Macquarie Investment Management

Macquarie Australian Fixed Interest Fund

Monthly report – 31 May 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	$255.7m
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.

SECTOR ROTATION
Duration, Credit and Cash
DURATION
Benchmark -2.5 to +1.25 years
PORTFOLIO CONSTRUCTION
SECURITY SELECTION
Government, Semis and Corporate
DYNAMIC ALPHA
Exploiting market inefficiencies

Fund performance to 31 May 2021

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	0.29	0.26	0.27	-0.01
3 months (%)	1.98	1.88	1.64	0.24
1 year (%)	-0.44	-0.88	-1.21	0.33
2 years (% pa)	2.58	2.11	1.81	0.30
3 years (% pa)	4.76	4.27	4.14	0.13
5 years (% pa)	3.96	3.45	3.32	0.13

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

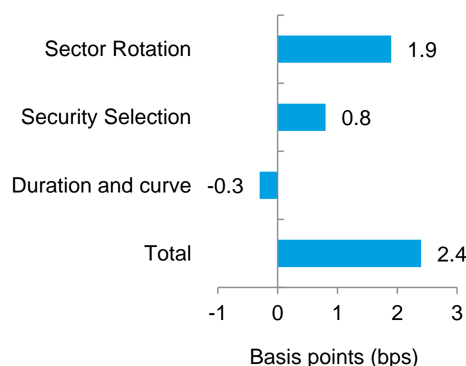
Asset allocation
(based on physical exposure)

	Fund (%)
Government	45.3
Corporate	26.2
Semi-government	19.8
Cash and equivalents	8.7

Fund statistics

Credit spread duration	0.9 years
Interest rate duration	5.8 years
Yield to maturity (% pa)	1.39%

Key contributors to performance



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Fund highlights

While society is discussing the evolving pandemic, vaccination rollouts and the re-opening of economies (or occasional lockdowns), fixed income investors are obsessing about inflation. During May, the data for April revealed that inflation was indeed rising, yet bond markets barely reacted. This was because the reasons behind the rise of inflation have been telegraphed. There are base effects, including the big declines in inflation at this time of 2020 now being reversed, logistical challenges as a result of supply chain disruption, and the impact of economic re-openings with a resultant surge in demand. It is also expected that these same forces will persist for the next few months. Over the past decade, fixed income markets have moved to fully embraced the theme of 'lower for longer', that is, persistently low interest rates. Therefore, inflation is a material threat to the current environment. We therefore expect the debate about inflation to rage for some time, which means that we are in a period of heightened sensitivity to inflation risk for fixed income markets.

While bond yields broadly moved within narrow ranges during May, this masked another theme – the lack of 'global synchronisation'. COVID-19 had an uneven impact across countries in 2020, which resulted in differentiated economic outcomes. The vaccine rollouts are also inconsistent across countries, which is expected to have a differentiated economic impact on countries through 2021. This can be observed microscopically in relative spreads. For example, US Treasury yields peaked at the end of March and have been grinding lower in subsequent months, while European yields posted their highs in late May. The relative spread moves are still modest because central banks globally have maintained a consistent 'dovish' approach to their policy, but as this evolves in the months ahead we suspect that spread volatility can increase.

The Fund slightly outperformed the benchmark this month on a pre-fee basis, driven by sector rotation and security selection.

Sector rotation

The Fund's sector positioning is underweight semi-government and overweight Australian Commonwealth Government Bonds (ACGBs). The semi-government spreads are tight with semi asset swap spread levels having entered negative territory out to the mid-curve, and it does not create an opportunity to get paid for the liquidity foregone relative to ACGBs.

The Reserve Bank of Australia's (RBA) weekly semi-government purchases have been supportive for 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. The RBA is to decide on whether to extend quantitative easing (QE) and yield curve control at their July meeting, and spreads should go a lot wider when QE eventually rolls off as the RBA has been the key buyer at current levels.

