

# Macquarie Australian Fixed Interest Fund

Monthly report – 31 December 2022

## Investment objective

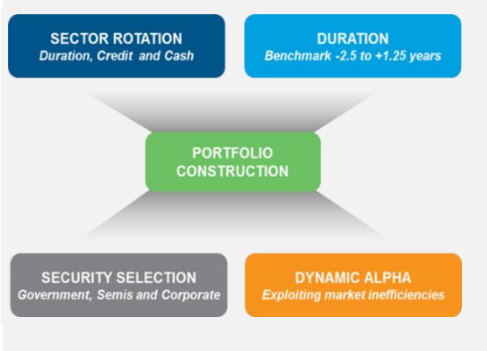
Aims to outperform the Bloomberg AusBond Composite 0+ Yr Index over the medium term (before fees) by using an active investment strategy. It aims to provide regular income and a moderate level of growth.

## Key information

### Fund details

APIR code	MAQ0061AU
Inception date	15 May 1995
Fund size	\$250.4m
Distribution frequency	Quarterly
Management fee*	0.390% pa
Minimum investment (Direct)	\$20,000
Unit prices and spreads	<a href="https://www.macquarie.com.au/unit_prices">macquarie.com.au/unit_prices</a>

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



## Fund performance to 31 December 2022

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
<b>1 month (%)</b>	-2.01	-2.05	-2.06	0.01
<b>3 months (%)</b>	0.65	0.55	0.38	0.17
<b>1 year (%)</b>	-9.34	-9.70	-9.71	0.01
<b>2 years (% pa)</b>	-6.07	-6.44	-6.35	-0.09
<b>3 years (% pa)</b>	-2.33	-2.74	-2.87	0.13
<b>5 years (% pa)</b>	1.08	0.63	0.54	0.09

### 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)

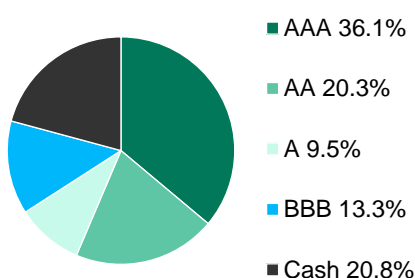
	Fund (%)
Credit	39.7
Cash and Equivalents	20.8
Semi-Government	19.8
Government	19.7

## Fund statistics

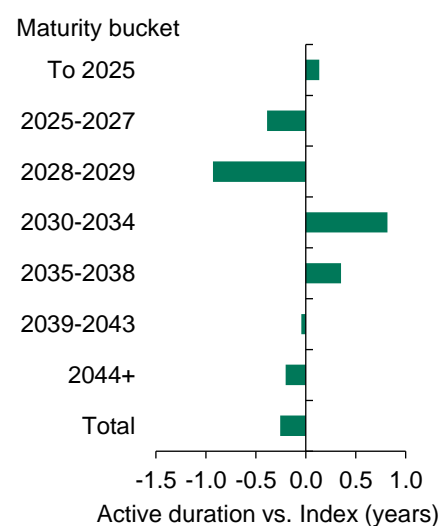
Credit spread duration	0.9 years
Interest rate duration	5.0 years
Yield to maturity*	5.08% pa

\*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

The event calendar through December was dominated by numerous central bank meetings. As expected, further rate hikes were delivered. However, it was the messaging from central banks that really caught attention where each reiterated a laser focus on returning current high inflation back to target. The signal from the European Central Bank (ECB) was perhaps the strongest guidance and this caused a significant repricing of sovereign bond yields across the yield curve. And yet it was the Bank of Japan (BoJ) that pulled out the biggest surprise of all, where they delivered an unexpected shift in their ultra-dovish YCC policy that has anchored the Japanese bond market in recent years. The shockwaves from this position change, just before the festive holidays, caused bond yields to slump and the Yen to spike.

So, what did asset markets make of this deluge of central bank change? Sovereign bond yields, which had been grinding lower, quickly reversed and surged higher causing yield curves to steepen in the process. Perhaps more interesting was the reaction of forward expectations: in the US they actually fell, signalling the markets belief that the US Federal Reserve (Fed) hiking cycling is almost done and that rate cuts will be in focus by late 2023; in Europe, expectations for total hikes in this cycle rose by around 50bps; in the UK forwards remained steady, discounting multiple further hikes; while in Japan bond yields all moved positive for the first time since November 2015. Equities markets embraced the change and repriced lower, expecting weaker earnings to dominate in 2023. However, credit markets,

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somewhat surprisingly remained very resilient, with spreads closing tighter in the month for investment grade and emerging markets, with high yield spreads modest wider.

