

Macquarie Master Enhanced Fixed Interest Fund

Quarterly report – 30 September 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	\$10.8m
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 September 2022

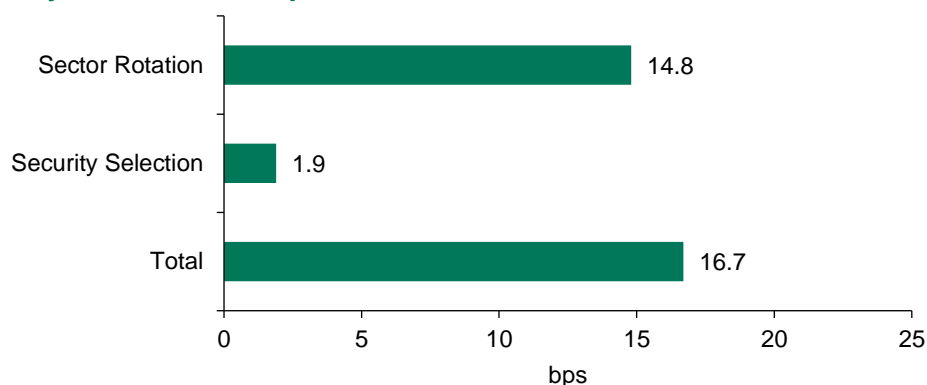
	Total Fund return (gross)	Benchmark return	Total excess return (gross)	Total Fund return (net)*
3 months (%)	-0.48	-0.64	0.17	-0.55
1 year (%)	-11.12	-11.36	0.24	-11.38
2 years (% pa)	-6.35	-6.58	0.23	-6.63
3 years (% pa)	-3.14	-3.42	0.28	-3.42
5 years (% pa)	1.04	0.75	0.29	0.75

Past performance is not a reliable indicator of future performance.

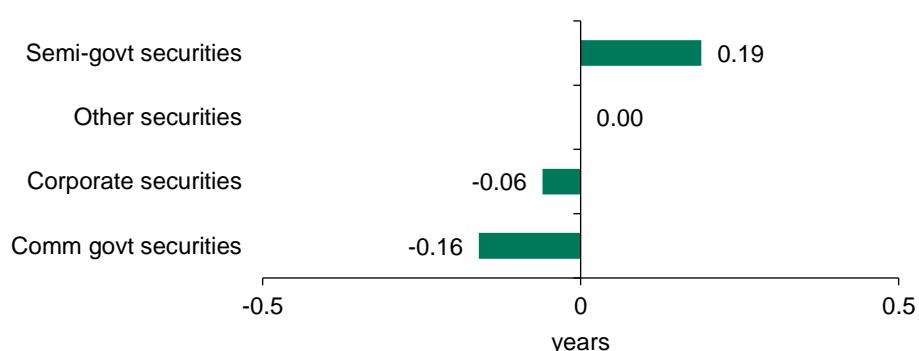
Total returns are calculated based on changes in net asset values and assumes the reinvestment of distributions. The Fund is benchmarked against the Bloomberg AusBond Composite 0+.

*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 performance



Relative duration positioning vs. Index



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Fund highlights

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

Sector rotation

The Portfolio increased its overweight to the semi-government sector over the quarter given the attractive excess yield on offer versus Australian Commonwealth Government Bonds. Our exposure is concentrated in the 10 year part of the yield curve given the steepness of curve spreads, and recent swap spread widening allowed an attractive entry point. The State Governments have had significant funding tasks, with significant supply still to come and the FY23 funding programs totalling \$A75 bn, with New South Wales Treasury Corporation and Treasury Corporation of Victoria making up the lion's share of supply. The outlook is more balanced going forward however and we are cognisant that balance sheets have large high quality liquid assets requirements and will take down a significant proportion of this.

The Portfolio's credit positioning performed broadly in line with the benchmark as credit spreads retraced their June wides.

