

Macquarie Master Enhanced Fixed Interest Fund

Quarterly Report – March 2021

Investment objective

The Macquarie Master Enhanced Fixed Interest Fund 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.

Fund performance to 31 March 2021

	Total gross fund returns	Benchmark returns	Total gross excess returns	Total net fund returns*
3 months (%)	-3.18	-3.22	0.04	-3.25
1 year (%)	-1.46	-1.81	0.35	-1.74
2 years (% pa)	2.74	2.40	0.34	2.45
3 years (% pa)	4.31	3.97	0.34	4.01
5 years (% pa)	3.74	3.46	0.28	3.44

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+Yr Index.

*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.

Fund highlights

The first quarter of 2021 was dominated by two evolving themes: the rollout of vaccinations and the delivery of further US fiscal stimulus. The two themes combined to provoke an upward revision to global growth expectations for 2021, even though the details reveal a very divergent path to recovery across regions and sectors. Asset markets embraced these themes, with equities pushing to new highs while credit spreads tightened. Bond yields surged higher, led by the US and Australia but with some marked divergence where the macro news was less positive, such as Europe, which had a more muted rise in yields through the quarter.

The rollout of vaccinations is highly dependent on supply. The UK and the US have led the way amongst developed countries, whereas supply problems have significantly hindered the rollout across Europe and, across emerging countries, the picture is even more divergent.

For the US, early in the quarter the Democratic party secured both the Georgia Senate seats and this gave them control of Congress, albeit on the slenderest of margins in the Senate – relying on the casting vote of the Vice President. However, this was enough for the Democrats to successfully pass another large fiscal stimulus package in March, including a substantial cash payment to qualifying households. With vaccination progress enabling a gradual re-opening and fiscal stimulus taking place, financial markets quickly embraced this positive news even though the economic fundamentals only began to improve through March.

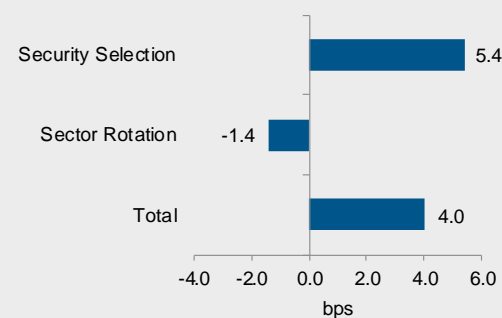
Central banks have maintained a cautious stance despite the emergence of positive news on vaccines and fiscal stimulus, with the US Federal Reserve stating that the activity gap created by the pandemic is large and will take some time to close when many of the inflationary pressures are most likely temporary. This consistent theme around developed countries has caused yield curves to steepen, as short-end rates remain strongly supported by the prospect of steady policy for some time to come.

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

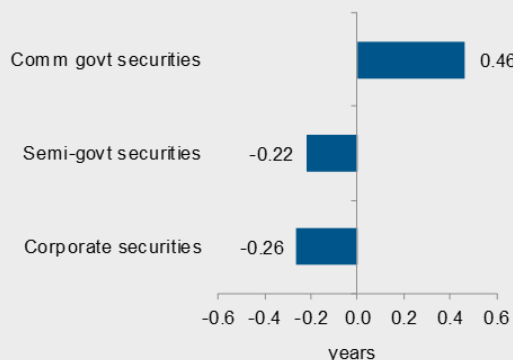
Security selection

Within the semi-government portion of the Fund, we have continued to hold a preference for the 10-12 year maturities where spread curves have remained steep due to a supply-demand mismatch for different tenors, with regulatory demand focussed on shorter maturities while issuers have preferred to term out their debt. The Fund also owns a holding in the 2024 semi's, which have been trading at an attractive spread over Australian Commonwealth Government Bond (ACGB) due to the impact of Yield Curve Control (YCC).

Key contributors to performance



Relative duration contribution



ACGBs have been actively traded during the quarter to take advantage of micro relative value opportunities. We have maintained an overweight to the ultra-long bonds given the steepness relative to global curves and attractiveness to foreign investors on a hedged yield basis. The Fund also continues to hold an overweight to the 4-6 year ACGBs offset by an underweight to the wings, with the ACGB forward gaps still implying an aggressive hiking pace, which we think is unlikely to be realised in practice. We have also been able to lend out bonds, which are trading special on repo at a negative interest rate, while investing the cash at a positive yield to increase return.

The Reserve Bank of Australia's (RBA) YCC policy on the front half of the 3 year bond basket has created a scarcity of these bonds in the market, which has seen the 3 year futures contract trade cheap relative to the physical bonds due to this scarcity. The Fund has been paid 3 year efp (exchange of futures for physical) to increase our exposure to the 3 year futures contract, which added value over the latter part of the quarter.

