

Macquarie Asset Management

New Zealand Fixed Interest update

Prepared for Aurora Capital Limited

August 2024



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Credit overview

A global credit platform offering focused expertise and solutions across liquidity, risk and return spectrums



MAM Credit Platform		
Fixed Income	Leveraged Credit	Private Credit
Global Fixed Income	High Yield	Infrastructure
US Fixed Income	Bank Loans	Fund Capital
Australian Fixed Income	CLO Debt	Real Estate
IG Credit and ABS	Multi-Asset Credit	Private Placements
Emerging Markets Debt		Asset Finance
Insurance		

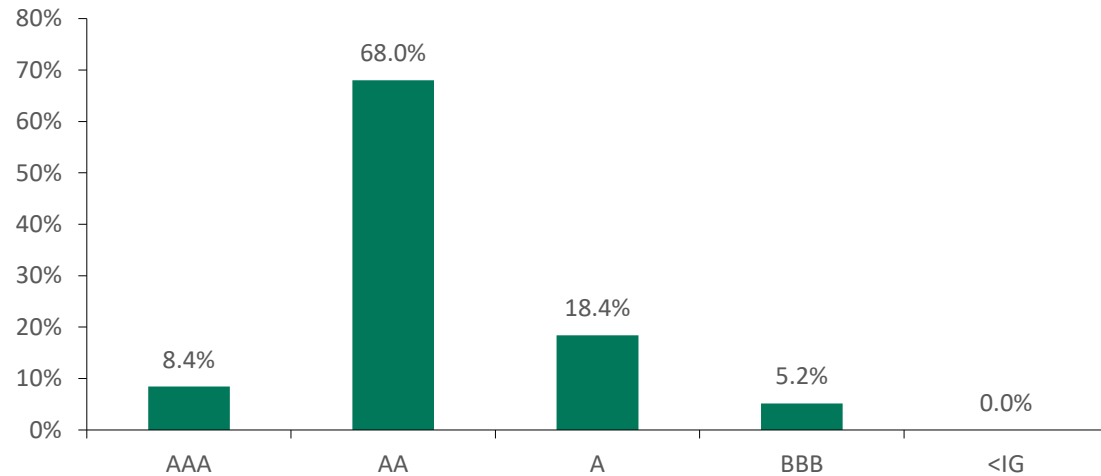
Source: Internal Macquarie data includes private credit transactions for both clients and balance sheet; assets under management represents the amount of capital that has been deployed into underlying investments and also includes undrawn commitments, as well as the enterprise value of asset finance investments. As at 30 June 2024.

The Mercer-Macquarie NZ Fixed Income Fund

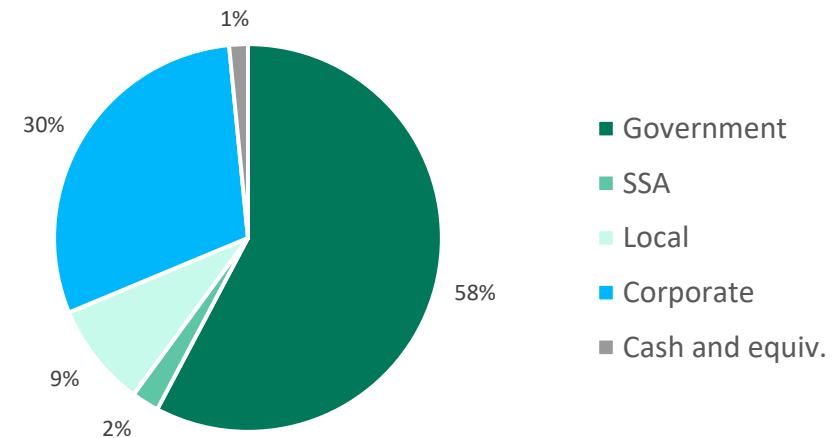
Performance and positioning

Pre fee as at 31 July 2024	YTD %	1 years % pa	5 years % pa	10 years % pa	Since inception* % pa
NZ Fixed Interest Fund	3.76	8.43	0.57	3.34	6.22
Benchmark^	3.39	7.81	0.10	2.83	5.41
Excess performance	+0.37	+0.62	+0.47	0.50	+0.81

