

Macquarie Australian Fixed Interest Fund

Monthly report – 30 September 2023

Investment objective

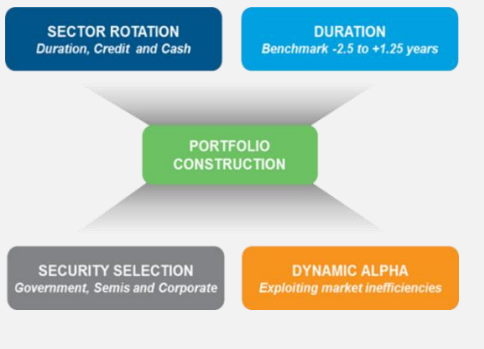
Aims to outperform the Bloomberg AusBond Composite 0+ Yr Index over the medium term (before fees) by using an active investment strategy. It aims to provide regular income and a moderate level of growth.

Key information

Fund details

APIR code	MAQ0061AU
Inception date	15 May 1995
Fund size	\$252.5m
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 September 2023

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-1.59	-1.62	-1.53	-0.09
3 months (%)	-0.02	-0.12	-0.28	0.16
1 year (%)	2.76	2.36	1.61	0.75
2 years (% pa)	-4.56	-4.93	-5.10	0.17
3 years (% pa)	-3.36	-3.75	-3.92	0.17
5 years (% pa)	0.97	0.54	0.34	0.20

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)

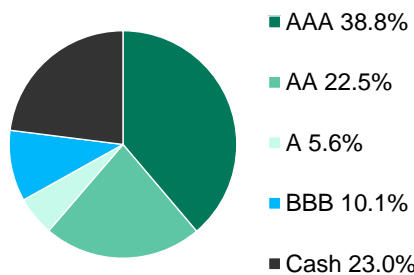
	Fund (%)
Credit	36.9
Cash and Equivalents	23.0
Semi-Government	22.9
Government	17.2

Fund statistics

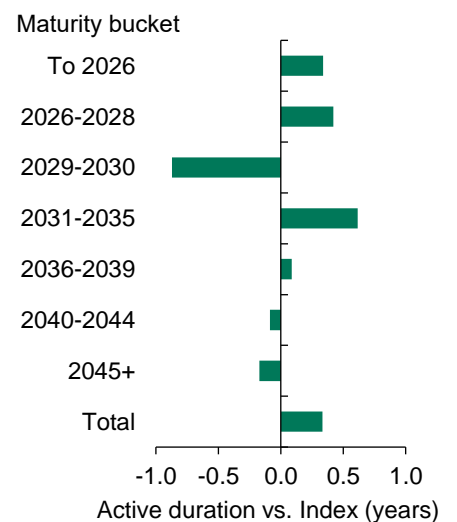
Credit spread duration	0.7 years
Interest rate duration	5.4 years
Yield to maturity*	4.91% pa

*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 underperformed the benchmark over the month, amid the ongoing rates volatility and the move wider in credit spreads.

Sector rotation

The Fund maintained its neutral semi-government position in September, with spreads remaining towards the low end of the range versus bond. With the first tranche of the Term Funding Facility now matured in full, the high quality liquid assets demand from bank balance sheets is no longer a certain support for the semi-government sector, with that demand seemingly shifting in favour of Australian government bonds in Q2. The Fund entered a paid 10-year swap exchange for physicals position as swap spreads have tightened materially in September, offsetting the contribution from the short 10-year payer swaption and leaving swap spread exposure marginally short with the outlook for swap flows looking more balanced at the lower end of the range.

The Fund's modest overweight physical credit positioning was a positive contributor to performance as credit markets remained resilient amid a volatile rates backdrop.

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 of the curve, with the longer end now close to flat. This richness continued to normalise in September as the market continues to price the possibility that the Reserve Bank of Australia undertakes active quantitative tightening. 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 to 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.

The Fund's credit security selection was a positive contributor to performance. Performance from financials was relatively neutral, with major bank senior spreads rangebound over the month and fixed rate bonds retaining their appeal as outright yields remain enticing. Tier 2 was a modest positive despite a fairly volatile month in spread terms, with positioning focused in shorter dated, high carry bonds. Corporates were broadly steady, with shorter dated auto names outperforming. Structured securities remain a bright spot, spreads rallying further over the month and providing high quality and low beta carry for the Fund over relatively tight corporate spreads. Over the month, the Fund participated in transactions from issuers such as Royal Bank of Canada, WestConnex, Conquest 2023-2 Barton 2023-1 and Driver 8.

