Macquarie Investment Management

Macquarie Australian Fixed Interest Fund

Monthly report – 31 January 2022

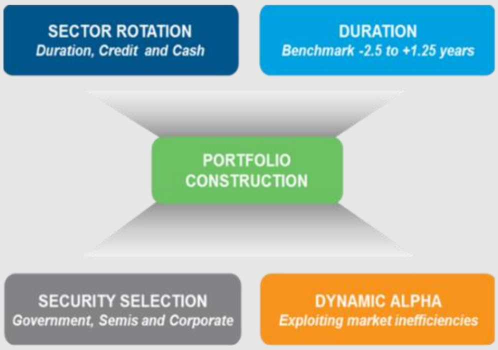
Investment objective

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	$264.1m
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 January 2022

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-0.88	-0.91	-1.02	0.11
3 months (%)	1.54	1.48	1.13	0.35
1 year (%)	-3.09	-3.44	-3.46	0.02
2 years (% pa)	-0.31	-0.72	-0.93	0.21
3 years (% pa)	3.00	2.55	2.30	0.25
5 years (% pa)	3.58	3.11	3.02	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

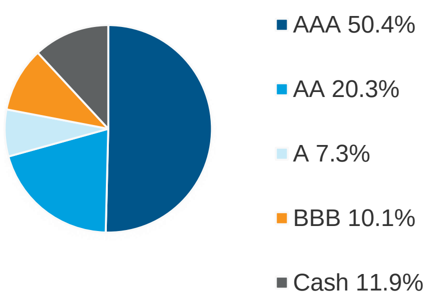
Asset allocation
(based on physical exposure)

	Fund (%)
Government	36.4
Credit	32.0
Semi-Government	19.7
Cash and Equivalents	11.9

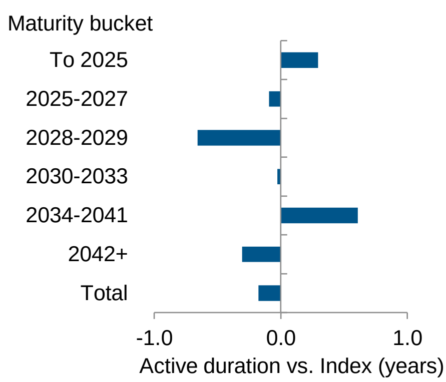
Fund statistics

Credit spread duration	0.9 years
Interest rate duration	5.5 years
Yield to maturity (% pa)	2.22%

Credit profile breakdown



Curve positioning breakdown



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Fund highlights

The Fund outperformed the benchmark during the month, driven by security selection as well as duration and curve positioning.

Duration and curve

The Fund's duration positioning has been actively managed over the month, with options held in the Fund taking the duration level shorter in January. The Fund continues to favour an overweight to AUD versus USD duration given the differences in the inflation outlook between the two economies. We hold this position in the shorter maturity part of the curve as well as in the 10 year segment as Australian rates remain very elevated versus equivalent US maturities in this part of the curve. We believe this does not make sense fundamentally, given the core inflation in Australia has undershot the Reserve Bank of Australia's (RBA) target by more than any other developed country over the last decade (except Japan) and they will likely lag behind other central banks in hiking rates. Australian households have a higher sensitivity to interest rates given high household leverage, and the domestic mortgage market predominantly consists of floating-rate or short-term fixed-rate debt, and this should result in a lower terminal rate.

Sector rotation

The Fund has been short the semi-government sector and remains so, but we have started to take profit on the position into month-end and reduced its size. Semi-government spreads continued to drift wider in January on expectations that the RBA will end quantitative easing and taper to zero, which benefited our positioning and contributed to the outperformance in the Fund this month. We still think semi-government bonds look slightly rich on an asset swap measure, particularly out to the belly of the yield curve where the RBA's balance sheets have typically been the main buyer. As such, we are still comfortable being short the semi-government sector, but will use opportunities in supply to continue to add back exposure.

The Fund's credit positioning was a positive contributor to the outperformance in January despite Australia credit finishing the month broadly unchanged. The Fund's credit positioning, which has been more tilted to the front to mid part of the curve, benefited from the credit curve bull-steepening.

Security selection

The Fund's security selection has been overweight to the ultra-long maturity Australian Commonwealth Government Bonds (ACGBs) given their steepness relative to global curves, and as this position continues to perform, we have reduced the size of the overweight to take profit. The tapering of quantitative easing (QE) should drive the outperformance of ultra-long ACGBs given the RBA has only purchased sub-12 year maturities, and we will see the relative scarcity of those shorter maturities reverse as QE ends.

