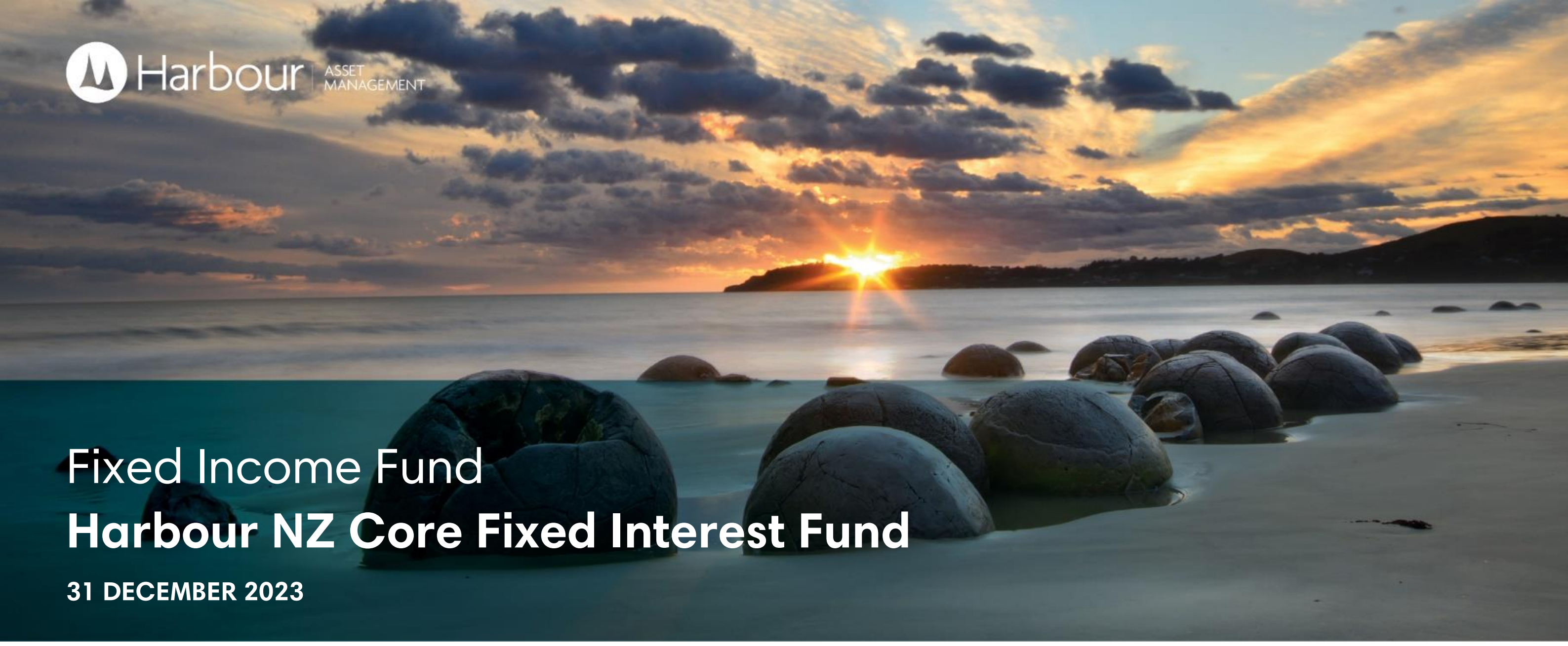


# Fixed Income Fund

# Harbour NZ Core Fixed Interest Fund

**31 DECEMBER 2023**

| 1 month performance | 1 year performance | Fund size | Average credit rating |
|---|---|---|---|
| **2.93%** | **7.17%** | **$602,651,302** | **AA-** |
| Before fees & tax | Before fees & tax | NZD | |

The New Zealand fixed interest market finished the year very strongly, with a monthly gain of 2.93%. This lifted the overall annual market return to 6.2%, with all of the gain occurring in the last two months. This was due to the sharp decline in bond yields seen recently, which has taken the 10 year NZ Government Stock yield 1.25% lower to 4.32%. The primary catalysts for the fall in yields during December were a lower than expected NZ GDP print for Q3 and a surprisingly dovish assessment from the US Federal Reserve, indicating that they might cut the Fed Funds rate 3 times in 2024. While the market has perhaps got ahead of itself at present, we are expecting yields to continue to decline through 2024.

