Henderson

AUSTRALIAN FIXED INTEREST FUND

Henderson GLOBAL INVESTORS

Monthly report at 30 November 2016

Fund objective
The Fund seeks to achieve a total return after fees that exceeds the total return of the Benchmark, over rolling three-year periods.

Benchmark
Bloomberg AusBond Composite 0+ Yr Index

Portfolio Manager
Glenn Feben and Jay Sivapalan

Risk profile
Medium

Suggested timeframe
3 years

Inception date
31 August 1994

Fund size
$353.5 million

Minimum investment
$25,000

Management costs (%)
0.47 p.a.

Buy/sell spread (%)
0.0/0.0

Distribution frequency
Quarterly

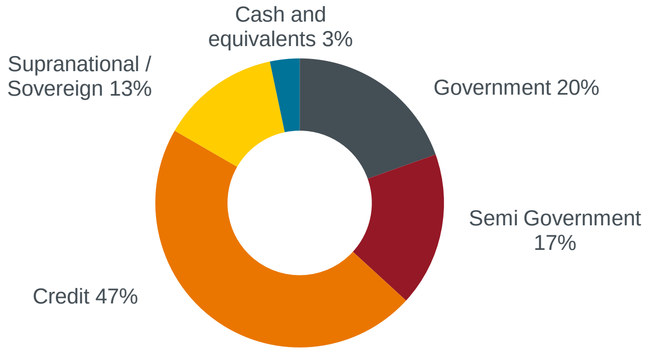
ARSN code
087 719 739

APIR code
IOF0046AU

Performance	1 month (%)	3 months (%)	6 months (%)	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	Since inception (% p.a.)
Fund (gross)	-1.44	-2.58	-0.23	3.81	5.46	6.14	7.83
Fund (net)	-1.48	-2.69	-0.47	3.33	4.97	5.65	7.25
Benchmark	-1.44	-2.92	-0.49	3.44	5.30	5.15	7.02
Excess return*	-0.04	0.23	0.02	-0.11	-0.33	0.50	0.23

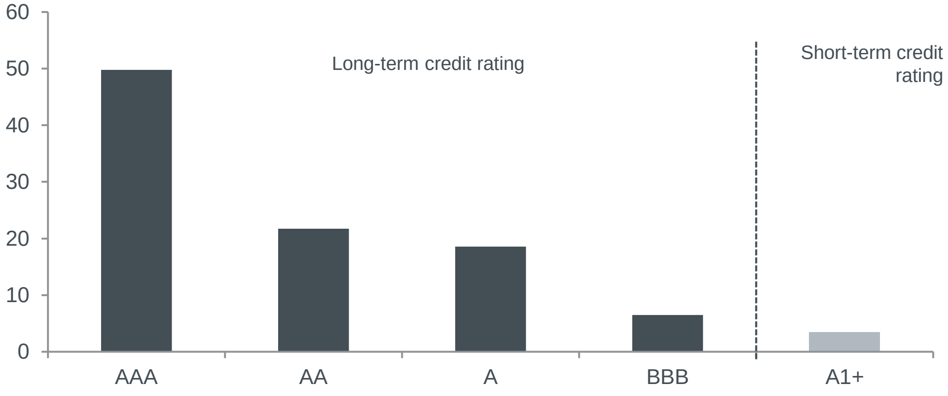
*Excess return is measured against net performance.
Past performance is not a reliable indication of future results.

Sector allocation



Rounding accounts for small +/- from 100%.

Credit rating distribution (%)



Portfolio characteristics

Estimated Weighted Average Yield to Maturity (EWAYTM)[1]	2.88
Benchmark EWAYTM	2.49

[1]Estimated Weighted Average Yield to Maturity is a measure of the average annual yield of all securities in the Fund.

Modified duration	Years
Fund	5.11
Benchmark	4.87
Active position	0.24

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(continued)

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Head of Australian Fixed Interest
Glenn Feben

Portfolio Manager
Jay Sivapalan

Fund performance

Bond yields continued to lose ground over November spurred on by the surprise US election result, with the pro-growth / inflation bias of the Trump administration adding to the bearish tone that has pervaded global bond markets over recent months. The fallout from increasing inflation expectations and a rise in the term risk premium was a further lift in bond yields across all maturities, with longer term yields lifting the most. Credit markets held their ground and performed slightly better than risk-free assets.

