

Macquarie Australian Fixed Interest Fund

Monthly report – 31 October 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.

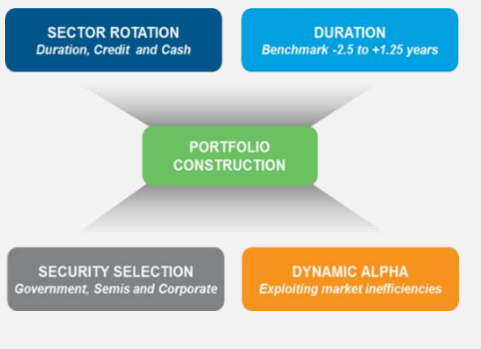
Key information

Fund details

APIR code	MAQ0061AU
Inception date	15 May 1995
Fund size	\$252.6m
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 October 2022

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	0.86	0.83	0.93	-0.10
3 months (%)	-2.73	-2.82	-2.98	0.16
1 year (%)	-6.91	-7.27	-7.24	-0.03
2 years (% pa)	-6.06	-6.43	-6.28	-0.15
3 years (% pa)	-2.54	-2.95	-2.97	0.02
5 years (% pa)	1.20	0.75	0.72	0.03

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)

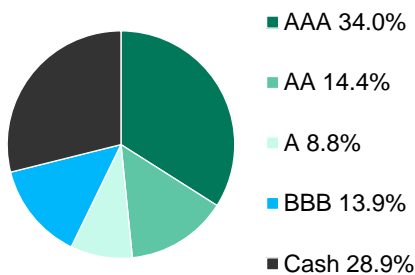
	Fund (%)
Credit	37.1
Cash and Equivalents	29.0
Government	17.2
Semi-Government	16.7

Fund statistics

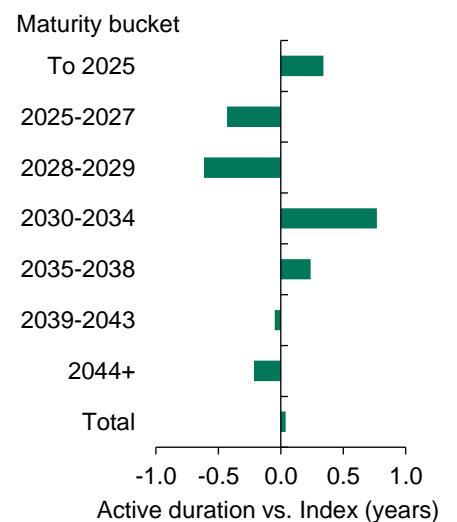
Credit spread duration	0.9 years
Interest rate duration	5.3 years
Yield to maturity*	4.96% pa

*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



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Fund highlights

The Fund underperformed the benchmark over the month, as a result of the ongoing rates volatility and the move wider in credit spreads.

Security selection

The Fund is overweight derivatives versus physical securities both in swap and futures, held in the 10 year part of the yield curve. The physical Australian Commonwealth Government Bonds (ACGBs) remain 'rich' to the overnight index swap curve, particularly in the front end and belly of the yield curve. Within ACGBs, we continue to hold our exposure in the back end of the yield curve where bonds offer more value versus overnight index swap and futures. Within semi-government, we remain short Treasury Corporation of Victoria given their poor issuance pattern, with a new 2036 bond issued this month. We prefer to be overweight Queensland Treasury Corporation given conservative coal price assumptions provide a tailwind to revenues, with a lower AUD also working in their favour. We are also overweight New South Wales Treasury Corporation given funding task is largely priced into spreads, and prefer to be underweight Western Australia Treasury Corporation given deteriorating outlook for iron ore, with conservative price forecasts for the commodity already reflected in spreads.

The Fund's credit security selection performed in line with the benchmark over the month. The overweight to the front-end part of the curve detracted as credit spreads bear-flattened, though higher than benchmark carry helped offset. The Fund participated in transactions from issuers such as Australia and New Zealand Banking Group, Commonwealth Bank of Australia and Firstmac 2022-4.

