Macquarie Investment Management

Macquarie Australian Fixed Interest Fund

Monthly report – 31 October 2021

MACQUARIE

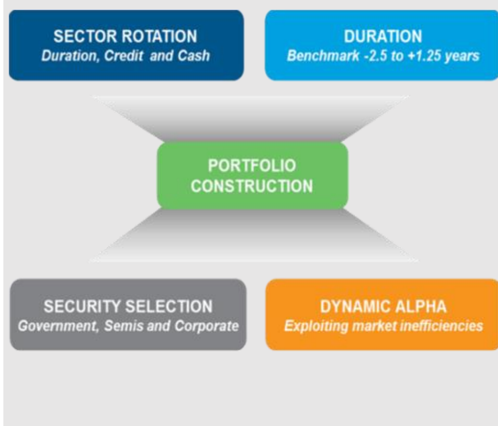
Investment objective

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	$270.1m
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.



Fund performance to 31 October 2021

	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-3.97	-4.00	-3.56	-0.44
3 months (%)	-5.16	-5.25	-4.93	-0.32
1 year (%)	-5.20	-5.58	-5.30	-0.28
2 years (% pa)	-0.28	-0.72	-0.76	0.04
3 years (% pa)	3.24	2.77	2.72	0.05
5 years (% pa)	3.08	2.60	2.58	0.02

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

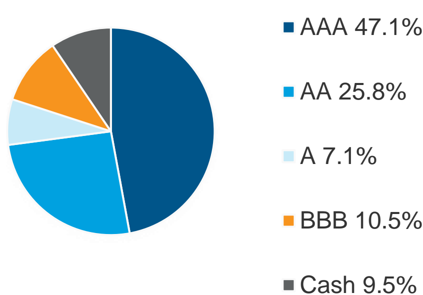
Asset allocation
(based on physical exposure)

	Fund (%)
Government	33.1
Credit	32.2
Semi-Government	25.2
Cash and Equivalents	9.5

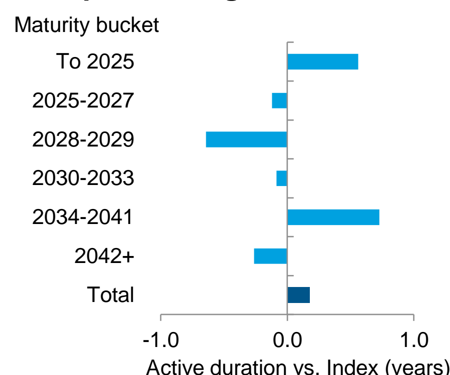
Fund statistics

Credit spread duration	1.0 years
Interest rate duration	5.9 years
Yield to maturity (% pa)	2.50%

Credit profile breakdown



Curve positioning breakdown



Fund highlights

The Fund underperformed the benchmark during the month, driven primarily by its duration and curve positioning amid the sharp moves in short-dated bonds in the Australian market.

Sector rotation

The Fund began the month with neutral positioning to semi-government bonds. During October we re-introduced a modest underweight to the sector, viewing performance as overdone following the announcement that the committed liquidity facility was winding down. Exchange Settlement balances are likely to remain high and also count as high quality liquid assets (HQLA), suggesting the balance sheets are unlikely to be an aggressive buyer unless spread levels are attractive. We still believe there is scope for spreads to drift wider as the RBA continue to taper.

The Fund's credit positioning contributed positively to performance in October despite a slight underperformance in Australian credit on the back of the outsized moves in the rates market in the last week of the month. Allocation to structured securities was a positive driver of performance over the month. Australian credit curve flattened with longer-dated high-beta corporate bonds outperforming. The Australian Prudential Regulation Authority's announcement last month to phase out the Committed Liquidity Facility program by the end of next year continued to have a lingering impact on senior financials and, consequently, led to some underperformance in the short to intermediate maturity part of the credit curve. Given the historical relationship, subordinated financial paper also drifted wider in sympathy.