Credit rating breakdown



Asset Allocation by issuer sector



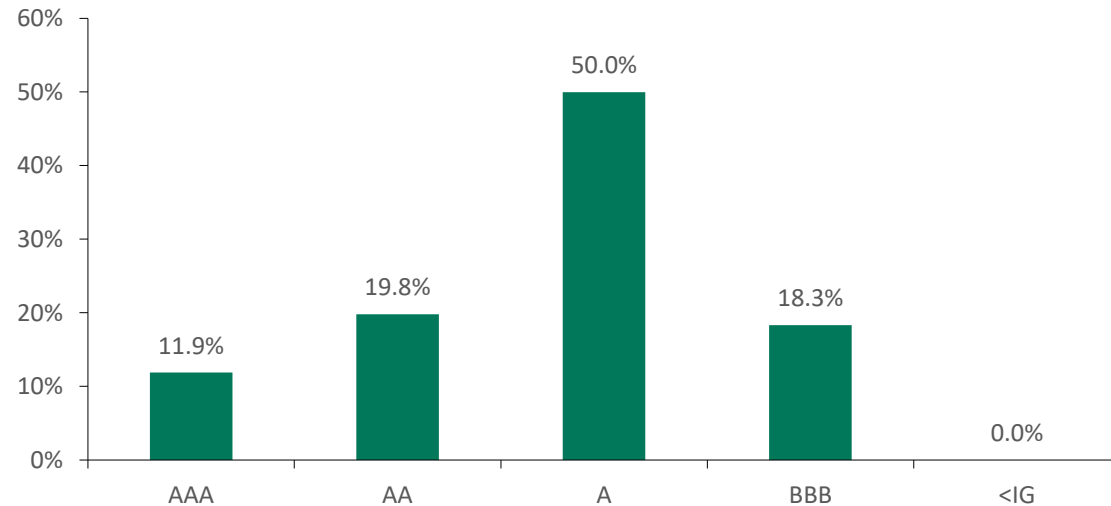
Past performance is not a reliable indicator of future performance. *Inception of the NZ Fixed Interest Fund is June 1995
 ^The current benchmark of the NZ Fixed Interest Fund is the NZBond Composite 0+ Yr Index. Previous to 2018 it was the NZBond Govt 0+ Yr Index.
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The Mercer-Macquarie NZ Short Duration Mandate

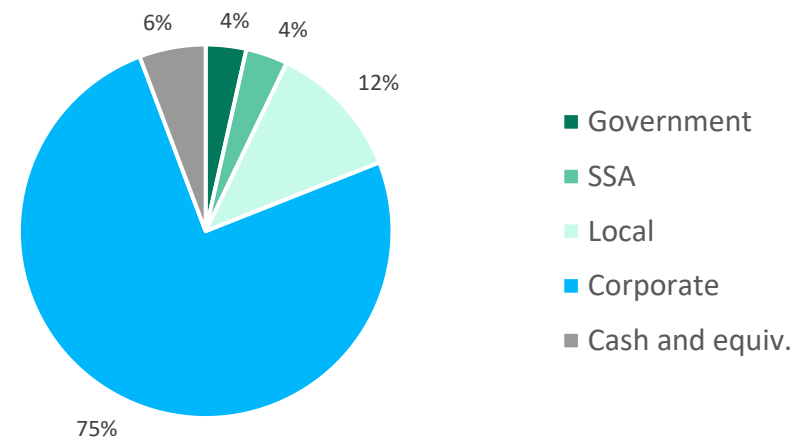
Performance and positioning

Pre fee as at 31 July 2024	YTD %	1 years % pa	5 years % pa	10 years % pa	Since inception* % pa
NZ Short Duration Fund	3.99	8.02	2.35	3.53	4.48
NZBond Swaps 1-3 Yr	3.66	7.53	1.63	2.63	3.08
Excess performance	+0.33	+0.49	+0.72	+0.90	+1.40

Credit rating breakdown



Asset Allocation by issuer sector



Past performance is not a reliable indicator of future performance. *Inception of the NZ Short Duration Fund is October 2007

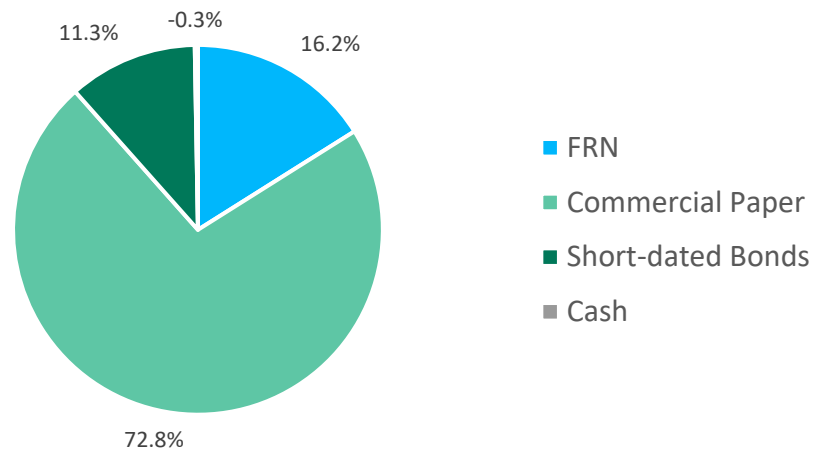
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The Mercer Macquarie NZ Cash Fund