Within semi-government holdings, we have trimmed some of the shorter-dated exposures where they are still trading at materially negative asset swap spread levels, and added in the 10 year maturities where curves were already steep as markets anticipate more supply. The Fund has remained overweight swap spread exposure as a partial hedge against the semi-government underweight. We expect that derivatives should outperform physical securities as the RBA continues to taper their asset purchasing program.

The Fund's credit security selection slightly underperformed the benchmark over the month. While the new senior financial deals issued during the month generally outperformed, longer-dated corporate bonds as well as higher-beta bonds, such as financial subordinated bonds, underperformed as volatility in risk markets picked up. Over the month, the Fund participated in primary transactions from issuers such as Commonwealth Bank of Australia, Westpac, Suncorp, Sumitomo Mitsui Banking Corporation, European Investment Bank and Asian Development Bank.

Market review

The main theme in January was the hawkish pivot by multiple central banks in response to continued and persistent inflation. While many emerging market central banks are already advanced in their monetary policy tightening cycle, it has been the messaging from the US Federal Reserve (Fed) that has had the most dramatic impact across global financial markets. Expectations for the number of Fed rate hikes (of +0.25% increments) during 2022 increased to almost five by month end. The impact across rates markets was broadly for bond yields to rise and yield curves to flatten, where short-dated yields have risen more than long-dated yields. Risk markets, underpinned for most of the past two years by easy and easier monetary and fiscal policy, reacted negatively. Equity indices broadly ended the monthly lower and volatility was higher. This dragged on credit markets, where spreads widened with lower quality names/ratings underperforming. The US dollar reversed its pullback in the previous month, with the Australian and New Zealand currencies notably weak despite the continued strength across commodity prices in the month.

During December and through January, the Omicron variant rippled across the world. While some countries tweaked restrictions tighter, most relied on voluntary measures and gradually the data is firming a belief that this variant may be more virulent but seems to be much less of a concern for hospitals and health in general. Thus, the UK's move to remove most restrictions towards the end of January is being viewed as the likely path for most countries in the coming months. Though, with the virus, nothing is assured.

Australian bond market

2022 began much the same as last year with renewed optimism as we saw higher yields across global markets, but with some central banks already in play and others soon tilted to join, the yield curves flattened sharply. The Australian bond market began January with a very strong sell-off but that was largely over by the first week, when the following 3 weeks saw yields range-traded. The hawkish tone of the US Federal Reserve (Fed) and early end to the quantitative easing program saw rates markets repriced for a steeper path, with current expectations now for five rate hikes in 2022. The Fed's admission that inflation may be more durable than previously anticipated generated discussion of the Fed actively selling down the balance sheet to drain liquidity out of the system sooner rather than later, in addition to rate hikes.

The market saw the strong swathe of Australian data as evidence that the Reserve Bank of Australia (RBA) could soon follow the Fed in hiking rates. This saw the Australian 10 year bond sell-off, with the yield 21.5bps higher at 1.90% by month end and mid-month peak even higher at 2.03%. The 3 year bond sold off by a larger 28bps as the market moved to price in a faster hiking cycle, in spite of the fact that RBA

Governor Lowe has gone to great pains to point out the differences in the inflation outlook between Australia and other developed markets, and his willingness to be patient and ensure inflation is sustained before raising rates. Australian inflation came in with the headline measure at 1.3% QoQ and 3.5% YoY, and the RBA's preferred trimmed mean (core inflation) measure at 1.0% QoQ and 2.6% YoY, above the midpoint of their target band. The unemployment rate dropped to 4.2%, materially lower than forecast, with job vacancies up 18.5% QoQ, and retail sales up 7.3% MoM.

The December-January Omicron outbreak looked to be only a brief interruption to a hawkish wave, as evidence both domestically and internationally seemed that the variant results in much lower hospitalisation and death rates than earlier variants. The data so far points to Omicron having dampened the recovery somewhat, with retail trade falling by 4.4% (over December), but not calamitously so as it remains near-record levels as positive trajectory is pointed to continue when the current virus outbreak recedes.

The Australian Office of Financial Management paused issuance over Christmas and started the year by advising the market that the annual task had fallen from $130bn to $105bn, and that there would be a Nov 2033 bond issued by syndication in 2Q22.

