

Macquarie Master Enhanced Fixed Interest Fund

Quarterly report – 30 June 2023

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	\$10.1m
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 2023

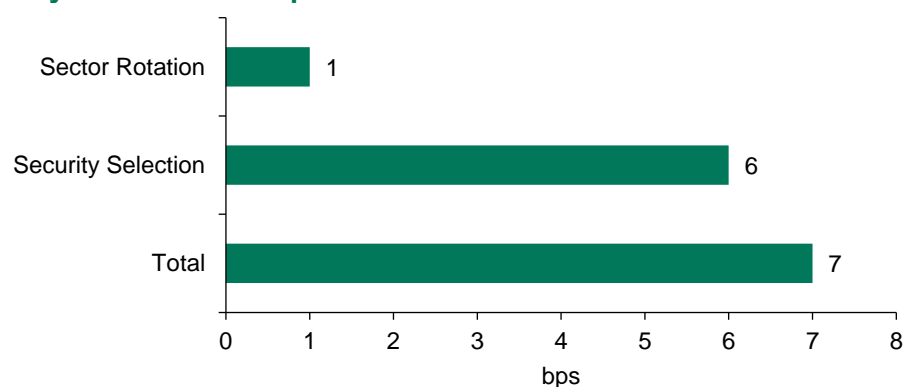
	Total Fund return (gross)	Benchmark return	Total excess return (gross)	Total Fund return (net)*
3 months (%)	-2.88	-2.95	0.07	-2.95
1 year (%)	1.73	1.24	0.49	1.44
2 years (% pa)	-4.49	-4.81	0.32	-4.77
3 years (% pa)	-3.21	-3.51	0.30	-3.49
5 years (% pa)	0.82	0.51	0.31	0.53

Past performance is not a reliable indicator of future performance.

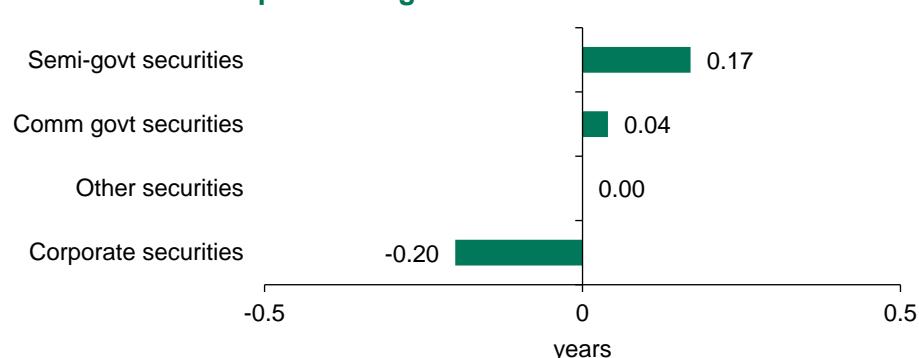
Total returns are calculated based on changes in net asset values and assumes the reinvestment of distributions. The Fund is benchmarked against the Bloomberg AusBond Composite 0+.

*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



Macquarie Master Enhanced Fixed Interest Fund

Quarterly report – 30 June 2023

Fund highlights

The Portfolio outperformed the benchmark in Q2, driven by security selection and sector rotation.

Sector rotation

The Portfolio increased its long semi-government exposure over the quarter, however this was largely a function of rebalancing after large cash inflows in the prior quarter. The exposure remains hedged with swap given the risk to spread products that emerged post the US regional banking crisis. Semi-governments broadly narrowed versus bonds over the quarter, however they widened versus swap, unable to keep pace with the relentless tightening in swap spreads over the quarter. Despite the tailwind to the sector from Bank high quality liquid assets demand being well past its peak as the Term Funding Facility maturities ramp up, the continued reduction in AOFM issuance should see the semi-government sector retain some high quality liquid assets bid.