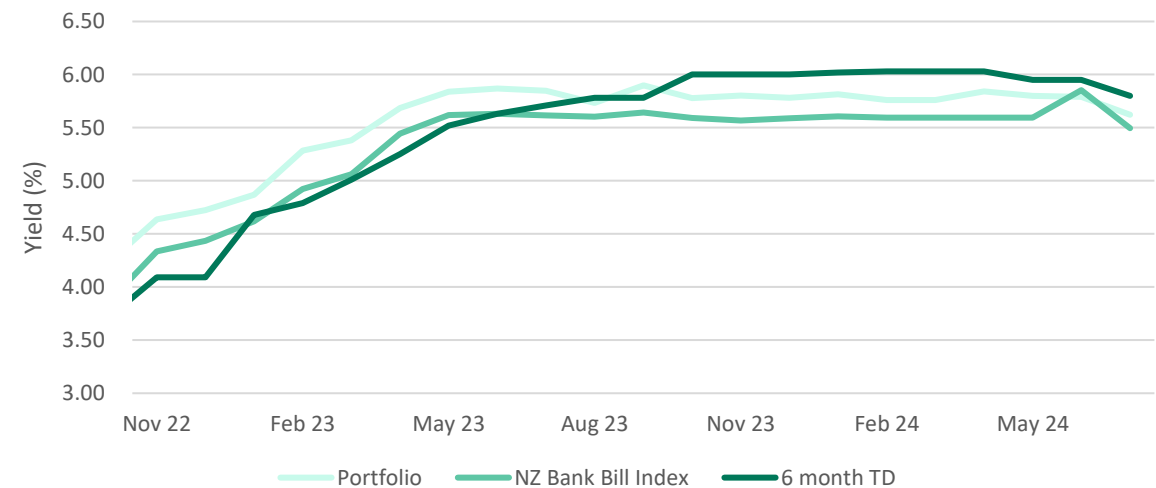
Performance and positioning

Pre fee as at 31 July 2024	YTD %	1 years % pa	5 years % pa	10 years % pa	Since inception* % pa
NZ Cash Fund	3.54	6.13	2.80	2.85	5.06
NZBond Bank Bill	3.33	5.80	2.52	2.51	4.72
Excess performance	+0.21	+0.33	+0.28	+0.35	+0.34

Allocation by security type (%)



Yield to maturity history



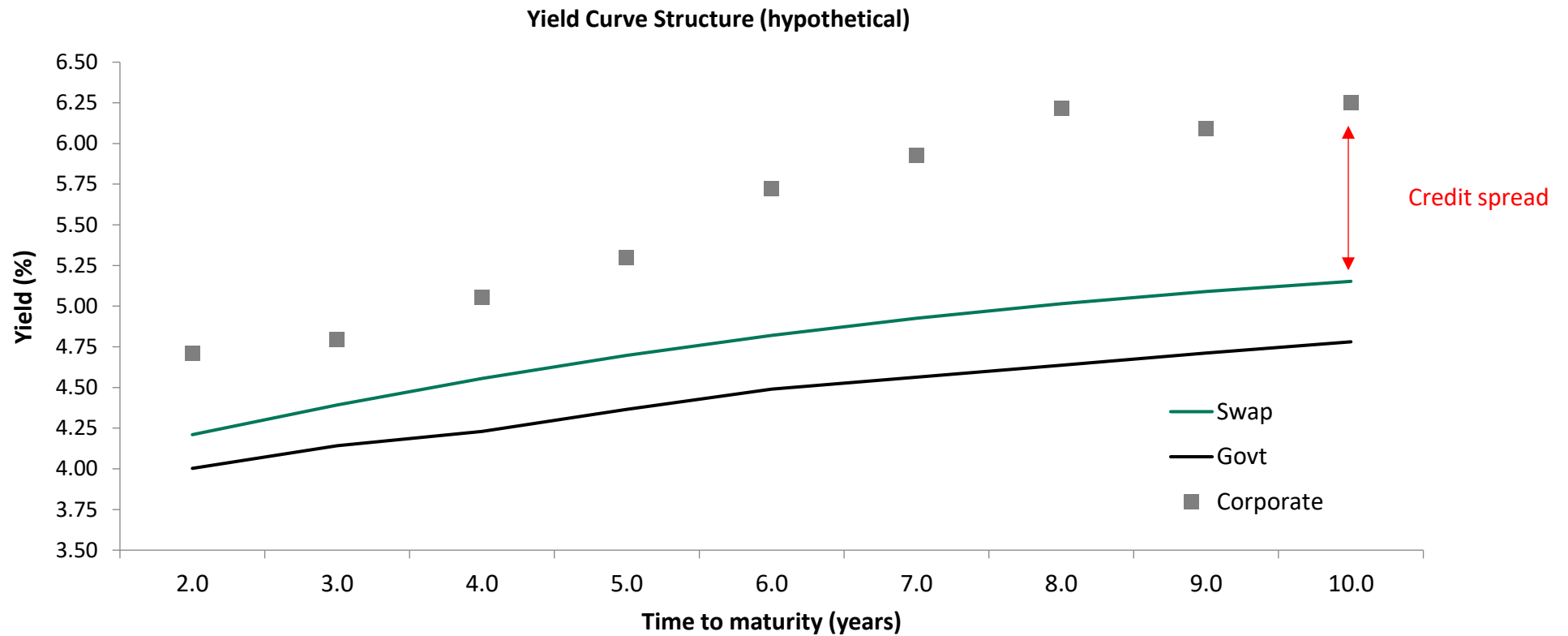
Past performance is not a reliable indicator of future performance. *Inception of the NZ Cash Fund is June 1995

