Macquarie Investment Management

Macquarie Australian Fixed Interest Fund

Monthly report – January 2021

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.

Fund performance to 31 January 2021

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-0.49	-0.52	-0.42	-0.10
3 months (%)	-0.66	-0.76	-0.80	0.04
1 year (%)	2.56	2.17	1.68	0.49
3 years (% pa)	6.02	5.63	5.36	0.27
5 years (% pa)	4.89	4.49	4.21	0.28
10 years (% pa)	6.26	5.85	5.44	0.41

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.
Benchmark is Bloomberg AusBond Bank Bill Index

Key information

Fund details	
APIR code	MAQ0061AU
Inception date	15 May 1995
Fund size	$238.1m
Distribution frequency	Quarterly
Management fee*	0.390% pa
Minimum investment (Direct)	$20,000
Unit prices and spreads	**macquarie.com.au/unit_prices**

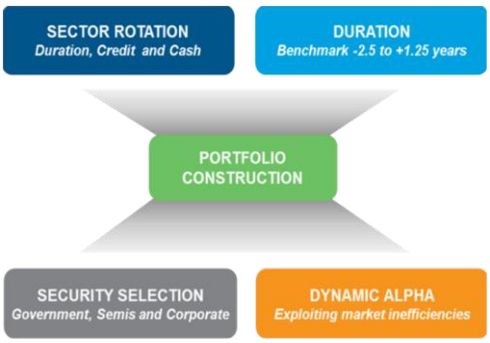
*Read the Product Disclosure Statement for more details on fees and costs.

Asset allocation
(based on physical exposure)

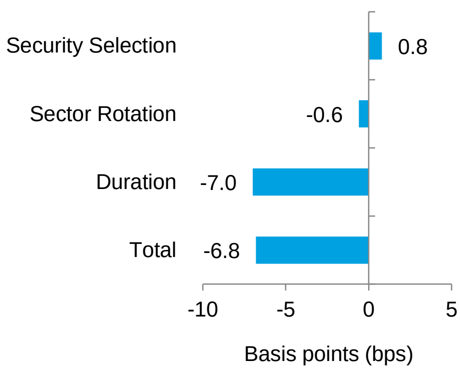
	Fund (%)
Government	51.2
Corporate	24.3
Semi-government	18.9
Cash and equivalents	5.7

Fund statistics

Credit spread duration	1.0 years
Interest rate duration	6.0 years
Yield to maturity (% pa)	1.09%



Key contributors to performance



Fund highlights

The new year did not start off quietly. Surging virus cases, new variants and pressure on hospitals have caused governments to re-tighten restrictions. In parallel, the vaccination process has begun but there is significant divergence taking place between countries in terms of supply and administration. The very long US election process came to a head with the Georgia Senate run-off early in the month. The Democratic party obtained both seats and, with the casting vote of the Vice-President, have won control of Congress. That said, the margin is wafer-thin, and is not the blue-wave sweep that pollsters had suggested. This reality was overlooked by the markets as expectations are for further near-term fiscal stimulus.

All of these events did not stop equity markets from surging to new highs in the US and credit spreads from tightening back towards pre-pandemic levels. Bond yields rose and yield curves steepened as the longer-maturity bonds underperformed, but rate markets are nowhere near their pre-pandemic levels. This has put bond markets in the cross-hairs of debate in terms of the outlook for 2021, where optimists are forecasting an inflation surge and higher interest rates. Others, like ourselves, are sceptical particularly as bond markets have a long history of accurately reflecting the reality.

The Fund underperformed the benchmark this month. While security selection contributed positively to performance, this was offset by duration as bond yields rose over the month.

Security selection

The Fund has maintained an overweight to the belly of the Australian Commonwealth Government Bond curve, which offers favourable rolldown given the impact of Yield Curve Control on the front-end. We have also continued to favour the ultra-long bonds given the steepness relative to global curves and attractiveness to foreign investors on a hedged yield basis. However, this positioning detracted from performance in January as the curve steepened with the directional move in outright yields.

Within the semi-government portion of the Fund, we have held a bias towards the 8 to 12 year maturity segment, where spread curves have been steep due to a supply-demand mismatch for different tenors as issuers have preferred to term out their debt. This positioning benefited performance in January as spreads in the 10 year curve segment narrowed more than the rest of the curve. We participated in the new Queensland Treasury Corporation 2032 deal, which was launched at attractive levels relative to our fair value model and performed well post pricing.

The Fund's credit security selection performed broadly in line with the benchmark in January. Over the month, the Fund participated in a subordinated transaction from Westpac Banking Corporation.

Sector rotation

The Fund remained underweight to the semi-government sector during the month, though the exposure has been held in the 8 to 12 year curve segment, which traded with a higher beta than the rest of the curve and meant that the Fund has been trading longer than it appears optically. The material supply still to come in the semi-government space will be largely offset by the Reserve Bank of Australia's (RBA) asset purchasing program, which was extended again in early February. However, with semi-government spreads at record tights, we believe the yield pick-up in the front-end is insufficient to compensate for the relatively lower liquidity in the sector.

