

Macquarie Australian Fixed Interest Fund

Monthly report – 30 April 2022

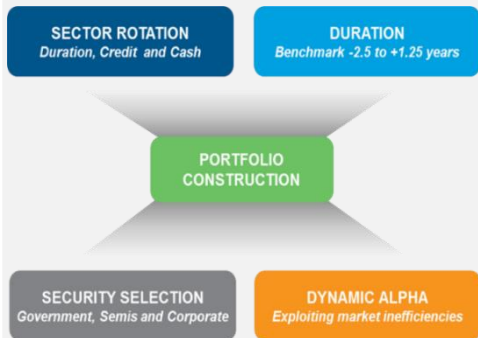
Investment objective

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	\$233.8m
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.



Fund performance to 30 April 2022

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-1.53	-1.56	-1.49	-0.07
3 months (%)	-6.55	-6.64	-6.33	-0.31
1 year (%)	-7.38	-7.74	-7.47	-0.27
2 years (% pa)	-3.88	-4.28	-4.39	0.11
3 years (% pa)	-0.37	-0.81	-0.91	0.10
5 years (% pa)	1.88	1.41	1.40	0.01

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.

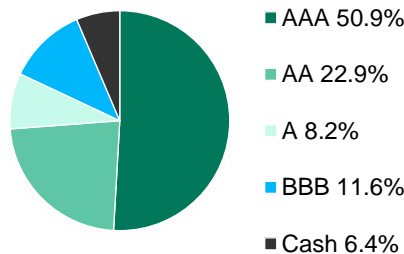
The management fee was reduced to 0.390% pa from 8 January 2021.

Benchmark is Bloomberg AusBond Bank Bill Index

Asset allocation (based on physical exposure)

	Fund (%)
Credit	35.7
Government	35.0
Semi-Government	22.9
Cash and Equivalents	6.4

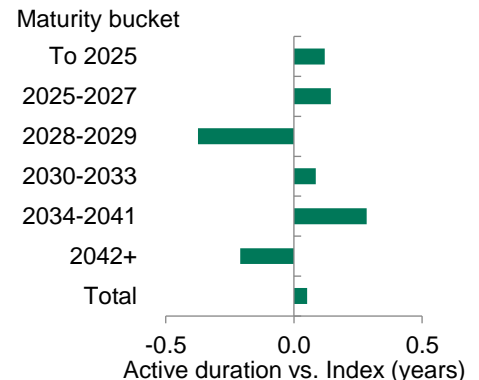
Credit profile breakdown



Fund statistics

Credit spread duration	0.9 years
Interest rate duration	5.5 years
Yield to maturity (% pa)	4.19%

Curve positioning breakdown



Macquarie Australian Fixed Interest Fund

Monthly report – 30 April 2022

Fund highlights

The Fund underperformed the benchmark during the month amid the continued broad-based volatility in markets driven by central bank tightening and concerns around rising inflation.

Duration and curve

The Fund began the month long duration but we pared this back closer to neutral early in April by paying front-end swap. This helped protect the Fund against further losses as yields continued to rise and swap spreads widen into month-end. The US Federal Reserve's (Fed) hawkish tone, together with the 50bp hikes from the Bank of Canada and Royal Bank of New Zealand and the stronger National Australia Bank Business Survey data, led to a reassessment of how quickly the Reserve Bank of Australia (RBA) will be able to hike in a world where global central banks are raising rates aggressively.

We still believe the RBA faces a lower terminal rate than other developed markets such that the amount priced into the front-end of the AU curve is attractive given it is unlikely to be realised in practice. There is a significant difference in the inflation outlook domestically versus overseas (e.g. headline inflation in Australia is 5.1% YoY, compared to 8.5% YoY in the US). RBA hikes will have a sharper impact on household spending given high household leverage domestically, with much of the Australian market also having short-term fixed rate mortgages which will start to roll off. We think current levels in the front end of the Australian yield curve are very attractive, but we believe that it makes more sense to wait until the RBA start hiking and liquidity is better before re-entering a long duration position. We still have an AU-US position in the front-end of the curve given our view that the RBA will be forced to hike slower than the Fed.

Sector rotation

The Fund increased its semi-government sector exposure from underweight to neutral this month in the 15 year maturity segment of the yield curve. Spread curves have been steep, reflecting the mismatch between demand and supply, with issuers preferring to term out their debt. Also, the balance sheet buying by banks, who are the main marginal buyer now that the RBA has ended QE, have traditionally preferred sub-6 year paper due to the lower cost of hedging it. In early April, we saw signs of the balance sheet buying being further out on the maturity spectrum than where they have traditionally held exposure, in the 10-15 year part of the yield curve. Given the shape in curves, we saw this as an opportunity to add, with scope for further performance in this part of the curve going forward if they continue to increase exposures.