Security selection

The Portfolio is overweight derivatives versus physical securities both in swap and futures, held in the 10 year part of the yield curve. The physical Australian Commonwealth Government Bonds (ACGBs) remain 'rich' to the overnight index swap curve, though this spread improved somewhat toward the end of the quarter. The market has increasingly become concerned about recessionary fears as leading indicators, particularly in North America and Europe continue to indicate a slowdown in economic growth, and started to price cuts starting early next year with US 2 year/10 year inverting early in July. We undertook micro extensions from the belly out to the 10 year part of the curve.

Within ACGBs we reduced our underweight to the ultra-long maturities, given there continues to be demand in the back end of the curve. Within semi-government we have further reduced our allocation to Treasury Corporation of Victoria, shifting into New South Wales Treasury Corporation and Queensland Treasury Corporation, as Treasury Corporation of Victoria no longer trades at an excess yield over other States and they continue to issue regularly via reverse inquiry which may limit price tension going forward.

In addition, we have deployed some excess cash backing futures into JPY bills fully hedged back to AUD for a favourable yield pickup as opportunities in the cross currency basis start to return post-pandemic.

The Portfolio's credit security selection outperformed over the quarter. While financial subordinated debt initially moved wider in July, issuance in early August was the catalyst for a significant spread rally. Senior financial paper also contributed to returns, in particular new issuance that came to market with generous concessions. Residential mortgage-backed security (RMBS) spreads stabilised over the quarter, and provided attractive carry for the Portfolio. Higher than benchmark carry was also a contributor to the outperformance.

Market overview

The past quarter has witnessed central banks hardening their focus on inflation by delivering rapid and sizeable rate hikes. This is the fastest rate hiking cycle since the early 1980 and the guidance to financial markets is to expect further aggressive rate hikes in coming months. With short term rate expectations re-pricing rapidly, it was not a surprise for global bond yields to shift higher. Risk markets are waking up to the prospect of the unintended consequence of central banks efforts to bring inflation under control could be a recession, with equity major indices falling and credit spreads widening into the end of the quarter. However, risk markets remain vulnerable should a hard landing for economies become a reality.

Fiscal policy was again under the spotlight, with governments in Europe and UK in particular offering support to households and businesses to protect against the rapid rise in energy costs. In contrast to 2020-21, most fiscal action is not stimulatory but rather preventing a worst-case scenario unfolding. In fact, the markets quickly punished the new UK Prime Minister and Chancellor who unveiled a surprise by announcing significant unfunded tax cuts that are biased to benefit high income earners. The UK government bond market exploded higher, particularly the long end – which rippled around global markets and eventually prompted the Bank of England to intervene and buy bonds, reversing its intent to begin unwinding its balance sheet.

Australian bond market

Yield movements were broadly in line with the global moves over the quarter as yields rose on the back of hawkish central bank rhetoric. The Reserve Bank of Australia (RBA) delivered consecutive 50 basis point hikes and took the overnight cash rate to 2.35% as they tackle inflation at all costs. Inflation remains strong but came in below market expectations with Q2 consumer price index 1.8% and the labour market tight with the unemployment rate at 3.5% and now just one unemployed person per job vacancy. The Australian 10 year bond futures implied yield traded between 2.96% and 4.18% in the quarter, with the 10 year yield ended the month at 3.92%, +20 basis points on the quarter. Consumer sentiment continues to deteriorate while business confidence is firmer but beginning to show signs of weakness, as retail sales rise on a price-level basis as people pay *more* for less. The Australian Government announced a significant ramp-up in immigration, with Treasurer Jim Chalmers easing migration caps and bringing more foreign workers into Australia. This increase in immigration will add spare capacity to the labour market, and in turn both unemployment and underemployment will rise. The 2021/22 Australian Government Budget outcome came in at \$A32bn or -1.4% of GDP, significantly lower than the previous government estimate of \$A79.8bn or -3.5% of GDP, coming from a combination of higher than expected revenue and lower payments.

The Australian Office of Financial Management (AOFM) issued \$A18.8bn in tender issuance in Q3, with an average maturity of November 2033 and weighted average yield of 2.33%. The AOFM's July Funding Update confirmed the initial issuance target of \$125 bn for FY23, to be revisited after the updated 2022/23 Budget in October. There is expected to be a new 2034 nominal bond issued in Q4, however the AOFM will formally step back from issuing new 20 year bonds and will focus on occasional curve extensions. The State Governments issuance was steady and remains heavily skewed towards the 10 year bucket.

