

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	\$234.4m
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 28 February 2021

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-3.82	-3.85	-3.58	-0.27
3 months (%)	-4.47	-4.57	-4.25	-0.32
1 year (%)	-2.23	-2.68	-2.80	0.12
2 years (% pa)	3.62	3.12	2.92	0.20
3 years (% pa)	4.55	4.05	3.99	0.06
5 years (% pa)	3.89	3.36	3.25	0.11

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

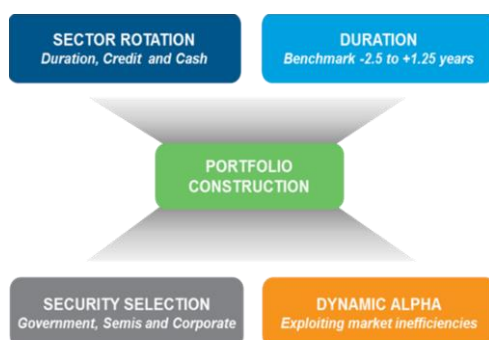
Asset allocation

(based on physical exposure)

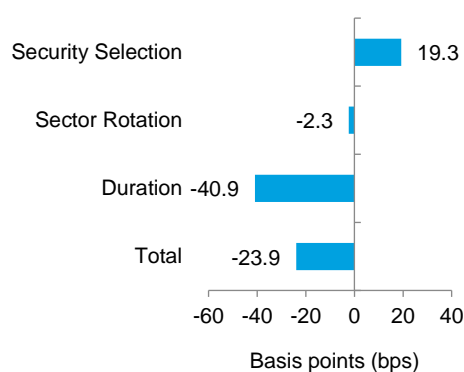
	Fund (%)
Government	52.1
Corporate	25.4
Semi-government	17.6
Cash and equivalents	4.9

Fund statistics

Credit spread duration	1.0 years
Interest rate duration	5.9 years
Yield to maturity (% pa)	1.58%



Key contributors to performance



Macquarie Australian Fixed Interest Fund

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Fund highlights

The reflation theme gripped bond markets during February, fuelled by the roll-out of vaccines, the continued surge in oil and copper prices, rising expectations for a large US fiscal package being agreed in March, and the continued strength across the manufacturing sector. Bond yields surged higher and yield curves steepened, with the Antipodean markets leading the charge. It was interesting to observe that credit spreads actually tightened amidst this big move in bond markets, which supports the thought that the movements in yields were generated by a belief in stronger growth rather than an outright fear of sustained higher inflation. Central bankers have weighed into this debate, arguing that the market is re-pricing because of growth. Despite the market bringing forward rate hike expectations, they are maintaining their already stated commitment to keeping policy focused on supporting the recovery.

The Fund underperformed the benchmark this month. While security selection contributed positively to performance, this was offset by duration due to the sharp rise further in bond yields over the month.

Security selection

Within the semi-government portion of the Fund, we have held a bias towards the 10- to 12-year maturities, where spread curves have been steep due to a supply-demand mismatch for different tenors as issuers have preferred to term out their debt.

Australian Commonwealth Government Bonds (ACGB) have been actively traded. We squared up the Fund's curve flattening bias during February to mitigate losses. However, the Fund has maintained an overweight to the 4- to 6-year ACGBs, offset by an underweight to the wings. The belly of the curve has underperformed the 10 year segment on a beta-adjusted basis this month, with the ACGB forward gaps implying an aggressive hiking pace, which we think is unlikely to be realised in practice. The Fund has maintained an overweight to the ultra-long bonds given the steepness relative to global curves and attractiveness to foreign investors on a hedged yield basis.

The Fund's outperformance in credit security selection was contributed by a further compression in spreads of the higher-beta names, such as Brisbane Airport and Qantas, which saw their bonds rally 30 to 50bps across the curve. Over the month, the Fund participated in a primary deal from Triton 2021-1.

Sector rotation

The Fund has been positioned with an underweight to the semi-government sector, though the exposure has been held in the 10- to 12-year curve segment, which trades with a higher beta than the rest of the curve, meaning the Fund has been trading longer than it looks optically.

