

Macquarie Australian Fixed Interest Fund

Monthly report – 31 July 2022

Investment objective

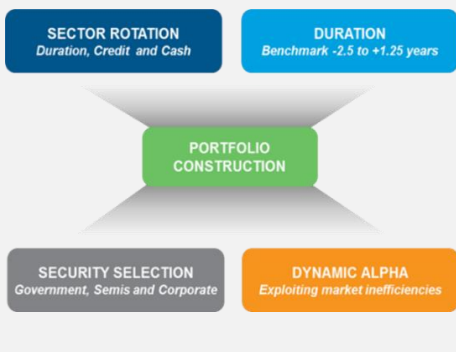
Aims to outperform the Bloomberg AusBond Composite 0+ Yr Index over the medium term (before fees) by using an active investment strategy. It aims to provide regular income and a moderate level of growth.

Key information

Fund details

APIR code	MAQ0061AU
Inception date	15 May 1995
Fund size	\$249.7m
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 July 2022

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	3.49	3.46	3.36	0.10
3 months (%)	0.82	0.72	0.93	-0.21
1 year (%)	-9.23	-9.59	-9.10	-0.49
2 years (% pa)	-4.20	-4.59	-4.41	-0.18
3 years (% pa)	-1.37	-1.80	-1.81	0.01
5 years (% pa)	1.93	1.47	1.49	-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

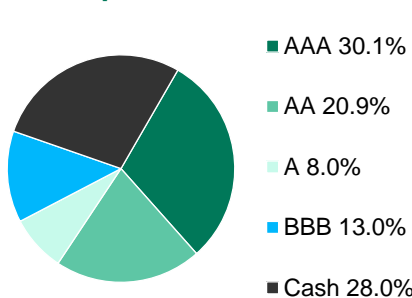
Asset allocation (based on physical exposure)

	Fund (%)
Government	34.9
Credit	28.0
Semi-Government	20.2
Cash and Equivalents	16.9

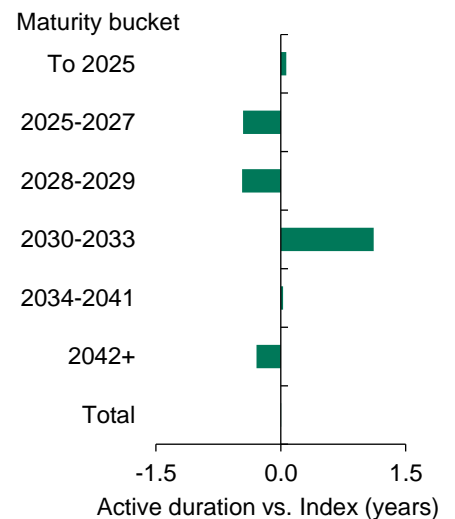
Fund statistics

Credit spread duration	0.9 years
Interest rate duration	5.5 years
Yield to maturity	4.22% pa

Credit profile breakdown



Curve positioning breakdown



Macquarie Australian Fixed Interest Fund

Monthly report – 31 July 2022

Fund highlights

The Fund outperformed the benchmark over the month, driven by security selection as well as duration and curve positioning.

Security selection

The Fund has an overweight to the 10 year part of the curve, which added value over the month as the curve flattened. The market has increasingly become concerned about recessionary fears as leading indicators, particularly in North America and Europe, continue to indicate a slowdown in economic growth, and have started in price cuts starting early next year with the US 2 year/10 year curve inverting early in July. We have continued to undertake micro extensions from the belly part of the curve out to the 10 year part.

The Fund remains overweight derivatives versus physical securities both in swap and futures. The physical Australian Commonwealth Government Bonds (ACGBs) remain exceptionally 'rich' to the overnight index swap curve, and we had expected they would revert to trading 'cheap' to the futures as net supply increased following the end of quantitative easing. However, this has taken longer than expected as collateral shortages remain. The overweight swap spread exposure began to recover in July following one-way pay flows into financial year-end.

Within ACGBs, the Fund remains underweight to the ultra-long maturities, which has continued to add value as the back-end of the curve steepened up. While this trade has performed well, we think it has further to run as the ultra-long end of the curve remains expensive on a hedged yield basis to offshore and the Australian Office of Financial Management remains keen to issue into any demand which will limit price tension.

