

Brave new fiscal world?

Fixed Income Strategic Forum 2024 | Issue 02



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Markets are complex systems with many intertwined factors driving outcomes. Many participants and commentators, however, like to simplify these factors and embrace persuasive narratives to justify all market movements.

As we approach the middle of 2024, there are two narratives we believe to be the most compelling and prevailing:

1. **The artificial intelligence (AI) revolution is here.** The foundation required to support this narrative has only begun to be laid and includes investment into data centres, energy supply, and infrastructure more broadly.
2. **Fiscal policy is back.** Most notably in the US, whether that be for deglobalisation and/or security needs.

The intertwining thematic to note is that the world is in a new era of “industrial policy” that will drive the “new economy,” real economic growth, and therefore the next or already current bull market. There is little doubt that this is a genuine, very attractive and appealing thematic – a boon for all things infrastructure, energy, data, onshoring and friendshoring, and, most importantly, greater national security (military)-associated industries.

Whether this turns out to be indeed just a narrative or in fact a new prosperous reality, it should be noted that these themes are broadly more centric to the outlook for the US, and recent global economic growth outcomes reflect this. The same outcomes cannot be as easily witnessed within all other global economies, where many of the larger ones remain soft and either in a mild recession or at risk of one. So, at worst, what we observe today might be all that it eventuates to be – a powerful US-centric theme with the potential to drive sentiment and belief. At best, it's real and may be just the beginning of a significant driver of change in the global economy.

Either way, these persuasive themes are increasingly manifesting themselves into views that the global economy is now a very different structural economic environment, one in which the cost of capital – interest rates and bond yields – can be sustained at higher levels for longer. This comes with many questions as well as second-, third-, and fourth-order consequences. These questions and consequences were central to our debate and discussion for Issue 02 of the 2024 Strategic Forum series.

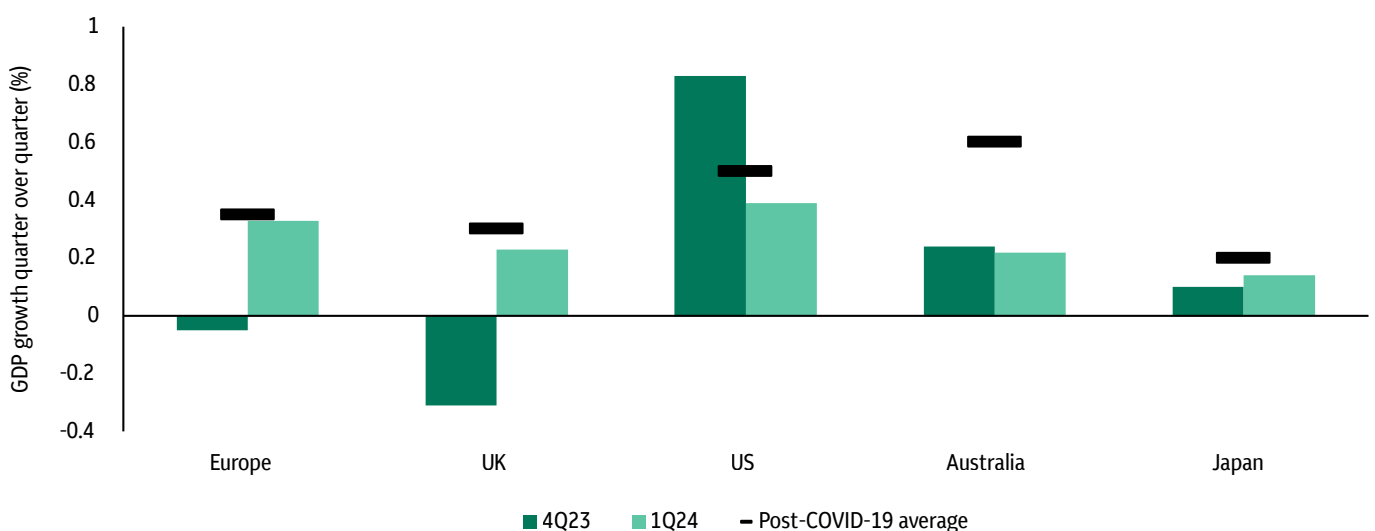
Will economies remain resilient?

As we reflect on our collective thoughts from past Strategic Forums, the key area that we underestimated was how large and how protracted US fiscal policy would be. Our view was that the fiscal stimulus relating to the pandemic was excessive and would diminish, returning to a more normalised level. While this did start to occur, it wasn't long before further fiscal largesse was enacted. As a result, we underappreciated how resilient economic growth would remain despite the significant tightening in monetary policy.