Semi-government spreads drifted tighter into month end as supply was well absorbed by investors, though this was predominantly in the 8 to 12 year tenors where the Fund holds its exposure.

The Fund's long credit positioning benefitted performance in January as the Australia credit market continued its positive momentum from last year. The lack of new issuance in the primary market over the month, coupled with an abundance of excess liquidity given the considerable amount of net negative supply and the unprecedented monetary policy settings in Australia, drove credit spreads tighter. It is also worth noting that the moderate outperformance in the Australian credit market was broadly based across ratings and sectors and the credit curve marginally bull-flattened. Lower-beta bonds that drove performance over the month were mostly Kangaroo financial paper, as they continued to attract demand given their cheapness relative to their own global curves and domestic repo-eligible senior unsecured financial paper. Unsurprisingly, the robust technical backdrop continued to support higher-beta bonds as spreads in the COVID-impacted sectors compressed further in January.

Duration

The Fund began the month with an overweight bias to duration, expressed in the belly of the swap curve. While this position offers favourable rolldown, it is highly correlated to the Australian 10 year yield, and as a result, was a modest detractor from performance as yields rose early in January.

As the month progressed, we reverted to neutral duration positioning, selling the USD long bond future to partially hedge the AUD ultra-long bond exposure in the Fund. We believe any further sell-off in bonds would likely be led by offshore yield moves as a result of the shifting economic outlook. There is also scope for outperformance in the AUD versus USD bonds given the net supply differential between the two regions, as well as the attractiveness of AUD hedged yields to foreign investors.

Market review

Australian bond market

Global yields drifted higher over the first half of January, as markets temporarily embraced the reflation trade on early optimism about the vaccine rollout, the 'light blue wave' resulted from the Georgia Senate runoffs, and ensuing hopes for further fiscal support.

Australian yields drifted higher in sympathy with the global moves, but outperformed equivalent US Treasury maturities on supply-demand technicals. While the Australian Office of Financial Management (AOFM) took a break from issuance over the holiday period, upon first returning to markets in late January, the RBA resumed their buying which drove the net Australian government bonds supply further into negative territory for the month. While the AOFM only issued $5bn of nominal bonds in January, the States were more active with the Treasury Corporation of Victoria syndicating a new 2025 tenor and Queensland Treasury Corporation bringing a new 2032 tenor.

The RBA are now more than halfway through their first foray into quantitative easing (QE), with $52bn of bonds purchased since November 2020, and the initial wave expiring in April this year. At their meeting in early February, the RBA announced an extension to QE, of an additional $100bn in size, and at the same $5bn/week pace as the first round. This was more dovish than anticipated by markets, with some economists having talked up the chance of a tapering in recent weeks. With a slightly smaller funding task expected from the AOFM for the next financial year, this purchasing envelope is likely to take net supply even further into negative territory for much of the calendar year ahead.

Drawdown of the RBA's term funding facility remains slow given the amount of liquidity already in the system – as of month end, $86bn had been utilised with a further $99bn available.

The consumer price index in 4Q20 was released during January. The headline measure was strong at 0.9% QoQ, largely due to one-off impacts such as the tobacco excise. The trimmed mean measure was a more modest 0.4% QoQ, or 1.2% YoY, which remained materially below the lower threshold of the RBA's target inflation band.

The 10 year implied futures yield ended the month 12bps higher at 1.14%, while the front-end of the yield curve has remained contained given the current RBA policy.

Global credit market

Credit markets slightly outperformed other risk markets in January as global equities modestly sold off during the month over a combination of concerns, including the US Federal Reserve's release of some less dovish language, uncertainty over the size of fiscal support that the Democrats can pass through, and the fascinating events occurring in equity markets with respect to online forums.

The US credit market finished January with a mixed tone, with the overall investment grade (IG) index 1bps wider to 97bps. Repeating the last several months, lower-rated credit outperformed, though this time it was a case of the CCC-and-below segment performing very well, and the rest of the credit market trading in a tight range. Within credit markets, earnings were a key focus, as well as movements in bond yields and progress on the US stimulus package. Events in equity markets, particularly the significant single name short squeezes, grabbed investors' attention, though so far there has been minimal direct impact to the broader credit markets. Overall, investor flows remained supportive, particularly for IG credit and more notably bank loans, which received consistent large inflows, after suffering considerable outflows through 2020.

