Macquarie Investment Management

Macquarie Australian Fixed Interest Fund

Monthly report – 30 April 2021

MACQUARIE

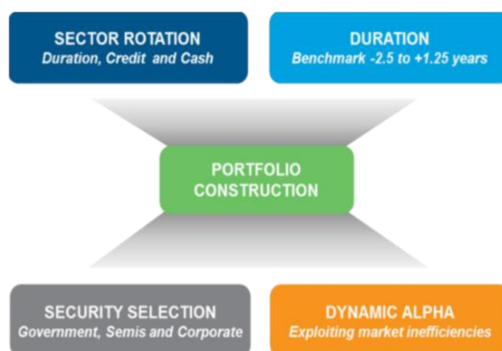
Investment objective

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	$251.8m
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 April 2021

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	0.64	0.60	0.56	0.04
3 months (%)	-2.20	-2.29	-2.26	-0.03
1 year (%)	-0.24	-0.69	-1.19	0.50
2 years (% pa)	3.33	2.85	2.54	0.31
3 years (% pa)	4.92	4.42	4.29	0.13
5 years (% pa)	4.20	3.68	3.52	0.16

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

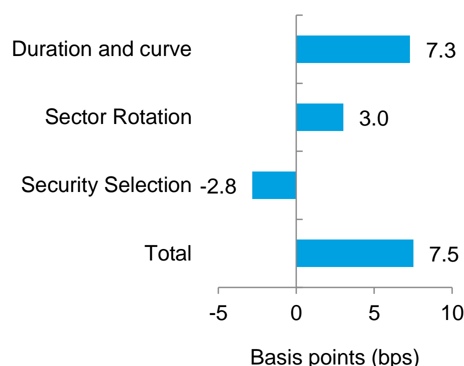
Asset allocation
(based on physical exposure)

	Fund (%)
Government	46.0
Corporate	26.2
Semi-government	19.4
Cash and equivalents	8.4

Fund statistics

Credit spread duration	1.0 years
Interest rate duration	5.9 years
Yield to maturity (% pa)	1.45%

Key contributors to performance



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Fund highlights

Some challenges continue to present in fixed income markets. Starting with the facts, during April US President Biden unveiled two infrastructure packages targeted at an additional $US4tn of stimulus, following hot on the heels of the third fiscal support package since the pandemic hit. In the US, as vaccine administration accelerates, new cases fall and pressure on hospitals eases, the process of re-opening the economy continues to be supported. Sentiment surveys rose, employment grew, and inflation jumped to 2.6%. Equities also surged to another new high and credit spreads tightened to pre-pandemic levels. Yet, bond yields were lower on the month.

Risk markets have been running on the growth recovery and the strength so far coming through in Q1 earnings. While bond yields marched higher through 4Q20 and 1Q21, reflecting the lifting of deflationary fears, price actions have suggested that inflation may not be as big a risk as many economists are suggesting. Central banks have dismissed the current and expected rise of inflation as transitory, citing deeps scars from the pandemic that are at work to add to the pre-existing structural downward pressures on inflation. Calming words echoed by most central banks have quelled, but not eliminated, the fears in bond markets that monetary stimulus can be tapered.

The Fund outperformed the benchmark this month, driven by duration and curve as well as sector rotation.

Duration and curve

The duration positioning over April has been similar to the benchmark, though this has been actively managed around supply events. We initiated a modest underweight ahead of the Australian Office of Financial Management (AOFM) syndication of a new November 2032 tenor, which was unwound into pricing of the deal. We also used the supply as an opportunity to enter a new long AU/short US spread position. We believe that AU yields can outperform the US on net supply differential and if inflation does appear, it should show up in the US first due to the fiscal spend.

The curve positioning favoured the belly of the curve, with the Fund maintaining an overweight to the 4-6 year tenors, offset by an underweight to the benchmark out to the 3 year point. Since November 2020 when the Reserve Bank of Australia (RBA) lowered the target for the yield on the 3 year Australian Commonwealth Government Bond (ACGB) to around 0.1%, yields have been anchored at the very front end of the curve, with limited prospect of active return.

This has been offset by the 4-6 year tenors where the market is pricing in a rate hiking cycle, which we do not believe can be achieved. Some are viewing the RBA's 3 year Yield Curve Control (YCC) target as more of a forecast than a pledge to keep rates on hold for 3 years, so whilst the targeted 3 year bond, the ACGB 04/2024, hovers around the 10bp target, the 4-5 year tenors along the curve have steepened to cater for the shift in RBA expectations.