The Fund's credit positioning contributed positively to its outperformance relative to the benchmark as a number of higher-beta sectors, especially those impacted the most by the pandemic, continued to see spreads compress. This was particularly true for retail REITs and financial Tier 2 sectors. The Fund also benefited from the rally in bank subordinated notes following Westpac and NAB's issuance in the EUR and USD markets, respectively, as this eased concerns around the potential for imminent supply in the AUD market.

Security selection

In the ACGB portion of the Fund, we are overweight to the belly versus the wings of the curve due the RBA's yield curve control policy, together with the bond purchasing program. These policies have anchored yields at the front end of the curve whilst sharply steepening after that to reflect a rate hiking cycle, which we believe is unlikely to be realised in practice. We have also 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.

In the semi-government portion of the Fund, our security selection has continued to hold a preference for the 10-12 year maturities. Spread curves have 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 yield curve control.

The Fund's credit security selection was marginally positive, with financial subordinated notes being the main driver. In particular, the Westpac 01/2031 bond (callable in 01/2026) widened to BBSW+145bps before ending the month tighter at BBSW+129bps following the NAB and Westpac issuance in non-AUD markets. The COVID-impacted sectors, such as retail REITs and companies in some of the industrial sectors, continued to drive positive performance for the Fund. For instance, spreads of Vicinity Centres bonds compressed more than 20bps across the curve. During the month, the Fund trimmed positions in a number of lower-beta investment grade (IG) paper as spreads hovered around historic tights. Over the month, the Fund participated in primary transactions from issuers such as Barclays, HSBC and AFG 2021-1.

Duration and curve

The Fund's duration positioning over May was shifted following the Australian Federal Budget 2021-22, as we trimmed the size of our AU-US spread duration position. The Australian Government is continuing to spend more aggressively and abandon the rush to budget repair, and we believe this leads to a more positive growth outlook. We are underweight to duration expressed in USD as we expect that yields can move a little higher when the Federal Reserve starts to talk taper, though there is a limit to how far this can run.

The curve positioning has favoured the belly of the curve, with the Fund being overweight to the 4-6 year tenors, though offset by the underweight to the benchmark out to the 3 year point. Since November 2020 when the RBA lowered the target for the yield on the 3 year Australian Government bond to around 0.1%, yields have anchored at the very front end of the curve. The RBA's yield curve control policy, together with this bond purchasing program, has diminished the potential for active returns in this end of the curve.

This has been offset by the 4-6 year tenors where the market is pricing in a rate hiking cycle, which we believe is unlikely to be achieved at this stage. Some are viewing the RBA's 3 year yield curve control target as more of a forecast than a pledge to keep rates on hold for 3 years, so whilst the targeted 3 year bond has been trading below the 10bp target, the curve has been steep in the 4-5 year tenors to cater for the shift in RBA expectations.

Market review

Australian bond market

Yields in Australia and the US traded in tight trading ranges over May, drifting slightly lower over the month, though moving in-step and in a relatively similar pattern. The Australian Government released the Federal Budget for 2021/21 in the major event for the month. Market sentiment continued to be buoyed by the prospect of continued strong economic growth amid ultra-easy monetary and fiscal measures, but there was circumspection in market pricing and less unbridled optimism.

US Treasury and Australian Commonwealth Government Bond (ACGB) yields fell slightly lower over the month. The US 10 year yield traded as low as 1.46% after nonfarm payrolls before reaching highs of 1.70% later in May, while the Australian 10 year bond futures implied yield traded between 1.57% and 1.78%. Both regions ended the month with yields slightly lower; the Australian 10 year yield closed 6bps lower at 1.64% while the US 10 year rallied 3bps to 1.60%.