The Fund's credit positioning was a broadly neutral contributor to performance in April despite the move wider in spreads. The ongoing flattening of the credit curve was a negative contributor this month as the Fund's credit positioning has been more concentrated in the front-to-mid part of the curve, though protective credit default swap positions provided a positive offset to the spread widening.

The Fund has been overweight derivatives versus physical securities both in swap and futures. We expect physical security valuations to revert back to trading 'cheap' to futures as net supply increases following the end of the RBA's quantitative easing (QE) program and the increase in the Australian Office of Financial Management's funding task for next year. The overweight in swap was a modest detractor this month as swap spreads widened, but we trimmed this exposure over the month. The Fund has taken micro relative value opportunities in semi-government securities as volatility in markets increased the incidence of mispricings on the curve.

The Fund's credit security selection underperformed the benchmark over the month. Shorter-dated credit has underperformed as recent deals have printed wider than secondary levels and structured securities also continued their march wider in spreads, though moves were more muted than prior months and most of the movement was in junior and mezzanine tranches. The higher-than-benchmark carry earned in the Fund continued to provide an offset to the underperformance. Over the month, the Fund participated in primary transactions from issuers such as NBN Co, Athene Global Funding and Royal Bank of Canada.

Market review

The upward pressure on inflation and increasing hawkishness of global central banks continue to be the main theme impacting fixed income markets. The Russia-Ukraine conflict continues as does the debate about its impact. The geopolitical environment is being shaken and likely re-shaped while the global economy is having to endure another significant and broader supply shock. We have often described the investment climate in recent years as 'contained', where central bank actions were to contain risks and create stability for investors. This 'container' is not only being shaken but potentially broken with the uncertainties on the outlook piling up, and at the same time central banks have shifted focus completely embarking on a rate hike cycle, the likes of which has not been witnessed for decades.

Global government bond yields have been pulled higher by inflation. However, it has been the urgency from central banks to tame inflation that has been the key driver of current higher yields. During April, after the rapid trend of yield curve flattening, the longer-dated bonds underperformed and yield curves steepened, in some cases brutally. However, by month-end some curve flattening returned as evidence emerged that the high inflation was beginning to weaken demand. Risk markets have been under pressure, but to date this continues to be an orderly sell-off, with corporates able to pass on higher prices at this stage of the cycle and therefore maintain relatively good earnings and credit profiles.

Australian bond market

Yields continued to climb over the month as upward pressure on inflation and the increasing hawkishness of global central banks played out in the global economy amongst another significant and broad supply shock. Central banks around the world increased their urgency to tame inflation, driving the rapid yield curve flattening, longer-dated bond underperformance and curve steepening. The Reserve Bank of Australia (RBA) left rates on hold at their April meeting but hiked rates by 25bps in early May, and the Australian Commonwealth Government Bonds 3 year yield rose 38.25bps to 2.72% while the 10 year yield rose 30bps to 3.14%. The National Australia Bank Business Survey data was strong and both cost price inputs and the pace at which those were being passed on to the consumer rising are at the highest level in the history of the survey. The RBA hikes will have a sharper impact on household spending than offshore given high household leverage domestically. With much of the Australian market also having short-term fixed rate mortgages, they will start to roll off as the RBA hiking

Macquarie Australian Fixed Interest Fund

Monthly report – 30 April 2022

cycle is underway. The Australian Office of Financial Management (AOFM) issued a new \$A15bn 3% November 2033 bond via syndication in April, \$A6bn in Treasury notes and tender issuance of \$A1.8bn. The Treasury Corporation of Victoria issued \$A2.5bn, Queensland Treasury Corporation issued \$A1.2bn and New South Wales Treasury Corporation had a smaller issuance amount of \$A300m.

Global credit market

The weakness in both risk assets and rates markets continued in April. China lockdowns added to global growth concerns and hawkish central bank rhetoric continued as the FOMC foreshadowed the start of balance sheet reductions.

The spread on the US investment grade (IG) index widened by 19bps to 135bps. This was the worst month for credit spreads since March 2020 and extending the worst start to year on record in total return for IG credit. There was some evidence of 'decompression' in spreads (ie, weaker credits underperforming). For the first time this year: spreads on CCC credits were +86bps to 711bps, the weakest amongst ratings category. Weakness was broad-based amongst sectors, with underperformance from financials and media. Financials underperformance was driven by economic concerns, but also very heavy issuance volumes: 4 of the 6 largest banks issued large benchmark deals. Relatively strong performers included less cyclical sectors such as utilities, but also airlines and US autos (with resilient results in these sectors providing support).

