

Macquarie Australian Fixed Interest Fund

Monthly report – 30 November 2022

Investment objective

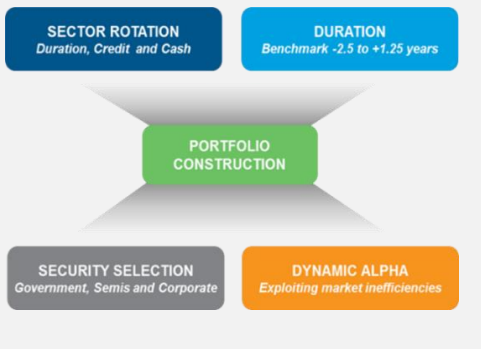
Aims to outperform the Bloomberg AusBond Composite 0+ Yr Index over the medium term (before fees) by using an active investment strategy. It aims to provide regular income and a moderate level of growth.

Key information

Fund details

| | |
|-----------------------------|---|
| APIR code | MAQ0061AU |
| Inception date | 15 May 1995 |
| Fund size | \$256.1m |
| 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 November 2022

| | Total Fund return (gross) | Total Fund return (net) | Benchmark return | Total excess return (net) |
|-----------------------|---------------------------|-------------------------|------------------|---------------------------|
| 1 month (%) | 1.84 | 1.81 | 1.55 | 0.26 |
| 3 months (%) | 1.45 | 1.35 | 1.09 | 0.26 |
| 1 year (%) | -7.35 | -7.71 | -7.72 | 0.01 |
| 2 years (% pa) | -5.20 | -5.58 | -5.50 | -0.08 |
| 3 years (% pa) | -2.21 | -2.63 | -2.74 | 0.11 |
| 5 years (% pa) | 1.40 | 0.94 | 0.86 | 0.08 |

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)

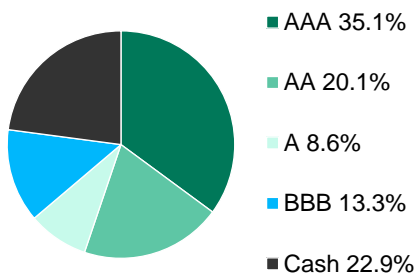
| | Fund (%) |
|----------------------|----------|
| Credit | 37.7 |
| Cash and Equivalents | 22.9 |
| Government | 19.8 |
| Semi-Government | 19.6 |

Fund statistics

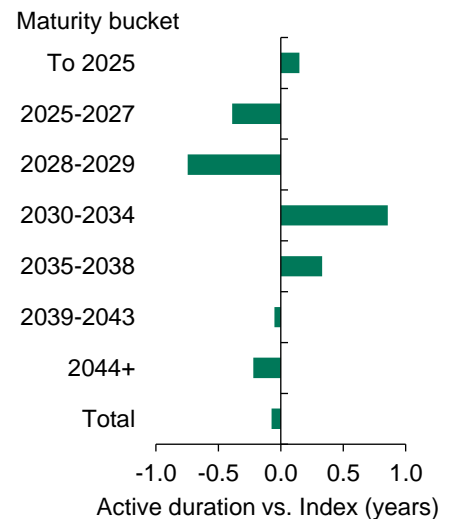
| | |
|------------------------|-----------|
| Credit spread duration | 0.9 years |
| Interest rate duration | 5.3 years |
| Yield to maturity* | 4.63% pa |

*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 outperformed the benchmark over the month, driven by security selection, duration and curve as well as sector rotation.

Security selection

The Fund is overweight derivatives versus physical securities both in swap and futures, held in the 10 year part of the 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 curve. Within ACGBs, we continue to hold our exposure in the back end of the curve where bonds offer more value versus overnight index swap and futures. Within semi-government, we reduced our underweight to Treasury Corporation of Victoria given considerable progression in their funding task, and spreads have widened to accommodate their irregular issuance pattern. 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 NSW 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. In addition, we have deployed some excess cash backing derivatives into JPY bills fully hedged back to AUD for a favourable yield pick up to Bank Bill Swap Rate (BBSW).

The Fund's credit security selection added to the outperformance. Despite the recent major bank senior note issuance, robust demand saw the major bank senior spreads tightened and curve bull-flattened. With the recent purchases of major bank subordinated debt notes at historically wide spreads, the return of demand in the sector this month following the widening seen towards the end of last month and the Australian Prudential Regulation Authority's letter on "Expectations of capital calls" contributed positively to performance over the month. Structured securities continued to contribute to the outperformance with the carry benefiting the Fund as spreads remained broadly unchanged. Over the month the Fund participated in transactions from issuers such as Westpac Banking Corporation, National Australia Bank, ING Bank, Firstmac Asset Funding Trust No. 1 Series Auto No. 1, Think Tank Commercial Series 2022-3 Trust and IDOL RMBS Series 2015-1 Class A note refinance.