Key drivers of wholesale interest rates

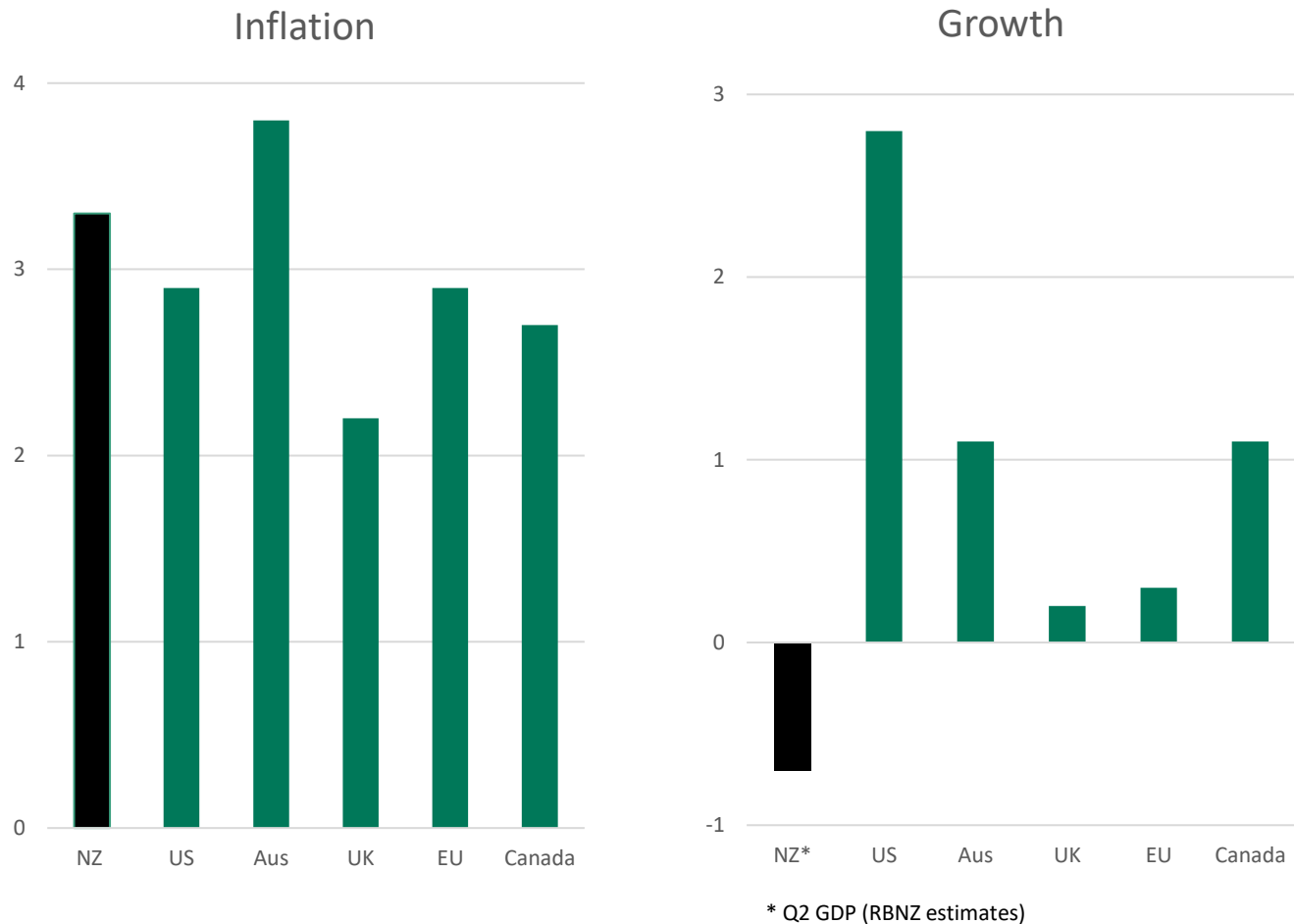
- Expectations for RBNZ policy rate - the Overnight Cash Rate (OCR)
- Where the OCR settles in time (“Neutral”) – a function of our trading partner’s growth and global inflation
- Fiscal policy – how this impacts the OCR and government bond issuance
- Currency
- Supply and demand for hedging / Issuance
- Liquidity and uncertainty – higher premium or insurance in case things don’t pan out as we expect
 - Inflation expectations become unhinged
 - Perhaps “Neutral” is shifting from prior cycles
 - High issuance when there are fewer buyers
- The business cycle / Bank funding costs – what offshore riskier assets are doing is important given our banks borrow offshore