The bond market as measured by the Bloomberg AusBond Composite 0+ Yr Index (Benchmark) returned -1.44% over the month which was the third consecutive negative monthly return, something that has not occurred since 1994. The Henderson Australian Fixed Interest Fund (Fund) performed in line with the Benchmark, returning -1.44% (gross) and -1.48% (net).

Rate strategies were broadly neutral with outperformance from inflation indexed bonds being offset by a small long duration stance over the latter stages of the month. Sector allocation via an overweight allocation to corporate debt added marginally to performance.

Market review

Global and domestic bond yields continued to lift and yield curves steepened as markets factored in the pro-growth policy agenda of the newly elected American President. With the Republican Party controlling both the Senate and Congress, expectations were raised that easier fiscal policy, a potential lessening in financial regulation and an expansive infrastructure spending programme could take some of the burden off US monetary policy.

This potential boost to US growth comes at a time when the US Federal Reserve's Chair, Janet Yellen, noted that the outlook for the US economy was consistent with a move on rates "relatively soon". While markets moved to price in a December hike, Yellen also indicated that the stance of policy was 'only moderately accommodative' and that any further tightening would occur at only a gradual pace. However, Yellen also noted that an expansion of fiscal policy could have inflationary consequences that would have implications for monetary policy. Against this backdrop, US 2 and 10 year government bond yields rose sharply, ending the month 28 and 56 basis points (bps) higher at 1.12% and 2.38%.

Monetary policy settings remain highly accommodative in Europe and Japan. Expectations of an extension to the European Central Bank's asset purchase programme and the Bank of Japan's strategy to keep long bonds at zero helped limit gains in European and Japanese 10 year government bonds. They ended the month 12 and 7bps higher at 0.28% and 0.025% respectively.

Australian yields continued to rise sharply, reflecting both offshore trends and markets winding back nearer term easing expectations and some bringing forward of when they expect the Reserve Bank of Australia (RBA) to begin lifting the cash rate. At the very short end of the curve, 3 and 6 month bank bills ended the month at 1.77% (up 2bps) and 2.01% (up 3bps). The winding back of easing expectations was evident in the 7bps lift in the yield on the August 2017 30-day interbank cash rate futures contract, which finished the month at 1.47%. The yield on the equivalent December 2017 contract rose from 1.41% to 1.52% over the same period. Further out along the curve, the yield on a 3 year government bond ended the month 20bps higher at 1.90% against the current cash rate of 1.50%.

Domestic data readings remained uneven. On the activity side, both the AIG manufacturing and services indices moved into expansion territory in October. In contrast, the AIG construction index fell sharply and into contractionary territory. Building approval data seems to corroborate this, with falls of 8.7% for September and 12.6% for October. Retail sales for September came in at a stronger than expected 0.6%, though after adjusting for price effects, the volume of retail sales actually fell 0.1% for the September quarter.

The NAB Business Survey had both business conditions and business confidence easing slightly in October and though overall levels remain solid, a sharp fall in forward orders and slip in the employment index gave the report a softer tone. The economy generated a lacklustre 9,800 jobs in October with the unemployment and participation rate steady at 5.6% and 64.4% respectively. Wages data for the September quarter appears consistent with ongoing slack in the labour market. The wage price index rose by a less than expected 0.4% and the yearly rate slipped to a new record low of 1.9%.

Construction work done for the September quarter fell a sharper than expected 4.9%. By component, residential building was down 3.1% while non-residential fell by almost 11%. Engineering construction work done declined by 3.8% and while this data may have been affected by a wetter than average winter, it suggests that GDP growth will be very weak in the September quarter.

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Our base view remains for a period of moderate economic growth as the drivers of the economy continue to rebalance towards the non-mining sectors of the economy.

Credit growth remains moderate, expanding by 0.5% over October for a yearly rate of 5.3%. Housing credit gained 0.6% and there was an encouraging lift in business lending from 0.2% last month to 0.5% in October.

Credit markets ended the month slightly wider with the Australian iTraxx Index finishing the month 6bps higher at 109bps. With the victory to Donald Trump in the US Presidential Election, the focus on credit investors was what his company tax policies would mean for US corporates. The fairly muted reaction in credit markets to date reflects the high degree of uncertainty about the final form of any changes. Primary markets were subdued this month, but the highlight was the ANZ bank which issued its first residential mortgage backed security in over 10 years and raised $2bn in the process.

In contrast to the previous month, the longer end of the domestic curve outperformed the US with the yield on an Australian 10 year government bond rising by 38bps to end the month at 2.72%. Sharply higher yields across the curve resulted in another month of significant capital loss for the Australian bond market with the Bloomberg AusBond Composite 0+ Yr Index falling 1.44% over November.

