MACQUARIE ASSET MANAGEMENT

Macquarie Australian Fixed Interest Fund

Monthly report – 31 May 2022

MACQUARIE

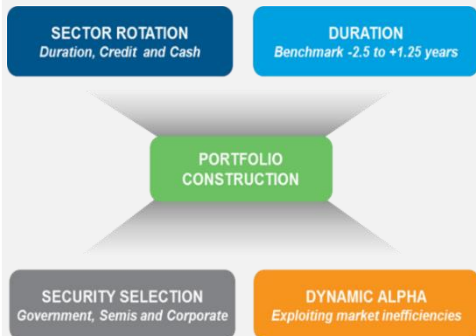
Investment objective

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	$232.6m
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 31 May 2022

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-0.99	-1.02	-0.89	-0.13
3 months (%)	-6.38	-6.47	-6.02	-0.45
1 year (%)	-8.56	-8.92	-8.54	-0.38
2 years (% pa)	-4.59	-4.98	-4.95	-0.03
3 years (% pa)	-1.27	-1.71	-1.76	0.05
5 years (% pa)	1.44	0.97	0.99	-0.02

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

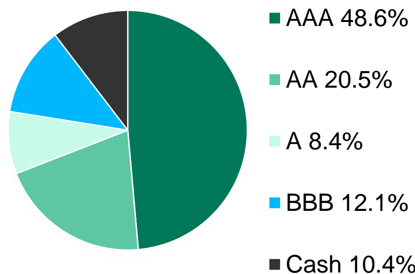
Asset allocation (based on physical exposure)

	Fund (%)
Credit	37.3
Government	32.1
Semi-Government	20.2
Cash and Equivalents	10.4

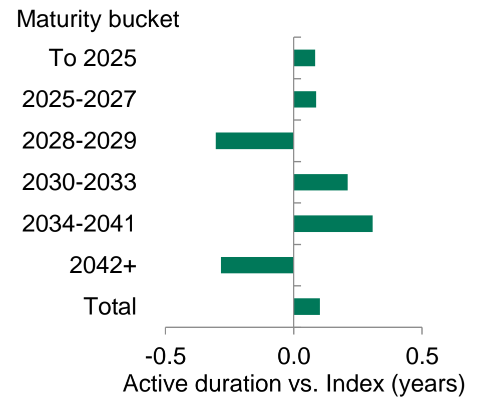
Fund statistics

Credit spread duration	1.0 years
Interest rate duration	5.5 years
Yield to maturity (% pa)	4.47%

Credit profile breakdown



Curve positioning breakdown



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Fund highlights

The Fund underperformed the benchmark during the month amid the broad-based volatility driven by ongoing concerns around central bank tightening and rising inflation, which continues to impact fixed income markets.

Duration and curve

The Fund changed its positioning in May as early on we shifted from close to flat duration to reinitiate our long duration position. We continue to expect that the Reserve Bank of Australia (RBA) will not be able to achieve the rate hiking cycle which is priced in. Also we had gotten back to neutral expecting that bonds could continue to sell off on momentum of the move with global central banks aggressively raising rates. Our view played out in the latter half of April as bonds sold-off and so we were able to re-instigate the long position at more attractive levels. This trade benefited performance as yields trended lower for most of the month.

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 still have an AU-US position in the front-end of the yield curve which detracted during the month as Australian bonds continued to underperform. We still believe that the RBA will be forced to hike slower than the Fed, but flow is currently outweighing fundamentals for the time-being.

Sector rotation

The Fund is neutral to the semi-government sector given our fairly balanced outlook. There is significant supply to come from the State Governments but we are cognisant that balance sheet buying by banks will take down a significant proportion of this, and the new incoming Federal Labour Government will likely favour a higher Australian Commonwealth Government Bonds supply versus State supply mix going forward. Semi-government spreads have drifted wider recently with the move in swap.

The Fund's credit positioning was a slight detractor to performance in May as spreads continued to move wider. The Fund's overweight to the front-to-mid part of the yield curve protected from much of the moves, though some higher-beta, longer-end positioning underperformed.

