

# Macquarie Master Enhanced Fixed Interest Fund

Quarterly report – 31 December 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	\$10.5m
Distribution frequency	Quarterly
Management fee*	0.290% pa
Minimum investment (Direct)	\$100,000
Unit prices and spreads	<a href="https://www.macquarie.com.au/unit_prices">macquarie.com.au/unit_prices</a>

\*Read the Product Disclosure Statement for more details on fees and costs.

## Fund performance to 31 December 2022

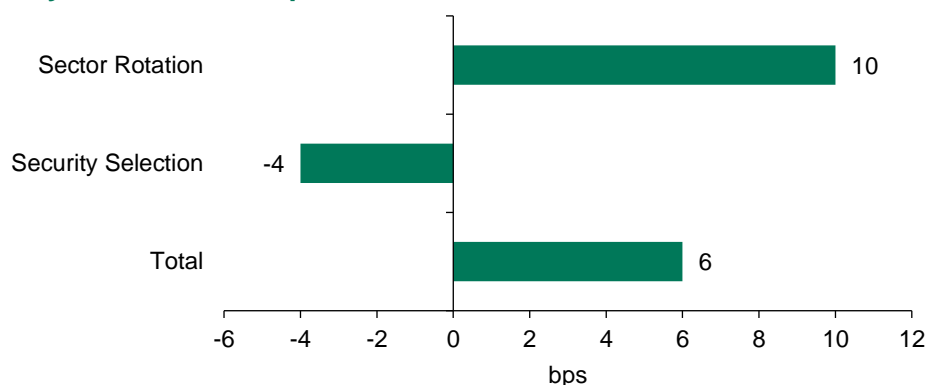
	Total Fund return (gross)	Benchmark return	Total excess return (gross)	Total Fund return (net)*
<b>3 months (%)</b>	0.44	0.38	0.06	0.36
<b>1 year (%)</b>	-9.43	-9.71	0.28	-9.69
<b>2 years (% pa)</b>	-6.14	-6.35	0.21	-6.41
<b>3 years (% pa)</b>	-2.59	-2.87	0.28	-2.87
<b>5 years (% pa)</b>	0.83	0.54	0.29	0.54

Past performance is not a reliable indicator of future performance.

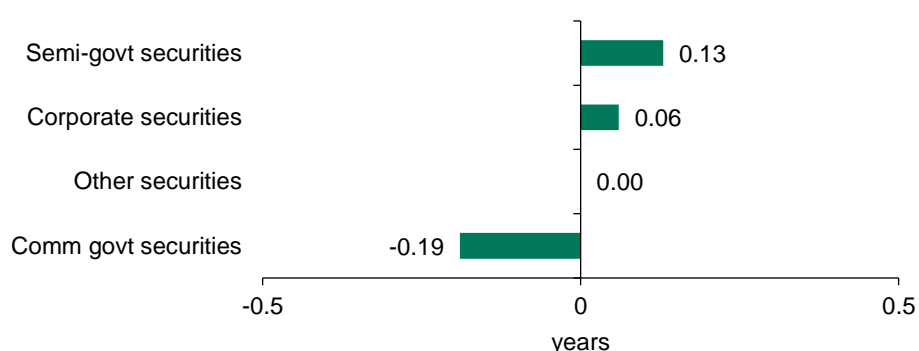
Total returns are calculated based on changes in net asset values and assumes the reinvestment of distributions. The Fund is benchmarked against the Bloomberg AusBond Composite 0+.

\*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.

### Sector rotation

The Fund's exposure to semi-government finished unchanged for the December quarter, sitting modestly long. The exposure was actively traded throughout the quarter, initially moving closer to neutral as semi-governments outperformed swap as swap spreads widened. We increased exposure in November as swap spreads peaked and began retracing whilst semi-government lagged this move. Whilst the state governments have large issuance tasks, we continue to believe the semi-government sector offers value given this is largely reflected in the price. They are well progressed through the issuance and bank balance sheets should have high-quality liquid assets requirements in 2023 given the expiry of Term Funding Facility and Committed Liquidity Facility.

The Portfolio's neutral credit positioning performed broadly in line with the benchmark over the quarter.

