MACQUARIE

MACQUARIE ASSET MANAGEMENT

The bigger they are, the harder the fall

Macquarie Fixed Income Strategic Forum | September 2022

For institutional investors and investment professionals only.

Key takeaways

- Central banks, led by the US Federal Reserve, are undertaking the most aggressive tightening cycle in decades, coupled with quantitative tightening (QT) alongside significant US dollar strength.
- If inflation were to remain persistently higher, as is the current market concern and narrative, then central banks appear likely to remain hiking at pace and with magnitude. The more persistent the inflation, the more tightening required… and **the harder the fall.**
- All things considered, inflation is likely to moderate into year end. Geopolitical tensions and China's zero-COVID policy, however, continue to pose risks.
- The current environment is best characterised as a "stagflation," which is usually followed by periods of lower growth and by association, recession.
- All signs indicate that a hard landing is likely unavoidable – something we believe risk assets have **not yet fully priced in**. Nonetheless, should central banks slow or pause, the chance of a soft landing would increase.
- We remind readers — with global indebtedness at such elevated and ever increasing levels, there is a genuine limit to how much financial conditions can tighten. The **safe havens of cash and bonds are looking increasingly attractive**.

Investment themes

Central banks – The gloves are off

- Central banks, led by the Fed, are undertaking the most aggressive tightening cycle in decades, coupled with quantitative tightening (QT) alongside significant US dollar strength.
- With the Fed leading, it is essentially exporting inflation to the rest of the world, forcing other central banks to hike in similar magnitudes, otherwise risk a weaker currency and higher import prices.
- Central banks are exhibiting an almost “myopic” focus on inflation, determined to bring it under control. The more persistent inflation is, the more tightening needed, and the harder the fall.

Lifting the lid on inflation – Blow by blow

- Near-term influences appear to be peaking or have already peaked, with supply chain disruptions and labour market shortages slowly improving.
- Little evidence that future influences impact current inflation dynamics (e.g. desire to embrace clean energy sooner, deglobalisation and fiscal support) are not yet driving inflation higher.
- Considering the above, and the rolling-off of base effects, inflation appears more likely to moderate into year end. Further supply shocks should not be discounted with the geopolitical tensions and China’s zero-COVID policy.

Economic growth – On the ropes?

- Global growth is slowing meaningfully, with Europe challenged by the energy crisis, China dealing with zero-COVID and property sector weakness, and many other economies impacted by the “cost of living” crisis.
- Fiscal contraction is also occurring in many economies at the same time.
- The current environment is best characterised as stagflation (low/no growth and high inflation).
- Analysis of similar environments throughout history suggests that periods of stagflation are usually followed by lower growth and by association, recessions.

Soft or hard landing – Points decision or going down for the count?

- Financial markets are hopeful of a soft landing. But soft landings are usually rare and even rarer when structural factors such as supply shocks are taking place.
- While central banks can slow, pause or pivot, the aggressive tightening so far likely results in a hard landing. Risk assets do not appear priced for this scenario.
- This environment is a significant adjustment for global economies and financial markets, which have grown very accustomed to zero rates, low cost of capital, and ongoing liquidity support since the global financial crisis.

Knowing where we’re going begins with remembering where we’ve been

- The by-products of the zero interest rate policy and endless quantitative easing (QE) were more and more debt and credit expansion, low volatility, higher and higher asset prices, and imbalances such as rising inequality.
- We are now in a world of much higher interest rates and ongoing QT driven liquidity reduction.
- As these pressures build, the chance of a considerable decline in risk assets rises. Safe havens of cash and bonds are looking increasingly attractive.
- With high debt levels, there is likely a limit to how much financial conditions can tighten.

Source: Macquarie. Views as of September 2022, subject to change without notice.

Macquarie Fixed Income Strategic Forum | September 2022

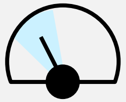
Investment implications

Our view

RATES

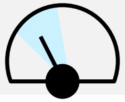
- Significant market uncertainty regarding inflation amid poor trading liquidity suggests that bond yields will continue to be volatile over the shorter term.
- Monetary policy operates with long and variable lags and while some of this has already impacted the leading economic indicators, the impact of the tightening cycle will likely be more apparent in early 2023.
- While acknowledging the presence of short-term volatility, we believe bond yields have risen considerably, offering an attractive entry point and strong protection levels. Structural drivers that have kept rates low in recent decades also still exist. For long-term investors, duration is offering an increasingly attractive opportunity and we will seek to add in portfolios as appropriate.
- In terms of regional preference, we continue to take opportunities to add duration where we believe markets have aggressively priced policy moves, e.g. Australia, New Zealand, South Korea and Canada.

