

Macquarie Australian Fixed Interest Fund

Monthly report – 31 May 2023

Investment objective

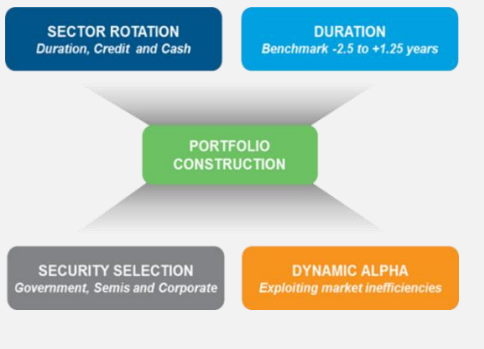
Aims to outperform the Bloomberg AusBond Composite 0+ Yr Index over the medium term (before fees) by using an active investment strategy. It aims to provide regular income and a moderate level of growth.

Key information

Fund details

APIR code	MAQ0061AU
Inception date	15 May 1995
Fund size	\$246.8m
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 May 2023

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-1.16	-1.19	-1.21	0.02
3 months (%)	2.35	2.25	2.11	0.14
1 year (%)	3.00	2.60	1.73	0.87
2 years (% pa)	-2.95	-3.33	-3.54	0.21
3 years (% pa)	-2.12	-2.52	-2.77	0.25
5 years (% pa)	1.61	1.16	1.00	0.16

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)

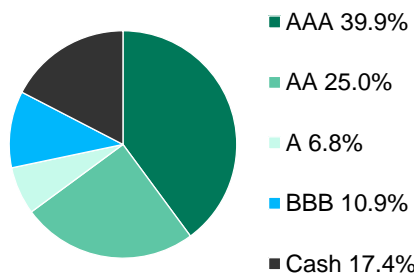
	Fund (%)
Credit	36.2
Semi-Government	25.2
Government	21.2
Cash and Equivalents	17.4

Fund statistics

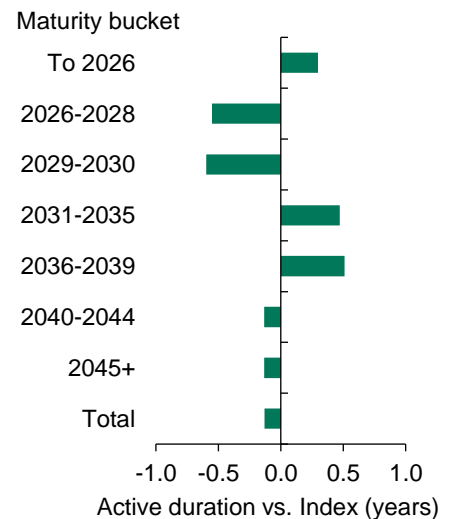
Credit spread duration	0.6 years
Interest rate duration	5.2 years
Yield to maturity*	4.22% pa

*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, as well as security selection.

Sector rotation

The Fund maintained its long semi government exposure, held against swaps. While semi-governments continue to look attractive on an outright yield basis, the potential for the US banking crisis to re-emerge puts spread products at risk to sentiment shifts, particularly as the US liquidity drain commences. Semi-governments widened slightly over the month, both to swaps and bonds, as several issuers delivered their Budget updates. Bank high quality liquid assets demand is likely to continue to support the sector over the coming months, although this effect will begin to wane. The short swap spread exposure was marginally reduced via the addition of 10-year swaptions.

The Fund's modest overweight physical credit positioning was a positive contributor to performance as Australian credit spreads moved tighter over the month.

Security selection

The Fund remains overweight futures vs physical securities, held in both the short and intermediate sector. 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 vs overnight index swap and futures. Within semi-government, exposure is concentrated in the 7-10-year part of the curve. We remain overweight Queensland Treasury Corporation and New South Wales Treasury Corporation and underweight Treasury Corporation of Victoria, with the latter materially underperforming post their Budget update.