Fixed Income - Hypothetical Yield Curve

Yield Curve Structure (Hypothetical)



Late rate cycle dynamics: The bumpy path to neutral



Source: Bloomberg, Stats NZ, RBNZ

- RBNZ joins BOE, ECB and BOC as the major central banks to cut rates.
- UK growth continues to recover from a weak start to 2024 while Eurozone performance is hampered by sluggish German production. The respective central banks, however, have signalled a very cautious and steady reduction in rates going forward.
- The US economic growth and consumer demand remains robust, although the economy is cooling steadily enough to bring inflation back towards the Fed's target band. Risks are skewed towards a harder landing and the Fed has signalled that rate cuts may begin in September, 2 meetings earlier than their forecast in July suggested.
- Australia is a global outlier, having not hiked rates as high as peers it's likely that RBA will need to hold rates for longer to bring inflation back towards their target band.

Investment implications

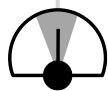
Our investment outlook

- Economic downside risk remains elevated, and as such we see value in a more **defensive positioning** given the balance of risks.
- For the time being, we prefer to stay **liquid**, stay **longer duration**, and remain **patient** for better entry levels in credit markets.
- While we are **wary of the inevitable greater use of fiscal policy** and its increasingly concerning impact on government financing, as well as its potential to create stickier inflation, we sense the sequence is bond yields down first, with perhaps greater bond yield curve volatility.



Constructive: Rates/duration

As inflation has come down meaningfully from its peak and interest rates remain in restrictive territory, we **remain longer duration** and utilise it as our main lever to express our defensiveness - which could prove advantageous as the softening economic trend continues.



Neutral: Risk markets

Risk markets have benefited from a benign environment. Corporate fundamentals are softening but are still in a strong position. In credit markets, technical support also persists with high demand from all-in yield buyers. This mildly positive outlook has seen credit spreads move to markedly tight levels, with only select pockets of value available. Hence, **we are neutral**.



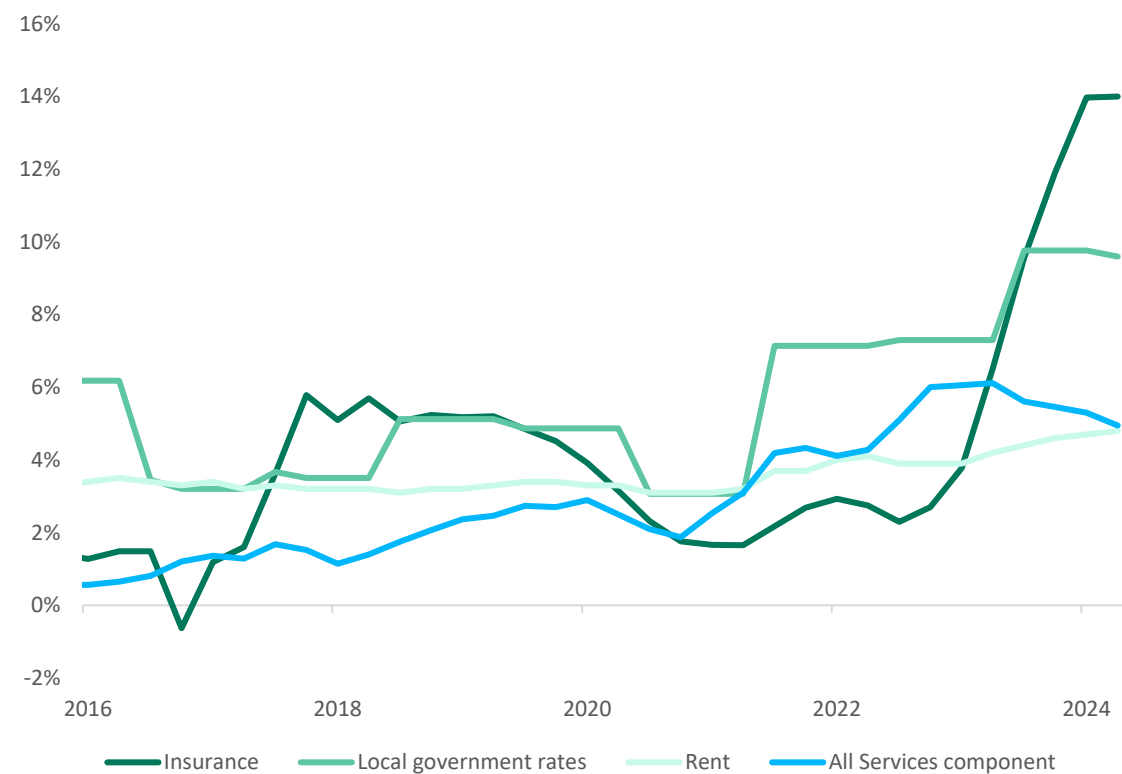
Constructive: Cash

We remain constructive on cash, given that there is a heightened importance to **maintain elevated levels of liquidity** to invest in opportunities as they arise when volatility subsides.

Economic downside risk remains elevated, and as such we see value in a more **defensive positioning** given the balance of risks

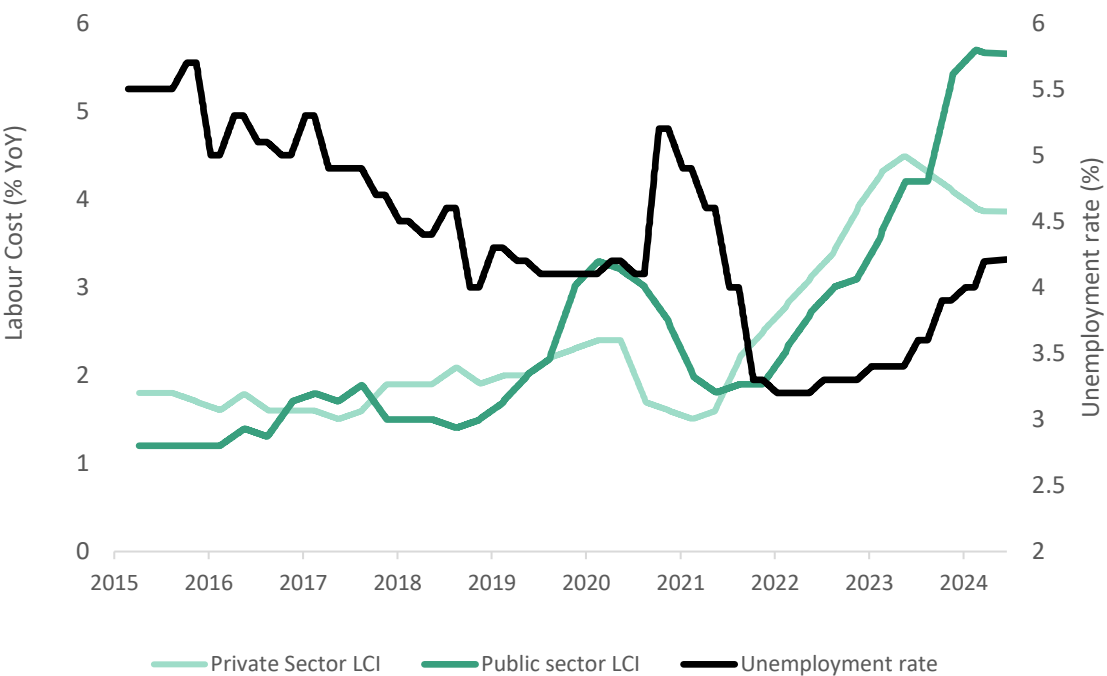
RBNZ has grown in confidence that inflation will continue downwards trend