CREDIT



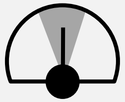
- Credit fundamentals remain strong in both the investment grade and high yield markets, though we foresee increased headwinds and weakening fundamentals ahead.
- Industry and issuer impacts will be varied with most acute risks to industries in those most exposed to consumer demand and interest rates.
- Credit valuations are not fully pricing in recession scenario. However, all in yields and dollar prices matter and provide support.
- Against this backdrop, we believe defensive positioning within credit is appropriate with a preference for highly-rated investment grade credit in favourable sectors.
- Within high yield and bank loans, we feel that a disciplined and cautious approach is warranted with a higher-quality bias within portfolios, focusing on compensation for fundamental risk.

EMERGING MARKETS DEBT



- Emerging market (EM) sovereign fundamentals are mixed amid inflationary pressure, though most countries have some financing flexibility.
- Corporate sector metrics peaked earlier this year with a move towards more neutral/negative outlooks, though with idiosyncrasy across industries.
- We are cautious on EM foreign exchange (FX) exposure as US dollar strength continues to be the key driver though recognise valuations are attractive.
- We maintain the risk-controlled approach within our EM strategies with very selective exposures, for example, favouring energy exporters, avoiding food importers and high-dollar-price high yield.

STRUCTURED



- Fundamentals are stable overall in the structured security market, but facing slower growth.
- Agency mortgage backed securities (MBS): Spike in rate market volatility leading MBS spreads materially wider – recommend reduction in underweight given spreads are near post-financial crisis widths.
- Mortgage credit: Delinquency and losses remain historically low, with inflation pressures impacting non-prime borrowers. Selective opportunities in the sector.
- Commercial MBS (CMBS): Rising rates will pressure valuations. Prefer selective participation in higher-quality segment.
- Collateralized loan obligation AAA-rated: Fundamentals are stable though liquidity is an issue. Rising rates and relatively attractive spreads should support demand for floating rate securities.
- Australian residential MBS RMBS: Expect spreads to be broadly stable. Watchful for unemployment as a risk indicator while selective participating at attractive valuation levels.

CURRENCY

- The USD has continued to appreciate off the back of higher federal funds rate and pricing of further rate hikes. While the US dollar appears overvalued, we believe further upside remains likely over the short term.
- Underlying weakness in global growth would be positive for the US dollar and may extend its strength over the medium term as investors seek safe havens.
- Other currency moves have largely been driven by US dollar strength, though we would note further downside to euro and Australian dollar is likely given the potential for divergence between the Reserve Bank of Australia, the ECB, and the Fed, alongside higher recessionary risk in the European Union (EU).
- The Japanese yen remains tied to the Bank of Japan yield curve control policy with occasional currency intervention, but could present an attractive hedge at lower levels.

Source: Macquarie. Views as of September 2022, subject to change without notice.

Investments in Collateralized Loan Obligations (CLO) may involve risks. CLOs are securities backed by a pool of debt, often low-rated corporate loans. Investors receive scheduled debt payments from the underlying loans but assume most of the risk in the event that borrowers default.

Important information

This market commentary has been prepared for general informational purposes by the relevant investment team, who are part of Macquarie Asset Management (MAM), the asset management business of Macquarie Group (Macquarie), and is not a product of the Macquarie Research Department. This market commentary reflects the views of the relevant investment team and statements in it may differ from the views of others in MAM or of other Macquarie divisions or groups, including Macquarie Research. This market commentary has not been prepared to comply with requirements designed to promote the independence of investment research and is accordingly not subject to any prohibition on dealing ahead of the dissemination of investment research.

Nothing in this market commentary shall be construed as a solicitation to buy or sell any security or other product, or to engage in or refrain from engaging in any transaction. Macquarie conducts a global full-service, integrated investment banking, asset management, and brokerage business. Macquarie may do, and seek to do, business with any of the companies covered in this market commentary. Macquarie has investment banking and other business relationships with a significant number of companies, which may include companies that are discussed in this commentary, and may have positions in financial instruments or other financial interests in the subject matter of this market commentary. As a result, investors should be aware that Macquarie may have a conflict of interest that could affect the objectivity of this market commentary. In preparing this market commentary, we did not take into account the investment objectives, financial situation or needs of any particular client. You should not make an investment decision on the basis of this market commentary. Before making an investment decision you need to consider, with or without the assistance of an adviser, whether the investment is appropriate in light of your particular investment needs, objectives and financial circumstances.

