Nikko Asset Management

Factsheet 31 July 2020

NIKKO AM NZ CASH STRATEGY

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

Market Overview

- Bank bill rates and credit spreads took a steady-as-she-goes course in July – rates remain low and spreads tight.
- As expected inflation was weak with the impacts of the COVID lockdown the primary contributor. Prices fell 0.5% over the quarter, reducing annual inflation to 1.5%.
- The markets attention now turns to the RBNZ's August Monetary Policy Statement where amongst the usual updates, the RBNZ will discuss its readiness to use unconventional policy tools, such as term-lending facilities, negative rates and FX intervention.

Fund Highlights

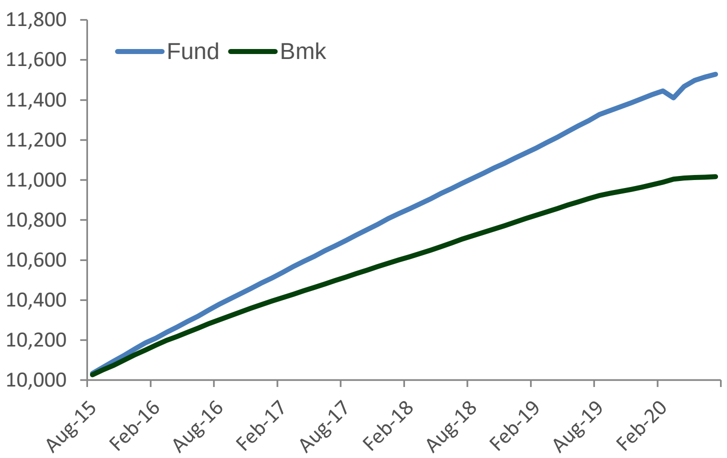
- The fund holds a portfolio of high quality credit which are expected to perform well in the aftermath of the COVID crisis.
- With a longer than benchmark duration position, the fund's yield to maturity is enhanced over its benchmark benefiting from slope in both the bank bill curve and credit curve.
- Returns are likely to moderate over the coming months as proceeds from maturities are reinvested at current prevailing market interest rates.

Performance

	One month	Three months	One year	Three years (p.a)	Five years (p.a)	Ten years (p.a)
Wholesale[1]	0.12%	0.53%	2.05%	2.61%	2.89%	3.52%
Benchmark[2]	0.03%	0.07%	1.01%	1.62%	1.96%	2.49%
Retail[3]	0.10%	0.46%	1.70%	2.24%	2.52%	
KiwiSaver[3]	0.09%	0.44%	1.67%			

1. Returns are before tax and before the deduction of fees.
2. Benchmark: Bloomberg NZBond Bank Bill 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, Fixed Income Manager and Matthew Johnson, Fixed Income Manager.

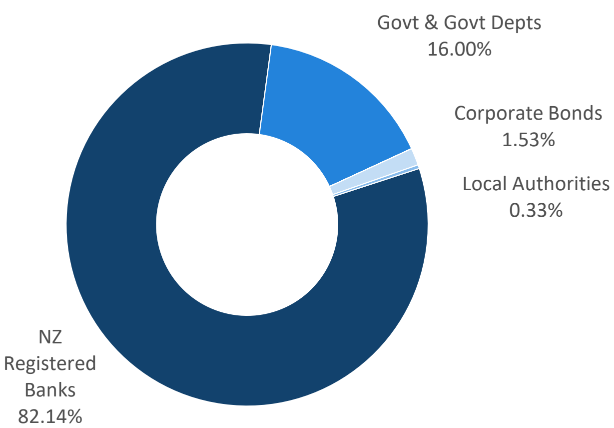
Overview

The strategy aims to generate income by constructing an actively managed investment portfolio of short-term deposits and bonds whilst preserving capital value.

Objective

The fund aims to outperform the benchmark return by 0.20% per annum before fees, expenses and taxes over a rolling three year period.

