

Macquarie Master Enhanced Fixed Interest Fund

Quarterly report – 30 June 2022

Investment objective

Aims to outperform the Bloomberg AusBond Composite 0+ Yr Index over the medium term (before fees). It aims to provide regular income and a moderate level of growth.

Key information

Fund details

APIR code	MAQ0180AU
Inception date	17 May 2000
Fund size	\$11.5m
Distribution frequency	Quarterly
Management fee*	0.290% pa
Minimum investment (Direct)	\$100,000
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 June 2022

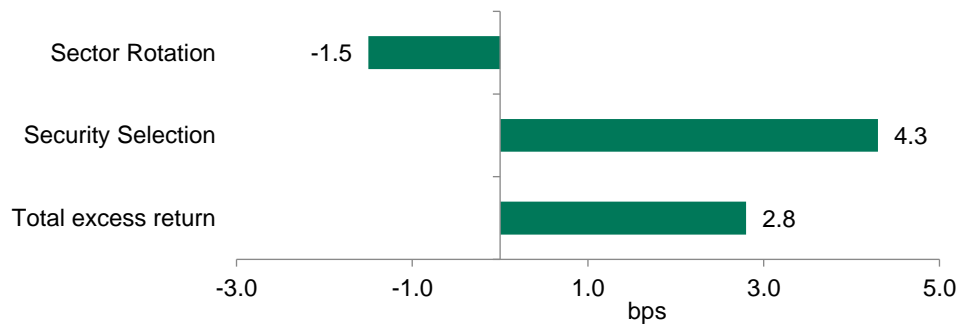
	Total Fund return (gross)	Benchmark return	Total excess return (gross)	Total Fund return (net)*
3 months (%)	-3.78	-3.81	0.03	-3.85
1 year (%)	-10.33	-10.51	0.18	-10.59
2 years (%)	-5.59	-5.80	0.21	-5.86
3 years (% pa)	-2.32	-2.58	0.26	-2.61
5 years (% pa)	1.13	0.87	0.26	0.84

Past performance is not a reliable indicator of future performance.

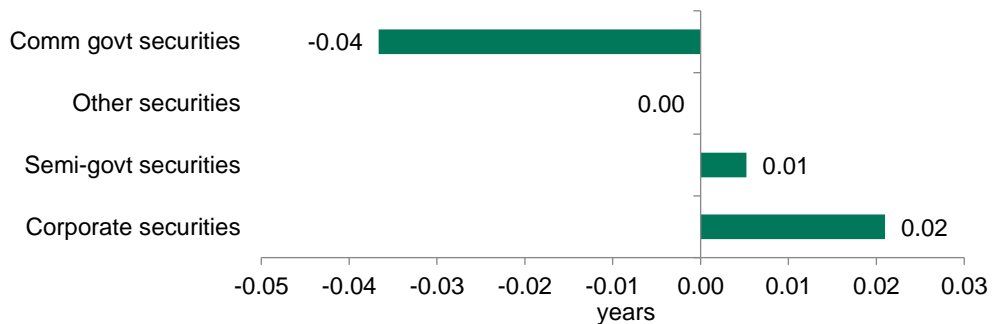
Total returns are calculated based on changes in net asset values and assumes the reinvestment of distributions. The Fund is benchmarked against the Bloomberg AusBond Composite 0+.

*Total net returns are quoted after the deduction of all fees and expenses. Due to individual circumstances, your net returns may differ from the net returns quoted above.

Key contributors to quarterly performance



Relative duration positioning vs. Index



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Fund highlights

The Portfolio outperformed the benchmark this quarter, driven by security selection.

Sector rotation

The Portfolio began the quarter with an underweight position to the semi sector. However, as the quarter progressed spreads widened materially given the sharp move in swap spreads, which has left semi-governments at multi-year wides to Australian Commonwealth Government Bonds. The Portfolio has gradually increased its exposure to semi-government bonds as levels became more attractive over the quarter. The outlook is more balanced going forward; while supply is expected to remain elevated, the balance sheets have large high quality liquid asset requirements and are expected to continue taking down a significant proportion of issuance. Moves in semi-government bonds going forward will likely continue to be dictated by swap, with asset swap spread levels needing to remain sufficiently attractive for the balance sheets to buy.

The Portfolio's credit positioning performed broadly in line with the benchmark despite the widening in investment grade credit spreads over the quarter.

Security selection

The Portfolio is overweight derivatives versus physical securities both in swap and futures. We expected physical security valuations to revert back to trading 'cheap' to futures as net supply increases following the end of the Reserve Bank of Australia's quantitative easing, but collateral shortages remain in the front-end and physical securities have continued to trade 'rich' to futures for longer than we expected. We have sold expensive 3 year basket bonds back into the equivalent futures maturity and taken micro relative value opportunities in semi-government securities as volatility in markets increased the incidence of mispricings on the curve.

Within Australian Commonwealth Government Bonds, we went underweight to the ultra-long end following the persistent flattening in the curve, with the 10s30s curve virtually flat and the 20s30s curve inverted. The Australian ultra-long maturity bonds no longer look attractive relative to offshore, and the Australian Office of Financial Management (AOFM) has issued regularly into any demand in the 30 year bond and extend out the maturity curve which we think limits scope for further performance. At their recent update, the AOFM ditched plans to issue a new 20 year bond due to lack of demand, but flagged the possibility of a new 30 year to extend out the curve, demand permitting.

Within semi-government bonds the underweight to New South Wales Treasury Corporation added value as spreads widened versus other issuers following the NSW Budget update, which saw projected issuance higher than expected. Western Australian Treasury Corporation was upgraded to AAA by S&P late in the quarter but there was limited impact on spreads with the stronger economic outlook already fully priced by markets.

