Macquarie Wholesale Australian Fixed Interest

Quarterly Investment Option Update

31 March 2021

Aim and Strategy

To outperform the Bloomberg AusBond Composite Index over the medium term (before fees) by using an active investment strategy.

Investment Option Performance

To view the latest investment performances for each product please visit amp.com.au/performance

Investment Option Overview

Investment Category	Australian Fixed Interest
Suggested Investment timeframe	Medium term
Relative risk rating	5 / Medium to high
Investment style	Active
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Australian and global fixed income	100	100

Sector Allocation	%
Investment grade credit	45.3
High yield credit	7.5
Emerging markets debt	6.2
Cash	41.0

Quality Allocation	%
AAA	11.0
AA	9.5
A	5.2
BBB	23.1
BB and below	10.2
Unrated	0.0
Cash	41.0

Top Holdings	%
Australian Government	4.0
Australian Government	2.3
Pacific National	1.8
Province of Ontario	1.8
New South Wales Treasury Corporation	1.7
AusNet	1.7
Ampol	1.7
AMP Life	1.7
KINGF 19-1	1.6
National Australia Bank	1.6

Investment Option Commentary

The Fund underperformed the benchmark over the quarter. While the Fund's credit positioning positively contributed to performance, this was offset by the Fund's duration positions as government bond markets suffered their worst start to a year in decades. The main detractor of duration performance was the exposure to AUD rates, with local curves steepening sharply and pricing in much more aggressive moves than we think is realistic from the Reserve Bank of Australia (RBA) in coming years. Amongst positive contributors, investment grade (IG), emerging markets (EM) debt and high yield (HY) credit all added to performance, reflecting the Fund's 'barbell' position in higher-beta sectors and recovery trades, which performed relatively well despite setbacks on the vaccination progress in some parts of the world. The overall credit market performance was characterised by significant spread compression, with BBB outperforming A-rated corporates and HY outperforming IG.

The Fund's credit sector exposures were reduced slightly during the quarter, with reductions focused on areas with little upside. These were a combination of longer-dated IG that were at tight spreads, were vulnerable to a rate rise and offered little upside even in the most positive risk scenario, and a small number of recovery trades that had performed strongly and offered little further spread compression. Holdings of Southwest Airlines and Sydney Airport, for example, were sold early in the quarter after trading back at or tighter than their pre-pandemic spread levels. The Fund's positioning has remained heavily focused on the barbell of higher-beta sector exposures and BBB-rated IG, while generally decreasing long-dated, lower-beta IG and instead preferring short-dated bonds with some spread as a place to maintain liquidity. The EM debt exposure was sensibly increased somewhat during the quarter, as this space offers some relative spread pick-up and capital upside versus most other parts of the market, and offers places to opportunistically accumulate some credit exposure. The Fund added modestly to its duration positioning during the quarter, viewing the gradual move higher in rates as offering entry levels to rebuild a position – after the interest rate duration in the Fund had been materially cut back in late 2020.

Market Commentary

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 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.

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 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.

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

Availability

Product Name	APIR Code
SignatureSuper	AMP0964AU*

*Closed to new investors

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