Security selection

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 Reserve Bank of Australia's quantitative easing program and the increase in the Australian Office of Financial Management's funding task for next year. We have continued to sell expensive 3 year basket bonds back into the equivalent futures maturity and have taken micro relative value opportunities in semi-government securities as volatility in markets increased the incidence of mispricing on the yield curve.

The Fund's credit security selection underperformed the benchmark over the month. Shorter-dated major banks underperformed as new issuance was focused in the 3 year part of the curve, and subordinated bonds also moved wider ahead of supply expectations following the new deal from Macquarie Bank. The higher-than-benchmark carry continued to provide an offset to the underperformance. Over the month, the Fund participated in primary transactions from issuers such as Air New Zealand, Australia and New Zealand Banking Group, National Australia Bank and Westpac.

Market review

Repeating the theme from last month, the upward pressure on inflation and increasing hawkishness by global central bankers have continued to be the main theme impacting fixed income markets. The second supply shock (following the first, which is the pandemic) from the invasion of Ukraine has been pushing inflation higher, with energy and food the key drivers. Central bankers continue to talk tough and deliver rate hikes or have signalled that a rate hike cycle will soon commence. This global pressure on interest rates have continued to pressure returns from fixed income portfolios.

That said, a new theme has also emerged, that is, risk for a recession as the global economy is facing strong headwinds from both inflation and policy. Consumer confidence surveys are very weak despite the robust position across labour markets. Thus, markets are weighing up the relative significance between strong lagging indicators (employment) with softening leading indicators (new orders). In the corporate world, the focus is on current strong earnings against signs of weaker guidance.

Asset market volatility is already reacting to this debate. Fears of weaker growth/recession hit risk markets and provide relief to sovereign bond yields, which is then followed by hopes for less central bank tightening, providing a bid for risk assets and returns the pressure on sovereign bond yields. This environment has just started, and this ebb and flow of market sentiment is likely to persist for months, or even quarters, and provide a volatile backdrop for all investors.

Australian bond market

Yields stabilised over the month of May as markets grappled to digest both persistently higher inflation and the risk of recession from policy overtightening, against a backdrop of a Chinese slowdown. Global central banks hiked interest rates in the US (+50bps), Australia (+25bps), the UK (+25bps) and New Zealand (+50bps) and they continued to communicate their urgency to tame runaway inflation. The US 10 year yield traded between 2.70% and 3.20% in May, ending the month at 2.84% and the AU 10 year bond futures implied yield traded between 3.21% and 3.67%, ending the month at 3.36%. In Australia the strong retail spending sits at odds with the weak consumer sentiment where there is a divergence between retail sales rising 0.9% (driven by both price and volume increases) and consumer confidence falling 5.6%, a reflection of the wider volatile ebb and flow of market sentiment. The Australian Federal Election delivered a new Labour Government under Anthony Albanese on May 21st which may deliver different Australian Commonwealth Government Bonds/semi-government supply mix going forward. The Australian Office of Financial Management (AOFM) only issued $A5bn in tender issuance and $A4.5bn in Treasury

notes. The Treasury Corporation of Victoria issued $A2bn and the New South Wales Treasury Corporation issued $A1.6bn as the State Budget cycles limited large semi-government deals.

Global credit market

May saw risk markets close at levels close to where they started the month disguising a volatile month where both equities and credit hit new lows for the year. The rebound was driven by a number of factors, notably a slight shift in Fed rhetoric from the relentless hawkishness of recent months.

US credit spreads finished approximately unchanged at an overall index level for the month with the benchmark US investment grade (IG) index finishing 5bps tighter, to 130bps, but this traded to a wide of 149bps, marking a new YTD wide in credit spreads. There was also a significant decompression in spreads (with lower credit quality underperforming higher quality) – a first for the year. CCC spreads finished 100bps wider, while AA spreads were 8bps tighter, outperforming all other categories. Also a slowdown in new issuance assisted the rebound.