The Fund's credit security selection outperformed in Q1, driven mostly by a further compression in spreads of the higher-beta names. The continued 'chase for yield' dynamic, combined with further opening of the economy and the announcement from the Australian federal government to support the travel and tourism industry, drove the Brisbane Airport and Qantas bonds 40-70bps tighter in spreads across the curve.

Sector rotation

The Fund has remained underweight to the semi-government sector. The material supply still to come will be largely offset by regulatory demand for HQLA (high quality liquid asset) paper, combined with the RBA's asset purchasing program, which was extended again mid-quarter.

However, semi spreads to bond remain extremely tight, with semi asw levels having entered negative territory out to the mid-curve. As a result, we view the yield pick-up in certain parts of the curve as insufficient to compensate for the relatively lower liquidity in the sector.

The Fund's credit positioning performed broadly in line with the benchmark in Q1. While the first half of the quarter was characterised by excess liquidity and the lack of secondary inventory, which resulted in further spread compression, risk markets were spooked by the inflationary concern and the subsequent jump in bond yields in the second half of Q1. Some of the lower-beta sectors such as repo-eligible senior financials, communications and utilities either traded sideways or moved wider in spread. Meanwhile, COVID-impacted and higher-beta sectors continued to outperform the broader credit market.

Market Overview

Australian bond market

Global bonds yields rose over Q1, with markets embracing the reflation trade on early optimism about the vaccine rollout, as well as the 'light blue wave' result from the Georgia Senate runoffs and ensuing fiscal package in the US. With many central banks indicating by mid quarter that they were comfortable with the rise in yields reflecting an improved outlook, the sell-off in bonds intensified as investors reduced risk. The Australian market specifically became disorderly at times in February as shortfalls in the RBA's Yield Curve Control (YCC) policy created market distortions.

At their February meeting, the RBA surprised markets in announcing that they would extend their bond buying program by an additional \$100bn at the conclusion of the current \$100bn programme. At the same time, the RBA reiterated their expectation that rates would remain on hold for 3 years, although they did make a slight alteration to their language using calendar-based guidance rather than time-based guidance. The February and March Statements both noted they would remain on hold until they achieve their inflation and employment targets, which they expect will be in 2024 at the earliest. RBA Governor Lowe also clarified in a Q&A that the guidance represents a forecast for policy rather than a pledge.

Following these remarks and in light of reflation expectations globally, markets shrugged off this dovish sentiment from the RBA and continued to trade irrationally, with domestic rates markets beginning to question the Bank's commitment to YCC and pricing a hiking cycle beginning as early as late 2022. In response, the RBA increased bond purchases to defend their yield target at 10bps, which had the unintended consequence of causing dislocation in the 3-5 year part of the bond curve, with technical factors around the 3 year futures contract resulting in bonds beyond the April 2024 maturity rising sharply in yield into the end of February. High frequency strategies which provide significant liquidity in stable markets withdrew as volatility spiked, driving a sharp decline in liquidity into the end of February, which exacerbated moves, with 20-30bps intraday yield swings occurring due to the lack of accessible volume.

By the beginning of March, the RBA and the Australian Office of Financial Management (AOFM) had increased their efforts to rectify disfunction in the bond market. The RBA doubled their scheduled bond purchases on 1 March, before expressing their willingness to bring forward purchases in response to market conditions at their monthly meeting in March. They also made adjustments to the repo eligibility of their YCC bonds. Previously,

the AOFM were a lender of the Australian Commonwealth Government Bond (ACGB) 2023s and 4/2024s. But halfway through the futures roll period, the RBA increased the repo rate on these bonds to -1.0%, introducing a significant penalty on borrowers of these lines. This measure was effective in taking the yield on the on-the-run 3 year back to the RBA's target without further YCC purchases as investors covered shorts in those tenors.

At the same time, the AOFM tapered their supply schedule down to \$1bn per week from late February through to mid-March. These measures were effective in calming bond markets and driving a partial reversal into the end of the quarter.

The benchmark 3-year ACGB yield ended the month at 0.12%, almost unchanged in yield as a result of the RBA's YCC policy. The curve steepened, with 10-year benchmark yields ending March 78bps higher at 1.79%.

Global credit market

Credit markets outperformed in the March quarter, though the final price actions showed distinct periods of volatility caused by concerns over rising bond yields and amidst stretched risk asset pricings. As certainty emerged about the Democrats' fiscal support package and as the vaccination rollout continued, markets took a more sanguine approach to the increase in bond yields and finished the quarter at the highs.

