MACQUARIE ASSET MANAGEMENT

MACQUARIE

Macquarie Income Opportunities Fund

Monthly report – 31 July 2022

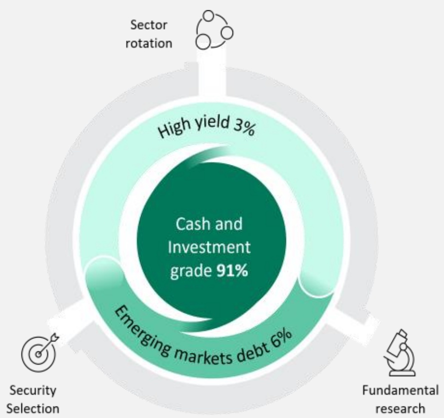
Investment objective

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	$3,603.7m
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 July 2022

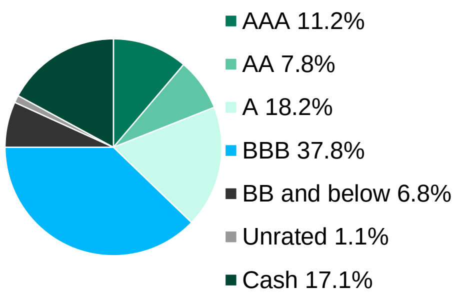
	Total Fund return (gross)	Total Fund return (net)	Benchmark return	Total excess return (net)
1 month (%)	1.52	1.48	0.12	1.36
3 months (%)	-0.36	-0.48	0.21	-0.69
1 year (%)	-3.58	-4.06	0.22	-4.28
3 years (% pa)	0.26	-0.23	0.33	-0.56
5 years (% pa)	1.52	1.03	0.94	0.09
10 years (% pa)	3.16	2.66	1.72	0.94
Since inception (% pa)	4.64	4.13	3.47	0.66

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.

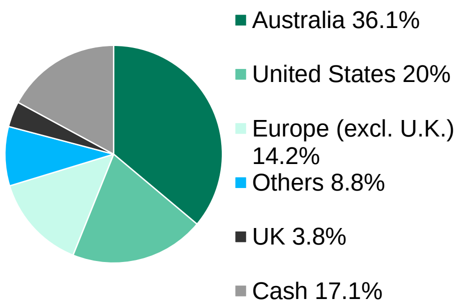
Credit profile breakdown



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^	53.6
Investment grade government*	0.2
Asset-backed securities	19.5
High yield corporates^	3.3
Emerging market corporate	4.4
Emerging market government^	1.9
Cash and equivalents	17.1

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 (0.0%) in emerging markets credit hedges as synthetic cash (reduction in percentage of physical cash exposure).

Fund statistics

Credit spread duration	2.8 years
Interest rate duration	1.7 years
Standard deviation^	2.0% pa
Yield to maturity*	4.9% pa
Cash	17.1%
Cash exposure through credit hedges+	0.8%

^Statistical measure of variance of Fund's post-fee monthly returns from its average post-fee return since inception used as gauge of volatility.

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

+Credit hedges swap the return for underlying credit index for cash.

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Monthly report – 31 July 2022

Fund highlights

The Fund outperformed the benchmark over July, with approximately equal contributions from both interest rate duration and credit positioning. Most developed credit markets regained a portion of their losses from June during the month, and wider spreads offered more attractive entry points to add to exposures. Amongst credit sectors, investment grade credit was the largest positive contributor, closely followed by high yield. Emerging markets was also a positive contributor, though smaller, given the rebound in these markets lagged developed market credit. Duration positioning added value, led by Australian rates positioning, with CAD and USD duration also contributing. Among individual performers, a newly added National Australia Bank subordinated bond was a strong contributor, as were European infrastructure issuers such as toll roads.

The Fund remains positioned with significant liquidity, with cash and short-dated investment grade credit totaling over 40% of holdings, offering meaningful possibilities to begin to look at opportunities in a sharply higher yield environment. During the month, the Fund added exposures to investment grade credit in the US and Australia, reflecting attractive spread levels even given the volatile and difficult market backdrop. Additions included a new National Australia Bank subordinated bond, which priced at the widest spread level for a new AUD issue since 2016, as well as US financials and US industrials, such as refiner Valero. The Fund also added approximately 0.5 years of interest rate duration during the first half of the month, similarly viewing bond yields as attractive and offering a hedge against growing global growth fears. Both of these additions helped add to returns over the period.

Market overview

Central banks continued to deliver rate hikes through July as inflation has continued to make new highs in many countries. The focus was increasingly on growth risks and asset markets paid particular note to sentiment surveys where the significant concerns being expressed by consumers were increasingly being reflected by businesses. This environment is called stagflation and it does not happen very often, where growth is slowing below trend and inflation remains well above trend. While the ‘flation’ component of ‘stagflation’ dominated the first half of this year, in July the ‘stag’ component has taken a prominent role in the mind of asset markets. The delivery of a US ‘technical recession’ with a second quarter of negative growth ignited a strong rally in government bond yields, though risk markets also rallied on the belief that the path is now set for central banks to cut rates in 2023. Interestingly, despite central banks raising rates aggressively over the month, the positive moves within asset markets actually eased financial conditions.