Duration and curve

The Fund's positioning changed from modestly long duration, held in the 10 year part of the curve, to neutral duration this month. Bonds rallied over the month as central banks stepped down the pace of rate hikes, slowing their tightening cycles. The Reserve Bank of Australia (RBA) stepped down the pace of their hikes to 25bps, the Bank of Canada stepped down the pace of their hikes to 50bps, and the European Central Bank (ECB) declined to set a date for quantitative tightening (QT). The UK Government was overhauled as Prime Minister Liz Truss was replaced in favour of Rishi Sunak, and Chancellor Kwasi Kwarteng was replaced in favour of Jeremy Hunt. The much-improved fiscal outlook under the new Government calmed the Gilt market, and this flowed through to global yields.

We unwound the short US leg of the AU versus US front end spread as US Federal Reserve (Fed) terminal pricing moved significantly higher than the RBA. We remain overweight the AU front end of the curve as we continue to believe the RBA remains more constrained than the Fed, given the predominately variable rate mortgage market and high household leverage. On month end, we utilised the larger than normal index extension, due to the Nov-2022 ACGB maturity, to take us flat duration. This is a short-term tactical trade, with a view to add back the duration, to capitalise the significant outperformance of AU 10 year versus US and the upcoming May-2034 syndication, which should see AU duration underperform into it.

Sector rotation

The Fund slightly reduced its semi-government exposure over the month given the slight outperformance to swap on persistent swap spread widening. The exposure remains concentrated in the 10 year part of the yield curve given the steepness of the spread curve. Semi-government continues to offer attractive yield versus Australian Commonwealth Government Bonds, but our outlook is balanced going forward.

The Fund's overweight credit positioning was a detractor from performance in October as Australian credit spreads moved wider, most notably as a result of the volatility in swap spreads. Financial spreads notably moved wider following a new senior deal from Australia and New Zealand Banking Group and a new subordinated deal from Commonwealth Bank of Australia as both came with hefty concessions to secondary curves. Structured securities were a strong contributor to performance as spreads held in despite the significant volume of offshore Bids-Wanted-In-Competition. The modest protective credit default swap positioning detracted as synthetic indices rallied in October.

Market overview

Cries of '*Pivot!*' were on everyone's lips as central banks around the world enacted their rate hiking cycles, though with more cautious outlooks, reflecting the competing forces of persistent inflation and deteriorating economic activity. The term 'pivot' can be defined in a number of ways – decelerated pace of tightening, declining implied terminal funds rate, increased implied pace of normalisation after terminal rate is achieved – and whilst there was no reversal in the direction of monetary policy, markets bounced around on the prospect of a 'soft' versus 'hard' landing. The RBA, Bank of Canada (BoC) and ECB all delivered dovish hikes, either slowing the pace of tightening or suggesting that they were nearing the peak in the tightening cycle.

Markets remain wary of the growing prospect the unintended consequence of central banks efforts to bring inflation under control could be recession, and a general risk-off sentiment was evident with weaker equity markets and wider credit spreads. There was mixed data and even more mixed fiscal policy announcements, as consumer and business sentiment remained weak and personal income and spending data have deteriorated. The improving LNG gas price situation in Europe will be a relief for households and policymakers as storage facilities have filled up significantly, however markets will want to wait until after winter before assessing the long-term situation. The Japanese Yen meanwhile continues to depreciate, despite efforts by the Bank of Japan to stem the tide.

Australian bond market

Australian rates outperformed US Treasuries across the curve in the month, with the surprise change in gear by our central bank supportive. The RBA delivered a 25 basis point hike in the October meeting, a step-down from the series of 50 basis point hikes as they

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slow the pace of tightening and take the overnight cash rate to 2.60%. The Australian 10 year bond futures implied yield traded between 3.65% and 4.33% in October (a range of 68 basis points versus 68 basis points in September), with the 10 year yield ended the month at 3.79%, -12.5 basis points on the month. The Australian 3 year bond futures implied yield traded between 3.08% and 3.89% in October (a range of 81 basis points versus 86 basis points in September), with the 3 year yield ended the month at 3.39%, -28 basis points on the month.