Duration and curve

The Fund marginally increased its long duration position in September. The Northern Hemisphere summer continued to weigh on market volumes and bonds were punished as a result. Yields moved steadily higher in the first half of the month before picking up steam into month end as the central bank decisions began streaming in. With most central banks signalling their reluctance to hike further, the continued sell-off in yields likely reflected the market rebuilding term premium given inflation remains above target globally and economic data relatively resilient. The European Central Bank (ECB) delivered a 25bp hike and signalled it was likely their last, with other monetary policy levers, namely quantitative tightening, coming into focus. The US Federal Reserve (Fed) followed with another 'skip', however updated the dot plot to indicate another hike this year, whilst also removing rate cut expectations in 2024 and 2025. This message was complicated by Chair Powell's press conference where he indicated soft landing was not his base case, leaving the market divided as to what this exactly meant. The Bank of England also elected not to hike for the first time in two years, as August CPI printed materially lower than expected, finally conforming to Governor Bailey's narrative.

The Fund drifted longer duration over the month primarily through the short 10-year payer swaption, as the delta increased as the sell-off moved the market past the strike. Despite the global sell-off being largely fuelled by US centric factors, Australian rates began to underperform in the second half of the month, providing attractive levels to enter a cross market trade of short US 10-year futures versus long AU 3-year futures. Given the cycle is likely near its end, this trade also provides steepening exposure to the Fund. The Fund also added Japanese T-bills opportunistically over the month, as the easing in Australian funding conditions alongside the depreciation of the Japanese Yen provided a decent pickup to Bank Bill Swap Rate. On curve positioning, we remain overweight at the front end, underweight at the belly of the curve and close to neutral from beyond the 10-year point, which generates a small steepening bias as we approach the end of the cycle.

Market overview

Higher bond yields and broadly steeper yield curves dominated September, as credit spreads drifted in range to end the month little changed to slightly wider, though equity markets posted more significant losses, however, September is seasonally the worst month for equity returns. Most major central banks kept policy rates on hold, though the ECB delivered what is being commonly termed as a 'dovish hold'. But it was the Fed 'hawkish hold' that dominated price action in rate markets, with the central bank guiding that while policy may not have actually peaked, the stronger message was that rates likely need to stay high for much longer than markets had previously been expecting.

The other major driver of markets in September has been the rise of oil prices, by roughly 10% in the month and by almost 30% through the quarter. With Gas prices and base metal prices giving a more mixed picture, the move in oil prices is more likely driven by production constraints rather than demand. Such a sharp move high in oil prices will impact headline inflation measures, and while this may ultimately prove temporary, there is concern that this re-enforces the "higher for longer" message coming from central banks at present.

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Australian bond market

Australia's central bank is edging towards neutral with a new Governor at the helm and the economy slowing but inflation sticky in its decline. The 'heart of the slowdown' is at home and household incomes are under pressure, household balance sheets are stretched, and the Reserve Bank of Australia's (RBA) aggressive monetary tightening combined with the reestablishment of fiscal conservatism has seen elevated household stress. It is a story all about 'population' in Australia and the surge in net overseas arrivals is masking the pain as it puts upward pressure on aggregate growth and inflation but downward pressure on growth per capita. The RBA has a 'dilemma,' and having paused, which way will they go? Australia GDP for Q2 came in at 0.4% QoQ and -0.3% QoQ per capita and a *per capita recession* has eventuated. The GDP print for Q2 was held up by services exports which rose 12.1% as high levels of international students arrived in the country, and if net exports were removed the GDP print would have come in at -0.4%. The Australian monthly CPI indicator continues to generate noise around the outlook but seems to 'predict' the official data fairly well on a quarterly basis, this month picking up to 5.2% YoY. This has added to volatility and seen the Australian market rival the selloff in US rates, despite a more dovish central and a significantly better government bond supply outlook. The Australian 10-year bond futures implied yield traded between 3.95% and 4.59% in September (a range of 64bps vs 37bp in August), ending the month 50bps higher at 4.50%. In the shorter end, the Australian 3-year bond futures implied yield traded between 3.66% and 4.19% in September (a range of 53bps vs 34bps in August), ending the month 36bp higher at 4.09%.

Global credit market

Rate volatility drove markets in September with US 10-year yields closing the month neatly 50bps higher. These moves saw risk assets softer on the month as the market embraced a 'higher for longer' narrative.