Global risk markets rebounded in July as back-end yields rallied on early signs that the front loading of rate hikes may quell demand quicker than central banks expect, though global inflation measures did not let up. This positive sentiment was reinforced with the earnings season absent any widespread negative surprises, alongside an appreciation by market participants of ‘value’ in risk markets starting to present itself.

In the US, the investment grade credit index tightened by 11 basis points (to 1.44%) and high yield tightened by 100 basis points (to 4.69%), recovering about half of June's losses. High yield credit did relatively better compared to investment grade, partly reflecting the more significant sell-off in that market in the prior month. Interestingly, there was limited differentiation within each market by sector or by ratings. For example, AA, single-A and BBB rated credits all tightened on average by about the same amount over the month, unusual in a market rebound. The earnings season continued, with results mostly good enough to dispel concerns of corporate stress in the immediate term. There were some disappointments, with broadband subscriber numbers stagnating and impacting cable issuers, and name-specific weakness impacting some healthcare issuers, for example. New issuance volumes were solid in investment grade, with double-digit concessions on average, but high yield issuance remained very light. On top of that, outflows from the investment grade market continued, whereas the high yield market turned around in late July to record a large inflow.

European investment grade credit outperformed peers, rallying 31 basis points in July following material underperformance in June. Several factors played into the rebound: the starting point of spreads was wide; the new European Central Bank tool (Transmission Protection Instrument) was well received by markets and the inclusion of credit securities in the eligible assets was a pleasant surprise; Nord Stream 1 flows resumed albeit at low levels; and global markets embraced risk assets. The technical side of cash credit markets also provided some support with supply very light. Investment grade fund flows turned to mild inflows from persistent outflows as bund yields rallied approx. 50 basis points and we have seen a slight uptick in corporate tenders. Performance across ratings in investment grade credit was reasonably uniform with lower-rated credit eventually gathering momentum into month end. Credit curves overall flattened as investors sought to extend duration at wider spread levels.

Australian credit underperformed its global peers in July, with credit index spread moving only 5 basis points tighter, mostly driven by retracement of swap spreads. Major bank senior spreads traded with high level of conviction as spreads tightened anywhere between 3-5 basis points across the curve, with front-end paper outperforming as the sell-side broker inventory was depleted quickly throughout the month. Otherwise, most of the other sectors traded with a heavy tone throughout most of the month. In particular, bank subordinated notes drifted materially wider for the better part of the month as investors braced for potential supply. This supply eventuated in the National Australia Bank’s recent ‘10NC5’ (10 year maturity, callable in 5 years) deal which was issued at a spread to 3-month bank bill yield of 280 basis points, the widest print since 2016 by any of the Australian major banks. The National Australia Bank subordinated 10NC5 spreads have since pulled tighter over the month. Elsewhere, corporate paper generally traded without much vigour over the month, with spreads edging marginally wider as there was very little issuance to provide any pricing clarity in the corporate sector. Structured securities were marked wider in spreads again as a number of non-ADI (authorised deposit-taking institution) issuers came to the mark with non-conforming deals printing at wider spread levels. Over the month, primary issuance picked up to $A7.8bn in the investment grade market, with all the deals concentrated in the banking sector except for one $A300m deal from John Deere.

Outlook

‘Stagflation’ is increasingly being used to describe the current macroeconomic environment. We have been warning of stagflation all year, and the market narrative is now evolving towards recession. We have stated that recession is indeed a risk but was not a certainty, the key lies with how central banks conduct monetary policy. The US Federal Reserve believes at a 2.5% rate that policy is neutral, however, they are signalling that policy rates need to go higher in order to bring inflation back to the target of 2% on average. Although this is a challenge, as the Federal Reserve’s own forecasts show rates rising to 3.75% during 2023 before falling modestly in 2024. In contrast, the market’s discount for the Federal Reserve policy has rates peaking at around 3.30% in 2022 and falling to around 2.75% in 2023. This reveals a significant mismatch, which is likely to result in further asset volatility.

With leading indicators already signalling that the economy is slowing, a Federal Reserve focused on inflation and rates hikes is very likely to lead to a recession becoming reality. Central banks are in a tough position, as even though the double supply shocks (from the pandemic and then the Ukraine war) are largely responsible for inflation ramping higher, it is their mandate to bring it back towards target. The problem is that the supply situation needs to repair to ease many of the inflation pressures (e.g., gas). Hiking rates will dampen demand and using this tool to lower inflation means that demand will have to fall lower, probably into recession to even partly achieve their goal. Markets see a benevolent environment yet that is delicately and correctly managed by policy makers. We see the risks around this benevolent assumption as significant, particularly for risk markets.

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