Duration and curve

The Fund's positioning moved from neutral duration to modestly short duration. Bonds rallied over the month, unwinding an initial spike higher in yields, as hawkish central bank rhetoric gave way to more concrete hopes of a central bank 'pivot' as inflation in several economies printed below consensus. The Reserve Bank of Australia (RBA) reaffirmed their step down to 25 basis point hikes, in comparison to the Federal Reserve, Bank of England and Reserve Bank of New Zealand who all hiked 75 basis points. Federal Reserve Chair Powell all but confirmed they would step down to 50 basis point hikes in his speech near month end, confirming the market's dovish read of the November FOMC minutes. The RBA further diverged from their global counterparts as Deputy Governor Bullock indicated it might be time to pause, appearing before a Senate Committee mid-month, which helped fuel the broad outperformance of Australian duration over the month.

We initiated a new short US front end position as market pricing expects the Federal Reserve to finish hiking and begin cutting immediately. We believe the Federal Reserve is more likely to pause once they finish hiking, to allow for the lag of monetary policy transmission, which should see the significant front end curve inversion normalise somewhat as cuts get priced out. We remain long AU duration, concentrated in the very front end and 10 year part of the curve, as the RBA remains constrained by the predominately variable rate mortgage market and high household leverage, which implies a lower peak and terminal cash rate. Intra-month, we traded duration tactically, going slightly short into duration supply events to capitalise on weakness.

Sector rotation

The Fund increased its semi-government exposure over the month as semi-governments lagged the narrowing in swap spreads over the month. We took the opportunity to add this exposure via the NSW Treasury Corporation 2035 syndication and also added exposure against swap, reducing our overall swap spread exposure as spreads look to have peaked.

The Fund's overweight credit positioning contributed positively to performance as credit spreads tightened on OAS basis over the month.

Market overview

Asset markets had a very strong month in terms of absolute returns. Bond yields fell, credit spreads narrowed, the dollar weakened, and equities rallied. Enjoy the ride or "eye of the storm"? Central banks continue to deliver the most aggressive rate hiking cycle since the 1980s even if there is recognition that smaller moves are more likely going forward. Bond yields have been pulled higher in 2022 by both rising inflation but also by central banks tightening monetary policy. However, bond markets provide a feedback loop to policy makers via the yield curve (that is, the spread between short- and long-dated maturities). During November both, the European and United Kingdom yield curves inverted, while the United States, Canadian, and New Zealand curve inversions deepened. Inverted yield curves imply economic fragility and are a reliable historic indicator for recession in 12 months' time. So, it seems that the rally in financial markets is reflecting the prospect that the elusive 'soft economic' landing in 2023 materialises. Our base case for 2023 is recession.

Against this background it was notable that the oil price slid by circa 9% in the past month, likely reflecting the slowing global demand environment. While this is good news for inflation, it could be yet another signal of tougher economic times ahead.

Australian bond market

Australian rates outperformed United States Treasuries across the curve in the month, with the RBA delivering a 25 basis point hike in the November meeting, as they slow the pace of tightening and take the official cash rate to 2.85%. The Australian 10 year bond futures

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implied yield traded between 3.48% and 4.07% in November (a range of 59 basis points versus 68 basis points in October), with the 10 year yield ended the month at 3.52%, -24 basis points on the month. The Australian 3 year bond futures implied yield traded between 3.11% and 3.59% in October (a range of 48 basis points versus 81 basis points in October), with the 3 year yield ended the month at 3.13%, -21 basis points on the month. The Australian consumer price index for October came in at 0.2% month-on-month and 6.9% year-on-year, with both the quarterly and annual pace of inflation slowing. The labour market remains tight with the unemployment rate coming in at 3.4% and close to 50-year lows, though confirms a trend in slowing employment gains. The Australian housing market continues to deteriorate as higher rates bite borrowing capacity. The Core Logic home value index, covering the eight capital cities, fell another -1.1%, while housing loan commitments fell 2.7%, with loan commitments down -22.7% year-to-date. Consumer sentiment continues to deteriorate while business confidence is firmer but showing signs of weakness, as retail sales rise on a price-level basis as people pay *more for less*.

Global credit market

November saw risk assets perform well on the back of the US consumer price index print that saw the market embrace the notion that inflation has likely peaked and will allow the central banks to slow their aggressive tightening.

United States High quality (investment grade) credit spreads tightened 25 basis points over the month, marking the sharpest move tighter in spreads since the early rebound from the Covid crisis, in May 2020. Lower quality credit (high yield) also tightened overall, but performance was much more mixed, with the index tightening 16 basis points but many issuers widening over the month. The strongest performers in investment grade were financials, with US bank issuers regaining a portion of their year-to-date underperformance. UK banks in US dollar also performed particularly strongly, rebounding from very weak performance after UK market turmoil in September. Other sector performance was generally broad-based, with most major sectors tightening 20-25 basis points. Earnings season in the US wrapped up, with generally positive results: approximately 60% of issuers beat expectations on sales and earnings, generally in line with past periods. Some sectors showed signs of weakness, with retail and tech hardware mixed, and earnings from big tech and media generally poorly received. But financials were strong, reflecting loan growth and sharply higher interest margins, and most industrial companies continue to effectively navigate the challenging environment.