Security selection

The Fund had previously favoured owning exposure in the front-end of the semi-government curve, which offered attractive carry over the equivalent Australian Commonwealth Government Bond (ACGB) maturities due to the impact of yield curve control. This positioning helped protect the Fund early in the October sell-off and following that we began reducing our exposure in front-end semis. We sold 3-year paper into front-end swap and extended slightly into the 3-year futures contract, which has a longer average maturity in the underlying basket. These derivatives should outperform vs physical securities as the RBA continue to taper their asset purchasing program.

Within ACGBs, the Fund remains overweight to the 20-year part of the curve. This positioning provided the Fund some protection during the aggressive curve flattening in late October. We continue to favour this positioning as the Australian curve remains steeper than global equivalents which is likely to attract offshore demand in the near-term. In addition, the tapering of quantitative easing should drive outperformance in the ultra-long end of the domestic curve as the RBA has only purchased sub 12-year tenors, driving a relative scarcity of these shorter tenors during the pandemic, which should now begin to reverse.

The Fund's credit security selection contributed positively over the month as performance of some of the COVID-impacted high-beta names, such as Qantas and Pacific National, rebounded after a couple of months of underperformance. The spread tightening over the past month has been pronounced in the Qantas bonds after the company announced the sale of surplus Mascot land, as Victoria and New South Wales eased COVID restrictions, and as the Queensland Premier proposed that border restrictions could be lifted by mid-December. The credit default swap protection initiated in July as well as higher-than-benchmark carry also provided a partial offset to the spread widening. Over the month, the Fund participated in primary transactions from issuers such as AFG 2021-2, GPT Wholesale Property Fund and APPF Commercial Finance.

Duration and curve

Following a drift higher in yields early in October, the Fund initiated an overweight to duration, though this was modest in size and expressed in the front-end of the curve, which we had expected to be a lower beta expression of our long bias. We had also been running an underweight to the 10-year part of the curve, offset by overweights in both the front-end and the ultra-long curve segments. Moves in the front-end became disorderly into the end of October with the curve flattening sharply after the RBA failed to defend their YCC target. As volatility rose, the traditional providers of liquidity in the domestic market withdrew, which led to even sharper moves as investors attempted to close out positions in very thin markets. Consequently, front-end positioning detracted from performance during the month, though the overweight to the ultra-long end of the curve mitigated these losses to an extent. Early into November, we have already seen some give-back to performance.

The Fund has favoured an overweight to AU versus US duration, which detracted this month as market dislocations centred around the domestic market. However, we continue to note that inflationary pressure in Australia is much lower than what is being experienced in the US, both currently, and historically over the last decade. The RBA have consistently undershot their inflation target and will need to wait for indications that current levels of inflation can be sustained before they can tighten policy. In addition, Australia has not undergone the same household deleveraging as the US since the GFC. This, combined with the fact that locally mortgages are either floating rate or short-term fixed, means that when the RBA does start to raise rates, it is likely to have a greater contractionary impact on the domestic economy than an equivalent rate rise in US. As such, we believe this move has been driven by flow, not fundamentals. We have maintained conviction in the trade and considered the widening as an opportunity to increase the size of the position, which we did in late October by paying US 2-year swap after the AU vs US 1y1y rate widened out to over +85bps, from an inverted spread at the beginning of the month.

Market review

Financial markets have witnessed the surge in supply-driven inflation for months but remained comforted by central banks consistently remaining relaxed, underpinned by an assessment that the inflation pulse was transitory. The rate hikes across many emerging countries, and even in New Zealand, were viewed as idiosyncratic and therefore did not rattle the market's confidence. However, much changed during the course of September. Specifically, the Bank of England announced its intention to raise rates in the near term. This was followed by a more aggressive tone from the Bank of Canada. The Reserve Bank of Australia (RBA) surprised by not defending the yield curve control purchases on the April 2024 bond. Finally, the stoically easy policy of the European Central Bank was put to the test and the defence put forward by President Lagarde was considered too weak. The net impact of this apparent shift in tone from global central banks brought forward the expectations for rate hikes, causing a significant rise in shorter maturity rates, but interestingly the moves on longer maturity

rates were contained and in fact 30 year yields ended lower in many countries. Thus, yield curve flattening was the major theme across bond markets during October.

