MACQUARIE ASSET MANAGEMENT

Macquarie Income Opportunities Fund

Monthly report – 31 May 2022

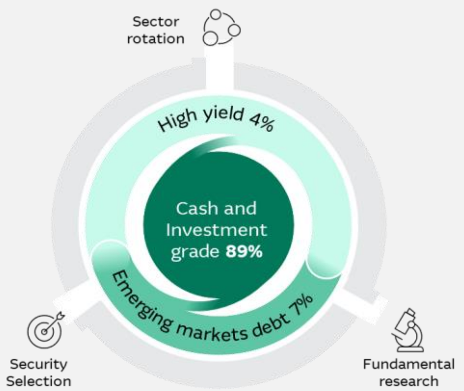
Investment objective

Aims to outperform the Bloomberg AusBond Bank Bill Index over the medium term (before fees). It aims to provide higher income returns than traditional cash investments at all stages of interest rate and economic cycles.

Key information

Fund details	
APIR code	MAQ0277AU
Inception date	18 September 2003
Fund size	$3,647.3m
Distribution frequency	Monthly
Management fee*	0.492% 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 May 2022

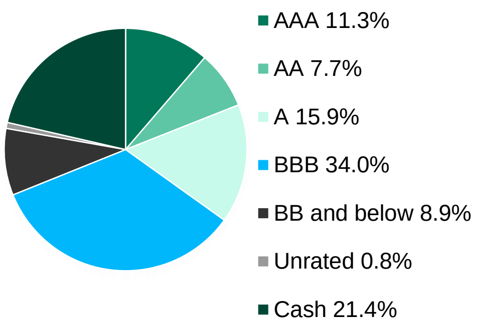
	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	-0.21	-0.25	0.03	-0.28
3 months (%)	-2.18	-2.30	0.02	-2.32
1 year (%)	-2.91	-3.39	0.05	-3.44
3 years (% pa)	0.71	0.22	0.36	-0.14
5 years (% pa)	1.73	1.23	0.97	0.26
10 years (% pa)	3.31	2.81	1.76	1.05
Since inception (% pa)	4.69	4.18	3.50	0.68

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.

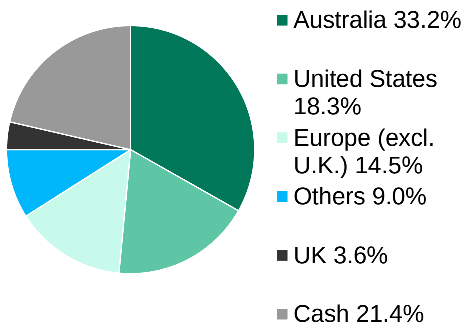
Credit profile breakdown



Average credit rating: A-

BB and below include direct holdings and residual exposure to issuers held through our investment grade and emerging markets allocation.

Region breakdown



Asset allocation

Sector	Market value %
Investment grade corporates^	47.3
Investment grade government*	0.2
Asset-backed securities	20.7
High yield corporates^	3.8
Emerging markets corporates	4.4
Emerging markets government^	2.2
Cash and equivalents	21.4

Asset-backed securities include but are not limited to residential mortgage backed securities, bank loans and other credit related securities.

^Fund holds (0.0%) in investment grade, (0.8%) in high yield and (0.1%) in emerging markets credit hedges as synthetic cash (reduction in percentage of physical cash exposure)

Fund statistics

Credit spread duration	2.6 years
Interest rate duration	1.4 years
Standard deviation[1]	1.9% pa
Yield to maturity[2]	4.6% pa
Cash	21.4%
Cash exposure through credit hedges[3]	0.9%

[1] Statistical measure of variance of Fund's post-fee monthly returns from average post-fee return since inception, used as gauge of volatility.

[2] Pre-fee returns Fund would earn over next year based on current market conditions if there were no changes to interest rates or holdings. It is not an actual or estimated return.

[3] Credit hedges swap the return for underlying credit index for cash.

Macquarie Income Opportunities Fund

Monthly report – 31 May 2022

Fund highlights

The Fund underperformed the benchmark during the month, with moves in both government bond markets and credit markets detracting. Government bond yields were wider over the month, despite a mid-month rally, as renewed hawkish rhetoric from central banks such as the Reserve Bank of New Zealand weighed on the Fund's positions in shorter maturity AUD bond holdings. Credit markets were volatile and ultimately finished mixed, with higher quality US denominated credit tighter, whilst other regions and lower credit quality securities were materially weaker. This reflects a continued lack of liquidity as well as uncertainty over the direction of global growth. Within the Fund's credit exposure, positions in a small number of European and higher beta US credit holdings were the main individual detractors, such as European toll roads and a hybrid security issued by US utility NextEra. Positive contributors included higher quality investment grade credit, and specific higher rated high yield issuers, such as Charter, a US cable operator.