Asset Allocation



Top 5 Issuers	(%)
ANZ Bank New Zealand	18.22%
Westpac New Zealand	13.29%
NZ Tax Trading	12.68%
ASB Bank	11.23%
Kiwibank	8.83%

Credit Quality	(%)
AAA	-
AA	60.61
A	39.39
BBB	-

Duration
Fund 124 days vs Benchmark 45 days

Yield
Fund (gross) 1.26% vs Benchmark 0.28%

Market Commentary

The short end of the interest rates market took a steady as she goes course in July – rates remain low and credit spreads tight. A strong supply of funds, weak demand for credit and accommodative monetary policy continue to be key contributors.

This supply demand imbalance can clearly be seen in bank balance sheets. Since the COVID outbreak took hold in March deposits at New Zealand registered banks have increased by over $20.6 billion whilst at the same time loans and advances have declined by $0.5 billion. To put this into perspective this deposit growth is larger than seen in each of the last three calendar years of $18.6b, $19.1b and $20.5b respectively and completely unaligned with loan growth which in general moves in the same direction as deposit growth. In addition it is notable that despite record low interest rates these deposits appear to be sticking around increasing by $2.9 billion in June.

Excess liquidity in the banking system impacts the rates markets in a couple of ways. First, when banks are well funded they do not need to compete for deposits or issue term debt, the former will reduce deposit and bank bill rates whilst the latter results in reduced primary market issuance and impacts longer rates. Second, if not lent out as loans and advances this excess liquidity will end up as either increased balances at the RBNZ or invested by banks in high credit quality debt securities. Both these categories are significantly higher than where they were at the start of March. Balances at the RBNZ are $16.5 billion higher and investments in debt securities $7.7 billion higher.

A second key source of funds into the market is KiwiSaver contributions – which averaged $615 million per month in 2019. The scheme in aggregate is now in the vicinity of $67 billion and expected to exceed $70 billion sometime during 2020. Based on data from the Reserve Bank over half of KiwiSaver funds are invested in New Zealand-based assets of which roughly half end up in cash or fixed income securities. In addition as a result of the market gyrations seen in March, there has been level of switching with investors moving out of balanced and growth funds into more conservative funds that hold a higher proportion of fixed income securities. In a market with weak credit growth and reduced debt issuance from the non-government sector this is a significant regular source of funds that needs to find a home.

In summary, we have (1) banks reducing deposit rates due to having excess funding and a lack of demand for loans, (2) banks buying high grade debt with this excess funding and (3), continued inflows of KiwiSaver contributions into the market. Further to these features which in themselves place downward pressure on short end interest rates, we have the RBNZ buying government and LGFA debt as part of their QE programme, placing further downward pressure on interest rates.

In the absence of credit growth returning or another unexpected economic shock, it is difficult to see a scenario where short term interest rates increase significantly over the coming months. The market's attention will next turn to the RBNZs' Monetary Policy Statement on August 12. We expect the RBNZ will continue to call out a weak economic outlook, low inflation and concerns around employment and global growth. Along with this standard update the RBNZ will discuss its readiness to use unconventional policy tools, such as term lending facilities, negative rates and FX intervention. In this update the market will look for inferences on the RBNZ preferred alternative policy tools with short end rates particularly sensitive to any expressed preference for negative rates.

Fund Commentary

The fund performed well in July returning 0.12%, a strong outperformance against the 90 day bank bill index which returned 0.03%. The fund holds a longer than benchmark duration position providing a yield enhancement over the 90 day bank bill index with benefits accruing from both slope in the bank bill and credit curves. With the markets current supply demand dynamics, the Reserve Banks LSAP in action and continued high uncertainty we expect interest rates to remain low and credit margins tight in the near term. In this environment we expect the fund's long duration position to perform well.

Key Fund Facts

Distributions

Wholesale fund: Calendar quarter
Retail fund: Calendar quarter
KiwiSaver fund: Does not distribute

Estimated annual fund charges (incl. GST)

Wholesale: Negotiated outside of unit price
Retail: 0.32%, refer PDS for more details
KiwiSaver: 0.45%, refer PDS for more details

Hedging

All investments will be in New Zealand dollars

Buy / Sell spread	Strategy size	Strategy Launch
0.00% / 0.00	$764.3m	October 2007

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

Contact Us
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