Technicals remained mixed. New issuance was strong in IG, with a total of over \$100bn – with new issuance concessions keeping pressure on the secondary market. In contrast, high yield issuance was very low, totalling just over 10bn, the slowest April for new issue since 2009. Outflows from credit also remained significant in April, averaging close to 3bn per week from IG and over 1bn for high yield.

Earnings season kicked off in the US, starting with financials and with over 75% of the S&P 500 reporting by month-end. Overall summary results were generally positive, with over 60% beating on sales and 80% on earnings. Investors are also focused on cost pressures – for the most part, companies remain confident in passing on costs to consumers, but causing some issuers to lower their guidance.

European credit markets finished April weaker, with the ongoing Russia-Ukraine conflict and its implications being the main focus. The increasingly hawkish messaging from the European Central Bank on rate hikes and potential timing of the end of net asset purchases as early as July also an underlying headwind. The overall IG index finished 21bps wider to 151, within a few basis points of the March post-invasion peak, and high yield finished over 50bps wider. The widening was most notable in cyclical sectors such as airlines and financials, reflecting ongoing concerns around economic growth. Some non-cyclical sectors also suffered in pockets, such as utilities with heavy exposure to Russian gas, as supplies to Poland and Bulgaria were cut off, highlighting the potential for broader shortages. There was also clear decompression over the month, with BBB- issuers underperforming BBB+ by over 12bps of spread widening on average.

New issuance was modest at under €30bn but concessions were elevated in mid-high teens in several cases, high quality financials such as Bank of America Corporation printed 20bps back of their curve which impacted the overall sector. There was one high yield issue for the entire market in the month, which broke the 11-week drought for European high yield, but priced weaker than initially expected highlighting the challenges in getting new deals done in that market.

Australian credit market

Australian credit weakened further in April with spreads widening 13bps on option-adjusted spread basis. With risk sentiment continuing to remain lacklustre given a further escalation of the Russia/Ukraine war and inflationary pressures prompting markets to price in more aggressive hikes by major global central banks. The Australian credit shifted wider across the curve. While major bank senior spreads widened further in April, the higher beta financial subordinated paper were the underperformers given concerns around further primary supply in the sector. A 5-year call major bank subordinated paper were trading around the 3-month bank bill yield +200bps mark – the widest level since the start of the pandemic and the peak spread level of 2019. Spread widening was also evident in structured products as RMBS leaked wider, particularly in the lower rated tranches. Unsurprisingly, the primary market was less active in April and only printed 5.5bn of IG deals amid significant volatility in the rates market.

Outlook

The impact of the pandemic supply shock continues to reverberate around the global, with attention moving back to China, who is persisting with a 'COVID-zero' policy, and as the latest variant spreads from Shanghai to other areas concerns about supply chain, growth and inflation have re-escalated. This is on top of a new supply shock stemming from the invasion of Ukraine. Inflation rates have moved even higher while just a few months ago expectations were for inflation to begin a steady trend lower by the start of Q2. Central banks have made inflation their prime focus and aggressive rate hikes are now expected. It is recognised that rate hikes will dampen demand and therefore slow growth in the medium term, but what is less understood is how inflation will react. Our view is that supply problems have been the primary driver of current high inflation and this factor is unlikely to be influenced by the central bank tightening. While economies and labour markets in particular are resilient, the medium-term outlook is clouded with uncertainty on how these colliding forces will impact both inflation and economic growth trend 2 to 4 quarters ahead.

A soft landing for the economy and inflation back towards target is the ultimate goal for policy makers. However, stagflation and recession risks are realistic scenarios for the medium-term outlook. For asset markets, the desired outcome is a soft landing but the questions overhanging investors is how to balance the risks for stagflation or recession with the knowledge that it will take considerable time before probabilities of any scenario becomes clear enough to position portfolios with conviction. Amidst this sea of uncertainties, there is one element of clarity emerging. Bond yields are becoming attractive. Timing is tricky with central banks hiking but for those investors with a longer term view, a gradual accumulation strategy of high quality sovereign bonds will add balance to a portfolio of credit and equities, which are vulnerable to any scenario that is not a soft landing.

Macquarie Australian Fixed Interest Fund

Monthly report – 30 April 2022

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

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