The Australian Government's Federal Budget 2021-22 was released where the Government's two-part 'COVID-19 Economic Recovery Plan' and 'Longer-Term Fiscal Sustainability' spending measures are set to offset the improvements in budget position. The Budget's 4-year forward horizon revenues and expenses have improved by a cumulative $121.8bn based on the Mid-Year Economic and Fiscal Outlook (MYEFO) in December on better-than-expected economic outcomes, but the government has decided to spend almost $87.7bn of this improvement. The 2020/21 deficit is now estimated to be lower at $161bn, or 7.8% of gross domestic product (GDP), and the 2021/22 deficit estimate is relatively unchanged at $106bn, or 5.0% of GDP. Post budget the Australian Office of Financial Management (AOFM) announced that gross debt issuance will be around $160bn in FY22.

The Reserve Bank of Australia (RBA) kept rates on hold at 0.10% and maintained their quantitative easing (QE) program over the month, confirming that they will maintain this target until inflation is sustainably in the 2-3% range. On the other hand, the Reserve Bank of New Zealand (RBNZ) took a more hawkish tone in this month's meeting, reintroducing Official Cash Rate (OCR) tracking, which shows rate hikes from mid-2022 and the OCR heading back to almost 2% by the end of 2024, as well as suggesting their asset purchases size was a limit, not a target, and they may not utilise the whole amount. The RBA signalled the Term Funding Facility roll-off at the end of June as expected and said they will make a decision whether to retain the April 2024 bond as the target bond for the 3-year yield target or to shift to the next maturity, the November 2024 bond. They will also make a decision in July regarding whether future bond purchases are needed following the completion in September of the $100bn QE2 program.

The AOFM maintained a steady supply schedule through May, continuing their weekly tender issuance of $2bn. They have completed around $198bn of their $210bn Treasury Bond Issuance Program for 2020-21. The Australian state-based treasury corporations of New South Wales, Queensland, Victoria and Western Australia issued a total of around $4bn, much of which was done via reverse inquiry, and the Treasury Corporation of Victoria budget was also released.

Global credit market

Risk markets grinded higher in May as the continued re-opening optimism, together with the supportive central banks and governments, outweighed the influences of history that generally sees May as a weaker month. This move higher was with less confidence though, as the narrative turned to when it might be appropriate to start reducing, or at least thinking about reducing, support.

US credit markets finished May mixed. Investment grade (IG) spreads tightened 4bps to 84bps, while US high yield (HY) spreads widened 5bps to 296bps. The tightening in IG spreads was driven by strong ongoing demand for high quality yield from both domestic and non-US issuers, and somewhat limited supply, resulting in the index spread hitting its tightest level since early 2007. Low volatility and somewhat lower yields in US Treasuries also supported the asset class, which is significantly exposed to long duration (with an average duration of over 8 years). The modest weakness in high yield, in contrast, was driven by larger-than-expected supply and modest indigestion as a result. Within HY, the lower-rated names continued to outperform, with CCC-rated issuers 8bps tighter compared to BB's.

The supply in US IG was $US130bn for the month, a healthy volume but overall 15% down compared to the last 4 years' May totals. In addition, the continued strong redemption activities (maturities, calls and bond buybacks) of $US57bn have kept new net supply more manageable and highlighted the theme of lower net supply that is expected to provide support for credit in the second half of 2021. Large issuers during the month included Amazon, which issued $US18.5bn in total across the curve, including a 10yr bond at +50bps. The company holds large cash positions and has no clear requirement for the debt, highlighting the opportunistic pricing levels available to high quality issuers in the IG market. Issuance in HY totalled $US46.5bn in May, a record for the month and leaving the sector on track for a likely record first half of the year in new bond volumes. Large issuers included wireless operator T-Mobile and payments company Square.

Corporate earnings wrapped up in May, with the tail end of the season continuing to produce very strong results. Overall, over 70% of issuers in the S&P 500 positively surprised on revenues, well above historical averages, and around 75% beat on earnings, marginally above average. The results generally indicated overall strong growth in revenues and earnings, as companies continue to rebound from the lockdowns last year. There was also significant evidence of inflation in input prices and continued pressure on some supply chains; continued improvement in bank asset quality; and continued strength from some of the beneficiaries of COVID lockdowns – such as home improvement stores – defying some predictions that the re-opening would be universally negative for these earlier winners. On inflation, many management teams cited increasing costs in commodities and other inputs, as well as the increased cost and difficulty in finding labour.