While the States' funding programs remain larger than ever, regulatory demand for high quality liquid asset (HQLA) paper, in conjunction with the Reserve Bank of Australia's (RBA) asset purchasing program, have allowed this material supply to be absorbed by markets with relative ease.

New South Wales released their mid-year update during February, revealing a \$6bn reduction to this year's borrowing task, to a new total of \$29.5bn. Moody's downgraded the Treasury Corporation of Victoria to Aa1, following on from the S&P downgrade 2 months prior.

Semi-government spreads to bond remained near record tights, and semi-government asset swap spread levels have entered negative territory in certain front-end tenors. As a result, we continue to view the yield pick-up in certain parts of the curve as insufficient to compensate for the relatively lower liquidity in the sector.

The Fund's credit positioning performed broadly in line with the benchmark in February. While the first half of the month was characterised by excess liquidity and the lack of secondary inventory, which resulted in further spread tightening, risk markets were spooked by the inflationary concern in the second half of the month which propelled bond yields substantially higher. While the Australian credit market was negatively impacted by the rise in real yields, it still ended the month slightly tighter. Some of the low-beta sectors, such as senior financials, communications and utilities, either traded sideways or edged slightly wider over the month, whereas higher-beta and COVID-impacted sectors continued to rally.

Duration

The Fund has held a similar amount of modified duration to its benchmark during February, though we have favoured an overweight to AUD versus USD duration, which has been expressed in the ultra-long end of the curve. As market expectations of the RBA shifted over the month, the domestic bond market became dysfunctional as investors stopped out of crowded carry trades. The relatively small size and larger proportion of offshore ownership of the Australian market contributed to this disfunction. Consequently, Australian yields underperformed global maturities across the curve, with this trade detracting from performance. However, this was also in part driven by the timing of month-end. Australian month-end levels are struck at the Sydney close, while US month-end levels are struck at the New York close, by which point yields were approximately 25bps lower given the extremely high levels of volatility on the day. This resulted in a wider implied AU-US spread for the month-end date, with a sizable reversal on the first day of March.

The Fund has been actively positioned across the curve. We have been underweight to the benchmark out to the 3-year maturity point, as the RBA's Yield Curve Control (YCC) policy, combined with surplus liquidity in the system, have anchored yields while eliminated the prospect for active return in this part of the curve. This has been offset by an overweight to the 4- to 6-year tenors, expressed in both ACGB and in forward-starting swap. As February progressed, the market began to price rate hikes into the end of 2022, with some now viewing the RBA's 3-year YCC target as more of a forecast than a pledge to keep rates on hold for 3 years. While the targeted 3-year bond, the 04/2024 ACGB, continued to hover around the 10bp target, subsequent bonds along the curve in the 4- to 5-year tenors steepened up sharply to cater for this shift in RBA expectations.

Forward-starting swaps in the belly of the curve were hit especially hard with the technical impact of YCC accentuating the impacting on forward curves. This, combined with heavy positioning in the trade for the roll dynamic, contributed to an extremely disorderly unwind across the market. The 4-year/2-year IRS yielded 2.0%, while the 3-year/2-year IRS ended at 1.65%. While this has negatively impacted portfolio performance in February, we believe that at current levels, belly swaps represent exceptional value and we continue to hold the position.

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The worst of COVID-19 is likely behind us, but the recovery could still be bumpy, with ups and downs as fiscal support programs eventually roll off, such as Jobkeeper in Australia. Following the global financial crisis, the eventual tightening of monetary policy was slower to commence and more gradual than initially anticipated by financial markets. We believe this time is no different. The RBA's eventual move away from the effective lower bound will likely be far more protracted than what markets are currently pricing into the mid-curve, with the levels seen at the end of February representing an opportunity going forward.

Market review

Australian bond market

Bond market volatility rose sharply in February. The month began with markets continuing to embrace the reflation theme. The vaccines rollout continued to progress, with hopes high for another US fiscal stimulus package. With the US Federal Reserve indicating that they were comfortable with the rise in yields reflecting an improving outlook, the sell-off in bonds intensified as investors reduced risk. In particular, the Australian market was at times disorderly as shortfalls in the RBA's Yield Curve Control (YCC) policy created market distortions.

