MACQUARIE ASSET MANAGEMENT

MACQUARIE

Macquarie Australian Fixed Interest Fund

Monthly report – 28 February 2023

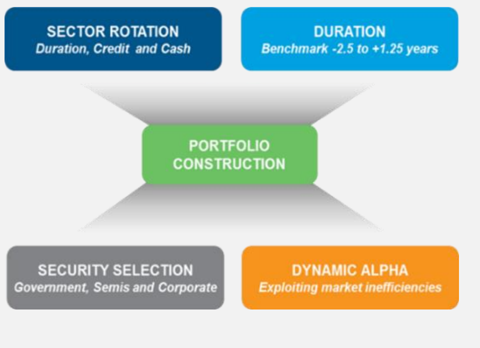
Investment objective

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	$256.7m
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 28 February 2023

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-1.04	-1.07	-1.32	0.25
3 months (%)	-0.24	-0.34	-0.69	0.35
1 year (%)	-5.78	-6.15	-6.37	0.22
2 years (% pa)	-3.13	-3.51	-3.76	0.25
3 years (% pa)	-2.83	-3.23	-3.44	0.21
5 years (% pa)	1.41	0.96	0.82	0.14

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)

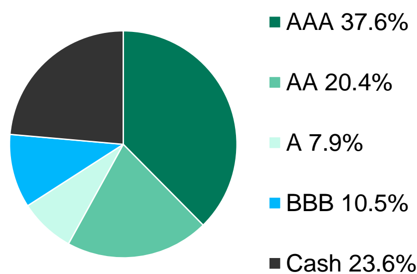
	Fund (%)
Credit	32.6
Cash and Equivalents	23.7
Government	22.7
Semi-Government	21.0

Fund statistics

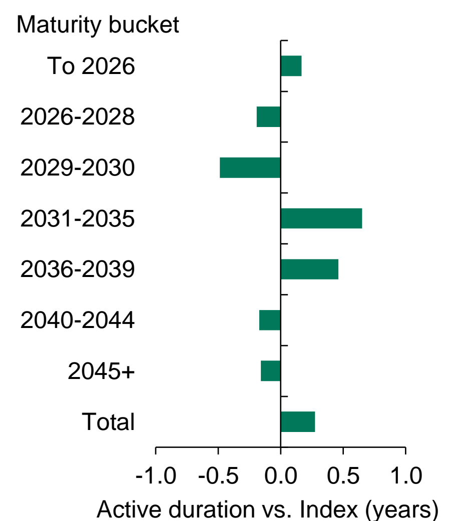
Credit spread duration	0.5 years
Interest rate duration	5.4 years
Yield to maturity*	4.62% pa

*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 sector rotation, duration and curve as well as security selection.

Sector rotation

The Fund marginally increased its semi-government exposure over the month, which contributed positively to performance. Semi-governments tightened versus both swap and bond over the month as there continues to be strong demand from both bank balance sheets and the official sector. Whilst the state governments have large issuance tasks, we continue to believe the semi-government sector offers value given this issuance task is well telegraphed, most issuers are well progressed through the issuance and bank balance sheets should have high quality liquid assets requirements in 2023 given the expiry of Term Funding Facility and Committed Liquidity Facility.

The Fund's overweight credit positioning contributed positively to performance as Australian credit spreads outperformed global peers.

Duration and curve

The Fund's duration positioning moved from neutral to long in February as a decisively hawkish pivot from the Reserve Bank of Australia (RBA) saw yields sell off significantly as terminal rate pricing reached an intra-month high of 4.40%. Globally, the trend of disinflation appears to have stalled, with upside surprises in US and EU consumer price index (CPI) seeing central bank policy paths reprice higher, and forecasted rate cuts pushed further out the curve. Locally, a stronger-than-expected Q4 CPI was the initial catalyst for the RBA's hawkish shift, leading them to consider a 50bps hike in February, however the outlook was muddied as employment data printed negative for the second consecutive month and Q4 Wage Price Index missed expectations. This saw Australian duration outperform globally.

We took profit on a short US front end position as stronger than expected US inflation saw the US front end repriced higher as the market began to accept the Federal Reserve is likely to pause after they finish hiking, pushing rate cuts further out the curve. We unwound this US exposure on a spread to AU 10-year as the AU yield curve bear flattened as rates moved higher. Over the month, duration was added in the AU front end primarily via futures, though we also took advantage of elevated volatility and initiated a swaption position that will take the Fund longer on a sustained sell off. Whilst we have reduced some flattening exposure, we continue to concentrate duration in the 10-year part of the curve given the relative steepness of the AU curve versus developed market peers.

Security selection

The Fund is overweight derivatives vs physical securities both in swap and futures, held primarily in the 10-year part of the curve albeit with an increased exposure in the 3-year part of the curve over the month. The physical Australian Commonwealth Government Bonds (ACGBs) remain 'rich' to the overnight index swap (OIS) 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 vs OIS and futures. Within semi-government, we marginally added exposure to South Australian Government Financing Authority as they came to market with a new 4.75% May 2038. We also increased exposure to Queensland Treasury Corporation (QTC) as they continue to have the strongest issuance profile, while we reduced exposure to Treasury Corporation of Victoria given their uncertain funding outlook and material tightening to the QTC curve. We remain neutral to slightly overweight to New South Wales Treasury Corporation as their mid-year funding outlook was slightly worse than expected, whilst the upcoming NSW State election adds further uncertainty.

The Fund's credit security selection added to performance. Excess returns were driven by BBB credits and higher beta corporates, with further credit curve flattening as the market digests a lack of issuance and higher all-in yields. Senior financials moved tighter despite heavy supply, with Tier 2 bonds also benefitting performance with primary not able to satisfy investor demand particularly in fixed rate tranches. Structured securities were a strong contributor, with spread tightening of over 20bps over the month and very strong demand from investors. Higher than benchmark carry also benefitted the Fund. Over the month the Fund participated in transactions from issuers such as HSBC, Svenska Handelsbanken, Westpac Banking Corporation, FPTT 2023-1 and TRTN 2023-1.

Market overview

The macroeconomic data has surprised on the upside in the new year, driven by a combination of a sharp fall in energy prices, particularly gas; easier than expected fiscal policy; and unusually mild weather across the northern hemisphere. In addition, inflation data is proving 'sticky', disappointing hopes for a rapid easing through 2023. This combination has ignited a debate about whether the outlook for year is a soft landing verses a hard landing or in is in fact the data pointing to a 'no landing' scenario (roughly defined as no recession and persistent above target inflation)?

Central banks continue to raise interest rates. The no landing scenario is not an option for any central banks with an inflation target, thus, financial markets initially reacted by removing the late year rate cut hopes then built in even higher terminal rates into expectations. This behaviour has paved the way for central banks to continue to tighten policy in the months ahead, where further hikes are expected in March and again in the second quarter. For rates markets this repricing was rapid and quickly reversed a large part of the strong returns for investors in January. Surprisingly, risk markets, while weaker in the month, have been relatively resilient to the repricing higher of interest rates.

Australian bond market

Australia, like the rest of the world, saw yields rise over the month and the curve finally submit to some flattening pressure. The RBA maintained its hawkish stance delivering a 25bp hike to take the official cash rate to 3.35%, and we saw the market reprice the terminal rate to 4.34%, up from 3.75% at the end of January. The Australian 10-year bond futures implied yield traded between 3.37% and 3.98% in February (a range of 61bps vs 76bps in January), with the 10-year yield ended the month at 3.86%, +30bps on the month. The Australian

3-year bond futures implied yield traded between 2.98% and 3.72% in January (a range of 74bps vs 71bps in January), with the 3-year yield ended the month at 3.61%, +42bps higher on the month.

The Australian Q4 gross domestic product showed that the economy has slowed, and growth in domestic demand was weak at the end of 2022, though consumer spending rose in January reversing the small fall in the monthly December data. The Australia labour market continued weakening with employment falling for the 2nd consecutive month in January -11.5k month on month (against market expectations of a +20k rise). The unemployment and underemployment rates rose, with the unemployment rate now 3.7% up from 3.5%, having increased each month from its October 2022 low. The Monthly CPI Indicator continues to show that our inflation remains sticky at high levels, but the Wage Price Index confirmed that there is no wages growth breakout in Australia with wages growth coming in lower.

Global credit market

The risk positive sentiment that started the year took a pause in February as the market increased terminal rates and embraced higher for longer as data continued to be resilient in the current tightening cycle.

US credit markets were mixed over February, with investment grade (IG) spreads widening, while high yield (HY) generated small spread tightening. Weakness in government bond markets and strong new issuance volumes were the key drivers for the underperformance in IG – HY tends to be less impacted by treasury market volatility and had much less issuance to deal with. New issuance volume was over $US155bn of bonds in IG (breaking the record for any February), headlined by a $US24bn 8-tranche offering from Amgen to fund M&A. Other large deals included CVS (totaling $US6bn) and Oracle (for $US5.25bn). Amongst industry sectors, financials outperformed while energy and communications mildly outperformed. Long-term bonds (with maturities greater than 10 years) were the weakest performers on the curve.

US Earnings season moved toward a close over the month, with over 95% of companies reporting. Almost 70% of companies beat earnings expectations, similar to long-term averages, but the details were more mixed: the size of the average earnings beat was well below historical levels; outright earnings on average declined by almost 5%, the first fall since 2020; and guidance has been heavily negatively skewed.

European credit markets were positive over February, though the overall result masks a weakening in performance into the end of the month. Positive drivers for the month included continued gradual normalization of European spreads compared to other regions as the threat of energy shortages continued to dissipate. European IG spreads have tightened by 25bps more than US equivalents since the peak in October. This was offset by renewed volatility in underlying government bond markets. Amongst sectors and ratings performance, the strong performers were higher beta issuers that had lagged the earlier recovery in Europe – real estate investment trusts (REITs), for example, which had been heavily impacted in late 2022.

Australian credit market

Australian credit outperformed global peers closing 10bps tighter on an option-adjusted spread basis. The outperformance was broad-based with senior financials tightening 8bps. Subordinated financials also performed well with spreads 15bps tighter in bonds with longer call dates despite a couple of new deals from ANZ and Suncorp. The outperformance in the long-end BBB corporates continued into February along with a rebound in some of the COVID-impacted REIT names. Given the lack of issuance in the corporate space and with expectations that long-end corporate issuance will likely be lackluster, long-dated bonds relatively outperformed. As a result, the credit curve flattened considerably. Residential Mortgage Backed Securities experienced considerable tightening in February by close to 20bps in the senior tranche as new deals attracted significant amount of interest with one non-bank issuer printing its senior AAA tranche 30bps tighter than its last deal in November. The primary supply was all from banks with more than $A12bn issued in February.

Outlook

With Q1 and 2023 growth forecasts being revised higher, we asked ourselves: has the global economy experienced a mid-air refuelling? Our base case outlook, presented and discussed at the January Strategic Forum, is for a cyclical recession during 2023. The process for determining this view is built around our Recession alert process. Step 1 is to ask if the global economy has experienced any of the key triggers for previous recessions: a supply shock, a financial crisis, and, or policy overtightening. Clearly, there has been two supply shocks, the pandemic and that resulting from the Ukraine war. Step 2 is identifying if either the yield curve or our proprietary Warning and Crisis signals have triggered. The 2-year-10-year yield curve inverted in late July and the 3 month-10 year curve inverted in November, which combined to give a strong warning of a recession 12 months ahead. Our warning signal is +4 which is an amber alert. Step 3 is to check prevailing conditions. Here our analysis suggests that both Households and Businesses are in a better starting position than typical should a recession materialise in 2023. This should help soften the impact of a recession, and why our base case is for a cyclical recession not a hard landing.

Reflecting on data and market pricing during February we conclude that the risk for central banks to push monetary policy into over-tightening mode has increased. This would trigger a second Step 1 signal for recession. In addition, the expected fiscal drag has been much less in recent months than expected. In the US, the approach of the debt ceiling was pushed back by use of extraordinary measures, but these will run out around May, and we expect fiscal drag to again reassert just at the same time the lagged effects of monetary tightening begin to bite. Therefore, demand destruction is expected to dominate the second half of this year and recession remains our base case, with risk that the probability for a hard landing is increased in coming months.

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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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