The beginning of the US earnings season was a key fundamental development over the month. So far, earnings have continued the recent quarters' theme of continued improvement and recovery, particularly in the industrial sectors that had initially been heavily impacted by the economic shutdown. Outside of commercial aircraft and a small number of other specific sectors, most industrials sectors have weathered the virus well, with manufacturing recovering well in 2H20. US banks also had a strong quarter and has begun releasing loan loss reserves that they have built in Q1 through to Q3 last year, as actual loan losses have so far been lower than initially feared. While the fundamental recovery in earnings continues, it is worth noting that the improvement has been well priced by markets.

Broader market attention was focused on the spectacular ramp-up in 'meme' stock prices, such as GameStop, into month end – fuelled by significant retail buying and narratives around significant short interest from hedge funds. While the flow-through impact to credit markets overall was minimal, it is worth noting that some of the worst 'laggards' in the credit market recovery were caught up in the frenzy, such as AMC Theatres, whose equity price was bid so high that the company was able to raise new equity and likely avoid a near-term bankruptcy. AMC Theatres secured bonds maturing in 2025, which were traded from 70 cents on a dollar to over 100 cents over the month.

It was a benign month overall in the European IG market with IG spreads closing 1bp wider at 93bps but 6bps off the tights of the month, as a slower-than-expected rollout of the European vaccination programme, combined with the equity market volatility, dampened sentiment. Supply came to €56bn in the month, which was below expectations, while certain sectors such as corporate hybrids experienced higher-than-anticipated supply. Several hybrid drive-by deals from names such as Total SE, Abertis, Aroundtown SA and Wintershall impacted the technical bid, which previously persisted in the sector. Single name performance was mixed, with cyclical recovery sectors such as airlines and oil majors underperforming.

Australian credit market

The Australian credit market started 2021 on a solid footing, outperforming global credit markets as the robust bid tone continued from last year. Not only did excess liquidity and the persistent chase for yield dynamic contribute to the rally, but the lack of issuance in the primary market also prompted investors to search for the limited amount of bonds that the street was able to offer given bonds are still tightly held. The outperformance in Australian credit was more broadly based in January, with both low- and higher-beta as well as A- and BBB-rated sectors tightening 5 to 15bps over the month. The credit curve of A-rated bonds bull-flattened, with the most notable outperformance coming from the NBN Co 2030 bond, which rallied more than 20bps over the month. Meanwhile, total loss-absorbing capacity (TLAC) financial bonds also attracted a reasonable amount of demand during the month as they continued to trade 30 to 40bps back from their USD curves and well-above the domestic repo-eligible senior unsecured bank paper. In the higher-beta sectors, COVID-impacted names continued to be the outperformers, with the Brisbane Airport 2030 bond compressing a further 15bps over the month. The primary market only saw $1.4bn of new issuance, with $1.25bn coming from Westpac Banking Corporation's subordinated debt alone and the rest from University of Melbourne.

Outlook

The Macquarie Fixed Income team conducted its latest Strategic Forum in January, in which the team dives deep into the themes that are driving asset markets. Given the advances of science enabling the vaccination process to get underway, it is tempting to look toward the time when things can get back to normal. However, we must first reflect on the significant scars that will be left in the wake of this pandemic – the significant job losses, small business failures, and behavioural changes that we all have had to make. This suggests that the fundamental landscape is expected to remain challenging for some time and be dependent on the continued support from policy makers. Central banks have been clear about their intent to maintain easy policy for as long as it takes. The focus now is on fiscal policy, where we have witnessed an unprecedented effort to provide support for workers and businesses impacted by the pandemic. In 2021, the debate is whether governments can evolve from fiscal 'support' to fiscal 'stimulus'.

In our deliberations at the Strategic Forum, we believe that the path of fiscal policy will play an important part in how the outlook is shaped. Continued 'support' by policy makers has prevented a worst case scenario, but the key looking forward is how can demand be kick-started? Monetary policy has little effectiveness in this regard with rates near the lower bound. With fiscal policy comes politics and we can already hear the siren voices of concern about the rise in budget deficit and debt levels. Politics is again on show in the US after President Joe Biden outlined his first fiscal package, where debate is not just between the two parties but also within the Democratic party itself. Thus, in contrast to monetary policy, applying fiscal stimulus is likely to prove more difficult than support.

What about valuations? What about positioning? Neither make a compelling case for investors, but technicals are strong, underpinned by a strong belief that central banks can continue to contain all risks. This disconnect between fundamentals and financial markets performance leaves us with an uncomfortable reality and the need to find yield. Thus, our challenge is to stay in front of consensus and not get caught up with uncomfortable positions.

What are the risks? On the upside we all hope for successful vaccine rollouts, which will enable economies to re-open and supply chains to unlock. Governments can surprise by increasing spending, particularly on infrastructure, to create jobs and income and kick consumer spending sustainably higher. On the downside however, there are also many risks around the virus and vaccines, while the scars left in the services sector and job markets will take years to repair. These all point to 2021 providing a challenging environment for investors, where our intention is to maintain discipline and recognise that opportunities will present themselves.

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