

Macquarie Australian Fixed Interest Fund

Monthly report – 30 September 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.

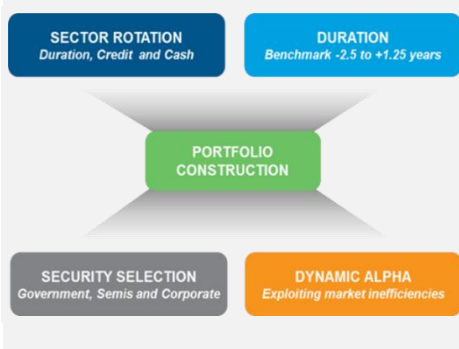
Key information

Fund details

APIR code	MAQ0061AU
Inception date	15 May 1995
Fund size	\$241.6m
Distribution frequency	Quarterly
Management fee*	0.390% pa
Minimum investment (Direct)	\$20,000

Unit prices and spreads [macquarie.com.au/unit_prices](https://www.macquarie.com.au/unit_prices)

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



Fund performance to 30 September 2022

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-1.24	-1.27	-1.36	0.09
3 months (%)	-0.19	-0.29	-0.64	0.35
1 year (%)	-11.36	-11.71	-11.36	-0.35
2 years (% pa)	-6.29	-6.66	-6.58	-0.08
3 years (% pa)	-2.94	-3.36	-3.42	0.06
5 years (% pa)	1.27	0.81	0.75	0.06

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)

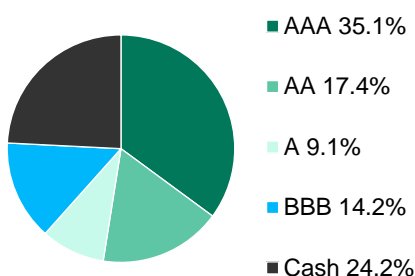
	Fund (%)
Credit	38.1
Cash and Equivalents	24.1
Semi-Government	20.4
Government	17.4

Fund statistics

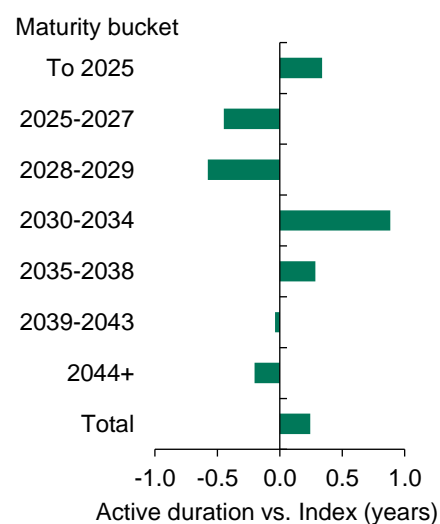
Credit spread duration	1.0 years
Interest rate duration	5.5 years
Yield to maturity*	5.04% pa

*Pre-fee returns Fund would earn over next year based on current market conditions if there were no changes to interest rates or holdings of Fund. It is not an actual or estimated return.

Credit profile breakdown



Curve positioning breakdown



Macquarie Australian Fixed Interest Fund

Monthly report – 30 September 2022

Fund highlights

The Fund outperformed the benchmark over the month, driven by duration and curve positioning.

Duration and curve

The Fund's positioning is modestly long duration, after we shifted from neutral duration last month. Bonds continue to sell-off on inflationary fears and central bank hawkishness, with US 10 year breaking above 4% this month as a sell off initiated by strong US Consumer Price Index was exacerbated amid a Gilt-led sell-off following the announcement of UK Government's unfunded tax cuts. Our view is that central banks will overtighten policy and cause a prolonged period of low growth which will make it hard to sustain any further rise in yields. The long position is predominately held in the 10 year part of the yield curve as we think curve flattens further as central banks hike through neutral.

We reduced our overweight to AU versus US in the front end of the curve this month as the US Federal Reserve's terminal pricing moved above the Reserve Bank of Australia (RBA) pricing. We continue to hold a small position as RBA 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.

Sector rotation

The Fund increased its overweight to the semi-government sector given the attractive excess yield on offer versus Australian Commonwealth Government Bonds (ACGBs). Recent swap spread widening allowed an attractive entry point, with our exposure concentrated in the 10 year part of the curve given the steepness of curve spreads. The State Governments have had significant funding tasks, with significant supply still to come and the FY23 funding programs totalling \$A75 billion, with New South Wales Treasury Corporation and Treasury Corporation of Victoria making up the lion's share of supply. The outlook is more balanced going forward however and we are cognisant that balance sheets have large high quality liquid assets requirements and will take down a significant proportion of this.