Services inflation remains far too high



Source: Bloomberg, Stats NZ, Macrobond

Labour costs remain elevated despite unemployment rising to pre-Covid levels

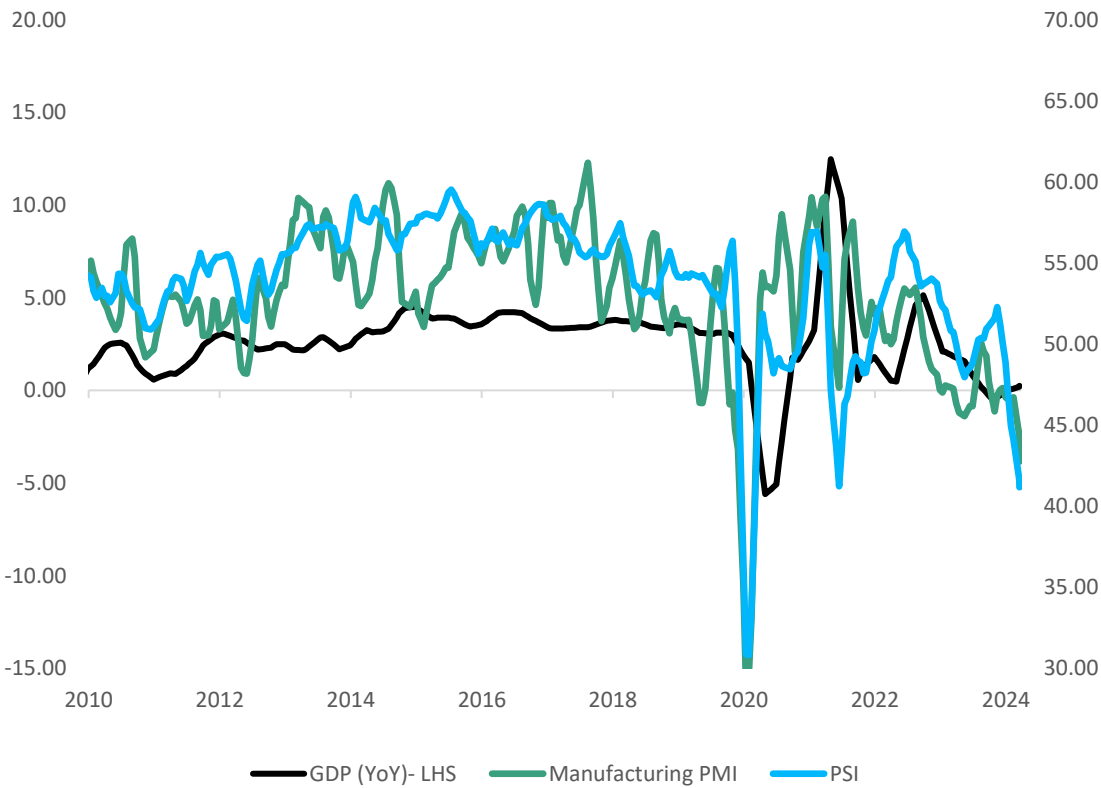


Source: Bloomberg, Stats NZ

NZ Economic Outlook

The New Zealand economic data has continued to soften, posing a risk to GDP ahead.
A bounce in sentiment re-igniting the housing market and spending could still see a slower pace of cuts

Economic data remains weak



Flicker of a glimmer of hope in ANZ's surveys



2H 2024 Outlook

In the short term, we expect growth to deteriorate rapidly before recovering in early 2025 as rate cuts take effect on the economy. Inflation is likely to retreat within RBNZ’s target range but the path to the 2% target level may be a drawn-out and bumpy process.

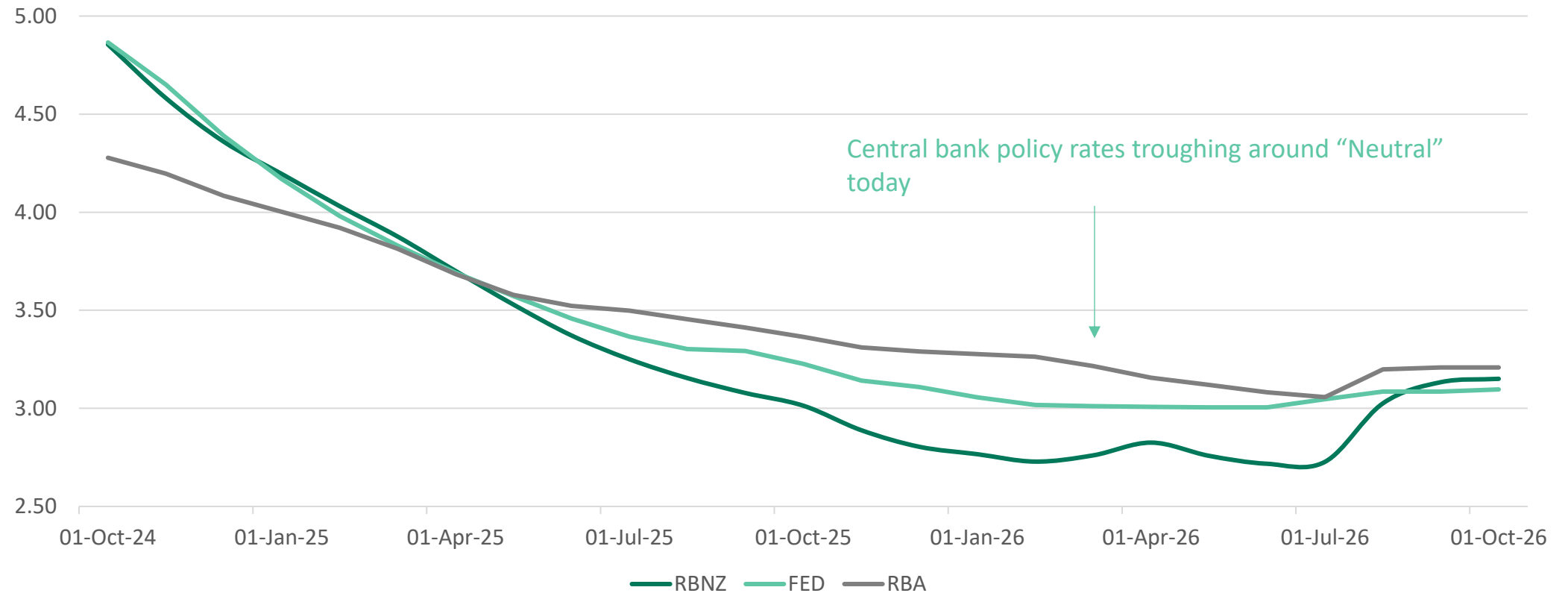
NZ Key Forecast Ranges			
	Current	Forecast	Commentary
GDP (YoY)	0.3%	-0.1 - -0.4%	<ul style="list-style-type: none"> Q2 GDP (released in September) is expected to deteriorate significantly, possibly pushing NZ into a triple dip recession. Early signs of optimism are apparent as RBNZ has signalled easing rates but it's too early to tell how quickly the economy will rebound from this year's weak levels.
CPI (YOY)	3.3%	2.2 – 2.7%	<ul style="list-style-type: none"> Inflation is expected to return to RBNZ’s 1-3% target band by year-end. Non-tradeable components are expected to remain sticky in the short term but ultimately subside as underlying inflation pressures ease
RBNZ	5.25%	4.75 – 5.00%	<ul style="list-style-type: none"> RBNZ is expected to steadily cut interest rates over the next 12-18 months, remaining vigilant of the inflation risks while balancing off any protracted weakness in the economy. Risks are skewed towards a more accelerated cutting cycle should economic weakness persist longer than expected.