### Security selection

The Portfolio is overweight derivatives versus physical securities both in swap and futures, held in the 10-year part of the curve. Physical Australian Commonwealth Government Bonds (ACGB) remain 'rich' to the overnight index swap (OIS) curve, particularly in the front end and belly of the curve. Within ACGBs, we continue to hold our exposure in the back end of the curve where bonds offer more value versus OIS and futures. Within semi-government, we closed our underweight to Treasury Corporation of Victoria given considerable progression in their funding task, and spreads have widened to accommodate their irregular issuance pattern. We prefer to be overweight Queensland Treasury Corporation given conservative coal price assumptions provide a tailwind to revenues, with a lower AUD also working in their favour. We are also overweight New South Wales Treasury Corporation given funding task is largely priced into spreads. We moved to underweight Western Australia Treasury Corporation given a deteriorating outlook for iron ore, with conservative price forecasts for the commodity already reflected in spreads. In addition, we deployed some excess cash backing derivatives into Japanese treasury bills over the quarter, fully hedged back to AUD for a favourable yield pick up to the Bank Bill Swap Rate.

The Portfolio's credit security selection outperformed over the quarter. Financials were a significant contributor to excess returns, with participation in new senior deals at wide issuance levels benefitting from the subsequent rally. Tier 2 also outperformed, and while Australian Prudential Regulation Authority's letter 'Expectations of capital calls' caused a knee-jerk bear flattening move, longer-dated and higher-spread lines rallied in line with broader credit markets and lower levels of extension risk. Higher-beta corporates also performed, particularly lower-rated issuers. Structured securities were a strong contributor to the outperformance, providing attractive carry for the Portfolio.

## Market overview

Central banks continue to dominate, with successive rate hikes delivered by all major central banks and even the Bank of Japan (BOJ) wading in with an unexpected widening of its band for its yield curve control policy on the 10-year area of the curve. The background fundamental driver continued to be inflation which pushed to new cycle highs, but evidence is suggesting that this pressure has peaked. Elsewhere the broad macroeconomic data was showing an increasing tilt toward slower growth, with the leading indicators suggesting further weakness in the quarters ahead. Importantly, all measures of supply imbalance were now clearly improving which further supports the evidence that inflation has peaked and will trend lower in coming quarters. The labour markets though remain tight, even though demand is beginning to wane supply remains compromised. Thus, wages growth has remained elevated but there is no evidence suggesting a wage-price spiral.

Against this background the price action across asset markets defied logic. Sovereign bond yields broadly moved higher, with the US outperforming on the belief that the US Federal Reserve (Fed) is nearly finished its rate hike cycle – a view that the Fed has pushed back on. Meanwhile, European bonds underperformed as the European Central Bank stated clearly its inflation busting intent which repriced expectations significantly. Risk markets surprisingly rallied through the quarter, equities higher and credit spreads tighter. This is despite the realisation that earnings are likely to fall through 2023 as the impact of demand destruction is felt. Our sense is that expectations are that the economic downturn will be short and this is where the risk lies for the year ahead.

### Australian bond market

Australian yields mostly outperformed in the December quarter as the Reserve Bank of Australia's deceleration to 25bps hike increments saw rates decouple somewhat from global peers with the AU-US 10-year bond spread re-entering negative territory consistently in October. However, the deterioration of liquidity into year end saw this reverse, with the Australian 10-year yield rising over 60bps in the second half of the December. Throughout the quarter, the Australian 10-year bond futures implied yield traded between 3.30% and 4.22%, with the 10-year yield ended the month at 4.08%, +16bps on the quarter. The RBA delivered consecutive 25bps hikes, taking the official cash rate to 3.10% and becoming the first G10 central bank to slow the pace of hiking. House prices continue to decline, with the roll off of fixed rate mortgages due to pick up pace in 2023, leading the RBA to become increasingly concerned over how household consumption will react. On the positive side, net migration continues to accelerate allowing the Australian economy to experience milder supply side constraints seen in other developed markets as our labour force grows. As a result, Australia's unemployment rate holds at a record low of 3.4%, whilst gross domestic product remains strong with Q3 printing at 5.9% year on year, despite slightly missing expectations. Q3 consumer price index (CPI) surprised to the upside, printing 1.8%. The new monthly CPI indicator printed below expectations in October, although the volatility in this measure means its readthrough to quarterly inflation data could be limited. Sentiment measures continue to deteriorate as the reality of rate hikes materialise, with business confidence finally dipping negative after lagging consumer confidence for several months.

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The Australian Office of Financial Management (AOFM) issued \$A26.8 billion in tender issuance in Q4, including a \$A14 billion syndication of a May 2034 bond, with an average maturity of January 2032 and weighted average yield of 3.64%. The AOFM's October Issuance Update, released post the Federal Government's October Budget, revised the issuance target for FY23 to \$A95 billion, down from \$A125 billion with further details to be released in their January update. The December quarter saw \$15.3 billion of issuance from state governments, which included new syndications from New South Wales Treasury Corporation with a \$1.7 billion February 2035 and Treasury Corporation of Victoria with a \$2.25 billion September 2036.

