MACQUARIE

MACQUARIE ASSET MANAGEMENT

Higher rates, tighter credit, and less liquidity matter

Fixed Income Strategic Forum 2023 | Issue 03

Key takeaways

Maybe it's different this time?	We believe contributors to market resilience, including fiscal support, artificial intelligence (AI)-led equities, and quantitative easing (QE), seem poised to fade, as does "maybe it'll be different."
Brace for impact	The long and variable lags of significant monetary, credit, and liquidity tightening are converging. It's only a matter of time.
QT – the straw that broke the (bond) market's back?	With the US Federal Reserve implementing quantitative tightening (QT) again, bond markets are asking "who will buy bonds now?" The market is disconnecting from fundamentals.
Higher for longer? Well, until something breaks	"Higher for longer," in such an indebted system, is not celebratory. The longer rates stay higher, the more inevitable financial market dislocation.

Take an in-depth look

Investment themes

Maybe it's different this time?

- Evidence supporting the likelihood of a recession has continued to build, yet financial markets have continued to perform well, seemingly embracing the soft or no recession scenario.
- Key contributors to this year's market resilience include stronger-than-expected fiscal policy, the pronounced influence of the seven mega technology firms which are referred to as the "Magnificent Seven" on equity markets, and the absence of QT.
- With the roll off of significant fiscal support policies, rising concerns over equity valuations, and the shift back to QT, these factors appear set to diminish in our view.
- As such, we believe the narratives of "more resilient economy," "higher for longer," and "maybe it's different this time" also seem poised to fade.

Brace for impact

- We are experiencing the fastest, broadest, and steepest hiking cycle in 40 years. Noting, monetary policy typically takes 12-18 months to show the full effects.
- We are also experiencing a significant shift toward liquidity contraction and/or QT, following more than 10 years of constant positive liquidity support via QE.
- Since March, financial institutions have tightened lending standards. Similar to monetary policy's long and variable lags, this level of tightening has typically led to recessions, with the onset lagging by approximately 6-9 months.
- Ultimately, higher rates matter. Tightening of credit conditions matters. QT matters. The long and variable lags have these three significant forces converging in Q42023 and into Q12024. **It's only a matter of time.**

QT – the straw that broke the (bond) market's back?

- The increase in US government borrowing has led to increased issuance of US bonds. This is while the Fed is attempting to implement QT again. Meaning, the previously largest buyer of US Treasurys, the Fed, is not a buyer anymore.
- As such, bond markets are increasingly concerned about "who will buy?" all the new issuance.
- We believe the imbalance will be further impacted by other significant buyers of US Treasurys, including China, Russia, and Japan, who are increasingly absent.
- Fundamentally, the bond market appears to be disconnecting from the softening economic cycle, and if this drift higher in yields continues, it will place even further pressure on the economy and financial markets.

Higher for longer? Well, until something breaks

- Our base case is for a cyclical recession, such as experienced in 2001. However, financial markets are not the economy, and like the 2001 "tech crash," we note the potential for a harder landing for financial markets this cycle.
- We would caution that "higher for longer" is not something to celebrate. "Higher for longer," particularly in such an indebted system, is not conducive to a soft landing at all. The more time that goes past, the more likely things will break in the financial system and the more likely a hard landing occurs, in our view.
- We do not believe the central banks will realise their aspirations of "higher for longer," given the converging of considerable monetary, credit, and liquidity tightening inevitably triggering further financial market dislocation.

Investment themes

Our investment outlook

- A **volatile (but delayed)** risk environment for markets is expected, necessitating a **prudent** investment approach.
- Our focus remains on defensive investment positioning, watchful for shifts in **liquidity** that could suddenly arise.
- **History** guides that bond yields decline once the hiking cycle has clearly peaked, and thus we remain **positive on bonds.**
- Global **credit** markets have been resilient, but we maintain a **cautious** outlook as valuations are pricing limited downside scenarios.

