Macquarie Income Opportunities

Quarterly Investment Option Update

31 March 2020

Aim and Strategy

Aims to outperform the Bloomberg AusBond Bank Bill Index over the medium term (before fees). It aims to provide higher income returns than traditional cash investments at all stages of interest rate and economic cycles. This strategy provides exposure to a wide range of Australian credit-based securities (predominantly floating and fixed rate corporate bonds, and asset-backed securities) and cash. It may also provide exposure to global investment grade credit securities, global high yield credit securities, emerging market debt, hybrid securities and a range of other credit opportunities when they are expected to outperform and reduce exposure to these sectors when they are expected to underperform. This strategy can hold securities either directly or indirectly through investments managed by a member of the Macquarie Group and external managers. This strategy may also be exposed to derivatives to implement its investment strategy or to hedge risk. This strategy is generally hedged to Australian dollars.

Investment Option Performance

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

Investment Option Overview

Investment Category	Aust. Fixed Interest
Suggested Investment timeframe	3 years
Relative risk rating	5 / Medium to High
Investment style	Income
Manager style	Single Manager

Asset Allocation	Benchmark (%)	Actual (%)
Investment Grade	20-100	95
Hybrids	0-10	0.0
Global High Yield	0-15	0
Emerging Market Debt	0-15	5

Sector Allocation	%
Banking	23.6
Residential mortgage	13.1
Non-agency CMBS	5.2
Electric	4.4
Owned No Guarantee	3.6

Regional Allocation	%
Australia	44.7
United States	18.5
UK	2.9
Europe Ex UK	6.2
Other	9.2

Top Holdings	%
NAB	1.7
Suncorp	1.3
Australian Government	1.2
CBA	1.2
WST_20-1	1.1
Bank of America	1.0
Suncorp	1.0
Transurban	1.0
NAB	0.8
METR_19-1	0.7

Investment Option Commentary

Performance for the first quarter was dominated by moves in March, with historic volatility and weakness in that month defining the period. Prior to March the strategy had outperformed in both January and February, and had moved into its most defensive position for several years with lower direct credit exposure, credit hedges in place in meaningful size, zero allocation to high yield (HY) credit, and an allocation to interest rate duration to provide some buffer to the strategy's risk positions. Despite these changes, given the speed and size of the moves, March performance was below benchmark and led to the quarterly result also lagging.

The strategy entered the period with a defensive stance holding lower credit risk than it has held for several years. The strategy significantly trimmed investment grade (IG) credit risk exposures in the second half of 2019 and early 2020 and held no exposure to high yield (HY) credit. The strategy continued to maintain a moderate level of interest rate duration as a buffer against volatility. Nonetheless, the strategy's holdings of global credit detracted from performance considerably during the month, against a backdrop of acute volatility and rapid weakness in credit markets. The scale of the volatility was historic and generally widespread, with moves in US IG spreads breaking records for the speed and size of the moves, widening from recent tights of just over 100bps to over 350bps by mid-March. HY spreads were more heavily impacted, widening by 750bps before rebounding modestly. The US market was most heavily impacted, partly reflecting the degree of change in outlook, but also because USD credit is generally the most liquid market and is able to be sold during periods where investors demand cash and safe havens.

There were modest portfolio changes in the quarter, with the strategy adding interest rate duration in Australia as yields rose around the mid-March liquidity squeeze at attractive levels. In IG credit some holdings were trimmed in energy and BBB rated issuers where the fundamental outlook has changed materially. US Agency MBS positions were reduced at spreads almost equal to pre-crisis levels in the latter half of March as the US Federal Reserve (Fed) announced they would purchase Agency MBS in unlimited quantities. These activities increased the strategy's cash and equivalent exposures to almost 20%.

Market Commentary

In the US investment grade (IG) spreads closed 179bps wider at an option-adjusted spread of 274bps after hitting levels as wide as 373bps, the widest since the global financial crisis (GFC). High yield (HY) also had significant moves finishing the month nearly 700bps wider at 1,142bps after being as wide as 1,275bps. Given the unprecedent support provide by central banks and governments the focus of the quarter were the events in March. Away from broad market moves, certain industries were clearly more affected, as IG energy bonds traded almost 400bps wider in Q1, and travel and leisure sectors such as airlines, hotels and cruise lines were also heavily impacted.

Australian credit widened over the quarter with most of the repricing occurring in March when concerns about COVID-19 became reality. In the March quarter credit widening 79bps, relative to US IG and European IG which widened 179bps and 146bps respectively. This was largely a function of the lower liquidity in the Australian credit market with relatively light volumes trading outside of major bank senior bonds. There is reasonable dispersion in performance across corporates with defensive issuers such as Coles outperforming stressed sectors such as airlines by approximately 150-200bps. The primary market in Australia had reduced liquidity during the quarter, a function of the summer holidays combined with growing concerns about COVID-19. Notably, the Australian Office of Financial Management (AOFM) started providing support to the securitisation market with a $15bn Structured Finance Support Fund to ensure liquidity, in particular for non-bank financial institutions. In the one primary deal during March, Firstmac 20-1, the AOFM was the sole third party investor in the class A2 note, buying 19% of the deal and bringing the pricing down to 75bps compared to the original price guidance of 225bps. The Term Financing Facility provided by the Reserve Bank of Australia (RBA) to the major banks returned some liquidity to Australian major bank paper by month end.

Outlook

Macquarie have often referred to the post-GFC environment as one where central banks have actively worked to reduce volatility and therefore contain the risks for investors – they referred to this as the central bank 'contained environment'. This environment delivered many years of healthy returns for asset markets. At present policy makers are witnessing a crisis in demand, in supply, and now in financial markets. The response has been breathtaking in speed, but none of these efforts can stop the spread of the virus. They therefore ask, has the container been smashed?

In the short term there is a lot of debate of just how deep the downturn will be. Early economic data is suggesting that this will be worse than 2008-09. Equity markets have moved to discount a recession, but not something worse. Thus, upcoming data will be scrutinised in this context. However, the more difficult question to be answered is how long will this slump persist? Monetary policy action is trying to keep markets functioning. Fiscal policy action is being called 'stimulus' in the media, but in reality it is more of a rescue effort for the loss of income for the many workers becoming unemployed. Macquarie are not experts on health, but this global shutdown seems likely to persist through most or all of the second quarter and while demand can respond quickly thereafter, the re-engagement of supply will take considerable time. Health experts also warn of the risk for a second wave of the virus once we go back to work. This suggests that growth will be compromised for an extended period and that a V-style rebound is not their base case assumption.

Availability

Product name	APIR
AMP Flexible Lifetime Super	AMP1525AU
AMP Flexible Super - Retirement account	AMP1585AU
AMP Flexible Super - Super account	AMP1573AU
CustomSuper	AMP1525AU
Flexible Lifetime - Allocated Pension	AMP1537AU
Flexible Lifetime - Term Pension	AMP2018AU
Flexible Lifetime Investment (Series 2)	AMP2038AU
SignatureSuper	AMP1549AU
SignatureSuper Allocated Pension	AMP1561AU

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