Nonetheless, while seemingly ignored by financial markets, which embraced the central bank suggestions of lower rates ahead, the reality is that global growth has softened. A closer examination of leading economic data still suggests a global economy that is dependent on more fiscal spending and/or lower rates and is not currently out of the woods. Even US economic growth, with its exceptional fiscal supports, will likely require further fiscal expansion and/or lower interest rates – likely both – to avoid the risk of further slowing ahead. We still believe that the current resilience will likely turn into fragility, as the impacts of the long and variable lags of the most aggressive monetary policy hiking cycle in decades are increasingly felt. And, yes, the long and variable lags are still out there as anyone involved in interest-rate sensitive sectors is more than aware.

Figure 1:

Regional GDP growth normalising below trend



Sources: US Bureau of Economic Analysis, UK Office of National Statistics, Eurostat, Australian Bureau of Statistics, and the Japanese Cabinet Office, May 2024.

In terms of the outlook from here, the key questions we are seeking to find answers to are:

- Will economic growth remain resilient?
- Are these prevailing, persuasive themes of AI and US fiscal-funded industrial policy enough to drive economies in a world? In other words, are we in a brave new fiscal world?
- Will fiscal policy remain elevated and supportive?
- Equally, will inflation trajectories continue lower to allow central banks to ease the monetary tightness?

All are required, in our mind, to be answered in the positive to ensure that the no-landing scenario that financial markets have embraced eventuates.

Fiscal “need” – a change of priorities as a sign of the times

Why could it be different this time? We point to the three most dominate themes.

1. The sheer magnitude of the pandemic response and subsequent ongoing use of fiscal policy – relating to infrastructure, onshoring and friendshoring, and, more interestingly, military spending – have played a significant role in offsetting much tighter monetary policy.
2. The AI hype/revolution and the Magnificent Seven (or is it six, or three, or perhaps just NVIDIA now) are leading equity market performance and affording a “halo-like” sentiment boost to broader markets and a FOMO (fear of missing out) environment.
3. The proliferation of less-interest-rate-sensitive borrowing and private market debt expansion may have changed the potency of tighter monetary policy.

These themes have elements of geopolitics, providing strong impetus and reflecting a sign of the post-pandemic times. With global trust collapsing during the pandemic and geopolitical friction rising, national priorities have changed markedly. No longer is the lowest-cost-provider globalisation model considered sensible or trustworthy. Now national security of “needs” is an equivalent, if not higher, priority. This encompasses everything from increased military expenditure to more reliant and dependable goods/needs supply chains, through to energy security, and extends to the AI-technology arms super-race inclusive of semiconductor supply (aka the CHIPS and Science Act). This shift in global prioritisation amounts to a considerable change to historical relationships and drivers of the global economy. They require governmental action, hence the now ongoing need, rather than simply want, for appropriate fiscal policy.

As a side note – yes, unfortunately the environment has lost its highest-priority mantle. Nonetheless, “greenification” should continue as an essential element of the infrastructure and energy security uplift and overhaul. Whether this will be a global priority in this environment remains questionable.

Brave new “fiscal” world?

Regardless of how persuasive the prevailing narratives may be, it is always sensible to seek evidence to answer the question, Is this real? Our views from our bottom-up credit research of specific issuers and related industries do support these themes as strong tailwinds for the US economy. We can also find evidence of the prevailing narrative in US fiscal deficits, although we are harder pressed to see it in genuine economic data releases such as Institute for Supply Management (ISM) Manufacturing Purchasing Managers' Index (PMI®), US industrial production index (IPI), and other leading indicators. Further, most consumer-related and small business sentiment indicators continue to be soft and weak. The US Federal Reserve (Fed) itself also appears eager to ease monetary policy as soon as it can, providing the inflation trajectory permits. In fact, even as we write this note, other G-7 areas (Canada and Europe) have already commenced easing monetary policy. Recall, the Fed flagged its intention to ease rates all the way back in November 2023, which in and of itself triggered the powerful belief and move in markets since. Nonetheless, the fiscal policy narrative has more recently evolved to highlighting that much of CHIPS and Inflation Reduction Act (IRA) actual fiscal spending is yet to come. Both presumptive US presidential candidates are also said to be pro-onshoring and national security, and both are likely to be further fiscally loose. So, perhaps, more evidence of the new era of industrial policy will show up soon. While this sounds promising, the counter is that it also means it has not yet formed part of the already significant US fiscal deficits (more on this shortly).

