

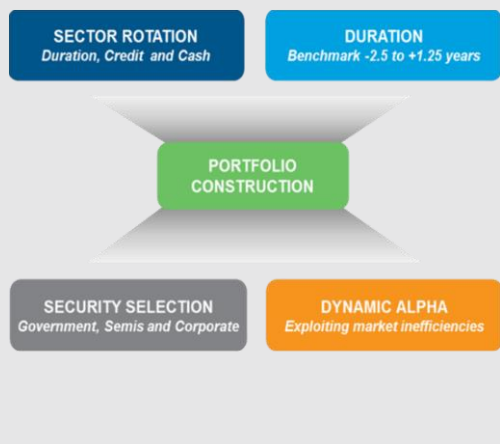
Investment objective

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	\$268.2m
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 December 2021

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	0.14	0.11	0.09	0.02
3 months (%)	-1.61	-1.69	-1.46	-0.23
1 year (%)	-2.71	-3.07	-2.87	-0.20
2 years (% pa)	1.36	0.93	0.74	0.19
3 years (% pa)	3.52	3.06	2.87	0.19
5 years (% pa)	3.91	3.43	3.36	0.07

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

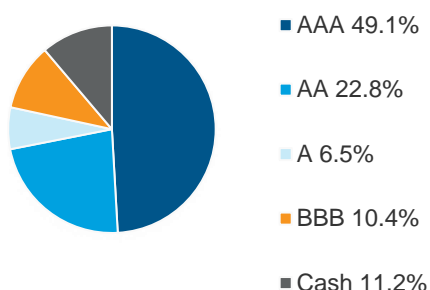
Asset allocation (based on physical exposure)

	Fund (%)
Government	35.2
Credit	30.6
Semi-Government	23.0
Cash and Equivalents	11.2

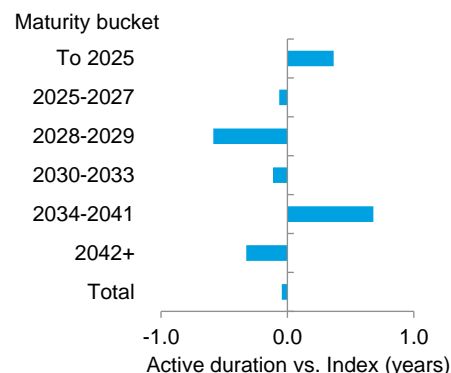
Fund statistics

Credit spread duration	0.9 years
Interest rate duration	5.7 years
Yield to maturity (% pa)	2.03%

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.

Security selection

Within security selection, the Fund has been overweight to the ultra-long Australian Commonwealth Government Bonds (ACGBs) given the steepness relative to global curves, but has reduced this position slightly in size given it has performed well in recent months, with micro steepening trades expressed from the 20 year area towards 15 year bonds. The tapering of quantitative easing (QE) should drive the outperformance of ultra-long bonds given the Reserve Bank of Australia (RBA) has only purchased sub-12 year tenors, and we will see the relative scarcity of those shorter tenors reverse as QE ends. Further micro steepening trades were expressed in the 10 year bonds where we bought the 2030 maturity ACGB given its cheapness on leaving the futures basket against longer tenor bonds. In semi-government bonds, we rotated out of mid curve Western Australia bonds that were trading relatively expensive in favour of Queensland, which we view as relatively cheap. We are slightly overweight swap spread exposure given the value on offer against ACGBs and semis. We expect that derivatives should outperform physical securities as the RBA continues to taper their asset purchasing program. Consistent with this, we sold our holdings of the 3 year bonds into futures given the arbitrage opportunity on offer.

The Fund's credit security selection contributed positively to performance over the month. With the dramatic rally in Tier 2 spreads in December, financial and corporate subordinated debt were a key contributor to the outperformance. The Fund remains defensively positioned with credit default swap (CDS) offsets, and during the month added some protective investment grade CDX positions to further hedge credit risk. Over the month, the Fund participated in a primary transaction from Centuria Industrial REIT.