Risk markets remained buoyant. Equities rallies and equity volatility fell. Credit spreads remained contained in narrow ranges and near historic tight spread levels.

Australian bond market

Bond market volatility rose sharply in October. The month began with markets embracing the idea that central banks are past peak monetary policy support. US Federal Reserve (Fed) Chair Powell signalled it was time to begin tapering but continued to sound balanced about the outlook, re-iterating that it was not time to hike rates as they still consider inflation risks to be transitory and driven by supply-side shocks. Other central banks took a more hawkish tilt. The Bank of England signalled they may need to hike in the near-term to avoid inflation expectations becoming entrenched, while the Bank of Canada ended their quantitative easing (QE) program and indicated they could start hiking by mid-2022. Closer to home, it was lift-off for the Reserve Bank of New Zealand with a 25bps hike and an upbeat accompanying statement.

As this theme was embraced offshore, locally the market began to test the RBA's 3-year yield curve control (YCC) target. The RBA re-introduced measures to discourage short-selling of the YCC bonds and later purchased $1bn of the Australian Commonwealth Government Bond (ACGB) April 2024 Bond. However, the Australian Q3 Consumer Price Index (CPI) released the following week was slightly stronger than the market expected at 0.7% QoQ and 2.1% YoY in the trimmed mean measure. This was the first time since 2015 that CPI was back within the RBA's target band. Markets took this as an opportunity to price an even more aggressive rate hiking cycle than forecast by the RBA, as evidenced through swap markets, and a further test of the RBA's commitment to YCC with the relevant yields trading 5 times above target on the morning of month end. The subsequent failure from the RBA to defend the target and effectively abandon policy before any public communications resulted in the 3-year bond yield closing at 0.77%.

The abandonment of the 3-year yield target drove heightened volatility across the Australian rates curve, but predominantly in the front-end, with moves becoming dysfunctional, especially into month end. This volatility shock saw market players who usually provide significant liquidity in stable markets withdraw, driving a sharp decline in liquidity in the lead-up to month-end. This further exacerbated moves as investors tried to exit positions when there was no market depth available, with 20-30bps intraday yield swings ensuing as a result. The implied yield on the 3-year futures contract broke above 1% and then kept going, ending the month 93bps higher at 1.40%. The curve flattened materially with 10-year yields 60bps higher on the month at 2.11%, with nearly half of that sell-off occurring on the very last day of the month.

Despite the sell-off being initially triggered by a globally led shift in sentiment around inflation and more hawkish central banks offshore, Australian rates materially underperformed other regions given the lack of liquidity and dysfunction in the market. The AU-US 10-year spread closed October at over 50bps, having begun the month around flat.

By the end of October, the market was pricing an RBA cash rate of over 1.25% from the current 0.1% against a central bank who re-iterated in November their central scenario is for rates to stay on hold until 2024. In the bank bill futures, the sell-off in the lead-up to month-end was the most aggressive since 1996. We believe this market pricing has been driven by a volatility shock in illiquid markets, exacerbated by uncertainty derived from an unannounced policy change at month end. Whilst we recognise the tone has shifted slightly and rate hikes may well be brought forward compared to RBA expectations, we consider market pricing to be aggressive and unlikely to be realised. Over the last decade, Australia's core inflation has undershot the RBA's target by more than any other developed market, excluding Japan. We believe the sustained inflation undershoot to date, combined with the high level of household debt in Australia, means the RBA will lag behind other central banks in hiking policy and be limited in the number of hikes they can deliver.