Figure 2:
US Inflation Reduction Act pipeline

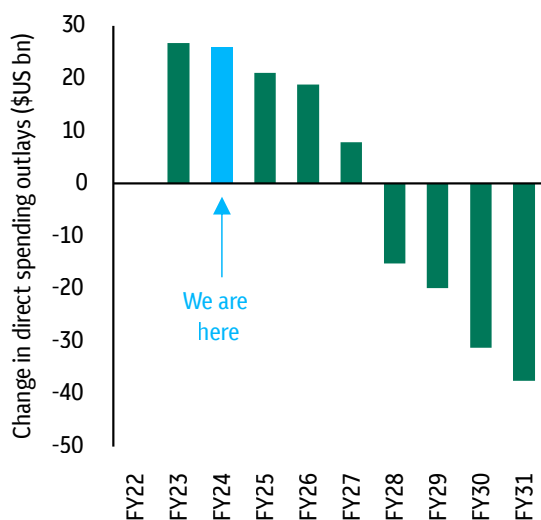
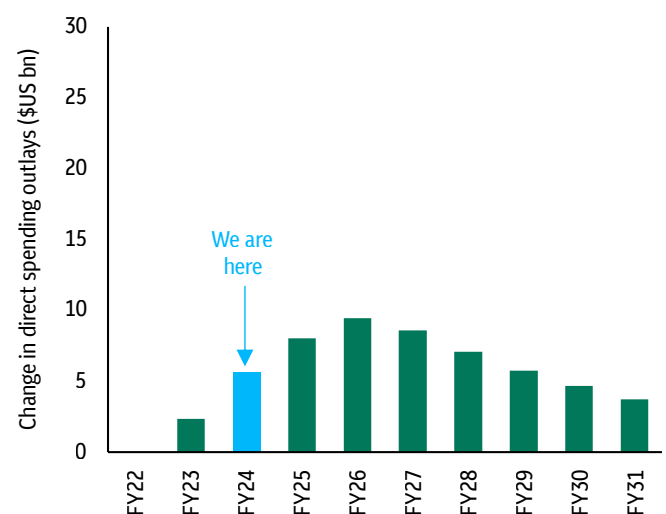


Figure 3:
US CHIPS and Science Act pipeline



Sources: Congressional Budget Office, May 2024.

In relation to the AI revolution, we continue to observe an equity market that remains very narrowly led. The benefactors of the AI revolution remain the Magnificent Seven (or is it six, or three, or perhaps just NVIDIA now) that are leading equity market performance. As we have noted previously, they make up an incredible 31% of the S&P 500® Index – this is not usually a healthy indicator. Nevertheless, the thematic remains strong and continues.

Does this all mean the environment has changed structurally – that economic growth is now supported by fiscal-induced industrial policy and AI revolution drivers, and thereby labour markets and overall economic capacity will be tighter? Does this in turn mean inflation will be higher and as a consequence also interest rates? And will it be so much so, that this will more than offset the impact to the benefactors of the prior monetary policy era? Recall that financial engineering and “the financialisation” of all things has created a significantly larger financial economy with many dependencies and benefactors. Do these players no longer prosper?

...if only it were that simple

A shift as substantial as this does not occur in a vacuum but rather in a very dynamic world. While they say, “it’s different this time,” these themes are now consensus. And whenever everyone congregates around a theme, something else usually occurs.

We note the following realities that will likely temper the prevailing persuasive narratives at some stage:

- The global economy is highly indebted and financialised, and higher interest rates do matter. This is not complex physics; it is simple financial mathematics. Just because it no longer forms part of the popular narrative doesn’t mean it isn’t still true. The “financial economy” is now many times larger than the real economy – it won’t enjoy adjusting to a higher-cost-of-capital world, let alone exist in one.
- The greater use of fiscal policy and the ever-increasing government deficits is not limitless. How will all the fiscal initiatives be funded? The US, for example, is already running very large fiscal deficits that are forecast to increase rapidly. Who will buy all the bonds the US needs to issue to fund this?
- Geopolitical friction and fracturing seemingly does not matter and will not affect the global economy. Yet, this is the very reason – the cause – for the greater focus on national security, and with it, fiscal looseness. Uncertain geopolitics continues to proliferate with risks in Ukraine and the Middle East, trade route disruptions, and US-China tensions rising.
- Perhaps, loose use of fiscal policy (re)ignites inevitable concerns regarding a return to higher inflation. While the temptation is to think about the impact on bond markets, the real consequence of inflation is the further aggrievance of already unhappy populations and the flow through to social impacts. This has already exacerbated polarised politics and the collapse of the centre. More volatile political outcomes and reactionist policy responses go hand in hand.

The first two realities are more likely to capture attention and affect financial markets more directly and sooner and are therefore worth more detailed discussion.

Higher for longer? What about the financial economy?

So, what about the world that preceded the “brave new fiscal” one? Four decades of monetary policy, byproducts of the proliferation of debt and credit to higher and higher assets prices, all built on very low cost of capital and abundant liquidity. Recall, as we detailed in our last note: since 1980, monetary policy has been the preferred policy tool to manage the economic cycle. Monetary policy encouraged the use of more and more debt/credit to support economic growth.