US credit markets widened slightly over September, with benchmark investment grade (IG) spreads 3bps wider, to 121bps, and high yield (HY) +22bps, to 394bps. Rate volatility was the most notable impact with the moves taking the year-to-date total return for IG credit back to zero, from as much as 5%: this was a factor in the turnaround in flows into the asset class, with clear outflows in the second half of the month after consistent inflows for a sustained period. New issuance was \$130bn in IG and \$24bn in HY, both significant step-ups from quieter northern hemisphere summer months.

Within US IG, the clearest outperformer has been the long end (30-year) maturities, with a lack of supply and strong demand driving long spreads lower, in some cases flat or even below 10-year spreads. Amongst sectors, Banks were the weakest sector, with rates moves weighing on the outlook for both major and regional US banks. Energy was an outperformer, reflecting a strong run-up in the oil price, as were utilities, after under-performing the broader market in recent months.

European IG spreads closed the month 2bps tighter to 153bps, spreads ended the month on a weaker tone having traded down to 147bps mid-month. Issuance totalled €62 which was largely in line with expectations. Auto issuance picked up with VW, BMW and RCI all issuing multi tranche deals, concessions moved considerably higher in the latter part of month generic IG risk requiring approximately 15bps concession to clear. The move higher in bond yields was the main theme in Europe with bunds reaching intraday highs of 2.98% and weakness starting to appear in the periphery as Italian sovereign spreads widened by 30bps.

Australian credit market

Australian credit outperformed its global counterparts in September, with the option-adjusted spread tightening a further 6bps. Despite most of the monthly move attributable to narrower swap spreads rather than credit spreads, the broad-based rally over the past six months has the index at 152bps and is the tightest since May 2022 when the Reserve Bank of Australia (RBA) commenced its hiking cycle. Financials moved modestly wider, driven by the longer-end with 5-year major bank spreads drifting a couple bps in September despite the front-end being well anchored as we passed the first major "cliff" of Term Funding Facility repayments. Tier 2 bonds followed a similar move to senior spreads for the first half of the month and weakened by 10bps, however strong reinvestment flows, and a well-received Suncorp deal ignited a sharp rally over the final two weeks with a near 15bp turnaround to close 3-4bps tighter. Of note in September was APRA's release of a discussion paper on enhancing Australian Additional Tier 1 bonds, although any outcome is likely to take many months. The theme in corporates was more curve than sector based, with the broad-based rates sell-off providing support for longer-dated bonds to modestly tighten over the month. The front-end wasn't so lucky, 5-10bps wider in some sectors as interest rate curves steepened and switching activity into new primary deals became more commonplace. There was around \$12bn of primary issuance in the Australian market in September, financials dominating once again.

Outlook

During September our global team conducted the third iteration of our Strategic Forum process for 2023. Our macro session concluded with a restatement of 'recession' as our base case outlook, noting that easier US fiscal policy has underpinned the more resilient growth that was expected in recent quarters. This has been in contrast with Europe in particular, where the slowdown has broadened. Thus, with the new fiscal year process in the US (from 1 October) rekindling the difficult political environment and rolling off student loan forbearance, our expectation is for fiscal policy to ease back to a more neutral impact on demand, therefore resulting in the overall policy mix (that is, in combination with monetary policy) to again move tighter. Thus, the growth slowdown should gradually emerge through the coming quarter and into 2024.

Our base case is for a cyclical recession, such as experienced in 2001. However, what happened in 2001 was the 'tech crash' which resulted in a more dramatic impact on asset markets than would have been expected given a mild recession for the economy. For this cycle we note similar risk environment for asset markets even if the economy does experience a mild recession. This risk stems from an environment of prolonged overtightening of monetary policy and tight credit conditions. Here we note that credit conditions are nothing like

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that of 2008, as here loan demand is already quite weak which offsets the fact that lenders have tightened lending conditions significantly. That said, we are alert to financial risk as a consequence of the current environment.

Managing duration has continued to be difficult with bond yields marching to levels not seen since 2007. Yet history guides that bond yields decline once the rate hike cycle has clearly peaked. Credit spreads have proved resilient despite the fact that earnings have entered a recession due to slowing revenue growth. While most companies entered this slowdown well prepared there has been a steady 'chipping away' at this resilience and the longer the tighter financial conditions persist the risks will continue to grow. Thus, the current pricing across asset markets when combined with our base case outlook is guiding our investment process to remain cautious despite the baying from the narrative that "this time (might) be different".

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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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