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

Security selection

The Portfolio remains overweight futures vs physical securities, held in both the short and intermediate sector. The physical Australian Commonwealth Government Bonds (ACGBs) remain 'rich' to the overnight index swap 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 vs overnight index swap and futures. Within semi-government, exposure is concentrated in the 7-10-year part of the curve. We remain underweight Treasury Corporation of Victoria and overweight Queensland Treasury Corporation and New South Wales Treasury Corporation, for relative value considerations.

The Portfolio's credit security selection outperformed over the quarter. Most credit sectors moved tighter, with stable to tighter spreads for major bank senior bonds allowing higher beta Tier 2 and corporates to outperform. The Portfolio added exposures in the long-end of the curve, with a range of utility issuers coming to the market in Q2. Structured securities continue to provide excess returns, finishing with an especially strong month in June as AAA spreads moved 10bps tighter across the board. Higher than benchmark carry also assisted Portfolio performance.

Market overview

While leading indicators for economic growth continue to point to slowing in the quarters ahead, the pace of slowdown continues to confound expectations. This in part has been due to the better starting position for both households and business balance sheets but also to the role of fiscal policy, which has continued to prove less contractionary than expected. Headline inflation continues to grind lower and while core inflation measures too are slowing (excluding the UK), the pace has not been sufficient to convince central banks that their job of tightening policy is done. During the quarter, the US Federal Reserve (Fed) again hiked rates, but paused in June despite signalling that there could be further tightening in the months ahead. In Europe and the UK, both central banks are having to fight harder to slow inflation, and clearly signalling that their job of raising rates is not done. The Reserve Bank of Australia (RBA) too has continued to raise rates and despite a pause in June, expectations are for at least one and possibly two more hikes to follow.

Rate markets bore the brunt of this hawkish monetary policy action, with short term yields shooting higher, dragging longer-dated yields higher. The spread (or yield curve shape) flattened further – and the Australian benchmark 3-year-10 year spread inverted for the first time since 2008. Risk markets remain surprisingly resilient, buoyed by the fact that the mini-financial crisis in US Regional Banks largely dissipated without any contagion. US equities stormed higher, clearly outperforming, but the gains were narrowly defined. Credit spreads ground tighter, supported by Q1 earnings proving better than expected, with the higher risk ratings and emerging markets outperforming.

Australian bond market

Australia is reflective of the global economic backdrop with high inflation and slower growth, though the fall in our inflation is lagging that of other developed counterparts. The RBA has continued its aggressive hiking cycle and signalled more to come, though consumption is plateauing, and the release of the RBA Review 'Fit for the Future' has played on the minds of central bankers. Australian 10-year bond futures traded between 3.16% and 4.06%, ending the quarter at 4.03%. The Australian 3-year bond futures implied yield traded between 2.74% and 4.04%, finishing the quarter higher at 4.00%. The 3-year-10-year bond curve inverted for the 1st time since 2008 and the AU-US 10-year bond spread widened to +27bps. The RBA is considering the possibility of active quantitative tightening given the comparatively slow roll off of the balance sheet beyond the next 12 months, using the liquidity drain of tranche one of the Term Funding Facility as an indication for how the system may cope.

The AOFM finished FY23 by issuing slightly less than \$A80bn of ACGBs, a significant reduction on the FY23 issuance target of \$A125bn made in March 2022. The strong fiscal outcome for FY23 saw a reduction in borrowing requirements and there was a notable reduction in pace to end the year with only \$A2.2bn issued in June. The AOFM announced in its June 30 Update that a new 30-year bond was to be issued in Q4 this year and said that guidance won't be given on a new borrowing target until post-MYEFO Update at the end of the year. Semi-government issuance, on the other hand, totalled \$A101bn for FY23, and saw the highest monthly issuance in June of \$A12bn. Semi-spreads tightened, led by the shorter maturities and 5-year semi spreads to ACGBs are at 12-month lows. There were Funding Updates from all the major issuers (except New South Wales Treasury Corporation) and gross issuance in FY24 is expected to again exceed \$A100bn and net issuance will approach \$A70bn.