Duration and curve

We have continued to hold an overweight to AUD versus USD duration, which continued to perform through December, assisted by continued QE by the RBA even as term supply from the Australian Office of Financial Management and semi authorities ceased. We hold the bulk of this position in the front-end as Australian rates remain very elevated versus equivalent US tenors in this part of the curve. We believe the elevated rates do not make sense fundamentally and have room to fall given the differences in the inflation outlook, with core CPI in Australia having undershot the RBA's target by more than any other developed country over the last decade except Japan. We continue to believe RBA will lag behind other central banks in hiking rates and expect they will not be able to hike as quickly as the US Federal Reserve. Furthermore, the higher sensitivity to interest rates (given high household leverage) and the domestic mortgage market being predominantly floating rate or short-term fixed should result in a lower terminal rate. We also hold an overweight to AUD versus USD duration in the 10 year part of the curve, which benefited from the negative net supply of bonds as a consequence of continued QE.

Sector rotation

The Fund has remained short the semi-government sector with minimal trading during December. Swap spreads continued to widen during December given mortgage paying in the front-end, and into the December futures rolls given the optical tightening of EFP (exchange of futures for physical) spreads into this event. However, the semi-government sector remained well supported in December with a lack of supply around mid-year budget updates and the broadly lower supply outlook coming from them. Additionally, regional demand for the sector, coupled with continued buying from the RBA's QE programme, saw a further richening on an asset swap measure, which is the valuation metric used by banks. We continue to believe there is scope for semi-government spreads to drift wider as the RBA continues their taper, with many now expecting they could taper down to zero when they review in February and prefer to be received swap spreads as a proxy.

The Fund's credit positioning was a neutral contributor to performance in December as Australian credit moved sideways. While short-end credit was impacted by ongoing rates volatility and longer-end BBB spreads widened in sympathy, Tier 2 spreads rallied over the month given ongoing demand and attractive outright levels.

Market review

Asset markets were buffeted during December by the prospect that the path of global monetary policy tightening was spreading from emerging market to developed market central banks and by the surge in new cases from the arrival of the Omicron variant. That said, risk markets performed, largely because they already reacted (negatively) heading into the end of November and partly because there is a consensus building that the health risk from Omicron is less than the Delta variant despite being more contagious. Amidst this were three key central bank meetings: the US Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE). In summary, the guidance was more hawkish than markets expected, which was a bias for tighter monetary policy going forward. In fact, the BoE delivered a 0.25% hike in its base rate, while the Fed guided its intention to hike rates earlier (in 2022) and more quickly. Even the perma-dovish ECB was leaning more hawkish. The driving factor behind their messaging was "higher and persistently higher-than-expected inflation".

With central banks moving to remove the pandemic stimulus, at the same time Omicron has created uncertainty on the economic outlook. Despite this uncertainty, asset markets ended the year with an aura of calm. Bond yields were broadly contained within ranges and yield curves were relatively flat given the elevated fears on inflation. Credit spreads, while off their lows, ended the year at the tighter end of valuations. Only emerging market spreads are cheaper, albeit modestly, and not a surprise given the stronger bias of the dollar of late.

Australian bond market

Bond market moves were moderate in December as markets drifted into year end with modest curve flattening, continuing the theme that higher and more persistent inflation outcomes would see central banks respond by raising interest rates. Actual inflation prints in December from the US met but did not exceed market expectations, allowing for a more stable move in bond yields over the month. Notable central bank action globally was delivered by the Bank of England (BoE). Having surprised markets by not hiking rates in November and delivering a more cautious statement, the BoE delivered a surprise rate hike to 0.25% in December.

In Australia, the Reserve Bank of Australia (RBA) delivered no surprises at their December meeting, but Governor Lowe did spell out a timetable for the end of quantitative easing (QE). The three scenarios revolved around a taper in February and a review for May, a taper in

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February with an end to the programme in May, and finally a hard stop in February, should data outcomes exceed their expectations. Notably on the data front, employment outcomes released in December were far stronger than consensus, with the unemployment rate falling to 4.6% from 5.2%, seeing markets moving towards the third scenario of a February hard stop of QE. The RBA also continued to back away from their forecast of when interest rates may rise. Having abandoned their Yield Curve Control policy in November which indicated a time-based guidance for interest rates, the December statement moved towards a data driven outcome for policy rates. Given the aggressive market pricing for interest rates in Australia for 2022, this shift didn't have a material impact on volatility.