US earnings season wrapped up during the month, and the tone shifted to be more negative into the end of the reporting season. Retailers such as Target and Walmart in particular, showed significant weakness in margins as 'COVID-era' goods built up in inventory and prices had to be slashed. Consumer spending remains solid, but is clearly shifting away from home furnishings and similar products while services demand and sales of travel-related goods remained very strong. Overall, for the US large cap cohort, earnings surprises remained elevated (with 75% of companies beating expectation), but guidance has become increasingly mixed and focused on cost inputs, and earnings misses expectation have been significantly punished by markets.

US credit funds continued to suffer outflows over the month, averaging over $5bn of outflows a week. This was offset somewhat, but lower issuance than expected with $89bn of new deals was well below average for May.

European risk markets underperformed peers with IG closing 12bps wider to 162bps although did close 9bps off the wides as markets rebounded into month end. The backdrop this month in Europe was one of equity volatility, strong primary markets in credit with elevated concessions of 15-20bps becoming the norm and an increasingly hawkish central bank in light of elevated inflation levels. The European Central Bank quantitative easing programme is scheduled to end at end of June as will net corporate purchases.

IG issuance totalled €60bn from a wide variety of issuers, initial deals performed poorly although deals priced in the last week have performed well notably Allianz Tier 2 and Barclays senior ~25bps inside pricing. In secondary markets, sectors such as real estate investment trusts 's continue to underperform as do cyclical low BBB's in IG. High Yield primary markets remain subdued running at a quarter of last year's pace and spreads did not decompress this month with BB actually outperforming BBB.

Australian credit market

Australian credit underperformed the US with spreads ending the month 8bps wider. The credit curve steepened further with the longer-part of the curve leaking wider. Major bank senior curve also moved wider with the 1-3 year part of the curve marginally underperforming the 5 year part of the curve which started to attract investor demand, particularly from offshore, when spreads broke above 100bps. Higher-beta financial subordinated bonds remained unloved over the month given the concerns around further supply with 5 year calls selling off close to 40bps. As rates rose further, the shift in investors' preference for fixed rate bonds accelerated with Lloyd's AUD 4 year deal having to forego the floating-rate note (FRN) tranche as it failed to garner sufficient demand. Further, the most recent CBA 10nc5 Tier 2 saw its fixed tranche outperform the FRN tranche by as much as 50bps. Over the month, $A13.2bn of investment grade primary deals printed with majority of the issuance concentrated in financials.

Outlook

Economists continue to debate whether currently higher inflation is due to strong demand or a supply shock. Central banks share that same debate, but these institutions face a credibility problem, that is, inflation is still rising and is so far above their target. Rate hikes have been delivered and more will come. But the real question is: will the rate hikes work effectively to fix the problem? Central banks have tools to manage liquidity and the demand side of the economy. So, if inflation is (as we believe) largely a supply-driven problem then hiking rates is unlikely to resolve the core of the inflation problem. What higher rates will eventually do is slow aggregate demand. Meanwhile, when will the supply shock end?

We therefore see stagflation as the most likely description of the economic environment in the second half of 2022, where inflation remains sticky at higher levels while the demand side of the economy is slowing. Recession is a risk, but not a certainty. A 'double supply shock' could be enough to deliver a recession, but the household and corporate sector balance sheets imply a level of resilience to the headwinds. This puts central bank tightening in the crosshair of focus, where policy makers target a soft landing for the economy, but markets fear that high inflation will cause over-tightening and therefore recession in 2023.

The economic and policy environment facing asset markets is challenging. We should expect periodic spikes in volatility to continue in the months and quarters ahead. As investors we are sailing in rough seas and into the wind and therefore must keep the sails trim and be alert and flexible.

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

Important information

Macquarie Investment Management Australia Limited ABN 55 092 552 611 AFS Licence 238321 is the issuer of units in, and responsible entity of the Fund. Macquarie Investment Management Global Limited ABN 90 086 159 060 AFSL 237843 is the investment manager of the Fund.

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