Over the year, the Fund's return before fees and tax was 7.17%, which was 0.99% above the benchmark. For many investors, this will provide a welcome outcome after two very difficult years.

| Performance | 1 MONTH | 3 MONTH | 1 YEAR P.A. | 2 YEAR P.A. | 3 YEAR P.A. | 5 YEAR P.A. | 10 YEAR P.A. | SINCE INCEPTION P.A. |
|---|---|---|---|---|---|---|---|---|
| Return before fees & tax | 2.93% | 6.58% | 7.17% | 0.17% | -1.20% | 1.44% | 3.52% | 3.83% |
| Benchmark return | 2.84% | 6.01% | 6.18% | -0.71% | -2.39% | 0.44% | 2.90% | 3.12% |
| Relative performance | 0.09% | 0.57% | 0.99% | 0.87% | 1.18% | 1.00% | 0.62% | 0.72% |
| Tracking error | - | - | - | - | 0.67% | - | - | 0.65% |
| Information ratio | - | - | - | - | 1.77 | - | - | 1.10 |

Inception: 1 September 2011. Benchmark: Bloomberg NZBond Composite 0+ Yr Index, effective 1 January 2019. Prior benchmark was 50/50 weighted average of S&P/NZX Govt Bond Index & S&P/NZX A-Grade Corporate Bond Total Return Index. Past performance is not indicative of future results.

| Key yield movements | 90 DAY BANK BILL | 2YR NZ GOVT STOCK | A-AAA AVERAGE CREDIT SPREAD TO NZ GOVT STOCK | 10 YR NZ GOVT STOCK |
|---|---|---|---|---|
| Yield | 5.64% | 4.60% | 0.25% | 4.35% |
| 1m change | 0.02% | -0.44% | -0.08% | -0.55% |
| 12m change | 0.99% | -0.35% | -0.44% | -0.12% |

Source: Bloomberg.

## Fund characteristics

| | FUND | BENCHMARK |
|---|---|---|
| Yield to maturity | 5.04% | 4.69% |
| Modified duration (years) | 4.38 | 4.40 |
| Credit duration (years) | 1.27 | 1.11 |
| Weighted average rating factor (WARF) ^ | AA- | |
| Number of issuers | 60 | |

^ Calculated as the weighted average credit rating of the fixed interest securities using a Moody's WARF factor. Securities not rated by a ratings agency are assigned an internally-assessed rating by Harbour.

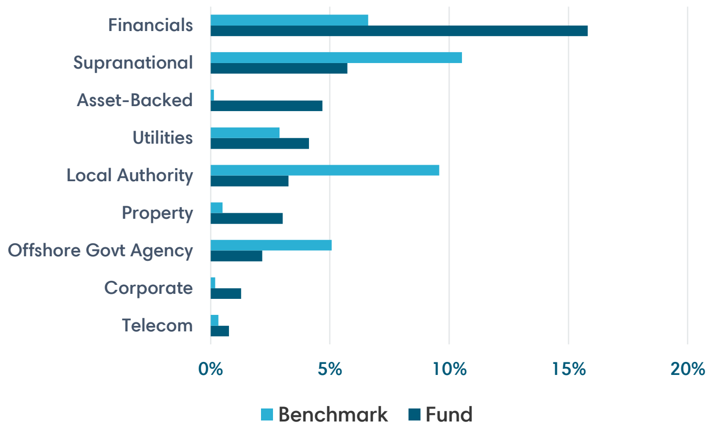
## Top 10 issuer exposures

| | POSITION |
|---|---|
| New Zealand Government | 55.41% |
| BNZ / NAB | 5.13% |
| Westpac | 3.26% |
| World Bank Group | 2.85% |
| Cash | 2.52% |
| Kiwibank | 2.10% |
| Auckland Council | 2.08% |
| ASB / CBA | 2.02% |
| Rabobank UA/New Zealand | 1.67% |
| Housing New Zealand | 1.32% |