Even as the RBA ultimately abolished YCC policy at their meeting in early November, the market has already begun to stabilise since the end of the month, with sharp retracements in front-end rates. This was because their decision was eventually accompanied by clear and dovish messaging with Governor Lowe pushing back on market pricing of rate hikes and highlighting Australia's differences with regards to the inflation outlook.

Global credit market

October saw volatility return to global markets. Both risk assets and bonds moved in wider ranges, though with the exception of credit markets, which demonstrated very low volatility. Equities finished the month at the highs after major indices were down 5% during the month as bond yields, concentrated in the shorter maturities, sold off into month end.

US corporate credit was little changed over October. This stability defied meaningful volatility in other markets. High yield credit was similarly little changed at an index level. Amongst sectors and ratings, results were little differentiated, with the lowest rating band (CCC-rated credit) underperforming slightly, though the underperformance was more idiosyncratic. The US earnings season kicked off in October, and so far has been strong, with familiar themes. Performance of the financials sector has been exceptional from a credit perspective, with earnings growth and very strong asset quality. Most other sectors have also beaten earnings expectations on average, though only about half of the companies had reported by month-end. Cost pressures and labour difficulties continue to be the themes from management, but in general, companies have continued to be able to pass on costs to consumers and maintain margins.

The primary theme this month in Europe was a repricing of central banks rate hikes led by the UK, which also spread to Europe as the month progressed. Credit markets, while marginally wider in spreads, were relatively benign in terms of market moves. Investment grade (IG) credit supply totalled €40bn, largely in line with expectations. There was notable weakness in European sovereign spreads, with Italian spreads widening 22bps relative to German bunds. The main area of credit impacted was peripheral financials, which moved 10-20bps wider.

Australian credit market

Australian credit was marginally weaker as volatility in the bond market picked up substantially. The flow-on impact from the Australian Prudential Regulation Authority's announcement to phase out the Committed Liquidity Facility (CLF) continued, with the long-end of the

major bank yield curve widening out further by around 10bps over the month. Concerns in the bond market were further impacted by a better-than-expected Q3 inflation print, as it spooked the market to price in rate hikes as early as next year. The Reserve Bank of Australia failing to defend the 'yield curve control' bond purchases in the last week of October exacerbated the sell-off in bonds and a particularly bad close at month end. Thought the negative moves have been reversed somewhat in early November. In the primary market, there was less than $3bn of IG issuance. Nevertheless, it is worth noting that Bank of Queensland issued a 5-year senior unsecured transaction at the wides of its recent spread relative to major bank senior paper, adding pressure on both senior and subordinated financial spreads.

Outlook

The market repricing of short-term rate expectations and the change in tone by several central banks have unsettled the rate markets but, to date, these are being largely ignored by risk markets. Our sense is that the reaction across markets are not consistent, but the key test may not come until 2022 on whether central banks follow the markets lead and actually deliver tighter monetary policy.

Meanwhile, the macro fundamentals continue to fuel the debate over whether current inflation will prove transitory or structural. Commodity prices, particularly oil and gas, are re-fuelling the upside risk for inflation. Labour shortages and wage pressures are keeping central banks restless. However, growth during the third quarter was soft and in many cases the start of the fourth quarter remains soft. This mix of data has the stagflation debate raging across media, economists and market participants.

The core of the debate is around whether current inflation is being driven by supply chain problems or rising demand. In addition, the word 'transitory' was used to describe the inflation surge in 2021 without any clear definition of what transitory means. We sit firmly in the camp that the world continues to be driven by a unique event as a result of the pandemic and while this persists, so will the supply chain problems. Demand surge is largely the result of a redistribution of spending from services to goods, which was supported by unprecedented government transfers/support to displaced workers. The world is working together to move on from the pandemic and when this happens the supply chain problems too should be released, the problem is that we do not know when that will happen.

We fear that central banks could repeat the errors of the 1970s by using a demand tool to try and fix a supply driven problem that could simply make the situation worse. This means the current volatility spike could repeat in the months/quarters ahead as markets navigate this difficult fundamental path at the same time central banks are seemingly changing their tune (or not).

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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