Constructive: Rates/duration

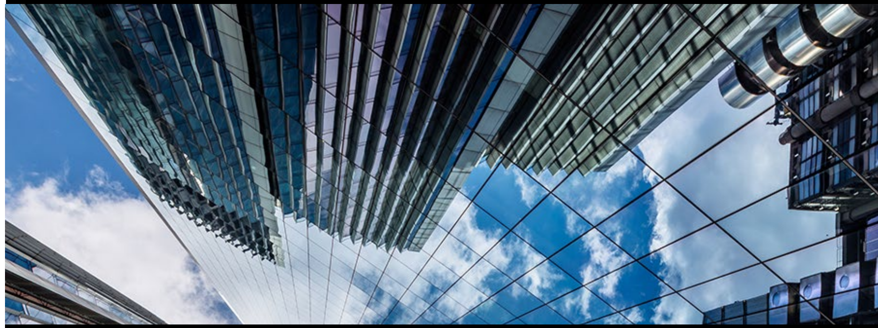
Bonds offer an increasingly **attractive investment proposition** both as a **recession hedge** and as an **outright source of yield for a defensive asset allocation,** although short-term volatility may remain.

Cautious: Risk markets

Defensive outlook – market valuations across the credit spectrum, including credit, structured securities, and emerging markets debt, have likely **not fully reflected downside risks** such as a weaker economic outlook and liquidity withdrawals. Some nuances across markets provide **selective opportunities.**

Constructive: Cash

Heightened importance of reserving dry powder as opportunities arise when volatility subsides



A **volatile (but delayed)** risk environment for markets is expected, necessitating a prudent investment approach.

Source: Macquarie. Views as of September 2023, subject to change without notice.

Important information and disclaimers

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.

Other than Macquarie Bank Limited ABN 46 008 583 542 (Macquarie Bank), any Macquarie Group entity noted in this document is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Commonwealth of Australia). The obligations of these other Macquarie Group entities do not represent deposits or other liabilities of Macquarie Bank. Macquarie Bank does not guarantee or otherwise provide assurance in respect of the obligations of these other Macquarie Group entities. In addition, if this document relates to an investment, (a) the investor is subject to investment risk including possible delays in repayment and loss of income and principal invested and (b) none of Macquarie Bank or any other Macquarie Group entity guarantees any particular rate of return on or the performance of the investment, nor do they guarantee repayment of capital in respect of the investment.

Diversification may not protect against market risk.

Past performance does not guarantee future results.

Important information and disclaimers

Equity securities are subject to price fluctuation and possible loss of principal.

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.

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.

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.

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.

Liquidity risk is the possibility that securities cannot be readily sold within seven days at approximately the price at which a fund has valued them.

Investments in collateralized loan obligations (CLOs) 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.

The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. It is also used to predict changes in economic output and growth.

The shape of the yield curve is closely scrutinized because it helps to give an idea of future interest rate change and economic activity. There are three main types of yield curve shapes: normal, inverted and flat (or humped). A normal yield curve is one in which longer maturity bonds have a higher yield compared to shorter-term bonds due to the risks associated with time. An inverted yield curve is one in which the shorter-term yields are higher than the longer-term yields, which can be a sign of upcoming recession. A flat (or humped) yield curve is one in which the shorter- and longer-term yields are very close to each other, which is also a predictor of an economic transition. The slope of the yield curve is also seen as important: the greater the slope, the greater the gap between short- and long-term rates.

Dry powder refers to cash reserves or other liquid securities that can be utilized when an attractive investment opportunity arises or to weather a downturn.

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.

Quantitative easing is a government monetary policy used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increased the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Quantitative tightening (QT) refers to when central banks raise the federal funds rate. In a tightening monetary policy environment, a reduction in the money supply is a factor that can significantly help to slow or keep the domestic currency from inflation.

Recession is a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in gross domestic product (GDP) in two successive quarters.

Economic trend information is sourced from Bloomberg unless otherwise noted.