The Portfolio's credit security selection performed broadly in line with the benchmark. While senior financial paper has held in relatively well despite the market volatility, subordinated debt has underperformed the broader market. Higher-beta corporate bonds have held in relatively well over the last few months, as higher all-in yields and historically wide spreads have attracted local and offshore interest. Residential mortgage-backed security (RMBS) spreads continued their move wider as high levels supply continued into the second quarter. The Portfolio continued to benefit from the higher-than-benchmark carry over the quarter.

Market overview

Inflation is the 'problem' facing central bankers and their action during the second quarter illustrated their commitment to bringing inflation back down to target ranges. Globally, central bank target rates rose throughout the quarter, though the Bank of Japan stands in contrast by remaining committed to its yield curve control target. Whilst inflation and central bank action remain dominant themes, for asset markets there has been a rapidly emerging concern that this combination will push economies into recession in 2023. Economic data released during the quarter has begun to suggest that growth is already slowing. With inflation being underpinned by a second supply shock stemming from the war in Ukraine, asset markets fear central bankers are heading for a policy mistake by over-tightening. We have already seen consumer confidence drop lower to well below average levels, and parts of the housing market have begun to turn. There have been some tentative signs, in spending data too, of some softening demand, and this is a difficult investment climate where volatility will continue.

Australian bond market

Yields rose as upward pressure on inflation and the increasing hawkishness of global central banks played out in the global economy amongst another significant broad supply-shock, with the Russia-Ukraine conflict disrupting key energy and food supply chains. Globally, central banks increased their urgency to tame inflation. The US Federal Reserve, Bank of Canada, Bank of England, Reserve Bank of Australia and Reserve Bank of New Zealand all delivered outsized interest rate hikes and committed to bringing inflation down to target ranges. Global data began to show hints of weakness and central bank speakers acknowledged the risk of delivering not a 'soft' but 'hard landing,' with the possibility of recession from policy over-tightening. Signs of China's reopening and easing of restrictions provided some support to the global backdrop, but this positive sentiment was offset by weak activity and consumption data amid ongoing supply chain issues.

Australia's Q1 headline consumer price index came in at 2.1% quarter-on-quarter and 5.1% year-on-year and the trimmed mean 1.4% quarter-on-quarter and 3.7% year-on-year. The strong retail spending sits at odds with the weak consumer sentiment where there is a divergence between retail sales rising 0.9% (driven by both price and volume increases) and consumer confidence falling 5.6%, a reflection of the wider volatile ebb and flow of market sentiment. The Australian Federal Election delivered a new Labor Government under Anthony Albanese in May and this may deliver different ACGB-semi government supply mix going forward, with Labor governments traditionally more fiscally expansive. The Australian Office of Financial Management (AOFM) issued \$A11.5bn in tender issuance in Q2 and a \$15bn syndication, taking the financial year total to \$A96bn as higher-than-forecasted commodity prices reduced issuance needs. The State Governments have had significant funding tasks, with significant supply still to come and the FY23 funding programs totalling \$A75bn, with NSWTC and TCV making up the majority of supply.

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Global credit market

Risk-off sentiment carried into the June quarter as central banks continued to remain hawkish with several central banks hiking policy rates aggressively amid persistent inflationary pressures. The ongoing war between Ukraine and Russia, zero-COVID policy in China and shortage of labour supply contributed to further price increase in goods and services over the quarter, and this posed further stress on supply and led to higher input costs. This prompted the market to start pricing in a higher risk of recession.

US credit widened substantially to year-to-date wides over the quarter as US investment grade credit had the worst first half of a year on record – second only to the extreme moves around the 2020 pandemic. Evidence of decompression in spreads, where weaker credits underperform, began to emerge in the June quarter as high yield credit spreads widened 288bps, outpacing the 65bps of spread move in investment grade. The tone of the US earnings season for the March quarter shifted to be more negative into the end of the reporting season as a number of retailers cited significant weakness in margins given the build-up in inventory during the COVID period.

European credit significantly underperformed its global peers, closing the quarter at 217bps which is only 30bps away from the March 2020 wides as the ending of net purchases of corporate bonds through the Corporate Sector Purchase Program coincided with the highest volatility in the credit market since March 2020. A hawkish European Central Bank led to significant underperformance in real estate investment trusts (REIT) which has now traded through the March 2020 wides as the sector is suffering from higher funding rates, weak technical, asset valuation concerns and single name issues in the sector. Cyclical sectors such as airlines widened over 200bps over the quarter given high oil prices.

Australian credit market

Australian credit also performed poorly as the Reserve Bank of Australia also embarked on an aggressive hiking cycle. Despite the lack of corporate issuance, the credit curve steepened over the quarter as longer-dated BBB corporates underperformed. Major bank senior paper did widen but they did so in an order manner. Meanwhile, higher-beta subordinated bank paper underperformed substantially given concerns around supply and the general risk-off environment.

Outlook

Our outlook for the economy is that the global economy has entered a stagflationary environment, where inflation remains well-above target but growth slows significantly. Recession is a risk, but not a certainty, for 2023 as we have experienced twin supply-shocks to the global economy and central bankers have the potential to deliver policy overtightening with aggressive rate hikes. Central banks are attempting to solve inflation problems, which are largely a result of supply chain issues, by restricting demand, yet these demand management tools will not directly impact the source of the inflation problem. Rate hikes will weaken demand and the prospect is that a sharp downshift in demand will be needed to match reduced supply levels so as to lower inflation. This points to a difficult environment where there is scope for higher yields and flatter curves amongst the volatility and momentum but also one that will ultimately see a bid return to rates and duration.

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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 macquarieim.com

Important information

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