December also saw mid-year Budget updates from the Commonwealth and State governments. For the Federal Budget revenues were again stronger than forecast but was largely offset by increased expenses relating to the NDIS, resulting in an overall \$7.9bn improvement in the current financial year budget forecast, that has resulted in a broadly unchanged issuance forecast from the Australian Office of Financial Management. The State governments also broadly showed improvement to May forecasts, with the exceptions being Western Australia in response to lower Iron Ore prices and Victoria following lockdowns. Overall, the issuance requirement for the semi-government sector is forecasted to be lower than at the May update.

In terms of bond yield moves, the 10 year Australian Commonwealth Government Bond (ACGB) finished the month slightly lower at 1.67%. The bigger move was seen in yield curve markets as measured by the spread between 3 and 10 year bonds. This flattened from 82bps to a low of 59bps by mid-month but re-steepened into year-end to close at 75bps. The Australian bond market outperformed the US Treasury market where yields finished the month 7bps higher at 1.51%.

Global credit market

Risk assets finished the calendar year strongly with equities close to all-time highs and credit rebounding from the weakness in November, though most of the rally came in the final days of the year and thinner trading conditions.

Credit markets, particularly in the US, took a number of developments in stride, including an increase in the US Federal Reserve's taper, the collapse of the Biden Administration's 'Build Back Better' fiscal push, and continued strong inflation readings. A lack of credit market issuance in the second half of the month contributed to spread tightening as investors chased limited investment options in credit, though the most significant factor was the improved sentiment on the economic outlook and low end of year liquidity. New issue supply in the US credit market was higher than expected, totalling just over US\$60bn for the month, with all supply concentrated in the first half. Notable new deals included large issuances from pharmaceutical companies Roche and Merck and left the US investment grade (IG) market with total supply in 2021 of just over US\$1.5tn, almost 20% down compared to 2020.

In European credit, IG spreads closed 14bps tighter to 95bps. Supply was seasonally light, which helped the technical backdrop, and issuance concessions returned to low single digits. The best performing areas were cyclical BBB's and REITs after their underperformance in November. High yield airlines remained slightly off recent highs as the outlook for international travel has deteriorated.

Australian credit market

Australian credit underperformed its global counterparts with spreads broadly unchanged over the month. Another bout of volatility in rates markets led to underperformance at the front-end of the credit curve, while in the longer-end generic BBB spreads continued to drift wider. The mid-curve remained the tenor of choice for outperformance this month, though most of the focus was on Tier 2 bonds, which initially traded with a heavier tone after the Australian Prudential Regulation Authority (APRA) announced lifting the Tier 2 capital requirement by 1.5% by 2026. However, the optically wide spread levels enticed buyers across the spectrum with strong interest into month-end. With major bank 10NC5 (10 year notes callable after 5 years) lines opening the month at just shy of 150bps after a period of underperformance, they rallied to around 135bps by year-end and some individual lines were up to 20bps tighter.

Outlook

The pandemic has defined the past two years' investment climate. While the signs are positive that the world is reaching a turning point in 2022, the legacy of the pandemic will linger for some time. As we consider the outlook for 2022, two questions come to the forefront: as fiscal stimulus wanes and central banks begin to withdraw support, where will the trend of economic growth settle; and how persistent is the inflation impulse?

We previously identified that the future trend of monetary policy was shifting from easing to tightening. The fiscal shift is less clear and even less understood. Asset markets embraced the global fiscal stimulus through 2020-2021. However, with the US seemingly unable to get the promised new fiscal stimulus through Congress it is a timely reminder that government spending is in fact decelerating from the initial surge, which will act as a drag on growth during 2022. And it should not be lost that many governments have an intent to begin the process of clawing back the explosion of government deficits. How these play out in 2022 will have important implications for growth, where our bias is that with the gyrations the trend will likely settle on the pre-pandemic trend.

The inflation outlook is complicated by the global disruption to supply. If this disruption persists, then even the uninspiring pre-pandemic growth trend would likely be enough to keep inflation elevated relative to pre-pandemic averages. Yet, forward looking asset markets could foresee a scenario where policy tapering begins to slow demand at the same time the supply chain begins to normalise, which could deliver a disinflation impulse.

Thus, we confront the outlook having to balance investors' need for yield against tight valuations and a high level of uncertainty and multiple possible scenarios for 2022. We remain invested but with balance, with the intention of using periodic volatility to selectively participate in opportunities.

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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

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