At their February meeting, the RBA surprised markets by announcing that they would extend their bond buying program by an additional \$100bn at the conclusion of the current \$100bn programme. At the same time, they reiterated their expectation that rates would remain on hold for 3 years, though they did make a slight alteration to their language using calendar-based guidance rather than time-based guidance. The February Statement noted they would remain on hold until they achieve their inflation and employment targets, which they expect will be in 2024 at the earliest. RBA Governor Lowe also clarified in a Q&A that the guidance represents a forecast for policy rather than a pledge. Following these remarks and in light of reflation expectations globally, markets shrugged off this dovish sentiment from the RBA and continued to trade irrationally. The domestic rates markets began to question the Bank's commitment to YCC, pricing a hiking cycle beginning as early as late 2022. In response, the RBA increased bond purchases to defend their yield target at 10bp, with \$7bn of YCC bonds purchased in the last week of the month. This had the unintended consequence of dislocation in the 3- to 5-year part of the bond curve, with technical factors around the 3-year futures contract resulting in bonds beyond the April 2024 maturity rising sharply in yield.

Swap rates also rose, with a more aggravated squeeze higher in forward-starting swap rates due to relatively anchored cash rate expectations out to the 3-year segment, and a very steep rise in yields thereafter. This move became dysfunctional as many investors tried to stop out of the same trade at once, with the 4-year/2-year interest rate swap (IRS) hitting 2.0% by month-end from 1.27% just a month earlier, indicating an aggressive rate hiking cycle in 3 years' time at the expected conclusion of the current near-zero interest rate policy.

High Frequency strategies, which provide significant liquidity in stable markets, withdrew as volatility spiked. This drove a sharp decline in liquidity over the last week of the month. This exacerbated moves, with 20 to 30bps of intraday yield swings occurring into month-end due to the lack of accessible volume. Month-end closing levels were taken during this period of extreme intraday volatility, with markets dislocated in the 5-year part of the curve. Much of this dislocation was addressed the following day, with mid-curve yields retracing after the RBA demonstrated flexibility in doubling their scheduled asset purchases on the first day of March.

The Australian Office of Financial Management scaled back their weekly tenders, announcing just \$1bn of supply in the last week of February in response to the market ructions from their usual pace of \$2.5bn per week. They issued a total of \$9.5bn in nominal coupon bonds during the month.

The benchmark 3-year ACGB ended the month at 0.12%, almost unchanged in yield as a result of the RBA's YCC purchases. In contrast, the implied yield on the 3-year futures contract rose 19bps over February to close the month at 0.37%; as a basket of 3- to 4-year maturities, it was impacted by the dislocation in the mid-curve ACGBs. The curve steepened sharply over the month, with the implied yield on the 10-year futures contract closing 76bps higher at 1.91%. This put the 3-year/10-year curve at 155bps, a record in terms of historical steepness on a closing basis, though the RBA's anchoring of the on-the-run 3-year bonds has altered the dynamic around curve shape.

Global credit market

Risk assets rallied over February, but this clearly does not tell the full story of two distinct halves. The first half of the month was a continuation of previous themes – improving growth outlooks and a chase for yield drove risk assets higher against a backdrop of an orderly rise in bond yields. However, the second half of the month was characterised by a much sharper focus on these rising government bond yields as the acceleration in expectations for a fiscal package in the US, combined with the improving infection and vaccination trajectories, increased growth and inflation expectations. This caused yields to rise and yield curves to steepen – which in turn, has the potential to pressure other asset classes that have benefited from an influx of cash looking for income and capital appreciation.

Overall, the impact on credit spreads was modest, with investment grade (IG) spreads repricing 4bps wider. Even in the most volatile days, credit continued to trade in an orderly fashion. Regardless of the late sell-off, lower quality and 'laggard' sectors continued to outperform. CCC-rated credit, for example, finished the month 73bps tighter to just under a 550bp spread level, the tightest since 2018 and well inside levels that prevailed through 2019 to 2020. Single-A credit, which we have generally viewed as offering less upside, tightened by only 6bps, though this also left the spread of 69bps at the tightest level since early 2018.

Earnings season continued in the US and came near a close, with retail the only major sector still yet to materially report by month end. In aggregate, the results were stronger than expected on both earnings and revenues. Approximately 70% of the companies beat revenues expectations, and close to 80% beat earnings expectations, both above historical averages, and management teams continue to become more confident in their outlooks. This aligns with the overall theme of better economic growth and continued re-openings, though much of the expected good news have already been priced into credit spreads at or near historic lows.