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Global credit market

The quarter started positively for global risk markets rebounding in July as back-end yields rallied on early signs that the front loading of rate rises may suppress demand quicker than central banks expect. This faded as we made our way into September with familiar themes of inflation and geopolitics, as well as accelerated US Treasury market volatility were joined by sharp sell-offs in non-USD bond markets, which drove broad asset market selling and illiquidity that culminated in the Bank of England intervening to buy long end bonds to restore stability.

In the US, the investment grade index widened by 4bps to 159bps with much of the move (+19bps) happening late in September after we had tightened early in the quarter. Amongst sectors, financials performed weakest, let by UK banks (reflecting the turmoil in that economy and government bond market), though US banks were also affected: JP Morgan senior 10 year bonds, for example, now trade with a 220bps spread, wide of any period in the last 10 years (outside the brief COVID market shock).

Earnings season in the US finished mid quarter, with results mostly good enough to dispel concerns of corporate stress in the immediate term. There were some disappointments, with broadband subscriber numbers stagnating impacting cable issuers, and name-specific weakness impacting some healthcare issuers, for example.

New issuance volumes were solid in investment grade early in the quarter but reflecting the weak backdrop, new issuance volumes were well below expectations in September. In total, just under \$US80bn was issued in the investment grade market during that month, which is half what was expected, and less than the two previous generally “lighter” months.

A similar trend for European credit markets with the developments in the Ukraine war and developments in the UK ensuring that they underperformed the moves in global credit markets. European Investment Grade finished the quarter at new wides of 225bps. In September there was significant volatility GBP credit following the UK government fiscal expansion as long end gilts went from 3% to north of 5% before the Bank of England had to intervene, GBP corporate spreads closed 29bps wider. There was forced selling of GBP credit even in the highest quality securitised deals as investors sought cash to fund collateral requirements. Valuations in credit continue to improve although the outlook remains challenged ahead of corporate earnings with elevated inflation and central bank tightening.

Australian credit market

Australian credit was less volatile than global credit markets as we underperformed in the July rally, with higher Tier 2 beta issuance put pressure on the broader market, and outperformed in the September sell-off. Spreads finished 2bps inside the quarter wide at an option-adjusted spread of 151bps. While there were no significant spread moves in the structured space, the market did receive several Bid-Wanted-In-Competition (BWIC) from a range of UK investors to cover margin calls on the back of the volatility seen in the UK rates market in late September.

With central banks reaffirming their intention to fight inflation above all else, we expect that volatility will continue and pressure on assets with fully priced valuations until central banks start to see their work represented in the data.

Outlook

Over the past two years, our analysis has determined that the economic environment was being largely defined firstly by the pandemic shock and then later by the energy price shock resulting from the war in Ukraine. However, the latest analysis at the Macquarie Fixed Income team's September Strategic Forum pointed to the outlook being increasingly defined by the aggressive stance by central banks to tame inflation.

Measures of the supply side point to continued gradual recovery, despite various setbacks, although there is still a lot of repairs to get back to pre-pandemic levels and the energy outlook is more uncertain due to geopolitics. The demand side is slowing, but the picture is varied across countries, with Europe and the UK the hardest hit and the US proving relatively resilient. The rate hiking cycle underway will impact demand, and central bank overtightening is expected to mean that demand destruction will become the dominant driver of the economic outlook in coming quarters. Unfortunately, inflation is not providing central banks with any reason to hold back, despite the hopes of asset markets for a reprieve and despite the knowledge that demand will be hit. Recession is increasingly becoming the consensus expectation for 2023.

Current stagflation and the prospect of recession in 2023 implies that high volatility will persist across asset markets. Inflation has pulled bond yields higher than expected, but we see value returning, with bonds offering an attractive entry point and strong protection levels for multi-asset strategies. Credit fundamentals remain strong, but the outlook suggests that these will come under pressure, particularly if a hard landing manifests.

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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

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