## Rating composition

| | FUND |
|---|---|
| AAA | 65.75% |
| AA | 18.68% |
| A | 8.43% |
| BBB | 4.67% |
| NR | 2.46% |

## Credit sector vs benchmark




| Fund attribution | 1 MONTH | 3 MONTH | 1 YEAR P.A. | 3 YEAR P.A. | 5 YEAR P.A. | 10 YEAR P.A. | SINCE INCEPTION P.A. |
|---|---|---|---|---|---|---|---|
| Credit allocation | 0.00% | 0.00% | -0.01% | -0.03% | 0.01% | 0.04% | 0.05% |
| Duration & yield curve | 0.09% | 0.65% | 0.46% | -0.19% | -0.04% | -0.04% | 0.02% |
| Relative value | 0.03% | 0.08% | 0.23% | 0.40% | 0.28% | 0.21% | 0.24% |
| Inflation - indexed | -0.03% | -0.07% | 0.25% | 0.57% | 0.38% | 0.16% | 0.16% |
| Security selection, transaction costs & other | 0.00% | -0.09% | 0.06% | 0.44% | 0.36% | 0.26% | 0.24% |
| Total | 0.09% | 0.57% | 0.99% | 1.19% | 1.00% | 0.62% | 0.72% |

## Outlook and strategy

**The US Federal Reserve performed an unexpected dovish pivot at its December meeting and markets now anticipate a "soft-landing" where inflation returns to 2% without the Fed having to inflict severe economic damage.** The Fed left its policy rate unchanged but cut its forecasts for inflation and forecast 75bp of rate cuts for next year, vs. 25bp previously. During the press conference, Chair Powell provided no push back on the recent easing in financial conditions which further encouraged market pricing of 2024 rate cuts to move from 110bp to 150bp. We think the surprisingly fast drop in annual core inflation to almost 3%, from almost 5% a year ago, has allowed the Fed to focus more on the maximum employment objective of its dual mandate, the other being low and stable inflation. 3% inflation, however, is not the 2% that the Fed targets and getting there may still require substantial economic pain. As such, the risk for markets is that policy rates may need to stay at more elevated levels for longer than anticipated.

**The "soft-landing" view is not unique to the US with economists expecting a version of that to occur for much of the world next year.** A lot needs to go right for economies to stick the soft-landing. Since the 1960's, for example, central bank tightening of more than 400bps is almost always followed by recession, though the starting point for policy rates this time was particularly low. Tight labour markets are generating wage growth that is keeping services inflation too high for comfort.

Forward labour market indicators suggest wage pressures should continue to ease, but if they don't, central banks may have to resume tightening cycles or keep rates higher for longer than markets currently assume. Ongoing consumption growth is another risk to the soft-landing narrative, particularly in the US, and may require central banks to further tighten financial conditions to reduce demand.

**Chinese growth is likely to remain lacklustre.** While public sector spending is expected to continue, the government recently announced a return to targeting a 3% fiscal deficit in 2024 after allowing a 3.8% deficit in 2023. Weak consumption, slowing exports and low rates of private sector investment are seen as providing ongoing challenges to growth. These sit in the context of structural headwinds such as a debt-burdened property sector and a highly challenged demography with plunging birth-rates and a fast-ageing population.

**The New Zealand economy is in much worse shape than previously thought and tight monetary policy appears to be working.** Q3 GDP data showed the economy unexpectedly contracted 0.3% in the quarter and negative historical revisions meant the economy is 1.8% smaller than the RBNZ had assumed in its most recent November MPS. The big signal here is that monetary policy is working better than previously assumed and, despite the large influx of migrants, activity is not holding up particularly well. On a per capita basis, it's awful, with GDP down more than 3% over the past year. All else equal, these data should lower the RBNZ's OCR forecast when we see it next. However, we still have inflation and labour market data before the RBNZ meets next at the end of February. In terms of fiscal policy, we didn't learn anything new from the Half Year Economic and Fiscal Update as it didn't incorporate any of the new government's policies or the weaker-than-expected GDP data. It's likely that the May Budget will be the first time we can assess the impact of these on the fiscal position.