European IG credit traded with a reasonably firm tone over the month, closing 4bps tighter to 89bps. The compression theme was most evident in the high yield space where European CCC credit closed 80bps tighter this month as demand for yield remained strong. Rates volatility certainly picked up in Europe, with bund yields rising 26bps to the highest level since March 2020. However, this did not have a material impact on credit. European Central Bank members have spoken out against this unwarranted rise in yields but have yet to take any action to address it.

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Sectors exposed to the re-openings theme outperformed, again including the airlines sector, with EasyJet closing 100 to 120bps tighter and Ryanair 50 to 60bps tighter, as the UK re-opening plan added further impetus to the sector.

Primary issuance came broadly in line with expectations at €50bn and was heavily skewed to senior financial issuance. Our involvement in the European primary market remains very selective at current levels, with a few opportunities such as the Deutsche Bank senior paper proving relatively attractive.

Australian credit market

The Australian credit market marginally rallied in February, though it ended the month with a softer tone. Excess liquidity and low sell-side inventory remained the dominant factors that helped drive further spread tightening in the first half of the month. The lack of primary supply in the first two weeks of February also contributed to the continued chase for bonds dynamic. However, sentiment turned in the second half of the month as reflation trades became the overriding theme that prompted a sell-off in broader risk markets, with Australian 3- and 10-year Treasury bond yields spiking 6bps and 78bps over the month, respectively. Given that the rise in yields was also partly driven by an increase in real rates, the market viewed this as tightening of financial conditions. This, coupled with a pick-up in primary market activity in the second half of February, quickly drove sell-side inventory of low-beta bonds to swell to levels that were not seen in months. As such, the broader credit market widened with thin liquidity in the final two weeks of the month. However, there was a divergence in performance across sectors. Low-beta sectors generally underperformed in February, while higher-beta and COVID-impacted sectors rallied further. Over the month, \$4bn of bonds were issued in the Australian primary market, with most of the issuance concentrated in financials.

Outlook

At our most recent Fixed Income Strategic Forum, we discussed the power of market narratives, which can seem at odds to actual fundamentals. Indeed, February bore witness to this exact situation. Fundamentals shift slowly and the noise around the current trend is large. Consistency around the vaccination rollout is yet to be seen among countries, a significant activity gap between the goods and services sectors persists for most countries, unemployment is sharply higher, and much of the fiscal actions to date has been to 'support' incomes rather than actual 'stimulus' to generate new activity. Despite this, the market narrative is embracing the re-opening of economies through 2021, as well as the expected big rebound in growth and possibly higher inflation. While we do expect a growth rebound in 2021 and strong cyclical inflation pressures through the coming quarters, our focus is on whether this recovery will lead to disappointment through 2022 as the huge structural headwinds gradually reassert. For fixed income investors, this debate manifests into a question: is this rise in yields a great buying opportunity or should investors be shedding duration into every rally?

Certainly, this rise in yields has been much quicker than expected. If the US Federal Reserve sticks with its new policy of targeting average inflation, then the steepening of yield curves makes sense as the economy recovers. However, if the recovery is to evolve from the 'animal spirits' generated by the re-openings, then income levels need to rise on a sustainable basis. Over the past year, governments have made significant transfer payments to boost income for workers and businesses impacted by the pandemic. In our opinion, this action staved off a worse economic outcome. The key to the recovery being sustained to generate higher inflation will be the labour market. As transfers taper, will job creations be quick enough to fill the employment gap opened during the pandemic? Structural dislocation has occurred in sectors such as retail, business travel and transport. It is unclear how jobs in these sectors will return, let alone the re-training needed to enable those workers to move to another sector.

This debate will not be settled next month. In fact, the cyclical forces are likely to be stronger in the coming months, implying that there is still upside risk to bond yields. But how high can bond yields go before their levels start to bite heavily indebted economies? We expect the disconnect between market narratives and fundamentals to persist for several months or even quarters. This implies a challenging investment climate particularly for fixed income, and our focus is to maintain discipline and recognise that opportunities will present themselves.

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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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