This four-decade pattern spurred an escalation of credit/debt, culminating in a bubble and its bursting in the global financial crisis (GFC) of 2007-2008, followed by even more extreme policymaker reactions resulting in monetary policy visiting the lowest of lower bounds – zero (and in some economies, even below zero). The ongoing use of once utterly unthinkable levels of quantitative easing (QE – liquidity injections) in the trillions came to be seen as normal and ultimately essential to support economic growth (or was it financial markets?).

This period was generally very favourable for users of credit and enabled the beginnings and then proliferation of the financialisation of developed world economies. It is no surprise to anyone that zero interest-rate policy (ZIRP) and trillions of QE spurred the far greater expansion of the credit/debt burden as investors increasingly reached for yield in a yield-starved world that was almost perfect operating conditions for financial markets and asset prices – a bonanza, typified by the proliferation of private equity and then private debt.

Now, in 2024, the resultant higher-cost-of-capital world that the post-pandemic economy has presented has been slowly, albeit with long and variable lags, challenging all things financialisation, the world that enjoyed years of ZIRP and QE. What worked so well then will not work so well in a higher-cost-of-capital world. All things that prospered during this financialisation will be challenged. “Higher for longer?” Be careful what you wish for.

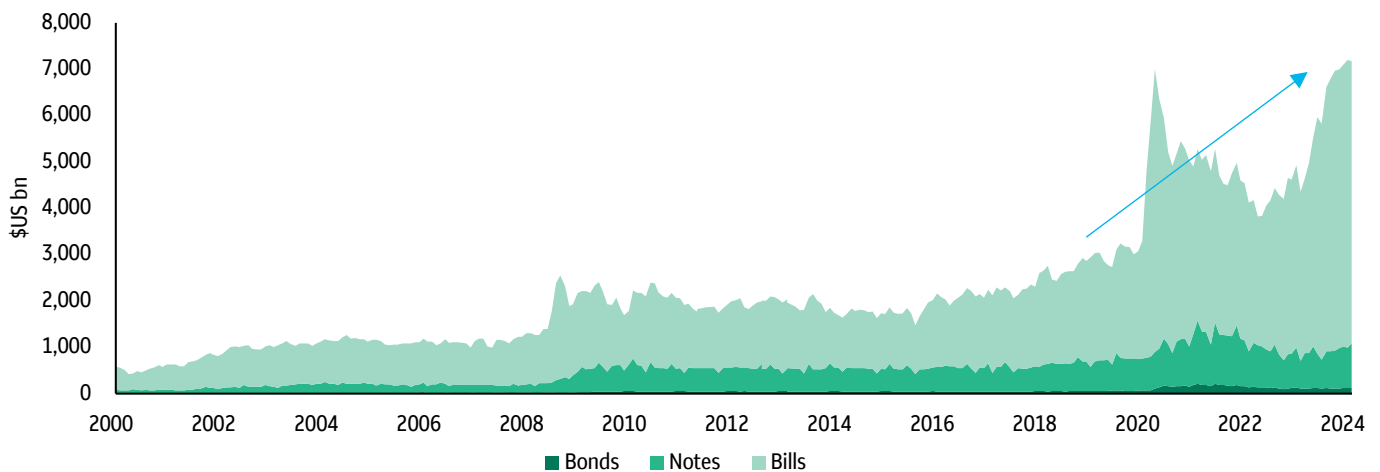
Higher for longer? How will fiscal deficits be funded?

As we have outlined above, the use of fiscal policy is now driven by genuine needs as it's increasingly seen as an essential policy lever – one that is in a very different post-pandemic economy and geopolitical world, and there is a catch.

The significant problem with ongoing fiscal support is that current government deficits are already considerable. Existing debt levels are extremely elevated and forecasted to worsen at an increasing rate. Additionally, this is before further fiscal utilisation is added, and these debt levels are being exacerbated by higher and higher interest cost burdens. Government finances are already very stretched and require massive ongoing borrowing. This is occurring in a world of fewer and fewer buyers of US Treasuries. Hence, a world of greater fiscal policy usage may also trigger a significant byproduct: the risk of long-end bond volatility and higher yields.

Figure 4:

Gross issuance of US Treasuries



Sources: US Department of the Treasury, Bureau of the Fiscal Service, May 2024.

Will markets begin to focus on future fiscal trajectories? Trajectories that most likely include greater, potentially aggressive, fiscal expansion beyond the US election, bringing with them further stretching of government finances and massive borrowing? Or perhaps loose use of fiscal policy (re)ignites inevitable concerns regarding a return to higher inflation. "Higher for longer?" