

Macquarie Australian Fixed Interest Fund

Monthly report – 31 July 2023

Investment objective

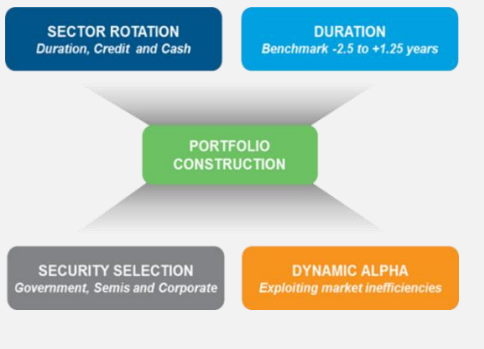
Aims to outperform the Bloomberg AusBond Composite 0+ Yr Index over the medium term (before fees) by using an active investment strategy. It aims to provide regular income and a moderate level of growth.

Key information

Fund details

APIR code	MAQ0061AU
Inception date	15 May 1995
Fund size	\$249.6m
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 July 2023

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	0.66	0.63	0.52	0.11
3 months (%)	-2.48	-2.58	-2.63	0.05
1 year (%)	-0.21	-0.60	-1.54	0.94
2 years (% pa)	-4.83	-5.20	-5.40	0.20
3 years (% pa)	-2.88	-3.27	-3.46	0.19
5 years (% pa)	1.20	0.76	0.58	0.18

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)

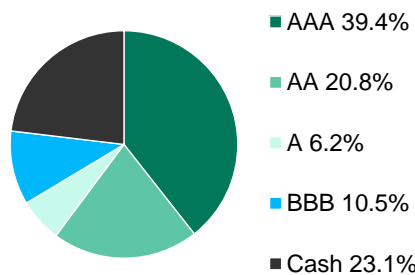
	Fund (%)
Credit	34.6
Semi-Government	23.7
Cash and Equivalents	23.2
Government	18.5

Fund statistics

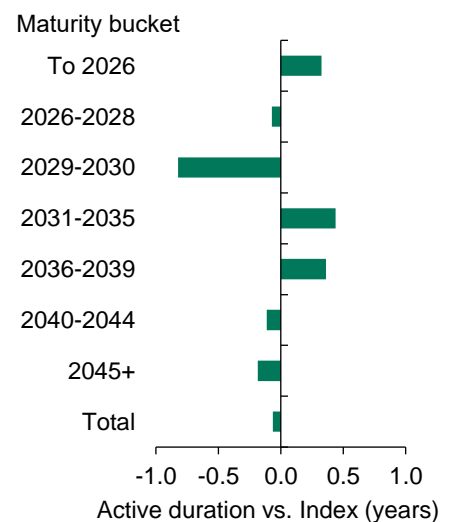
Credit spread duration	0.6 years
Interest rate duration	5.1 years
Yield to maturity*	4.61% pa

*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 duration and curve as well as sector rotation.

Duration and curve

The Fund moved from slightly long duration to slightly short duration in July. Central banks seemed to shift gear in July, with the Reserve Bank of Australia (RBA) deciding to pause as inflation surprised to the downside, whilst the US Federal Reserve (Fed) and European Central Bank both delivered well-flagged 25bps hikes, but stressed further hikes were not guaranteed. Yields sold off early in the month as the June Federal Open Market Committee minutes tilted hawkish, but this changed tack to see yields finish only marginally higher as inflation data printed to the downside across several economies and soft leading data began to show some weakness. The Bank of Japan relaxed Yield Curve Control towards the end of the month, keeping the 50bps target band but only as a guide, stating yields would be allowed to trade up to 1%. Whilst activity data seems to be somewhat resilient, particularly in the US, it seems most central banks could very well have delivered their last hikes.