Global credit market

Global markets finished January on a weaker note, reflecting volatility induced by a sharp repricing of the US Federal Reserve (Fed) rate hike expectations, with the Fed's policy statement also bringing forward expectations for balance sheet reduction (or 'QT' – quantitative tightening).

US credit spreads widened in January, the largest monthly move since March 2020, though that reflected the low volatility environment of 2021 more than suggesting a significant move wider. Equity markets led the weakness, and in comparison, credit markets were more orderly. This partly reflected differing weights: tech, which led the sell-off, is around a third of the S&P 500 Index, compared to less than 10% in US investment grade (IG) credit. In contrast, energy and financials were much better performers, and make up almost 40% of IG credit, compared to only 15% in the S&P 500. With moves not significantly differentiated across the credit ratings spectrum, this suggests that credit was heavily influenced by the rates market volatility than growth concerns, given the lowest-rated credit are usually much more sensitive to economic growth.

The US earnings season kicked off and was well advanced by month end, with about a third of the companies reported. Overall, earnings have continued to be supportive but with notably fewer upgrades to guidance. Cost pressures are an ongoing theme, with management teams generally confident in passing on prices (with consumer demand so far resilient). But some industrial earnings misses were driven by the lack of available raw materials. Most management teams expect the supply chain issues to gradually dissipate over 2022.

European IG closed 10bps wider at a spread of 105bps. Hawkish central bank commentary (mainly from the Fed with 5 hikes being priced by markets) resulted in a notable uptick in equity volatility, which put a pause to the chase for yield. German bund 10 year yields are now trading at a positive yield for the first time since 2Q19. Credit curves steepened over the month, with the longer maturities (10+ years) widening 15bps and swap spreads drifting wider again. Supply came to €69bn but this was front loaded. Issuers began to step back from the primary market as macro volatility picked up in the latter half of the month. New issue concessions picked up, with double digit premia commonplace, while REITs suffered in the secondary market amid a wave of supply in the sector. Higher-beta IG REITs underperformed. In high yield credit, there was a trend of decompression as single-B underperformed BB credit by 31bps on the month.

Australian credit market

Australian investment grade (IG) credit relatively outperformed its global peers, with spreads ending the month broadly unchanged. Credit curves bull-steepened over the month as the shorter maturities grinded tighter in spreads and longer-dated bonds leaked wider, particularly bonds rated in the BBB category. After reaching the widest spread level since February 2021 in the previous month, subordinated financial paper kicked off the new year on a stronger footing with spreads tightening close to 4bps initially. However, the Commonwealth Bank of Australia and Westpac came to the market in mid-January and printed two of the largest senior deals compared to all the active major bank senior bonds currently on issue. This led to some selling of major bank subordinated financial paper, with spreads finishing the month slightly wider. January marks the biggest month of IG issuance in the last two years with circa $12bn of IG credit printed.

Outlook

Fixed income markets are acutely focused on the outlook for inflation and the reaction by central banks. These two themes were central to our debates within the Macquarie Fixed Income team's recent global Strategic Forum. From a macroeconomic perspective, a deep dive into the drivers of aggregate demand and aggregate supply has enabled us to understand that the currently high inflation has been largely a product of a slow recovery in supply and demand being broadly back to the pre-pandemic trend. Looking into 2022, we asked what are the big demand drivers and noted that policies – both monetary and fiscal – were moving in the opposite direction from those of the past two years. Gradually, we expect this action to drag demand lower. We note the narrative that the consumers can drive demand higher, fuelled by higher wages and excess savings, but see that there is little actual evidence in the spending data that supports an above-trend consumption. Finally, on the supply side, we note that the pandemic needs to pass for a sustainable improvement to take place, and recent evidence gives optimism for progress through this year.

Thus, we expect inflation to trend lower in 2022, notably in the second quarter and more noticeably later in the year. This should offer respite the investor and central bank fear that inflation is a structural problem, but this path is not without risks from the virus, factors such as oil as well as policy (error). This implies a tricky investment outlook path to navigate, where periods of volatility spikes should be expected. We also recognise the investors' need for yield. During 2021, our investment approach was cautious, holding low levels of duration and low levels of exposure to risk assets. This gives our team the opportunity to take advantage of expected volatility in 2022 to add duration and risk either from both our top-down and bottom-up processes.

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For more information speak to your financial adviser, call us on 1800 814 523, email mim.clientservice@macquarie.com or visit macquarie.com