31%	4.20%	7.81%	-0.56%	0.10%	2.83%
Retail³	2.81%	5.22%	8.85%	0.04%	0.75%	3.18%

1. Returns are before tax and before the deduction of fees and including tax credits (if any).
2. Current benchmark: Bloomberg NZBond Composite 0+ Yr Index. No tax or fees.
3. Returns are before tax and after the deduction of fees and expenses and including tax credits (if any).

Five Year Cumulative Performance, \$10,000 invested^{1,2}



Portfolio Manager

Fergus McDonald,
Head of Bonds and Currency



Fergus is responsible for the investment of the Bond, Cash and Currency mandates. Fergus has been actively involved in the NZ financial markets since 1981. The portfolio management team for the domestic fixed income funds includes Ian Bellew, Senior Fixed Income Manager and Matthew Johnson, Senior Fixed Income Manager.

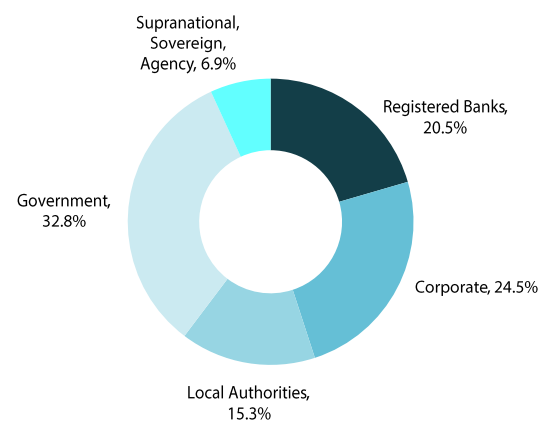
Overview

The fund aims to provide investors with regular income by constructing an actively managed investment portfolio of New Zealand bonds, deposits and cash with the potential for capital gain from New Zealand dollar fixed interest markets.

Objective

The fund aims to outperform the benchmark return by 0.60% per annum before fees, expenses and taxes over a rolling three-year period.

Sector Allocation



Top 5 Corporate Issuers*	(%)
New Zealand Local Govt Funding Agency	9.72
Housing New Zealand	6.87
Kiwibank	5.21
Auckland International Airport	4.18
Westpac New Zealand	3.51

* Excludes NZ central government

Credit Quality	(%)
AAA	58.20
AA	9.79
A	28.05
BBB	3.96

Green, sustainable and social bonds
22.69% of the fund
Duration
Fund 6.14 years vs Benchmark 4.83 years
Yield to Maturity*
Fund (gross) 4.76% vs Benchmark 4.43%

* Excluding the inflation component of government inflation linked bonds

Market Commentary

The NZ bond funds had a strong performance in absolute and relative terms as interest rates moved lower. The move lower in rates was the main driver of returns for the month. Pleasingly all bond sectors performed well. Credit holdings were generally the star performer - benefiting returns through a higher yield and credit margin contraction. NZ governments were also a positive due to the fall in interest rates, but their performance relative to swap and credit holdings lagged as government bonds widened in spread relative to swap-based product.

The yield curve has become more positive in shape with short terms rates falling more than longer maturities. (It is however important to note longer maturity bonds have greater capital price increases than short bonds for an equal fall in rates). At month end government yields finished as follows; 2yr -54bp, 5yr -49bps, 10yr -32bps and 30yr -18bps. For comparison swap maturities were 2yr -73bps, 5yr -57bps, 10yr -44bps and 30yr -40bps.

We acknowledge NZ government bonds are looking cheap on a spread to swap basis, but with ongoing supply it's hard to predict a catalyst that will materially change this in the near term. Another challenge for NZ government bonds may be that cross-market spreads have compressed relative to US 10-year bonds and Australian 10-year bonds. To justify current market pricing, we will likely need to see further weakness in data and lower inflation with rate cuts before year end. As always, the timing and magnitude of rate cuts will remain subject to how the data evolves. We do however think there is a high chance of rate cuts this year and despite the timing there is still further room for rates to move lower from here over the medium term.

It is pleasing bonds are performing well after building a longer duration position. We want to maintain a higher yield through quality credit and participate in further capital gains as rates move lower over the coming months. Depending on how quickly and how much longer-term rates fall and the shape of the yield curve we may trim some of our duration and move shorter on the yield curve. But this would also be based on our expectations for the terminal OCR rate.

Fund Commentary

The fund had a strong absolute and relative return for the month outperforming the Bloomberg NZBond Composite benchmark. The move lower in interest rates over July was the main attributor of returns, and the fund outperformed due to a higher yield and longer duration positioning versus benchmark. Credit holdings performed better than similar maturities of NZ government bonds as government widened in spread with continual high supply. The fund holds less government bonds than benchmark, so this was a positive for the fund.

The fund is positioned with a long duration with a view that the ultimate direction of rates is lower over the next 12-18 months. Our preference is to hold higher yielding quality credit, but we have added NZ government bonds when they look cheap relative to swap. NZ government bonds are approximately 2/3rds of the benchmark.

Key Fund Facts

Distributions		Hedging: Any foreign currency exposure are hedged to NZD within operational range of 95%-105%	Strategy Launch: October 2007
Wholesale:	Calendar quarter	Exclusions: Controversial weapons	Strategy size: \$570.8m
Retail:	Calendar quarter	Restrictions: Adult entertainment, gambling, fossil fuels, alcohol stocks, tobacco stocks. For more information, please refer to the Statement of Investment Policy and Objectives (SIPO) on our website https://www.nikkoam.co.nz/invest/retail .	Buy / Sell spread: Click to view
Estimated annual fund changes (incl. GST)			
Wholesale:	Negotiated outside of unit price		
Retail:	0.65%, refer PDS for more details		

Compliance

The wholesale fund complied with its investment mandate and trust deed during the month.

Contact Us

www.nikkoam.co.nz | nzenquiries@nikkoam.com

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