New issuance continued at a solid pace, with just over \$US100 billion for the month well ahead of projections of \$US75 billion, though still down over 17% versus this point last year. Large issuers included Amazon (with \$US8.25 billion across 5 tranches) and GE Healthcare. Concessions continue to be modest (low single-digits for most new bonds), reflecting strong demand. Flows continued to be mixed, with sharp outflows from investment grade credit, in contrast to high yield which has enjoyed a turnaround, now with 5 weeks of consecutive inflows.

It was a strong month for European investment grade credit outperforming peers with spreads rallying 40 basis points and now 53 basis points from the wides of October. Swap spreads which have been a persistent headwind for European credit this year rallied ~20 basis points this month having reached extreme levels in October. Issuance was strong as risk appetite improved with €70 billion coming to market. Primary issuance was well received, new issue concessions trended lower as the month progressed and the market opened for lower quality issuers. Sectors which were previously challenged to access the market such as chemicals, real estate and corporate hybrids all issued this month. Outperformers in secondary were in higher beta sectors such as low BBB's in sectors like chemicals, mining and real estate investment trusts' where names rallied over 100 basis points. The fundamental outlook remains challenging in Europe where it is widely believed there could be a recession. Credit spreads are likely to remain volatile despite very strong performance over the past month.

Australian credit market

Australian credit rallied with the investment grade index option-adjusted spread tightening 15 basis points in November. However, this was driven mostly by the tightening in swap spreads. Senior financial paper were the outperformers with curve bull-flattening as 3 year and 5 year senior paper ended the month at Bank Bill Swap rate (BBSW) +80 basis points and BBSW+100 basis points. On 1st November, Australian Prudential Regulation Authority (APRA) released a letter in response to *"requests to make uneconomic calls"* in Tier 2/subordinated paper. It outlined capital calls on AT1/Tier 2 instruments that are to be replaced with new instruments at a *"higher credit spread or that is otherwise more expensive"* can *"(i) satisfy APRA as to the economic and prudential rationale of the call; and (ii) satisfy that such action will not create the expectation that other instruments will be called in similar circumstances."* This letter created disruptions to the sector with short-dated call notes gapping 50-60 basis points wider initially and longer dated lines 20-30 basis points wider. As a result, the market has since shied away from low coupon reset paper, mostly the short-dated calls, but demand for the more recent issues with higher coupon resets did return towards the end of the month and drove spreads sharply lower as the on-the-run fixed rate 10NC5 Tier 2 bond finished November in the low 220 basis points after issuing at +270 basis points a month earlier. Otherwise, it was generally a directionless month for corporate paper with the lack of corporate issuance to provide guidance on clearing levels in the secondary market. Primary issuance continued to be concentrated in the financial sector with only \$A500 million out of \$A12 billion of new issuance incoming from November in non-financial sector.

Outlook

In trays are beginning to fill up with 2023 outlook papers. Long term experience and the huge uncertainties thrown up by two supply shocks in the past two years suggest that one should have a base case but be alert for unexpected surprises. There is a strong consensus that inflation can fall significantly during 2023, a view we agree with, resulting from as a combination of base effects, on-going supply improvement and the prospect of a demand shift as recessions unfold. However, the bigger question is: where will inflation settle? Central banks understand the uncertainties and the policy lags involved, yet they are speaking with a consistent voice that their greater fear is for under-tightening than overtightening, as the consequence could leave inflation stubbornly above target. This suggests that central banks

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could continue to hike further than is expected – take note that the Reserve Bank of New Zealand, an early adopter of tighter policy, actually increased the size of its rate hike at the meeting in November. In addition, central banks could hold onto tighter policy for much longer than expected, to ensure that inflation does return sustainably to target.

For this reason, our base case outlook for 2023 also assumes that demand destruction can become a dominate theme. If demand falls into recession, as we expect, and supply continues to adjust this should ensure lower inflation through the coming year. This is good news for sovereign bond yields, which should be in the process of peaking. However, demand destruction is bad news for consumer spending and corporate earnings. This implies that credit spreads are vulnerable to widening from current levels.

We therefore expect sovereign bond yields to offer attractive value for investors during 2023, with the added attraction of offering Fund protection against risky assets. We are cautious on corporate credit, preferring highly rated investment grade issuers that are not exposed to the cycle. Our approach to higher yield corporates and emerging market debt is more cautious, preferring selective opportunities.

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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 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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