The Fund's credit positioning was a slight detractor from performance in September as credit spreads moved wider. Bank senior holdings detracted marginally from performance as spreads drifted 3bps to 8bps wider over the month. This was offset by the Fund's higher than benchmark carry.

Security selection

The Fund is overweight to the 10-year part of the curve and remains overweight derivatives versus physical securities both in swap and futures. The physical ACGBs remain 'rich' to the overnight indexed swap curve, though this spread has improved somewhat this month. Within ACGBs we reduced our underweight to the ultra-long maturities, given there continues to be demand in the back end of the curve. Within semi-government we have further reduced our allocation to Treasury Corporation of Victoria, shifting into New South Wales Treasury Corporation and Queensland Treasury Corporation, as Treasury Corporation of Victoria no longer trades at an excess yield over other States, and they continue to issue regularly via reverse inquiry which may limit price tension going forward.

The Fund's credit security selection performed broadly in line with the benchmark. Over the month, the Fund participated in primary transactions from issuers such as BPCE and Progress 2022-2.

Market overview

Central banks around the world maintained aggressive rate hiking cycles over the month and signalled that there is more to come. This is the fastest rate hiking cycle since the early 1980s and the magnitude is rising, with 75 basis points moves delivered by the US, European, and Canadian central banks, and 50 basis points moves in the UK and Australia. These actions and statements of intent to tame inflation continue to pull bond yields higher. Risk markets are waking up to the prospect that the unintended consequence of central banks' efforts to bring inflation under control could be a recession, with major equity indices falling by 5-8% in the month. Credit spreads too are widening, with US investment grade spreads 17 basis points wider (European investment grade was 23 basis points wider) in the month, but as would be expected sub-investment grade underperformed, widening 68 basis points while emerging market sovereign spreads were 58 basis points wider.

If this was not enough for markets to contend, the new UK Prime Minister and Chancellor unveiled expected fiscal support measures to contain the impact of higher energy prices on households and businesses but tagged on significant unfunded tax cuts that are biased to benefit high income earners. The UK government bond market exploded higher, particularly the long end – which rippled around global markets and eventually prompted the Bank of England to intervene and buy bonds, reversing its intent to begin unwinding its balance sheet. The Japanese yen meanwhile continued to decline against the US dollar, despite efforts by the Bank of Japan to stem the tide.

Australian bond market

Yield movements were broadly in line with the global moves as yields rose over the month on the back of hawkish central bank rhetoric. The RBA delivered another 50 basis points hike in the September meeting, taking the overnight cash rate to 2.35% as they continue to front-load the tightening cycle. The Australian 10-year bond futures implied yield traded between 3.51% and 4.18% in September (a range of 68 basis points versus 78 basis points in August), with the 10-year yield ended the month at 3.92%, +31 basis points on the month. The Australian 3-year bond futures implied yield traded between 3.07% and 3.93% in September (a range of 86 basis points versus 78 basis points in August), with the 3-year yield ended the month at 3.67%, +39 basis points on the month. The 2021/22 Australian Government Budget outcome came in at \$A32 billion or -1.4% of GDP, significantly lower than the previous government estimate of \$A79.8 billion or -3.5% of GDP, coming from a combination of higher than expected revenue and lower payments. The labour market remains tight with the unemployment rate coming in at 3.5% and a +33.5 thousand increase in employment, as there is now just one unemployed person per job

Macquarie Australian Fixed Interest Fund

Monthly report – 30 September 2022

vacancy. Consumer sentiment continues to deteriorate while business confidence is firmer but beginning to show signs of weakness, as retail sales rise on a price-level basis as people pay *more* for less.

Global credit market

Markets were weak in September, with familiar themes of inflation and geopolitics, as well as accelerated US Treasury market volatility. Those themes were joined by sharp selloffs in non-USD bond markets, which drove broad asset market selling and illiquidity the culminated in the Bank of England intervening to buy long end bonds to restore stability.