The Fund remains positioned with significant liquidity, with cash and short-dated investment grade totalling over 40% of holdings, offering attractive possibilities to consider new opportunities in a sharply higher yield environment. For example, the Fund added holdings in A3/BBB+ rated coatings company PPG, and A3/A- Swiss bank UBS, both in new issue offshore. We consider these types of higher quality issuers offer attractive value (particularly with new issue concessions) and are well set up to perform despite the difficult market backdrop. Offsetting this, the Fund reduced exposure to some high yield issuers during the month, including Air Canada (which rebounded strongly after airlines sold off in March, post the invasion of Ukraine), and hybrids issued by Vodafone. We remained fundamentally comfortable with the issuers, but higher beta exposures are clearly more impacted by the market volatility and we view as appropriate to trim in periods of strength.

Market overview

Repeating the theme from last month, the upward pressure on inflation and increasing hawkishness by global central bankers has continued to be the main theme impacting fixed income markets. The second supply shock (following the first, which is the pandemic) from the invasion of Ukraine has been pushing inflation higher, with energy and food the key drivers. Central bankers continue to talk tough and deliver rate hikes or have signalled that a rate hike cycle will soon commence. This global pressure on interest rates have continued to pressure returns from fixed income portfolios.

That said, a new theme has also emerged, that is, risk for a recession as the global economy is facing strong headwinds from both inflation and policy. Consumer confidence surveys are very weak despite the robust position across labour markets. Thus, markets are weighing up the relative significance between strong lagging indicators (employment) with softening leading indicators (new orders). In the corporate world, the focus is on current strong earnings against signs of weaker guidance.

Asset market volatility is already reacting to this debate. Fears of weaker growth/recession hit risk markets and provide relief to sovereign bond yields, which is then followed by hopes for less central bank tightening, providing a bid for risk assets and returns the pressure on sovereign bond yields. This environment has just started, and this ebb and flow of market sentiment is likely to persist for months, or even quarters, and provide a volatile backdrop for all investors.

US credit spreads finished approximately unchanged at an overall index level for the month with the benchmark US investment grade (IG) index finishing 5bps tighter, to 130bps, but this traded to a wide of 149bps, marking a new YTD wide in credit spreads. There was also a significant decompression in spreads (with lower credit quality underperforming higher quality) – a first for the year. CCC spreads finished 100bps wider, while AA spreads were 8bps tighter, outperforming all other categories. Also, a slowdown in new issuance assisted the rebound. US earnings season wrapped up during the month, and the tone shifted to be more negative into the end of the reporting season. Retailers such as Target and Walmart in particular, showed significant weakness in margins as 'COVID-era' goods built up in inventory and prices had to be slashed. Consumer spending remains solid, but is clearly shifting away from home furnishings and similar products while services demand and sales of travel-related goods remained very strong. Overall, for the US large cap cohort, earnings surprises remained elevated (with 75% of companies beating expectation), but guidance has become increasingly mixed and focused on cost inputs, and earnings misses expectation have been significantly punished by markets.

European risk markets underperformed peers with IG closing 12bps wider to 162bps although did close 9bps off the wides as markets rebounded into month end. The backdrop this month in Europe was one of equity volatility, strong primary markets in credit with elevated concessions of 15-20bps becoming the norm and an increasingly hawkish central bank in light of elevated inflation levels. The European Central Bank quantitative easing programme is scheduled to end at end of June as will net corporate purchases.

Australian credit underperformed the US with spreads ending the month 8bps wider. The credit curve steepened further with the longer-part of the curve leaking wider. Major bank senior curve also moved wider with the 1-3 year part of the curve marginally underperforming the 5 year part of the curve which started to attract investor demand, particularly from offshore, when spreads broke above 100bps. Higher-beta financial subordinated bonds remained unloved over the month given the concerns around further supply with 5 year calls selling off close to 40bps.

Outlook

Economists continue to debate whether currently higher inflation is due to strong demand or a supply shock. Central banks share that same debate, but these institutions face a credibility problem, that is, inflation is still rising and is so far above their target. Rate hikes have been delivered and more will come. But the real question is: will the rate hikes work effectively to fix the problem? Central banks have tools to manage liquidity and the demand side of the economy. So, if inflation is (as we believe) largely a supply-driven problem then hiking rates is unlikely to resolve the core of the inflation problem. What higher rates will eventually do is slow aggregate demand. Meanwhile, when will the supply shock end?

We therefore see stagflation as the most likely description of the economic environment in the second half of 2022, where inflation remains sticky at higher levels while the demand side of the economy is slowing. Recession is a risk, but not a certainty. A ‘double supply shock’ could be enough to deliver a recession, but the household and corporate sector balance sheets imply a level of resilience to the headwinds. This puts central bank tightening in the crosshair of focus, where policy makers target a soft landing for the economy, but markets fear that high inflation will cause over-tightening and therefore recession in 2023.

The economic and policy environment facing asset markets is challenging. We should expect periodic spikes in volatility to continue in the months and quarters ahead. As investors we are sailing in rough seas and into the wind and therefore must keep the sails trim and be alert and flexible.

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