The earnings season for Q4 in the US saw results stronger than expected on both earnings and revenues. Approximately 75% of the companies beat revenues expectations, and 80% beat earnings expectations, both above historical averages, and management teams showed more confidence in their outlooks. This aligns with the overall theme of better economic growth expectations and continued re-openings of the economy, though much of the expected good news have already been priced into credit spreads at or near historic lows.

Whilst spreads were marginally better over the quarter with US investment grade (IG) spreads tightening 6bps to 90bps, the main story was in high yield (HY) credit, with CCC-rated credit tightening 130bps to 524bps. Issuance volumes were strong in the US credit market, which helped keep new issue concessions elevated. Flows also continued to be positive in the US IG sector with over \$US60bn year to date, though in HY credit it was - \$US11bn year to date.

European credit performed more modestly over the quarter to finish 2bps wider at 90bps as, although it was driven by the same themes as those for the US markets, the slower vaccination rollout and continued lockdowns weighed on markets until positive sentiment into quarter end saw performance improve.

Australian credit market

The Australian credit market started 2021 on a solid footing, outperforming global credit markets as the robust bid tone continued from year end, amplified by the initial early quarter period of low issuance. This positive performance continued until late February when sentiment turned, as reflation trades became the overriding theme that prompted a sell-off in broader risk markets, with Australian 3 and 10 year Treasury bond yields spiking 6bps and 78bps over the month, respectively. However, there was a divergence in performance across sectors. Low-beta sectors generally underperformed in February, while higher-beta and COVID-impacted sectors rallied further. As we entered March, the Australian market continued to be softer as indigestion from the sell-off in late February persisted throughout the month, particularly in lower-beta bonds. Consequently, higher-than-expected issuance, coupled with elevated dealer inventories, led to a more subdued spread performance in the latter half of March. The broader weakness in Australian credit was mainly contributed by lower-beta bonds such as senior financials, as well as more counter-cyclical corporate bonds that have performed well throughout the pandemic. This was evident in the newly issued bonds from Verizon Communications, which underperformed considerably in the secondary market relative to other corporate bonds. Meanwhile, higher-beta and COVID-impacted sectors remained constructive and rallied further in March. This was particularly true in sectors such as retail REITs, airports and airlines.

Outlook

The market narrative has embraced the re-opening of economies to date, where a strong growth rebound and a pick-up in inflation are expected. As the movements in bond yields through March attest, one needs to state which country that outlook is referring to. In the coming quarter, the US is poised to lead the way, while Europe is expected to continue struggling. The US will benefit from the upcoming substantial fiscal package, which includes large direct stimulus payments. As the services sector gradually re-open, the benefit should manifest in both spending and employment. These all point to a likely robust rebound in growth in the coming quarter, which will be accompanied by the surge in oil prices and base effects to push headline inflation rates higher. Interestingly, despite the market narrative, central banks have been consistently citing the transitory nature of these factors, expecting the large structural dampeners on inflation to contain the longer-term risks. Thus, a gap has opened between the markets' outlook for inflation and that of central

banks. This suggests that bond market volatility is likely to persist until one side shifts their view.

Certainly, this rise in US rates has been larger and quicker than we had expected, but elsewhere the move in rates has been more gradual. Thus, the scene is set for a lot of noise in fixed income markets, where managing duration risk is in focus. We are also alert to any shift by policy makers. We expect central banks to maintain their easy policy stance, which leaves fiscal as the likely factor for surprise. On one hand, as economies re-open the huge fiscal support measures are expected to roll off. The risk here is that there is an 'activity gap' particularly in terms of employment. On the other hand, there is scope for fiscal policy to shift from 'support' to 'direct' stimulus. The US is again leading the way, with President Biden outlining an ambitious infrastructure package. This could be good news, as it tilts policy toward investment into the supply side of the economy, which could help lift the current low level of productivity. While there is a long way to go for what package will eventually be passed, theoretically the US fiscal policy approach is supportive for growth going forward. But as it is supply-driven, the inflation risk should be contained. A side effect to consider is that this fiscal initiative could widen the gap for growth further between the US and regions such as Europe.

We therefore expect a challenging investment climate to persist, where our intention is to maintain discipline and recognise that opportunities will present themselves.

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Unit prices	
Application price	\$1.0051
Redemption price	\$1.0040
NAV price	\$1.0047

Cum prices	
Application price	\$1.0097
Redemption price	\$1.0086
NAV price	\$1.0093

Distribution	
Cents per unit	0.4629

Fund details	
APIR Code	MAQ0180AU
Inception date	17/05/2000
Fund size	\$18.1m