

Investment objective

Aims to outperform the Bloomberg AusBond Composite 0+ Yr Index over the medium term (before fees) by using an active investment strategy. It aims to provide regular income and a moderate level of growth.

Key information

Fund details

APIR code	MAQ0061AU
Inception date	15 May 1995
Fund size	\$272.4m
Distribution frequency	Quarterly
Management fee*	0.390% pa
Minimum investment (Direct)	\$20,000
Unit prices and spreads	macquarie.com.au/unit_prices

*Read the Product Disclosure Statement for more details on fees and costs.

SECTOR ROTATION

Duration, Credit and Cash

DURATION

Benchmark -2.5 to +1.25 years

PORTFOLIO CONSTRUCTION

SECURITY SELECTION

Government, Semis and Corporate

DYNAMIC ALPHA

Exploiting market inefficiencies

Fund performance to 30 June 2021

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	0.78	0.75	0.69	0.06
3 months (%)	1.71	1.61	1.52	0.09
1 year (%)	-0.11	-0.54	-0.84	0.30
2 years (% pa)	2.42	1.95	1.64	0.31
3 years (% pa)	4.87	4.38	4.21	0.17
5 years (% pa)	3.84	3.33	3.18	0.15

Past performance is not a reliable indicator of future performance.

Total returns are calculated based on changes in net asset values and assumes the reinvestment of distributions.

Total net Fund returns are quoted after the deduction of fees and expenses. Due to individual circumstances, your net returns may differ from the net returns quoted above.

The management fee was reduced to 0.390% pa from 8 January 2021.

Benchmark is Bloomberg AusBond Bank Bill Index

Asset allocation

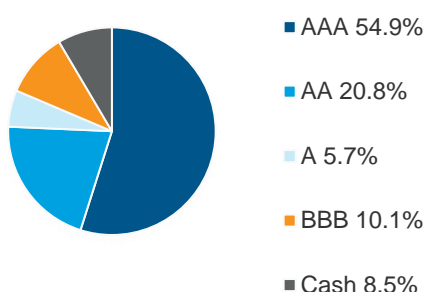
(based on physical exposure)

	Fund (%)
Government	46.8
Credit	25.0
Semi-Government	19.7
Cash and Equivalents	8.5

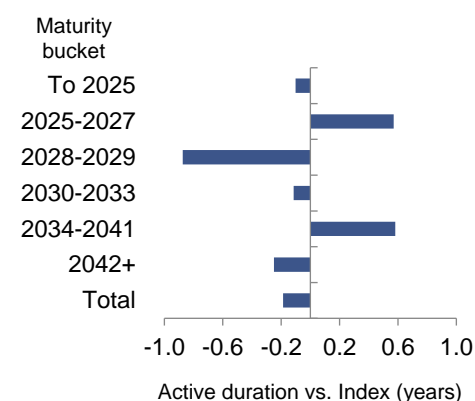
Fund statistics

Credit spread duration	0.9 years
Interest rate duration	5.8 years
Yield to maturity (% pa)	1.35%

Credit profile breakdown



Curve positioning breakdown



Macquarie Australian Fixed Interest Fund

Monthly report – 30 June 2021

Fund highlights

The Fund outperformed the benchmark this month, driven by sector rotation as well as duration and curve positioning.

Sector rotation

The Fund's sector positioning is underweight semi-government bonds given that semi-government spreads are tight and we view the yield pick-up in certain parts of the curve as insufficient to compensate for the liquidity forgone.

Semi-government spreads drifted a little wider in June following the state government budget announcements, where they signalled bigger funding tasks than expected. The state government budgets have improved their budget bottom line as Australia has recovered quickly from the impacts of COVID-19, but they are spending all the improvements, and hence the short has added value. The NSW Treasury Corporation in particular is looking to borrow \$35.5bn next year, with some of the borrowings to be invested in the NSW Generations Fund.

In addition, the Reserve Bank of Australia's (RBA) weekly semi-government purchases have been supportive for spreads and allowed supply to be absorbed by markets with relative ease. However, the RBA is to make a decision on whether to extend quantitative easing (QE) and the yield curve control (YCC) policy at the July meeting, and spreads should go a lot wider when QE eventually rolls off as the RBA has been the key buyer at current levels.