Inflation remained low and below RBA's target, with the Q1 result undershooting expectations. The RBA is committed to maintaining highly supportive monetary conditions until actual inflation is sustainable within the 2-3% target range and they have indicated that for this to occur, wages growth will have to be materially higher than it is currently. We believe that the tightening cycle will be more gradual than the market is currently pricing into the belly of the curve.

Sector rotation

The Fund has been positioned underweight to the semi-government sector and favouring owning a larger holding in ACGB. The budget positions of both the Australian Commonwealth and state governments are improving, but semi-government spreads to bond have remained tight, with semi asset swap spread levels having entered negative territory out to the mid-curve.

State government issuance remained elevated relative to pre-pandemic levels, though most states have made good progress with their nominated tasks and started to pre-fund. Queensland Treasury Corporation issued a $2bn November 2024 floating-rate note and $2.9bn overall. New South Wales Treasury Corporation and Treasury Corporation of Victoria (TCV) both issued around $2bn in total, with TCV issuing a $1.6bn September 2033 benchmark line.

There is still material supply to come, though this will be largely offset by Basel III's regulatory-driven demand for high quality liquid assets (HQLA), combined with weekly semi-government purchases from the RBA. The Bank has been supportive of spreads and allowed supply to be absorbed by markets with relative ease. However, we 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 contributed positively to its outperformance relative to the benchmark, as the broader Australian credit market resumed the retracement of spreads in April following some widening in the previous month. Despite the busier-than-expected primary issuance calendar, which resulted in lighter flows in the secondary market, COVID-impacted sectors, such as retail REITs, airports and airlines, were again the major contributors to the outperformance of the Australian credit market.

Security selection

Within ACGBs, the Fund has been overweight to the belly versus the wings of the curve due to RBA pricing, with the RBA's YCC policy having anchored yields around the 3 year point before the curve steepened up sharply to reflect a hiking cycle in the 4-6 year tenors, which we believe is unlikely to be realised in practice. We have maintained an overweight to the ultra-long bonds given their steepness relative to global curves and attractiveness to foreign investors on a hedged yield basis.

We have taken profit on the paid 3 year EFP (exchange of futures for physicals) position after a material widening in swap spreads.

In the semi-government portion of the Fund, our security selection continued to hold a preference for the 10-12 year maturities. Spread curves remained steep due to a supply-demand mismatch for different tenors, with regulatory demand focussed on shorter maturities while issuers have preferred to term out their debt. The Fund has also owned a holding in the 2024 semi's, which have been trading at an attractive spread over ACGB due to the impact of YCC.

The Fund's credit security selection was broadly in line with the benchmark. In addition to the continuation of spread tightening in the Qantas and Brisbane Airport bonds, retail REITs such as Vicinity Centres and QIC Shopping Centres rallied 15-20bps across the curve over the

month. While the Fund benefited from these COVID-impacted names that continued to perform strongly as well as the broader Australian credit curve flattening, longer-dated subordinated major bank paper underperformed somewhat as the market has started to speculate a pick-up in supply in the near future. Though spreads of other subordinated financial paper and some of the shorter-dated subordinated major bank bonds marginally tightened in April. Over the month, the Fund participated in primary transactions from issuers including Groupe BPCE, Bank of Queensland, Firstmac 2021-2, Vermilion 2021-1 and Solaris 2021-1.

Market review

Australian bond market

Curves flattened over April from post-pandemic highs and yields began to stabilise, spending most of the month in a relatively narrow trading range. The implied yield on the 10 year Australian bond future ended the month 11.5bps lower at 1.70%, while moves in the front-end were much smaller with the yield on the 3 year futures contract only 2.5bps lower at 0.27%. The Australian Office of Financial Management (AOFM) was back in the market for its final syndicated deal of the financial year, with the states continuing to issue as well. There was more rationality about the economic exuberance on show earlier in the year and whilst local data remained strong, there was more circumspection in market pricing and less unbridled optimism.