The Fund's credit security selection slightly underperformed the benchmark in July. This could be partly attributed to the further underperformance in financial subordinated paper as well as structured securities, particularly residential mortgage-backed securities which were marked wider again in July. It was a healthy month of supply in the primary market, and the Fund participated in transactions from issuers such as Canadian Imperial Bank of Commerce, John Deere, Toronto-Dominion Bank and National Australia Bank.

Duration and curve

The Fund held a long bias to duration during July, which added to returns as bonds rallied given that market focus moved back towards recession risk. We took the Fund back to neutral duration following the material rally near month-end. Reserve Bank of Australia (RBA) Governor Lowe pushed back on market pricing at the end of June and said current conditions only call for a 25-basis point or 50-basis point hike. This contributed to the rally which extended in early July. The US Q2 gross domestic product (GDP) print delivered a technical recession, Australian consumer price index (CPI) missed expectations and the US Federal Reserve became more data dependent, all having an impact on the rally too.

We believe that the RBA faces a lower terminal rate than other developed markets as there is a significant difference in the inflation outlook domestically versus oversea. RBA rate hikes will have a sharper impact on household spending given we have a higher proportion of variable mortgages and higher household indebtedness than other countries. As such, we maintained an overweight to Australian duration versus the US in the front-end of the curve, where the AU-US spread tightened this month.

Sector rotation

The Fund increased the size of its overweight to the semi-government sector slightly during July, though the position is still relatively modest in size. This contributed to outperformance in July as semi-government spreads narrowed slightly over the latter half of July given swap spreads started to come back in. The state governments have had significant funding tasks, with significant supply still to come and the FY23 funding programs totalling \$A75bn. NSW Treasury Corporation and Treasury Corporation of Victoria made up the lion's share of this supply. However, the outlook is more balanced going forward, and we are cognisant that balance sheets have large 'high quality liquid asset' requirements and will take down a significant proportion of this.

The Fund's credit positioning contributed positively to performance in July as rates and credit spreads stabilised. Persistent demand saw senior financial paper outperform in the Australian credit market. While spreads of higher-beta bonds generally ended the month sideways to slightly wider, higher-than-benchmark carry and steep rolldown of the credit curve continued to contribute positively to performance.

Market overview

Central banks continued to deliver rate hikes through July as inflation has continued to make new highs in many countries. The focus was increasingly on growth risks and asset markets paid particular note to sentiment surveys where the significant concerns being expressed by consumers were increasingly being reflected by businesses. This environment is called stagflation and it does not happen very often, where growth is slowing below trend and inflation remains well above trend. While the 'flation' component of 'stagflation' dominated the first half of this year, in July the 'stag' component has taken a prominent role in the mind of asset markets. The delivery of a US 'technical recession' with a second quarter of negative growth ignited a strong rally in government bond yields, though risk markets also rallied on the belief that the path is now set for central banks to cut rates in 2023. Interestingly, despite central banks raising rates aggressively over the month, the positive moves within asset markets actually eased financial conditions.

Australian bond market

Bond yield movements in Australia were broadly in line with the global moves, as there was a mild sell-off mid-month but it was overwhelmed by a strong late rally. Inflation has remained strong but came in below market expectations, with Q2 consumer price index coming in at 1.8% and the labour market remains tight, though it is expected to loosen as the Australian federal government announced a significant ramp-up in immigration and will ease migration caps to bring in more foreign workers. Consumer sentiment has continued to

Macquarie Australian Fixed Interest Fund

Monthly report – 31 July 2022

deteriorate and business confidence has been soft, as retail sales has continued to weaken, causing volatility in yields as incoming data was digested. The Reserve Bank of Australia delivered another 50-basis point hike in the July meeting, taking the overnight cash rate to 1.35% as the Bank continues to front-load the tightening cycle. The Australian 10 year bond futures implied yield traded between 3.06% and 3.72% in July (a range of 66 basis points versus 95 basis points in June), with the 10 year yield ended the month at 3.07%, 61 basis points lower on the month. The Australian 3 year bond futures implied yield traded between 2.74% and 3.39% in July (a range of 66 basis points versus 111 basis points in June), with the 3 year yield ending the month at 2.78%.

Global credit market

Global risk markets rebounded in July as back-end yields rallied on early signs that the front loading of rate hikes may quell demand quicker than central banks expect, though global inflation measures did not let up. This positive sentiment was reinforced with the earnings season absent any widespread negative surprises, alongside an appreciation by market participants of 'value' in risk markets starting to present itself.