United States investment grades (IG) spreads finished the month 19 basis points wider, to 159 basis points, which much of the move occurring in the final days of the month. Amongst sectors, financials performed weakest, led by United Kingdom banks (reflecting the turmoil in that economy and government bond market), though United States banks were also affected: JPM senior 10-year bonds, for example, now trade with a 220 basis points spread, wide of any period in the last 10 years (outside the brief COVID market shock). Across the quality spectrum, results were unusual: BBB (the lowest investment grade rating) outperformed single-A, but CCC bonds (the lowest rating rank in high yield before default) underperformed the entire market, suggesting credit weakness is both a combination of solvency concerns for weak companies, as well as poor liquidity in all markets.

Reflecting the weak backdrop, new issuance volumes were well below expectations – September is generally a very heavy month as the Northern hemisphere returns from Summer. In total, just under US\$80 billion was issued in the IG market, around half of initial estimates, and only a few \$billion total in high yield: with several 'hung' M&A deals either pricing with very large discounts or withdrawing from sale entirely: all indicators of the weak tone in the market. Notable issuers in IG included T-Mobile, one of the largest mobile operators in the market, which issued its first 10, 30 and 40 year bonds after an upgrade to full investment grade earlier this year.

European credit underperformed global peers closing 23 basis points wider to new wides of 225 basis points. The weakness was broad based, but cyclicals underperformed such as higher beta chemical names +50-80 basis points and lower rated IG airlines such as Easyjet almost 100 basis points wider this month. Issuance totalled €44billion which was heavily skewed to the first half of the month with more stable spreads. High yield (HY) supply remains very light but the names that did come highlight the dynamics of the market re-pricing, Verisure (B/B1 consumer services) paid a 9.25% coupon to refinance their upcoming 3.5% 2023 maturity.

There was significant volatility GBP credit following the United Kingdom government fiscal expansion as long end gilts went from 3% to north of 5% before the Bank of England had to intervene, GBP corporate spreads closed 29 basis points wider. There was forced selling of GBP credit even in the highest quality securitised deals as investors sought cash to fund collateral requirements. Valuations in credit continue to improve although the outlook remains challenged ahead of corporate earnings with elevated inflation and central bank tightening.

Australian credit market

Australian credit widened over the month albeit to a lesser extent relative to the offshore markets. Investment grade (IG) spreads finished the month +15 basis points on option-adjusted spread basis though this was partly driven by swap spread widening. The credit curve steepened slightly with long-end generically flat to 10 basis points wider. Senior financials underperformed with spreads drifting +3 basis points to +8 basis points with the latest 5-year CBA senior bond ending the month at 100 basis points. In the financial subordinated space, spreads on the new 10NC5 bonds tightened as much as 12 basis points mid-month before giving back most of the gains in the last week of September to be only 2 basis points tighter. While there were no significant spread moves in the structured space, the market did receive several Bid-Wanted-In-Competition from a range of United Kingdom investors to cover margin calls on the back of the volatility seen in the United Kingdom rates market. In the primary market, the IG market saw slightly less than \$A6 billion of issuance all in financials and it is worth noting that this included a number of private placements via reverse enquiries. In the structured space, \$A3.6 billion was priced across height deals and a further circa ~\$A3 billion has already been mandated for early October.

Outlook

Over the past two years, our analysis has determined that the economic environment was being largely defined firstly by the pandemic shock and then later by the energy price shock resulting from the war in Ukraine. However, the latest analysis at the Macquarie Fixed Income team's September Strategic Forum pointed to the outlook being increasingly defined by the aggressive stance by central banks to tame inflation.

Measures of the supply side point to continued gradual recovery, despite various setbacks, although there is still a lot of repairs to get back to pre-pandemic levels and the energy outlook is more uncertain due to geopolitics. The demand side is slowing, but the picture is varied across countries, with Europe and the UK the hardest hit and the US proving relatively resilient. The rate hiking cycle underway will impact demand, and central bank overtightening is expected to mean that demand destruction will become the dominant driver of the economic outlook in coming quarters. Unfortunately, inflation is not providing central banks with any reason to hold back, despite the hopes of asset markets for a reprieve and despite the knowledge that demand will be hit. Recession is increasingly becoming the consensus expectation for 2023.

Current stagflation and the prospect of recession in 2023 implies that high volatility will persist across asset markets. Inflation has pulled bond yields higher than expected, but we see value returning, with bonds offering an attractive entry point and strong protection levels for multi-asset strategies. Credit fundamentals remain strong, but the outlook suggests that these will come under pressure, particularly if a hard landing manifests.

Macquarie Australian Fixed Interest Fund

Monthly report – 30 September 2022

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 AFSL 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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