Inflation remained low and below central bank targets, with the consumer price index (CPI) for Q1 undershooting expectations. The headline CPI result was only 0.6% QoQ and 1.1% YoY, and the trimmed mean result was 0.3% QoQ and 1.1% YoY. This was materially below the bottom of the Reserve Bank of Australia's (RBA) target band, and contributed to the modest rally in bonds over the month.

The labour market continued to show signs of post-pandemic improvement, with unemployment dropping to 5.6% at the latest release. Anecdotally, Seek, the leading Australian job search website, noted that they have the highest number of jobs online in their 23 years of history and the lowest number of people applying for each job ad since 2012. However, Australia's JobKeeper program expired at the end of March, with high frequency indicators such as the Australian Bureau of Statistics weekly payrolls and wages having softened in the first half of April.

The RBA kept rates on hold at 0.10% and maintained their quantitative easing (QE) program in April, noting that they will maintain this target until inflation is sustainably in the 2-3% range. The US Federal Reserve (Fed) continued their dovish tone, with members suggesting that policy will remain accommodative for some time and that they will be reactive rather than proactive when the time comes. The Bank of Canada reduced their weekly QE purchases from $4bn to $3bn as widely expected, though the amount of QE they were doing as a percentage of gross domestic product was much higher than the US.

The AOFM maintained a steady supply schedule through April. The AOFM syndicated a new Treasury Bond line maturing in November 2032, printing $14bn at the new line for 1.90%, which was met with good demand. They also continued their weekly tender issuance, with two twin issuances of $1.2bn and $0.8bn at the beginning and end of the month. The AOFM have advised that their Treasury Bond Issuance Program for 2020-21 is expected to be around $230bn, of which $194bn has been completed at a weekly rate of $2-3bn in most weeks. They are likely to provide estimates for the upcoming financial year, including potential new lines to be issued, after the Commonwealth budget release in May.

The budget balance is tracking $29.5bn ahead of its pro-rata forecast published in December and in a major shift in rhetoric and budget policy, Australian Treasurer Frydenberg indicated that government spending plans will be in line with aggressive monetary policy. In a speech, the Treasurer gave in the lead up to the Budget in May, suggesting that the government is happy to proceed with the budget deficit while abandoning any rush to post-pandemic austerity.

The month-end extension for the Ausbond Composite benchmark was a much larger-than-average 0.18 years, owing to the new syndicated 2032 bond in conjunction with the 5/2021 Australian Commonwealth Government Bond (ACGB) exiting the benchmark, though this had little impact on bond markets.

Global credit market

Risk assets reached new highs in April, as the market focussed on central banks that are looking beyond temporary increases in prices and determined to maintain an easing stance as well as governments that planned further fiscal initiatives. Though these moves were more modest in credit as most indices were starting to price little room for material upside.

Overall, US credit markets were slightly stronger in April with investment grade (IG) spreads finishing the month at 88bps, a post-COVID tight, with only modest intra-month volatility. Overall, fundamentals continued to improve, with strong revenue growth and cost controls put in place in 2020 helping to boost earnings, though this has been fully priced in. The technical backdrop also remained supportive – with relative stability in the government bond market, continued inflows into the asset class, and manageable issuance volumes in IG.

There was modest new issuance indigestion mid-month, with US banks issuing a large volume of new bonds. Benchmark 10 year spreads in high quality names, such as JP Morgan, were as much as 15bps wider mid-month, a significant move given the tight overall level of spreads. The high yield (HY) markets were even more focused on issuance, with US HY hosting $49bn of new bonds, putting the market on track for a record first half of 2021.

Down-in-quality continued to modestly outperform, with single-B and CCC credit 9bps tighter on average, BBB 4bps tighter, and single-A 2bps tighter, though clearly the pace of the rally in the lowest credit quality rungs has tapered off. In a similar vein, long-dated (10+ year maturity) names underperformed in April, after a very strong outperformance in the first quarter.

Investor flows remained supportive, which was a pleasant surprise given the negative total returns in IG credit in the first quarter, as these periods are often followed by outflows. US IG has received a total of over $80bn inflows year-to-date, which has provided a consistent backstop for demand. High yield has been more mixed with a total of over $8bn leaving the asset class this year so far, though April recorded an inflow of approximately $2.6bn.