**Migration and sticky non-tradable inflation continue to pose a risk that interest rates may need to remain high for longer than markets assume.** Exceptionally high rates of migration have seen population growth surge to a record high of 2.7% y/y and suggests meaningful demand for housing services, whether that be renting or buying. Housing costs make up almost 30% of CPI and almost half of non-tradable inflation. Higher house prices may slow the decline in residential investment and the rate of construction cost (9% of CPI) disinflation. Rents, which make up 10% of the CPI, have been running at 4.5% y/y - about double the pre-COVID average. New rents have been growing even faster at 6% y/y and wage growth hasn't yet slowed sufficiently to suggest this rate of increase is going to drop a lot any time soon. Higher council rates and insurance costs (collectively almost 4% of the CPI) are also contributing to high rates of non-tradable inflation which is still running at more than 6% y/y. While the November MPS was delivered prior to the very weak GDP data, the RBNZ was particularly concerned about sticky housing-related inflation. This may have greater relevance after the Remit for the Monetary Policy Committee was recently amended by the new government to make low inflation the sole objective, unless the RBNZ is prepared to be more patient in achieving it.

**We still think more RBNZ rate cuts can be priced for this year, and the market-implied trough for the OCR is too high at 3.5%, but the recent decline in interest rates has delivered market pricing that better reflects the balance of risks, in our view.**

### Investment Strategy

After a very strong performance relative to index in November, December was something of a missed opportunity, with returns fairly close to index. The market rallied hard over the month, with the 5 year NZ Government Stock yield falling by 0.6% to finish at 4.15%. We had decided in early December to reduce duration to only be modestly longer than benchmark, primarily due to the signal from the Reserve Bank about their frustration that core inflation was not falling quickly enough. Their projection that another rate hike was more likely and that a much slower path towards rate cuts than the market was pricing prompted us to reduce duration. At the time the market was not in sync with the Reserve Bank's mindset, but we could appreciate that the stubborn housing-related aspects feeding into non-tradable inflation could persist for a while. In mid-December the US Federal Reserve's completely different assessment of their rate outlook, despite a stronger economy than New Zealand's, drove a rapid decline in yields in both markets of around 30 basis points.

The divergence in approach between the two central banks can be partly understood through their respective mandates, with the US Federal Reserve having split objectives of both jobs and inflation, while the Reserve Bank now has an inflation-only target. One can argue that for the Reserve Bank of New Zealand to entertain meaningful rate cuts this year, they will have to be quite forward looking and recognise that the very problematic inflation sources such as rates, insurance, rents and building costs will come down over the next couple of years. We think that this would be a sensible approach, but it remains to be seen how they will act. Market pricing currently reflects our thinking, but the old mantra "don't fight the Fed" bears remembering. Our current strategy is to add duration on any meaningful backups in market yields.

Corporate bond performance was in strong in 2023, after 2 weak preceding years. On a duration equivalent basis, the S&P/NZX Corporate A-Grade Index beat NZ Government Stock by 1.8% on our calculations, compared to an average of 1.4% over the last 15 years. Much of this came from performance of the interest rate swap curve, which credit is primarily priced against. The cause of this move has been the relative weakness in NZ Government Stock, as the market has been wary about the very large increase in issuance required by the government to fund spending incurred through the Covid-19 years. Issuance is likely to be a focus for markets in 2024 as well, both in New Zealand and globally. Sir Robert Stheeman, the retiring head of the UK's Debt Management Office offered a salient comment last week saying, "Don't kid yourself in thinking that you can develop policy in a vacuum without taking the market into account. In a world where you have debt to sell, policymaking cannot be divorced from the reality of the market." That is perhaps also a relevant message for the local authority sector.

Over the year we expect the yield curve to steepen, with 2 year rates declining below 10 year rates. This reflects the contrasting influences of expected cuts in the Official Cash Rate, while longer-term bonds are somewhat constrained by issuance challenges. Our portfolios are positioned accordingly, with a bias for duration overweight exposure to be held in the 1-3 year maturity range.

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**Data sources:**

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# COMPLIANCE CERTIFICATE

## Harbour NZ Core Fixed Interest Fund (the "Fund") (Wholesale Unit Trust)

**For month ended 31 December 2023**

Harbour Asset Management Limited (the "Manager"), certifies that, to the best of our knowledge, after having made reasonable enquiries, and except as specified in this certificate;

1. The Fund has at all times complied with the Fund's Trust Deed;
2. The Fund has complied with internal investment guidelines, established as at 28 Sept 2011.
3. The Manager has at all times during the month complied with the policy and procedures set out in its Compliance Manual

**Tim Morrison**
Head of Compliance
Harbour Asset Management Limited

**Dated 04 January 2024**