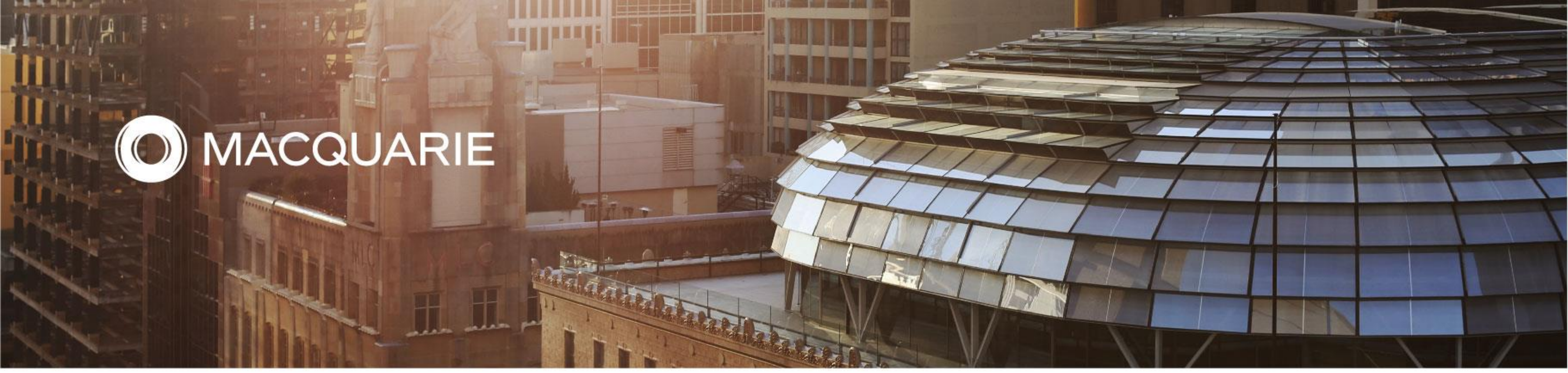


Investment Strategy Update #140

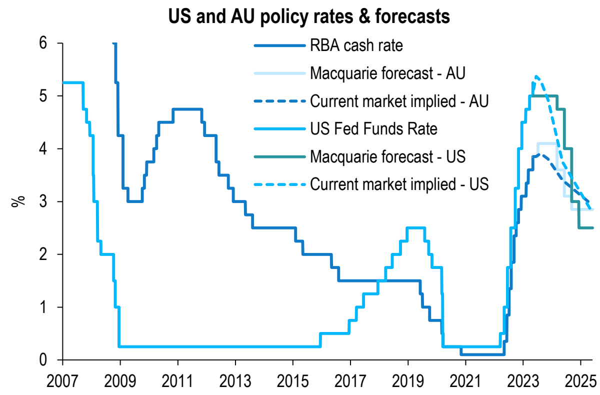
Fixed Income: How to position for the end of rate hikes

- We believe we are close to the end of central bank rate hikes across most of the developed world including the US and Australia.
- Typically bond yields peak on average around 3 months before policy rates peak. If history is a guide, and we have no reason to believe otherwise, investors have a short window to lock in peak yields before they begin to decline.
- We believe risk-adjusted returns will favour bonds over equities in the coming 3-6 months as policy rates stabilize and as economic growth risks materialize. We recommend investors begin to reduce cash allocations in favour of (sovereign) bonds as a first step towards raising portfolio risk exposure. Raising equity exposure will come when rate cuts are more imminent but there is limited transparency around timing at this stage.
- For more than a decade, investors have sought to boost yield (income) in areas outside of sovereign bonds such as equities, credit, and alternative assets (property & infrastructure). This has changed. Sovereign bonds now provide yield and protection against a deteriorating economic backdrop.
- However, while we are positive on the outlook for sovereign bonds, the outlook for credit is more nuanced. Credit conditions are tightening, and default rates are expected to increase. We don’t expect a broad-based credit crunch, but macroeconomic risks alongside oscillating fears around financial stability mean we prefer investment grade over high yield.
- We recommend investors reduce overweight cash holdings in favour of sovereign bonds before interest rates and return on deposits (cash accounts) begin to fall. At this stage, we are underweight credit where the risk reward trade-off is unappealing We would not recommend adding risk in the pursuit of higher yields outside of short-dated investment grade credit.