The earnings season kicked off in the northern hemisphere and results so far have been strong and generally beating estimates on both sales and earnings. As of month-end, approximately 60% of the S&P 500 companies had reported, with almost 90% beating earnings expectations. A few key themes came through. Firstly, in financials, loan loss reserves were much smaller or were reversed in the quarter, along with healthy capital markets business, which drove strong results for most banks. Secondly, many companies have been seeing cost pressures from raw material inputs, and are raising prices or planning to do so to maintain margins. Thirdly, supply chain issues have remained a key factor for several industries, such as the automotive industry where semiconductor shortages are likely to last for the rest of the year, with production interruptions as a result.

European IG credit had another strong month as spreads inched tighter to close the month 6bps tighter at 84bps. The pace of vaccinations in Europe has picked up and a slow easing in restrictions is starting to come in core Europe, with the UK further ahead on this path. Supply underwhelmed at just €33bn, while demand remained robust with average revision from initial pricing of 24bps. IG gross issuance was down a quarter from 2020 levels and, in combination with central bank buying, helped to support tight valuations. Issuance came from a wide variety of sources this month with a few large multi-tranche deals. Coca-Cola issued an M&A financing deal, and US banks Morgan Stanley and Goldman Sachs also issued.

The theme of sectors with wider spreads outperforming continued this month. Lower-rated IG REITs were 20-50bps tighter and in particular, large cap retail REITs such as Unibail rallied 30-35bps. Underperforming sectors included tobacco (5-10bps wider) and some long-duration US names such as Verizon and Medtronic (~5bps wider). European HY closed 18bps tighter amid strong primary issuance, with spread performance largely in line across rating buckets.

Australian credit market

The Australian credit market slightly outperformed its global peers in April despite a rather busy month in the primary market. With focus mainly on primary supply in both the corporate and structured space, flows in the secondary market remained subdued. Notwithstanding the lighter flows seen during the month, the main driver of outperformance in Australia credit was again the COVID-impacted sectors, which included retail REITs, airports and airlines. While these sectors performed strongly and the credit curve generally flattened over the month, longer-dated subordinated major bank paper underperformed as the market has started to speculate a pick-up in supply in the near future. Though spreads of other subordinated financial paper and some of the shorter-dated subordinated major bank bonds marginally tightened in April. While new deals attracted healthy demand overall with the Bank of Queensland subordinated deal more than four times oversubscribed, there seemed to be some new issuance fatigue as the Australian IG market saw slightly over $5bn of primary issuance in April, with over $1bn of issuance coming from corporate issuers rated in the BBB band. Primary activity in the structured space was also buoyant with close to $7bn of residential mortgage-backed securities deals printed.

Outlook

Divergence has been a theme since the onset of the pandemic. The virus impact across countries as well as the vaccine rollouts have not been even. While monetary policy has broadly been consistent, the applications of fiscal policy has diverged, in terms of both the type of support and more importantly the application of direct stimulus. This is leading to different economic cycles across countries. Having all experienced a short sharp downturn, the upcycle has been led by China, with the US now in the spotlight and Europe expected to follow in coming quarters. However, many countries will likely have to wait until 2022 before restrictions can be eased as vaccinations rebuild confidence. In contrast, asset markets have traded to a consistent beat, with risk markets rallying, credit spreads narrowing and bond yields drifting higher. This apparent mismatch between fundamentals and asset valuations is a persistent discussion point amongst investors.

That said, ‘recovery’ continues to be the consensus theme. Though the more important question, ‘recovery to what?’, is hotly debated. The pre-pandemic trends in growth were uninspiring and underpinned by massive monetary support. Over the past year, central banks have done ‘even more’ given the pandemic. What is different is that fiscal policy, previously shackled by concerns about deficits and debt, has been unleashed. However, the fiscal responses have mostly been ‘support’ not ‘stimulus (i.e. direct spending), so deficits and debt levels have risen but with little growth multiplier. The US is now shifting strategy and the infrastructure plans fit into the ‘stimulus’ mode, which opens up the potential for stronger growth in the future. While the passing of the stimulus plans can take months, we can conclude that infrastructure spending is an investment on the supply side of the economy, which can lift growth trend and productivity without necessarily lifting inflation.

Most of this could already be ‘in the price’ or at least within the markets’ framework of understanding. This suggests that we could be in a period of consolidation until the outcomes become clear. This thinking, however, is at risk to any change in the technical forces within asset markets, change in positioning or seasonal factors such as ‘sell in May’. We therefore expect a somewhat more challenging investment climate to persist, where our intention 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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