Global credit market

October saw most risk markets perform well despite elevated inflation keeping pressure on bond yields. The market appeared to take some support in the idea that the Fed would begin to scale back the pace of tightening in the coming months.

United States credit markets were mixed for the month, with small moves at the overall investment grade index level (-1 basis points over the month, to 158 basis points) masking more significant deviation amongst sectors. High yield (HY) credit meaningfully outperformed investment grade (IG), with HY attracting inflows for only the second time this year: IG accelerated outflows. Amongst industry sectors, financials performed worst, pricing 10 basis points wider on average – dragged down by continued weakness in European banks. In contrast, most US banks performed well, and industrial sectors generally traded tighter over the month. Supports for the overall performance included limited new issuance (approximately US\$80 billion of new IG credit, remaining below longer term averages for this time of year), and earnings. The portion of earnings season that had completed by month-end was mostly benign – apart from large cap tech, which is not heavily represented in the credit market – with some indicators of slowing economic momentum but no material negative acceleration. Valuations remain attractive by any historic measure – with spreads in their top historic quartile and total yields at the highest level since 2009. Also spreads can clearly trade wider in a recession, which remains at the front of market mind (the US 3 months-10 year curve inverted during the month marking a further yield curve inversion, a broadly watched indicator of growth slowdowns).

European credit traded with a firm tone closing 4 basis points tighter in IG to 221 basis points and 35 basis points tighter in HY. Supply totalled €38 billion and was skewed to non-financials. New issuance was broadly taken down well, but concessions remain elevated with higher quality names indicatively paying 15-20 basis points new issue concessions. European utilities in particular were heavy issuers this month with names such as Tennet, Energias de Portugal, Électricité de France, Suez and Electricity Supply Board all active in primary thus weighing on secondary spreads.

UK credit while only 5 basis points tighter on the month closed 32 basis points off the intra month wides as the UK government U-turned on their previous fiscal expansion and the Bank of England's intervention calmed risk markets in the UK.

Credit spreads in Europe remain at historically elevated levels at 221 basis points, while there has been some short-term improvement in areas such as energy pricing the outlook remains challenging.

Australian credit market

Australian credit significantly underperformed its global peers with the IG index option-adjusted spread widening 26 basis points over the month. This was mostly driven by consistent pay side flow which drove further widening in swap spreads as IG spreads on asset-swap spreads basis were 3 basis points wider over the month. The major underperformers were Total Loss Absorbing Capacity (TLAC) instruments, especially European banks and Australian bank subordinated bonds. European banks were impacted by the geopolitical uncertainty, while Australian major bank subordinated bonds were pushed wider on the back of the largest major bank A\$ subordinated deal on issue from Commonwealth Bank of Australia. While the front-end of the major bank senior curve remained broadly unchanged to only marginally wider, the longer dated lines underperformed with ANZ issuing 5 year senior at +120 basis points which was close to 20 basis points wider than the previous on-the-run 5 year major bank senior at the start of October. Corporate curve bull-flattened with short-dated bonds underperforming while longer-dated paper moving broadly sideways. In the structured space given a reasonably light month of issuance, the main focus was on the Bids-Wanted-In-Competition (BWICs) which mainly came from Liability Driven Investment (LDI) pension funds in the UK. Despite close to \$A2bn of Residential mortgage-backed/Asset-backed securities sold over the last two months, it had minimal impact on the spreads. Over the month, the Australian IG market saw around \$A11 billion of primary issuance with more than half of that coming from two mega deals which included the largest major bank senior and subordinated transactions from ANZ and Commonwealth Bank of Australia, respectively.

Outlook

Over the past two years our analysis has determined that the economic environment was being largely defined by first the pandemic shock and then later by the energy price shock resulting from the war in Ukraine. However, at our September Strategic Forum our analysis 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 repair 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/UK the hardest hit and the US proving relatively resilient. The hiking cycle underway will impact demand, and we expect central bank overtightening 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 and offering an attractive entry point and strong protection levels for multi

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asset strategies. Credit fundamentals have softened in Q3 but remain at robust levels. The outlook suggests these will come under pressure, particularly if a hard landing manifests.

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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

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