The Fund's credit positioning contributed positively to its outperformance relative to the benchmark. The Australian credit market performed broadly in line with offshore credit markets. Lower dealer inventory, coupled with high levels of oversubscription across most of the primary deals in June, drove the spread tightening in Australian credit in June. The credit curve bull-steepened over the month as the Term Funding Facility drew to an end in June, with Authorised Deposit-taking Institutions (ADIs) looking to find a home for the last \$A80bn of the facility available to be drawn down.

Duration and curve

The Fund's duration positioning remains tactically underweight, as we expect yields could move higher as the Federal Reserve starts to talk about tapering. We have put option structures in place that cover the short if yields move higher from here, and this is expressed in the US exposure as we think the sell-off would be US-led. We trimmed the size of our AU-US spread duration position following the 2021-22 Federal Budget last month and, as the Australian Government continues to spend most of the budget improvement, we believe this leads to a more positive growth outlook.

In curve positioning we have favoured the belly of the yield curve. The Fund is positioned with an overweight to the 4-6 year tenors, while offset by an underweight to the benchmark out to the 3-year point. Since the beginning of the RBA's YCC policy, yields have been anchored at the very front end of the curve. The RBA's YCC policy, together with its bond purchasing program, have diminished the potential for active returns in this end of the curve. The curve then steepens up sharply into the 4-6 year tenors, implying a rate hiking cycle which we do not believe can be realised in practice, offering attractive rolldown.

Security selection

The Fund's security selection remains overweight to the belly versus the wings of the curve in the Australian Commonwealth Government Bond (ACGB) portion of the Fund, and is bar-belled in the semi-government portion of the Fund. Within the ACGBs, the RBA's YCC policy and bond purchasing program have anchored yields at the front end of the curve, whilst sharply steepening after that to reflect a rate hiking cycle, which we consider unlikely to be realised in practice. We are overweight to the ultra-long bonds given their steepness relative to global curves and attractiveness to foreign investors on a hedged yield basis, and this position worked well in June given the flattening in curves. We have been actively taking advantage of relative value opportunities, such as shortening from the 30 year part of the curve into 20 year when curves flattened following the Federal Reserve meeting this month.

In the semi-government portion of the Fund, we continue to hold a preference for the 10-12 year maturities. Spread curves remain steep due to a supply-demand mismatch for different tenors, with regulatory demand focused on shorter maturities while issuers have preferred to term out their debt.

Semi-government spreads widened in June, with NSW in particular underperforming other issuers given their larger budgetary needs relative to other states. We have been positioned underweight to NSW Treasury Corporation, and this added value over the month. The Fund also continues to hold the 2024 semi's, which have been trading at an attractive spread over ACGB due to the impact of YCC.

The Fund's credit security selection performed broadly in line with the benchmark. COVID-impacted sectors remained a major contributor to the overall index performance, with spreads of retail REITs and industrial sectors compressing further. Following a more volatile month, financial subordinated paper steadily grinded tighter in June. Over the month, the Fund participated in primary transactions from issuers such as AGI Finance, Wesfarmers and Progress 2021-1.

Market review

The key event in June was the decision of the US Federal Reserve (Fed), which surprised markets by shifting its tone and forecasts for the outlook of rate hikes. Despite the Fed continuing to emphasise that the recent rise of inflation is transitory, markets viewed the upward shift in rate expectations as validation of their speculation. This caused shorter-term yields to push higher. Longer-dated bond yields went the other way, with a flatter yield curve the result. The debate amongst market participants was not only interpreting the Fed's signal, but also why the bond market rallied. There is merit in the view that earlier-than-expected Fed tightening could put a lid on the recovery and hence cap inflation, but there were also more subtle technical forces at play, which combined to squeeze many 'short' positions that further fuelled the rally in Treasury yields.

While these events were unique to the US, the impact rippled across countries, and curve flattening was a common theme and magnified in Australia and New Zealand, where recovery has already returned to pre-pandemic levels. Risk markets proved resilient, with credit spreads

Macquarie Australian Fixed Interest Fund

Monthly report – 30 June 2021

grinding tighter and high yield bonds outperforming. Emerging markets debt underperformed as the US dollar reversed its downward trend, but also because the pandemic is having a differentiated but significant impact on many countries.