Opinions, information, and data in this market commentary are as of the date indicated on the cover and subject to change without notice. No member of the Macquarie Group accepts any liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this market commentary and/or further communication in relation to this market commentary. Some of the data in this market commentary may be sourced from information and materials published by government or industry bodies or agencies, however this market commentary is neither endorsed or certified by any such bodies or agencies. This market commentary does not constitute legal, tax accounting or investment advice. Recipients should independently evaluate any specific investment in consultation with their legal, tax, accounting, and investment advisors. Past performance is not indicative of future results.

This market commentary may include forward-looking statements, forecasts, estimates, projections, opinions and investment theses, which may be identified by the use of terminology such as “anticipate”, “believe”, “estimate”, “expect”, “intend”, “may”, “can”, “plan”, “will”, “would”, “should”, “seek”, “project”, “continue”, “target” and similar expressions. No representation is made or will be made that any forward-looking statements will be achieved or will prove to be correct or that any assumptions on which such statements may be based are reasonable. A number of factors could cause actual future results and operations to vary materially and adversely from the forward-looking statements. Qualitative statements regarding political, regulatory, market and economic environments and opportunities are based on the relevant investment team’s opinion, belief and judgment.

Macquarie salespeople, traders and other professionals may provide oral or written market commentary, analysis, trading strategies or research products to Macquarie’s clients that reflect opinions which are different from or contrary to the opinions expressed in this market commentary. Macquarie’s asset management business (including MAM), principal trading desks and investing businesses may make investment decisions that are inconsistent with the views expressed in this commentary. There are risks involved in investing. The price of securities and other financial products can and does fluctuate, and an individual security or financial product may even become valueless. International investors are reminded of the additional risks inherent in international investments, such as currency fluctuations and international or local financial, market, economic, tax or regulatory conditions, which may adversely affect the value of the investment. This market commentary is based on information obtained from sources believed to be reliable, but we do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in this market commentary.

Important information

Diversification may not protect against market risk.

Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer's ability to make interest and principal payments on its debt. This includes prepayment risk, the risk that the principal of a bond that is held by a portfolio will be prepaid prior to maturity at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate.

Market risk is the risk that all or a majority of the securities in a certain market – like the stock market or bond market – will decline in value because of factors such as adverse political or economic conditions, future expectations, investor confidence, or heavy institutional selling.

Natural or environmental disasters, such as earthquakes, fires, floods, hurricanes, tsunamis, and other severe weather-related phenomena generally, and widespread disease, including pandemics and epidemics, have been and can be highly disruptive to economies and markets, adversely impacting individual companies, sectors, industries, markets, currencies, interest and inflation rates, credit ratings, investor sentiment, and other factors affecting the value of the Strategy's investments. Given the increasing interdependence among global economies and markets, conditions in one country, market, or region are increasingly likely to adversely affect markets, issuers, and/or foreign exchange rates in other countries. These disruptions could prevent the Strategy from executing advantageous investment decisions in a timely manner and could negatively impact the Strategy's ability to achieve its investment objective. Any such event(s) could have a significant adverse impact on the value and risk profile of the Strategy.

International investments entail risks including fluctuation in currency values, differences in accounting principles, or economic or political instability. Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility, lower trading volume, and higher risk of market closures. In many emerging markets, there is substantially less publicly available information and the available information may be incomplete or misleading. Legal claims are generally more difficult to pursue.

Currency risk is the risk that fluctuations in exchange rates between the US dollar and foreign currencies and between various foreign currencies may cause the value of an investment to decline. The market for some (or all) currencies may from time to time have low trading volume and become illiquid, which may prevent an investment from effecting positions or from promptly liquidating unfavourable positions in such markets, thus subjecting the investment to substantial losses.

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.

IBOR risk is the risk that changes related to the use of the London interbank offered rate (LIBOR) or similar rates (such as EONIA) could have adverse impacts on financial instruments that reference these rates. The abandonment of these rates and transition to alternative rates could affect the value and liquidity of instruments that reference them and could affect investment strategy performance.

Economic trend information is sourced from Bloomberg unless otherwise noted.

SUMM-MFI-SF-SEPT2022 (2453142 – 10/22)