End of rate hikes = the peak in yields

Forecasting peak rates has been a moving feast throughout the past 6 months. Macquarie think the RBA has one further rate hike to come (from 3.85% to 4.10%) with expectations that the Fed is not done (at 5.00-5.25%). Regardless of whether this forecast proves correct, we are close to the end of the most aggressive rate hike cycle since the 1980’s.

Interest rates have peaked in the US and Australia



Source: Factset, MWM Research, May 2023

While inflation is falling fast, the consequences of policy tightening is only beginning to emerge – exacerbated by recent US bank failures / takeover of Credit Suisse by UBS - which is driving a broad tightening in lending standards. At this stage we are still hopeful of a US soft landing (a short and shallow recession), but the risk around a deeper and/or more prolonged slowdown cannot be ignored.

Macquarie’s base case remains for a short, shallow recession in the US commencing in 3Q23. However, in contrast to market pricing which implies the Fed will deliver ~75bps of rate cuts before year end, Macquarie expects the Fed to remain on hold into year end and with the first cut to rates in 2024 in line with the Fed’s forecasts.

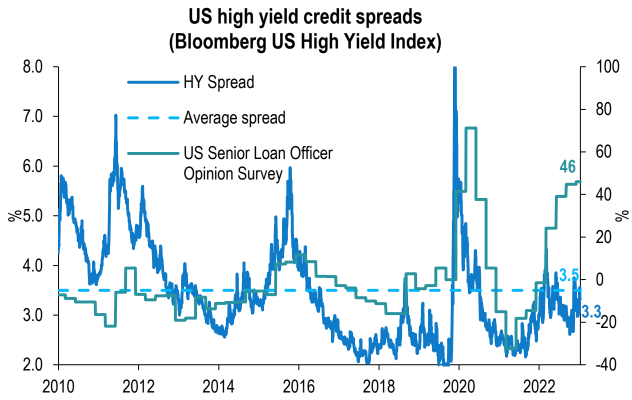
What do peak rates and slowing economic growth mean for fixed income? Empirically, bond yields tend to peak on average 3 months before the last interest rate rise which mean we could have already seen the peak in bond yields for the current tightening cycle with meaningful declines expected over the coming 12 months. (Macquarie forecasts that US and AU 10-year treasury yield at 2.50% and 2.75%, respectively, by the end of 2024 from peak levels in the current cycle of ~4.00%).

Uncertainty around the economic outlook and/or how quickly the Fed and other central banks start the rate cut cycle (exacerbated in the near term by US debt ceiling negotiations) will keep bond market volatility elevated, particularly in the short end of the yield curve.

Credit not priced for economic risks despite solid fundamentals

We remain cautious on corporate credit despite solid fundamentals that would suggest spread widening remains modest versus other economic downturns and idiosyncratic. Moody's base case is for the default rate to increase to ~4.9% by 2Q24 (from ~3% currently) with the greatest impact on low-rated, speculative debt issuers. This would put it back in line with long run average levels.

Tighter loan standards lead credit spreads higher



Source: Factset, Bloomberg, MWM Research, May 2023

We see no signs that the default cycle will be worse than anticipated and/or lead to a broad-based credit squeeze like that was seen in the Global Financial Crisis. However, tightening credit standards in conjunction with ongoing balance sheet reduction by Central Banks means we remain cautious on credit and believe liquidity should be a key driver of investment positioning within fixed income.

Reduce cash and raise sovereign allocations

We recommend investors reduce overweight allocations to cash before deposit rates come under downward pressure and move overweight sovereign bonds before yields begin to move lower in anticipation of recession and the start of a policy rate cut cycle. For a balanced portfolio, with a total of 35% allocated to fixed income we would recommend ~25% should be invested in sovereign bonds.

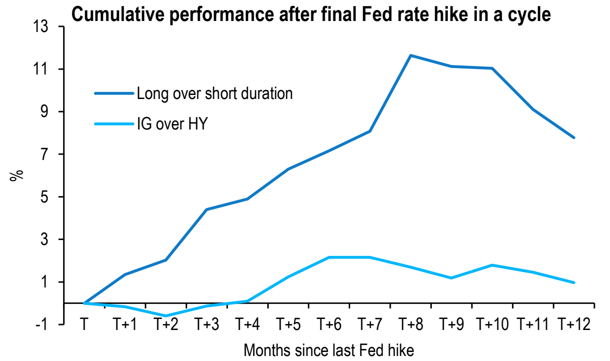
Sovereign bonds offer diversification and downside protection in the case of growth asset weakness while also offering attractive absolute and relative yields. Historically, on average,10-year treasury yields fall between ~2.0% - 2.5% in recession which off current levels would see yields down to ~1.5% and generating a total return from sovereign bonds of ~19%. Furthermore, if the past is any guide, once the Fed has completed raising rates, it does not pause for a long time, cutting rates on average 5 months after the last hike.