## Australian bond market

Australian rates outperformed US Treasuries for the first half of the month, with the RBA delivering a 25bps hike at the December meeting, taking the official cash rate (OCR) to 3.10%. This outperformance reversed mid-month as liquidity deteriorated rapidly and Australian yields became subject to global data flow, notably progression in China's reopening and the BoJ widening of the Yield Curve Control (YCC) band. The Australian 10-year bond futures implied yield traded between 3.30% and 4.08% in December (a range of 78bps versus 59bps in November), with the 10-year yield ended the month at 4.08%, +55bps on the month. The Australian 3-year bond futures implied yield traded between 3.03% and 3.59% in December (a range of 56bps versus 48bps in November), with the 3-year yield ended the month at 3.59%, +41bps on the month. The Australian economy continues to expand with Q3 gross domestic product (GDP) printing 0.6% quarter on quarter and 5.9% year on year, as the domestic supply side remains remarkably resilient. The labour market remains tight with the unemployment rate unchanged at 3.4%, with monthly employment gains driven by a surge in part-time employment associated with holiday seasonality. The Australian housing market continues to deteriorate as higher rates reduce borrowing capacity as the Core Logic home value index, covering the 8 capital cities, fell another 1.1%, matching last month's fall. Consumer sentiment continues to deteriorate, with business confidence also entering negative territory for the first time this tightening cycle.

## Global credit market

Risk markets were more cautious as 2022 concluded with central banks signalling the need to remain hawkish. Equities and US high yield (HY) were mostly weaker for the month, though higher quality investment grade (IG) outperformed to finish the month tighter, with rates responding to the continued hawkish tone and drifted higher.

US credit markets finished the year mixed over the month. At an index level, benchmark IG spreads ended at 129 bps, -3bps over the month, but US HY spreads were somewhat wider, +21bps to 469bps. Sector dispersion was modest, with European financials outperforming, and short-maturity bonds under 3 years underperforming. Lack of liquidity into the end of the year was a key factor in relative performance. Technicals have remained supportive for IG with very low issuance, lighter dealer inventories, and continued inflows providing support for pricing. Macro indicators were mixed in the US with the US Consumer Price Index (CPI) again coming in below expectations, but the Fed painted a hawkish outlook with their meeting and 'Dot Plots', which showed continued hikes and a lower growth outlook.

New issuance came in well below expectations, with only \$US3bn in HY and a total of \$US8bn in IG, including deals from pipeline operator Energy Transfer, and utility Duke. January is expected to be much more active as investors and issuers both return to markets.

European credit closed at 168bps, 13bps tighter on the month and outperforming the move in HY which closed 11bps tighter. Issuance was very light, just over €3bn in IG while 4 issuers in HY did come to market to take advantage of stronger funding conditions to price approximately €2bn. The ECB meeting this month reinforced the need for further tightening and to maintain higher rates for longer to dampen inflation. While this had a negative impact on rates with Bunds back towards Year-to-Date highs of 2.5% and to a lesser extent credit default swap (CDS) spreads, the impact on cash credit was negligible. In IG, banks outperformed with large cap seniors closing 15-25bps tighter. REIT's were the main area of underperformance as the move higher in rates along with single name volatility impacted the sector. The outlook in Europe remains mixed with higher IG yields offering a reasonable entry point for yield based investors. While a hawkish central bank, a looming recession and a spread rally of 66bps from October should lead to continued volatility.

## Australian credit market

Australian credit ground tighter by a further 10 bps as the tightening of swap spreads partly helped with the spread compression. After a stellar month of performance in November, senior financial paper traded broadly sideways with 5-year major bank paper finishing the year at Bank Bill Swap Rate (BBSW) +100bps. Meanwhile after the underperformance in the first half of November, financial subordinated paper were the outperformers in December, particularly 10 year non-call 5 year which tightened around 10bps further in the fixed rate and 25bps in the floating rate notes to 215bps and 225bps, respectively. Corporate paper generally grinded tighter over the month with long-dated airline and airport related names outperforming. The primary market saw around \$A3bn of new issuance which was dominated by the financial sector again, with Suncorp printing \$A1bn of 5-year senior paper at Asset Swap Spread/BBSW+125bps

## Outlook

The past year has been dominated by escalating supply tensions emanating from the war in Ukraine which pushed inflation much higher and for longer than anyone was expecting. The ramped-up response by central banks, in retrospect, should have been widely expected.

Looking into 2023 we feel that asset markets will have to work through the consequences of the above events of 2022. First, we must recognise that geopolitical tensions are likely to remain elevated and also assume that these tensions could take an unexpected turn at any time. Be warned and be prepared to adapt. Secondly, we can observe that many supply problems have dissipated and while there is no return to the pre-Covid norm, the economic impact from supply is likely to be much less in 2023. Third, we are expecting the year ahead to be the report card on demand destruction wreaked by the most aggressive monetary policy tightening cycle since the 1980s. And finally, we recognise that prevailing conditions for households and corporates have been robust compared to past tightening cycles, however the signalling from central banks is they intend to cause stress for both groups.

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Again, we will thoroughly review our portfolio management strategy from the bottom up via the Strategic Forum during January. Our base case call has been for a recession in 2023 and that inflation will continue to fall through the year. We believe this combination will prove to be good news for sovereign bond yields. However, demand destruction is bad news for consumer spending and corporate earnings. This implies that credit spreads are vulnerable to widening from current levels.

Thus, sovereign bond yields can offer attractive value for investors during 2023, with the added attraction of offering portfolio 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](mailto:mam.clientservice@macquarie.com) or visit [macquarieim.com](http://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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