Macquarie Master Enhanced Fixed Interest Fund

Quarterly report – 30 June 2023

Global credit market

Risk assets performed positively in Q2 2023 even though volatility persisted into the start of the quarter. This was due to nervousness over the US regional banking sector, which intensified in the last week of April following earnings reports from First Republic Bank (FRC), and the news that FRC had gone into receivership and immediately sold to JP Morgan. Despite those pressures, strong Q1 earnings results, particularly driven by the US largest tech firms and some of the large US and European banks, as well as the passage of US debt ceiling bill drove risk assets higher over the quarter with NASDAQ posting its second-best 6-month period ever.

US investment grade (IG) credit finished the quarter 15bps tighter, approaching the tightness of the year so far. All the outperformances came in June, as the first two months of the quarter were impacted by the volatility caused by the regional banking, as well as US debt ceiling crisis, despite positive flows into the sector. While the financial sector was the underperformer in Q1, off the back of the failing of Silicon Valley Bank and then Credit Suisse, it led the outperformance in Q2 though financials were the only significant sector still meaningful off their year-to-date tightness, after the March stress events.

European IG closed 6bps better in what was a reasonably volatile quarter. Spreads initially tightened, despite a significant issuance month with €38bn of supply in April, partly reversing some of the underperformance in March. However, sentiment weakened in May with industrials underperforming financials, in part due to prior outperformance and an uptick in non-financial supply. European credit finished the quarter on a strong note, with REITs as the standout performer rallying 20bps, after having some creditor -friendly actions such as Unibail Rodamco hybrid exchange and several tenders on IG lines.

Australian credit market

Australian credit outperformed global peers on an option-adjusted spread basis, with spreads narrowing 20bps, though this was driven partly by swap spread tightening. REITs generally lagged over the quarter, while recently issued utility transactions as well as some of the higher beta sectors such as industrials and financial subordinated paper outperformed. Major bank senior paper edged tighter in Q2, with NAB being the only major bank to issue a term deal. Structured securities were marked tighter in Q2, as most of the prime Residential Mortgage-Backed Securities (RMBS) transactions were significantly over-subscribed, with a number of issuers revising the final pricing tighter than the Initial Price Thought levels.

Outlook

Given the move in asset markets over the past quarter our team reviewed our outlook during the May Strategic Forum. The review of the macroeconomic outlook noted that the supply recovery continues a slow, steady, sustainable path; and while demand has decelerated it has not turned into a destructive force. Importantly, our analysis noted the unexpected positive impulse from US fiscal policy in the early months of the year (from increased defence spending and cost of living adjustments to benefits) and this spending path was not curtailed by the eventual agreement to extend the US debt ceiling in early May. Government spending has a rapid transmission into the economy, compared to the long and variable lags and impact of monetary policy, and this is working to soften the slowdown in growth that is underway. However, this is placing more of the burden of reducing inflation onto monetary policy. Thus, while inflation has turned lower, the pathway back to target is considered too shallow to satisfy central banks and they remain in tightening mode.

We concluded at the Forum that for many economies, monetary policy was already near or had crossed into over-tightening territory. The action and guidance from central banks in the past month show that their intent is to keep going on hiking rates. This sends a clear message that monetary policy over-tightening is now a key risk for asset markets. History shows that while tighter monetary policy does not always end in recession it does, particularly if credit conditions are tightening at the same time, which ends with something 'breaking'. We therefore believe that financial risk is more elevated, where the stress around US Regional Banks in Q1 could manifest in other areas of financial assets in the quarters ahead and this could be the trigger that tips economies into recession.

From a risk perspective, again history guides that risky assets do not tend to react significantly until evidence of a downturn or financial risk becomes clearly evident. We therefore maintain a strategically constructive view on duration and cautious of risk markets, recognising that the pathway ahead is potholed by a high level of uncertainty.

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Quarterly report – 30 June 2023

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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