## Global credit market

The December quarter saw risk assets consolidate as the market embraced the notion that inflation had peaked, and this will allow central banks to moderate their aggressive tightening. This did moderate towards quarter end as central banks signaled the need to remain hawkish.

US credit performed well during the quarter with the key moves in November following the weaker consumer price index print that saw the notion of a more moderate Fed going forward. Over the quarter investment grade (IG) outperformed high yield as concerns remained that weaker names might not evade an impact from tightening, even if it will be more modest than originally feared.

Earnings season in the US wrapped up, with generally positive results: approximately 60% of issuers beat expectations on sales and earnings, generally in line with past periods. Some sectors showed signs of weakness, with retail and tech hardware mixed, and earnings from big tech and media generally poorly received. But financials were strong, reflecting loan growth and sharply higher interest margins, and most industrial companies continue to effectively navigate the challenging environment.

European credit had a strong quarter with sectors which were previously challenged to access the market such as chemicals, real estate and corporate hybrids. Concerns on both the UK and Ukraine moderated over the quarter, though there is still some caution given the weaker economic outlook and a still hawkish central bank. The outlook in Europe remains mixed with higher IG yields offering a reasonable entry point for yield-based investors while a hawkish central bank, a looming recession, and a spread rally of 66bps from October wides should lead to continued volatility.

## Australian credit market

Australian credit rallied over the quarter, and this was emphasised on an option-adjusted spread basis as swap spreads also rallied. Despite a strong quarter, Australian credit did underperform global indices and still offers global relative value.

On 1st November, APRA released a letter in response to "requests to make uneconomic calls" in T2/subordinated paper. It outlined capital calls on AT1/T2 instruments that are to be replaced with new instruments at a "higher credit spread or that is otherwise more expensive" only if they "(i) satisfy APRA as to the economic and prudential rationale of the call; and (ii) satisfy that such action will not create the expectation that other instruments will be called in similar circumstances." This letter created disruptions to the sector with short-dated call notes gapping 50-60bps wider initially and longer dated lines 20-30bps wider. As a result, the market has since shied away from low coupon reset paper, mostly the short-dated calls, but demand for the more recent issues with higher coupon resets has returned and drove spreads sharply lower as the on-the-run fixed rate 10NC5 T2 bond finished November at +220bps after issuing at +270bps a month earlier. Though shorter dated lines with lower initial coupons have some questions marks.

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

## Outlook

The past year has been dominated by escalating supply tensions emanating from the war in Ukraine which pushed inflation much higher and for longer than anyone was expecting. The ramped-up response by central banks, in retrospect, should have been widely expected.

Looking into 2023 we feel that asset markets will have to work through the consequences of the above events of 2022. First, we must recognise that geopolitical tensions are likely to remain elevated and also assume that these tensions could take an unexpected turn at any time. Be warned and be prepared to adapt. Secondly, we can observe that many supply problems have dissipated and while there is no return to the pre-Covid norm, the economic impact from supply is likely to be much less in 2023. Third, we are expecting the year ahead to be the report card on demand destruction wreaked by the most aggressive monetary policy tightening cycle since the 1980s. And finally, we recognise that prevailing conditions for households and corporates have been robust compared to past tightening cycles, however the signalling from central banks is they intend to cause stress for both groups.

Again, we will thoroughly review our portfolio management strategy from the bottom up via the Strategic Forum during January. Our base case call has been for a recession in 2023 and that inflation will continue to fall through the year. We believe this combination will prove to be good news for sovereign bond yields. However, demand destruction is bad news for consumer spending and corporate earnings. This implies that credit spreads are vulnerable to widening from current levels.

Thus, sovereign bond yields can offer attractive value for investors during 2023, with the added attraction of offering portfolio protection against risky assets. We are cautious on corporate credit, preferring highly rated investment grade issuers that are not exposed to the cycle. Our approach to higher yield corporates and emerging market debt is more cautious, preferring selective opportunities.

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**For more information speak to your financial adviser, call us on 1800 814 523, email [mam.clientservice@macquarie.com](mailto:mam.clientservice@macquarie.com) or visit [macquarieim.com](http://macquarieim.com)**

## Important information

Macquarie Investment Management Australia Limited ABN 55 092 552 611 AFSL Licence 238321 is the issuer of units in, and responsible entity of the Fund. Macquarie Investment Management Global Limited ABN 90 086 159 060 AFSL 237843 is the investment manager of the Fund.

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