The Fund's credit security selection was a neutral contributor to performance. Bank senior paper outperformed, and while Tier 2 spreads moved modestly wider the excess carry more than offset. High quality covered bonds and Kangaroo names also contributed to performance. In corporates, the utilities space provided solid performance as several primary deals set firm spread levels and led to a broad-based sector rally. The Fund's overweight to NBN continues to perform strongly, with the ratings upgrade by Moody's to Aa3 catalysing another rally in spreads. Structured securities again contributed to Fund returns, but were offset by a rally in Supranational, Sovereign and Agency bonds where the Fund is underweight. Over the month, the Fund participated in transactions from issuers such as Ausnet, National Australia Bank and Suncorp.

Duration and curve

The Fund moved from neutral to short duration in May, trading duration tactically over the month. The Reserve Bank of Australia (RBA) hiked 25bps in May, a mere month after pausing to reassess the data. Governor Lowe cited persistent services inflation and stronger labour data as catalysts for the hike in order to achieve inflation within the target band by 2025. This hawkish shift surprised the market, triggering a sell off which was exacerbated as the US debt ceiling debate generated uncertainty and reduced market participation. The Reserve Bank of New Zealand also surprised the market, but in the opposite direction, delivering a 25bps hike and signalling it is likely the last. The US Federal Reserve (Fed), European Central Bank and Bank of England all hiked 25bps, but these were second order events to the US debt ceiling, which saw yields volatile and at the mercy of rapidly shifting sentiment.

Duration was initially added via swaptions as the Fund sold payers in the 10-year sector, allowing duration to extend in the event yields continue to sell off. We then initiated a paid 2-year/1-year position in Japanese overnight index swaps to provide upside exposure to any Bank of Japan-induced global duration sell off in the event of a change to Yield Curve Control, with limited downside risk, taking us short. The Fund maintained a small short in the very front end of the curve, which has contributed positively to performance as the RBA tilted hawkish in May. We remain overweight the 10-year part of the curve and underweight the belly.

Market overview

The noises surrounding the US debt ceiling negotiations were very distracting, but asset markets mainly focused on the facts they understood, namely that inflation was falling only slowly, labour markets remained resilient and while the Fed may prefer to hold policy, the data may yet force another rate hike. The above combination enabled risk markets to largely end the month flat or in positive territory, while bond yields pushed higher led by the front end of yield curves as expectations for further rate hikes increased in the month.

The US debt ceiling was a major talking point because of the skew of risk to the downside. While fear of a default was probably overplayed the greater risks lay in the prospect of the Republicans forcing significant spending cuts to agree a lift of the debt ceiling. Memories of 2011 haunted financial markets, where President Obama's was forced to agree to the Budget Control Act and Sequester that prematurely ended his planned fiscal expansion and set the scene for the subsequent period of uninspiring growth. While the current agreement has not yet passed through Congress the details available point to a modest reduction in net spending going forward, essentially neutralising the fiscal risk from a market perspective.

Australian bond market

The RBA surprised the market in May, delivering a 25bps hike only one month after pausing to reassess. Governor Lowe cited the persistence of services inflation and strong labour data, alongside reports of continued wage strength from their business liaison program, as the reasons for resuming their tightening cycle. The May minutes also revealed the RBA will consider the possibility of active quantitative tightening given the comparatively slow roll off of the balance sheet beyond the next 12 months, using the liquidity drain of tranche one of the Term Funding Facility as an indication for how the system may cope. Australian yields were dragged higher over the month, trading with a higher beta to the US, which saw Australian 10-year bond futures trade between 3.22% and 3.78% (a range of 56bps v 40bps in April), ending the month 30bps higher at 3.59%. The Australian 3-year bond futures implied yield traded between 2.81% and 3.50% in May (a range of 69bps v 45bps in April), finishing the month 36bps higher at 3.29%.

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Global credit market

Risk finished May pretty much flat albeit a month that commenced with US regional banks still in the headlines and ended as we got to the pointy end of the US debt ceiling negotiations with a strong close into month end as a resolution became more likely.