The moves were relatively benign in European IG, which traded largely sideways in just a 2bp range over the month. The yield curves did steepen, with the 10+ year index underperforming the 1-3 year by 6bps, primarily driven by movements in rates. HY moves were also benign, while relative performance between rating buckets was limited and underperformance was focussed more on longer duration issuers.

Primary issuance totalled €57bn in IG, skewed to financials with gross issuance 26% below 2020 levels year to date. Larger deals this month included issues from Tennet, American Towers and VW, however, the amount of multi-tranche non-financial issuance remained limited.

Secondary market performance was mixed but the re-opening trades in higher-beta IG tended to outperform. For example, EasyJet (BBB-) tightened 15-20bps and Rome Airport (BB+/Baa3) tightened 8-12bps. The underperformers were concentrated in long-duration (20-30 year) names, which closed as much as 10bps wider, and names such as Germain REIT Vonovia widened 8-10bps on M&A news.

Australian credit market

Australian IG credit spreads moved broadly sideways to marginally tighter, with the credit index finishing the month unchanged. A reasonable amount of maturities in May, coupled with a lighter month of supply, provided a positive technical backdrop for investors to absorb some sell-side inventory that have been built up over the past few months post the bond market sell-off earlier this year. While the COVID-impacted sectors continued to perform positively, some of the higher-rated university bonds benefited from a pick-up in demand in May for higher quality IG paper that were still trading above historical levels. For instance, the University of Wollongong 2028 bond, which was marked above ASW+90bps in February, rallied 15bps over the month to finish below ASW+70bps. There were more than $A7bn of financial maturities in May, with only $A1.7bn of issuance in the Australian market. This helped drive spreads of financial paper tighter, particularly in Tier 2 paper. Spreads initially started the month 7-8bps wider given the concerns around the potential for an imminent Tier 2 issuance in the market. However, this quickly dissipated after Westpac and National Australia Bank (NAB) decided to issue Tier 2 bonds in EUR and USD, respectively. As a result, financial Tier 2 spreads have re-tightened back to post-COVID tights. In the primary market, there was only around $A3bn of issuance in the Australian IG market, with $A1.7bn coming from financials. There were only three structured deals of note worth $A1.7bn in total in May.

Outlook

In the debate over the outlook for inflation, our research guides our thought process to separate the drivers of ‘cyclical’ from ‘structural’ factors. The structural factors driving inflation lower over the past decade are now well known: the rising level of government debt, aging demographics, digitalisation of the workforce, dependency of many corporates on low interest rates, and the trend towards de-globalisation. An interesting observation we have made in the past year is that many of these trends have actually worsened during the pandemic. Thus, currently the structural trends supporting ‘lower for longer’ remain very much intact.

Cyclical forces, by their nature, can be very strong but tend to be ‘transitory’ as most central bankers are describing. However, supply chain disruptions continue and many companies are reporting difficulties in re-hiring workers laid off during the pandemic. The fear amongst economists and fixed income markets is that these cyclical forces will become persistent.

At the Macquarie Fixed Income team’s latest Strategic Forum, we explored a key factor that could turn the tide on the low inflation environment, namely active fiscal policy. US President Biden’s twin infrastructure investment package provided substance to analysing this possibility, where we asked whether the spending package would be large, targeted and persistent enough to turn the tide of inflation? Our analysis assessed that it is indeed likely to be targeted and planned to be persistent, but may not be large enough – even in the size proposed. The risks are that politics can negotiate the actual spending amount to be much smaller than the President hoped. We therefore concluded that while fiscal spending may extend the transitory period of higher inflation, it is unlikely to be large enough to turn the structural forces that is needed to end the ‘lower for longer’ environment.

That said, with cyclical forces ‘in play” for a few months we are navigating a cautious path in terms of managing our duration positions, as well as our credit risk exposures. Overall, we expect a challenging investment climate to persist, 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

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