Duration moved marginally higher at the start of the month as yields took the swaptions further into the money, then retreated as yields reversed course. Duration primarily moved shorter as we sold September bank bills towards month end as a hedge against the RBA hiking again, before Philip Lowe's term ends after the September meeting. The rally in the front end of the curve also saw the duration contribution from the 2-year short payer swaption also fall, detracting slightly from duration. As the Term Funding Facility repayments gathered steam, yields in the funding market moved higher as some market participants positioned for potential funding stress. We used this opportunity to take profit on Japanese T-bills and rotate back into bank bills as the basis narrowed. The yield curve steepened materially into month end as major central banks delivered potential last hikes, consistent with end of cycle price action. We were positioned well for this, being overweight the front end, whilst underweight the belly and relatively neutral further out the curve.

Sector rotation

The Fund continued to reduce its long semi government exposure passively through the month end index extension. We continue to hold the semi government exposure against swap to hedge against the risk of a sustained widening given the relentless issuance profile. However, it appears the collective issuance profile is largely in the price, with semi to bond and semi to swap spreads both spiking wider in the month before falling back to finish largely unchanged. Although with the roll off of the Term Funding Facility in full swing, further bank high quality liquid assets demand is uncertain. The Fund's swap spread exposure moved shorter over the month, which was primarily function of the short September bank bills, with a small contribution from the 2-year payer swaption moving out of the money.

The Fund's modest overweight to physical credit was a positive contributor to performance as Australian credit spreads rallied towards their 2023 tights.

Security selection

The Fund remains overweight futures vs physical securities, held in both the short and intermediate sector. 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 vs overnight index swap and futures. Within semi-government, exposure is concentrated in the 7-10-year part of the curve. We remain underweight Treasury Corporation of Victoria and overweight Queensland Treasury Corporation and New South Wales Treasury Corporation, for relative value considerations.

Market overview

The market narrative with regard to the economic outlook has evolved toward a belief that a soft landing for the economy can be achieved, while inflation gradually eases back toward target. Risk markets have embraced this narrative, with equities surging, led by the US (S&P500 +3% in July and +10% since end May), and credit spreads tightening (Investment Grade -16bp in EUR and -10bp in USD, High Yield -23bp and Emerging Markets -35bp). The inflation data is clearly slowing, again led by the US, as supply pressures continue to dissipate, and slower demand gradually quells pricing power. The economic data is more mixed, but where the broader resilience of the service sector stands in stark contrast to the manufacturing sector which is in recession in most countries. Perhaps the biggest surprise has been the resilience of the labour market, where the slowdown has slowed hiring but not leading to large job losses.

Central banks, on the other hand have yet to be convinced of this 'goldilocks' outcome on growth and inflation. Certainly, policy rates have been tightened faster and more significantly than any time since the 1970s, yet many central banks continue to push rates higher. Hopes (from markets) for a 'pause' are ever present but this belief was put to the sword several times already in this cycle. Part of the problem is that governments have been reluctant to wind back spending despite the passing of the pandemic crisis. Thus, monetary policy is carrying more weight to slow growth and pull inflation back to target. For bond markets, lower inflation should be good news for lower yields but the upward pressure on short term yields from central bank tightening has created a negative carry environment that is proving difficult to fight.

Australian bond market

Australia's inflation remains high at sticky levels, whilst growth is slowing, and Australia diverges away from the experience of the US. Australia's inflation is falling, but slowly, and this puts the RBA between a 'rock and a hard place' as it seeks to return CPI to target ranges. Australian 10-year bond futures traded between 3.84% and 4.32% (a range of 48bps v 50bps in June), ending the month 3.5bps higher at 4.10%. The Australian 3-year bond futures implied yield traded between 3.76% and 4.27% in July (a range of 51bps v 71bps in June), finishing the month 13bps lower at 3.86%. The AU-US 10-year bond differential widened to 23bps early in the month before retracing to close at 6bps. The 3-year-10-year bond futures curve, which inverted for the 1st time since 2008 in June last month, gradually steeped

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through the month closing +19bps. The RBA is considering 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.

Global credit market

Positive sentiment in risk assets continued in July as markets were stronger with a combination of earnings and supportive technicals being key to the moves.

US investment grade (IG) credit tightened by 11bps to 112bps, a new year-to-date tight, and high yield tightened by 23bps at an index level. US Q2 earnings season kicked off, and by month-end about 60% of companies had reported: starting with Financials and continuing overall, the general theme was of beats against low expectations. Approximately 80% of companies beat earnings expectations, in line with historical averages; but that masks the fact that aggregate earnings were down over 7% YoY. Positive technicals were also supportive of spreads, with higher yields attracting buyers and lower issuance volumes: \$90bn in new bonds, a lower than average result reflecting the Northern hemisphere summer, and earnings blackouts. Banks and Financials were the strongest performing major sectors after better than expected earnings were reported. Subsequently the month saw the first new issuance from a regional bank – Fifth Third, who issued a new bond that was strongly over-subscribed and performed very strongly.

European credit outperformed peers this month with IG closing 16bps tighter to an option-adjusted spread of 147bps. Financials and REITs outperformed as both continue to make back underperformance from earlier in the year. Supply as expected was muted at only €20bn, this helped the technical backdrop for the asset class in conjunction with overall inflows. We have experienced some single name underperformance following weaker Q2 results especially in paper/packaging as well as chemicals, however this has not impacted the overall asset class. High Yield (HY) underperformed IG closing 20bps tighter on the month, single name issues mainly the Altice complex and a lower financial weighting resulted in HY underperformance. The technical backdrop for the asset class remains firm in the short term but with spreads approaching YTD tightens and a weakening European macro environment, an increase in spread volatility is plausible.

Australian credit market

Australian credit had another strong month in July with Index option-adjusted spread tightening 6bps. The positive momentum was broad-based across sectors. In the financial space, domestic regional banks and European issuers significantly outperformed the major banks, though even the on-the-run 5-year major bank senior bonds ended the month more than 2bps tighter below 90bps. Financial subordinated paper crunched in post Westpac T2 issuance in June as spread tightened 28bps to 189bps with the lack of supply, light street inventory and attractive all-in yield contributing to the rally over the month. The recent outperformance in subordinated bonds meant that the spread ratio to senior bonds has tightened to 2.1x, which is at the tighter end of the historical range, compared to 2.4x at the end of June. There was also a reasonable spread performance in the corporate sector, particularly the recently issued bonds in the utility sector as well as some of the previously unloved REIT and high beta names that have underperformed the broader credit market over the past few months. Primary issuance market was lighter in July with 3.7bn of benchmark eligible bonds printed, mostly in shorter tenors from banks.

Outlook

The battle lines of debate have been drawn, are you in the recession camp or the no recession camp. Consensus for a long time has been convinced recession would be inevitable, sustained yield curve inversion never gets it wrong? Yet long and variable lags are difficult to live through even if the inevitable ends up becoming true.

The big surprise in 2023 has been fiscal spending, which has remained more persistent than expected, underpinned by large increases to benefits and salaries and support for the Ukraine war effort. As fiscal spending feeds directly into the economy it has underpinned the jobs market, household incomes and therefore spending. The impact of monetary tightening is gradual and importantly felt differently between countries depending on lending practices. That said, higher rates are a drag on growth but for households and business there can be winners (e.g. savers) and losers (e.g. borrowers). Key for the economy is when this is accompanied by a tightening of lending conditions, which is taking place, the combination of monetary over-tightening and excessive tightening of credit conditions has resulted in recession every time in the past.

Our base case outlook remains for a cyclical recession, similar to 2001, acknowledging that hard landing risks have reduced in recent months. Our highest conviction view this year has been for inflation to fall, highlighting the possibility of a dip into deflation, remains on track. This is key for our position to add duration into each back up in the bond market. Risk markets remain very tightly priced, and therefore vulnerable to weaker growth emerging through the second half of this year. In addition, the environment of monetary over-tightening and tightening credit conditions also signals risk for potential financial dislocation, such as experienced with US Regional Banks earlier in the year. History guides that risky assets do not tend to react significantly until evidence of a downturn or financial risk become clearly evident. We therefore maintain a strategically constructive view 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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