Australian bond market

The Australian rates market saw a flattening of curves over June in sympathy with the US move, which was driven by a hawkish surprise at the June Federal Reserve meeting, with the median 'dots' suggesting two rate hikes in 2023. This led to a shift in beliefs around inflation, with markets now expecting that central banks will hike early enough to kill off any sign of excess non-transitory inflation, and a resulting unwinding of the reflation trade that has persisted since the beginning of the year. This resulted in a modest sell-off in front-end rates, while longer-dated yields moved lower as the market began to price in a lower premium for inflation uncertainty going forward. The Reserve Bank of Australia (RBA) kept rates on hold in June and maintained their quantitative easing (QE) program at a rate of \$5bn per week, whilst they signalled that they will make a decision in July on yield curve control and how they intend to proceed with QE after the end of QE2 in September. The Australian Office of Financial Management (AOFM) maintained a steady supply schedule through June, continuing their weekly tender issuance of \$2bn, whilst the Australian state-based treasury corporations mostly slowed their issuance given they are well ahead of their annual task. The NSW Treasury Corporation released their budget and announced a much larger than expected borrowing task of \$35.5bn for 2021/22, which triggered a move wider in semi-government spreads versus government bond. Into the end of June, many Australian capital cities went into flash lockdowns as COVID cases rose.

Global credit market

Risk markets continued to go higher and rates rallied as markets embraced the possibility that inflation may be only transitory. US credit continued to perform in June, though the pace of spread tightening has slowed at historically low spread levels. Overall, investment grade (IG) credit tightened 4bps to 80bps. In particular, lower-rated credit performed most strongly. High yield (HY) credit tightened by 28bps and CCC credit by 50bps, to the lowest level since mid-2007. Supply-demand technicals remained a key support, as investors continue to move down the quality spectrum to search for yield. In addition, corporate fundamentals have continued to improve. In Europe, IG credit tightened 2bps in spreads and primary issuance volumes were slightly ahead of expectations at €54bn. Within IG, high-beta names in sectors such as REITs and sub-insurance outperformed. The emergence of the delta virus variant in Europe, primarily in the UK, has resulted in a revision of European summer travel expectations. HY supply remained elevated, with several large multi-tranche deals such as Picard (~€1.7bn) and Softbank (~€3bn), contributing to an underperformance of European HY relative to the US this month.

Australian credit market

Australian IG credit grinded tighter, in line with its offshore counterparts, edging 2bps tighter in June as the rates market have stabilised further and the search for yield dynamic persisted. COVID-impacted and higher-beta sectors, such as industrials and financial subordinated paper, remained a dominant force in driving the overall performance as spreads compressed further, with longer-dated BBB utilities underperforming. With the Term Funding Facility closing at the end of June, attention will turn to the timing for the first AUD senior issuance from major banks in more than 18 months to set the tone for the Australian credit market for 2022. Primary IG issuance increased slightly in June to around \$A5bn, with corporates making up nearly half of the total issuance.

Outlook

The pandemic continues to exert an influence on the shape of recovery as countries are at different stages, while new variants remind that vaccination may quell the hospitalisation risk but the virus will likely be with us for some time to come. There are still many unanswered questions on the future, such as: when will normal activity resume; when will international travel resume; what will the post-virus workplace look like?

As we move into the second half of 2021, attention is on the shape of recovery as economies re-open and whether the current inflation pulse will prove transitory as expected by policy makers or persistent. A key feature of the pandemic was massive government support to workers and businesses, but this is nearing its end, with many states in the US deciding to withdraw the Federal support early in the hope that this encourages people back to work. How quickly these furloughed/unemployed workers return will be key in determining the shape of the recovery. Businesses trying to re-open have reported difficulty in hiring and many have offered financial incentives, including higher wages, which has fuelled concerns that inflation will become persistent. Yet the data has shown that the majority of government transfer support to these workers during the pandemic was saved, suggesting that persistent uncertainty will hold back consumption. While supply disruption is likely to continue to pressure inflation, in our opinion, the evolution of consumer income and demand will prove the decisive determinant of inflation longer term.

These vital but unanswered questions, combined with low bond yields and tight valuations, guide to a cautious approach to investment. However, we also recognise the ferocious insatiable need for yield. We balance these forces by maintaining discipline and 'doing the work' to determine the best risk-adjusted positioning for portfolios.

Macquarie Australian Fixed Interest Fund

Monthly report – 30 June 2021

For more information speak to your financial adviser, call us on 1800 814 523, email mim.clientservice@macquarie.com or visit macquarie.com

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