Bond pricing reflects cash rates troughing around “Neutral”

Fed is expected to begin easing in September and progress quickly. RBNZ is expected to follow US

What matters for future bond returns is how expectations change from here

US, Australia & NZ expected cash rate paths, %



Government bond – the risk-free rate??

Government bonds have been the laggards – not dissimilar to what we experienced post the Christchurch earthquake. Corporate issuers are having to compete with more attractive government bond prices.

10yr swap yield less 10y Government bond yield, %



ESG engagement and key themes

ESG analysis is a key input into our Company research and credit assessment

Electricity sector plays a key role in decarbonisation

- Electricity generation needs to increase 10-20% by 2030. Managing dry-year risk has not yet been solved.
- We had previously assigned an ESG score of Medium / High risk for Genesis due to the industry's reliance on Genesis's Rankine fossil fuelled generation, and Kupe ownership.
- We have upgraded in our ESG score to "Medium" as several ESG risk mitigants baked into our prior score have since played out:
 - Genesis has a clearer strategy to net zero while still reliant on new technology for alternative fuels.
 - Green bond programme is now in place
- Genesis have also shored up their balance sheet mitigating rating downgrade risk as Kupe becomes stranded demonstrating commitment to the BBB+ rating.
- We continue to engage with the broader sector. For the issuers we have exposure to we don't see any real ESG concerns, however smaller distributors may struggle to fund their network resilience.
- The greater ESG risk is neglecting to maintain assets and failing infrastructure leading to significant penalties or legal action.

Developments in the Airline Industry

- Science Based Targets Initiative (SBTi) is the globally recognised organisation setting standards and providing guidelines to companies to meet their emission reductions in line with the Paris Agreement (1.5 degrees rise in temperature).
- Air NZ was leading peers by signing up to this initiative while Qantas had not.
- This key enabler to meeting these targets is the development of commercially viable Sustainable Aviation Fuel (SAF) and now requires significantly more SAF to remain on track due to global supply chain issues and sourcing of more carbon efficient aircraft by Air NZ.
- Importantly they remain committed to 10% usage of SAF by 2030 (previously thought to be sufficient to meet the SBTi targets) and will publish an updated 2050 roadmap later this month.
- This reduces the risk of green washing accusations and brings Air NZ sustainability ambitions closer to peers.

Summary

- Central banks are done hiking and forward-looking bond markets have already adjusted in anticipation of cash rates normalising quickly, bringing strong returns in 2024 to date.
- History tells us that cash rates can fall much faster if something breaks
- However, the speed to get to end points is less certain – underpinning volatility in bond markets
- A US Recession is not set in stone, but the economy is fragile and cannot sustain high rates.
- NZ government bonds relative to swap and credit securities have reached an attractive level
- We continue to expect bonds to perform well and deliver strong diversification