Market outlook

Our base view remains for a period of moderate economic growth as the drivers of the economy continue to rebalance towards the non-mining sectors of the economy. The drag to growth from falls in mining investment is expected to fade as we go through 2017 and a pick-up in export volumes, particularly as mega gas projects are completed, should help boost overall GDP growth over the next couple of years. While the RBA has noted that such growth may not be as employment-intensive, recent gains in the terms of trade suggest that the drag to the income side of the economy from earlier falls in the terms of trade could be behind us.

Just as the economy is navigating the transition from the investment to production phase of the mining boom, it will have to navigate the end of a significant housing boom. While building approvals have fallen sharply over recent months, there should be enough work in the pipeline for dwelling investment to add to growth over most of 2017. However, the size and speed of recent falls in approvals suggest that once the work in the pipeline is completed, activity in this sector could fall abruptly from late 2017 onwards.

With a reasonable pipeline of public infrastructure spending building, there is scope for this sector to offset the drag from a weakening housing sector. Under such a scenario, the economy continues to rebalance and gradually absorb excess capacity with underlying inflation gradually lifting to 2% by the end of 2018. Such an outlook is consistent with the RBA keeping the cash rate at 1.5% until early 2019. Given the scope for a timing gap to open up, we still see the balance of risks tilted towards the RBA having to provide another burst of easing over the second half of 2017.

We see markets bringing forward expectations of the first tightening into the first half of 2018 as premature. While the incoming US administration has a pro-growth agenda, which could potentially boost global growth, it also appears pro-protectionist. Any slowdown in global trade or reduction in market access would have negative consequences for Australia's external sector, put downward pressure on the currency and increase the likelihood of further monetary easing.

Accordingly, we see 3 year government bonds heading towards 2% as offering value, especially so if we see, as some market participants still expect, further monetary easing in 2017. We also feel comfortable with longer term yields and see limited scope for significant further weakness in the absence of a major reassessment of where monetary policy is heading over the next 1 to 2 years. We see this as unlikely, especially so in the near term. The recent steepening in the yield curve means investors are receiving more sensible compensation for term risk and whilst there is always the risk of markets overshooting, we are inclined to view such an occurrence as a buying opportunity.

We believe the theme of the last few years surrounding the search for yield remains intact. Looking forward, we remain constructive on credit given the continued stimulus by global central banks. This provides a backstop to how far global credit spreads can widen and we believe this will support domestic valuations. We have been encouraged by the performance of Australian credit markets since the election of Donald Trump and post the 'Brexit' vote. The impact of these two events on Australian corporate bond spreads has been quite muted. While steeper interest rate curves are generally seen as a positive for banking institutions from a profitability viewpoint, we anticipate a period of generally stable corporate spreads going forward. Semi-government spreads are at post Global Financial Crisis lows and we continue to see little scope for further compression to government bonds.

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(continued)

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As the bond sell-off gathered pace in the aftermath of the US election result, we moved to a modest long duration stance.

Investment strategy

The following is a summary of the key strategies in the Fund:

Interest rates:

As the bond sell-off gathered pace in the aftermath of the US election result, we moved to a modest long duration stance. Consistent with previous comments, we feel there is a good chance markets have become a little too optimistic about the pro-growth policies of the Trump administration, recognising what ultimately gets implemented remains highly uncertain. Locally we can be reasonably confident that we face an extended period of stable monetary policy with the risks in our view still skewed to the downside. We expect this will constrain the extent to which the curve can steepen in the near term. We maintain an allocation to inflation indexed bonds as means of providing some protection to the portfolio in the event inflation rises more quickly than we currently expect.

Sector allocation:

Debt issued by good quality, stable corporates continues to provide investors with an adequate margin to cover any additional risk relative to risk-free assets. In what remains a low yield environment, sectors such as investment grade credit continue to be a suitable alternative to government bonds for investors. Our focus remains on selectively investing in financial, LPT and infrastructure names where our credit assessment of the underlying fundamentals is compelling. Whilst we have not made new investments, we continue to be invested in prime AAA rated residential mortgage backed securities. Despite recent volatility, we expect the likelihood of a prolonged period of stable cash rates in Australia will continue to support demand for higher yielding sectors. Excess return is expected to come from income as opposed to capital appreciation associated with declining credit margins.

For further information
please visit our website at
www.henderson.com/australia