In the US, the investment grade credit index tightened by 11 basis points (to 1.44%) and high yield tightened by 100 basis points (to 4.69%), recovering about half of June's losses. High yield credit did relatively better compared to investment grade, partly reflecting the more significant sell-off in that market in the prior month. Interestingly, there was limited differentiation within each market by sector or by ratings. For example, AA, single-A and BBB rated credits all tightened on average by about the same amount over the month, unusual in a market rebound. The earnings season continued, with results mostly good enough to dispel concerns of corporate stress in the immediate term. There were some disappointments, with broadband subscriber numbers stagnating and impacting cable issuers, and name-specific weakness impacting some healthcare issuers, for example. New issuance volumes were solid in investment grade, with double-digit concessions on average, but high yield issuance remained very light. On top of that, outflows from the investment grade market continued, whereas the high yield market turned around in late July to record a large inflow.

European investment grade credit outperformed peers, rallying 31 basis points in July following material underperformance in June. Several factors played into the rebound: the starting point of spreads was wide; the new European Central Bank tool (Transmission Protection Instrument) was well received by markets and the inclusion of credit securities in the eligible assets was a pleasant surprise; Nord Stream 1 flows resumed albeit at low levels; and global markets embraced risk assets. The technical side of cash credit markets also provided some support with supply very light. Investment grade fund flows turned to mild inflows from persistent outflows as bund yields rallied approx. 50 basis points and we have seen a slight uptick in corporate tenders. Performance across ratings in investment grade credit was reasonably uniform with lower-rated credit eventually gathering momentum into month end. Credit curves overall flattened as investors sought to extend duration at wider spread levels.

Australian credit market

Australian credit underperformed its global peers in July, with credit index spread moving only 5 basis points tighter, mostly driven by retracement of swap spreads. Major bank senior spreads traded with high level of conviction as spreads tightened anywhere between 3-5 basis points across the curve, with front-end paper outperforming as the sell-side broker inventory was depleted quickly throughout the month. Otherwise, most of the other sectors traded with a heavy tone throughout most of the month. In particular, bank subordinated notes drifted materially wider for the better part of the month as investors braced for potential supply. This supply eventuated in the National Australia Bank's recent '10NC5' (10 year maturity, callable in 5 years) deal which was issued at a spread to 3-month bank bill yield of 280 basis points, the widest print since 2016 by any of the Australian major banks. The National Australia Bank subordinated 10NC5 spreads have since pulled tighter over the month. Elsewhere, corporate paper generally traded without much vigour over the month, with spreads edging marginally wider as there was very little issuance to provide any pricing clarity in the corporate sector. Structured securities were marked wider in spreads again as a number of non-ADI (authorised deposit-taking institution) issuers came to the mark with non-conforming deals printing at wider spread levels. Over the month, primary issuance picked up to \$A7.8bn in the investment grade market, with all the deals concentrated in the banking sector except for one \$A300m deal from John Deere.

Outlook

'Stagflation' is increasingly being used to describe the current macroeconomic environment. We have been warning of stagflation all year, and the market narrative is now evolving towards recession. We have stated that recession is indeed a risk but was not a certainty, the key lies with how central banks conduct monetary policy. The US Federal Reserve believes at a 2.5% rate that policy is neutral, however, they are signalling that policy rates need to go higher in order to bring inflation back to the target of 2% on average. Although this is a challenge, as the Federal Reserve's own forecasts show rates rising to 3.75% during 2023 before falling modestly in 2024. In contrast, the market's discount for the Federal Reserve policy has rates peaking at around 3.30% in 2022 and falling to around 2.75% in 2023. This reveals a significant mismatch, which is likely to result in further asset volatility.

With leading indicators already signalling that the economy is slowing, a Federal Reserve focused on inflation and rates hikes is very likely to lead to a recession becoming reality. Central banks are in a tough position, as even though the double supply shocks (from the pandemic and then the Ukraine war) are largely responsible for inflation ramping higher, it is their mandate to bring it back towards target. The problem is that the supply situation needs to repair to ease many of the inflation pressures (e.g., gas). Hiking rates will dampen demand and using this tool to lower inflation means that demand will have to fall lower, probably into recession to even partly achieve their goal. Markets see a benevolent environment yet that is delicately and correctly managed by policy makers. We see the risks around this benevolent assumption as significant, particularly for risk markets.

Macquarie Australian Fixed Interest Fund

Monthly report – 31 July 2022

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

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