US investment grade (IG) closed 2bps wider on the month to 138bps, non-financial sectors also underperformed in the US. Volatility in regional banks remained though as the market focused on issuers with greatest commercial real estate exposure and hold to maturity securities. KRE (regional bank equity index) closed almost 9% lower although credit spreads stabilised in the latter part of the month.

IG fund flows remained positive but both High Yield (HY) and Bank Loans saw outflows. Primary volumes were elevated as the \$31bn, 8-part Pfizer deal gaining much of the market attention with orderbooks more than \$85bn.

European IG spreads closed 9bps wider in May to 171bps, industrials underperformed financials in part due to prior outperformance and an uptick in non-financial supply. The weakest sectors were generally cyclicals such as capital goods, metals & mining and packaging as large new issue concessions impacted secondary curves. HY outperformed closing 4bps tighter on the month with CCC's faring best. Supply for the month totalled €80bn, there has been a material increase in reverse yankee issuance with names such as AT&T, AMT, Honeywell and Booking all issuing multi-tranche deals.

Australian credit market

Australian credit marginally outperformed global credit tightening 4bps on an option-adjusted spread basis over the month May, though most of the outperformance came from the narrowing of swap spreads. Financial senior paper finished unchanged for the month while bank subordinated bonds drifted wider as ANZ priced \$A1.15bn of 10NC5 at +235bps which came with a 15bp concession to existing secondary curves. This created some indigestion which caused longer-dated subordinated debt to widen 15bps before retracing most of the weakness in the back half of the month. Recent demand has been heavily skewed towards floating rate notes leading to a material outperformance relative to the fixed rate bonds. Corporate spread performance was mixed with REITs continuing to lag and telecommunications recording a more broad-based tightening. The primary market saw more than \$A16bn of issuance with most of the transactions coming from banks, though we did have 3 long-dated corporate deals with the most notable being Ausnet's 700mil 10-year deal which garnered more than \$A1.2bn of final orderbook.

Outlook

During May our research and investment teams undertook a deep dive into our views using our triannual Strategic Forum process. The review of the macroeconomic outlook noted that the supply recovery continues on a slow, steady, sustainable path; and while demand has decelerated it has not turned into a destructive force. Importantly, our analysis noted the unexpected positive impulse from US fiscal policy in the early months of the year (from increased defence spending and cost of living adjustments to benefits). This combination has caused inflation to start turning lower, however it remains well above target which has induced central banks to tighten further. Our proprietary analysis suggests that US central bank policy is already in over-tightening mode, and historically when this occurs something breaks – the recent US regional bank turmoil is a good example.

A key dilemma for central banks and markets is the fact that monetary policy works with long and variable lags, and this has been the fastest and largest tightening cycle for several decades. In addition, yield curve inversion analysis had been pointing to late 2023 for recession. This highlights a key debate on the outlook- should focus be on leading or lagging indicators? Employment, inflation and wages are all lagging reflections of the economic cycle. Spending data and forward guidance are leading indicators. For the consumer, despite higher nominal wages, spending has remained constrained in real terms as the scars of the supply shocks has increased prices. Thus, with the positive impulse from government cash handouts dissipating and concurrent monetary tightening grinding, the overall impact is we still see recession as our base case outlook for late 2023.

The skew of risks debated at our Strategic forum were biased to expecting a harder landing for the economy. The first risk lay with the debt ceiling and at the time of writing this may have been neutralised. Secondly, is that monetary over-tightening persists, potentially exacerbated by the chance of another hike in June. Thirdly, credit conditions have tightened, already to levels that historically correlate with the near-term onset of recession, yet we expect even more tightening to come. Finally, economic fragility brings financial dislocation. Concerns surround Commercial Real Estate and Private markets for example.

We therefore remain constructive strategically on duration and cautious of risk markets, recognising that the pathway ahead is potholed by a high level of uncertainty.

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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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