Attractive returns on bonds irrespective of Fed actions

	Fed pause (expansion)	Fed pause (recession)	Fed pivot (expansion)	Fed pivot (recession)
S&P 500	22%	-21%	34%	8%
10-yr UST	8%	0%	19%	12%

Source: PIMCO, MWM Research, May 2023. "Fed pause" defined as average 12-month forward return when the next Fed rate change is at least six months after its last change in policy rates. "Fed pivot" is defined when the next Fed rate change is before 6 months. Index data since 1950.

Long dated sovereigns outperform post final rate hike

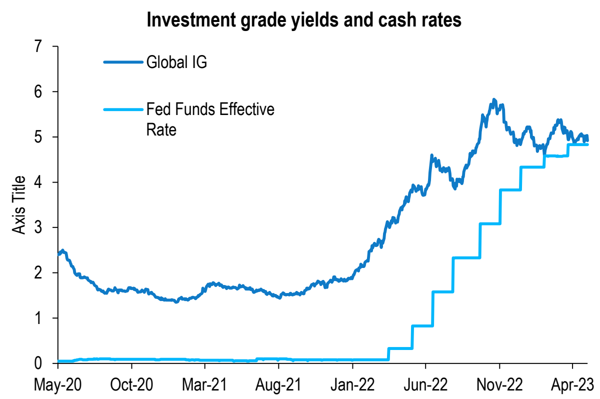


Source: Factset, MWM Research, May 2023

Underweight credit until economic growth risks become clearer

Credit is a relative call. We think sovereign bonds will outperform credit as growth risks intensify and for high quality credit (investment grade) to outperform low quality credit (high yield). However, investment grade yields are already close to the cash rate and while default risk is low, there remains significant risk of mark-to-market to loss as credit spreads widen which they always do when credit conditions tighten and growth slows.

Yields on IG bonds are only slightly above cash



Source: Factset, MWM Research, May 2023

For this reason, we prefer short-dated (less than 3 years) investment grade credit where the impact of credit spread widening is negated by the pull-to-par impact as bonds get close to maturity (bond prices approach $100) and liquidity is superior. Absolute yields on high yield and EM debt are attractive, but we think that there will be better entry points for patient investors with access to liquidity to take advantage of superior risk-reward opportunities once credit spreads widen.

Macquarie WM Investment Strategy Team

The report was finalised on 15 May 2023.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

The analyst(s) responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited (ABN 94 122 169 279 AFSL 318062) ("MGL") and its related entities (the "Macquarie Group", "MGL", "We" or "Us"). No part of the compensation of the analyst(s) was, is or will be directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited (ABN 41 002 574 923 AFSL 237504) ("MEL" or "We"), a Participant of the ASX. MEL is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Cth), and MEL's obligations do not represent deposits or other liabilities of Macquarie Bank Limited (ABN 46 008 583 542). Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MEL.

This research contains general advice and does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. Past performance is not a reliable indicator of future performance. You should consider all factors and risks before making a decision. Please refer to MEL's Financial Services Guide (FSG) for more information at **https://www.macquarie.com.au/advisers/financial-services-guide.html**.

This research has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient, you must not use or disclose this research in any way. If you received it in error, please tell us immediately by return e-mail and delete the document. We do not guarantee the integrity of any links, e-mails or attached files and are not responsible for any changes made to them by any other person. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research 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 it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. The Macquarie Group produces a variety of research products, recommendations contained in one type of research product may differ from recommendations contained in other types of research.

The Macquarie Group has established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. The Macquarie Group, its officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. The Macquarie Group may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. The Macquarie Group's employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research. Investors should obtain and consider the Product Disclosure Statement ("PDS") or offer document of the financial product before making any financial investment decision. You can obtain the relevant PDS or offer document by contacting the issuer of the product, or as identified below:

Important disclosure information regarding the subject companies covered in this report is available at **macquarie.com/disclosures**.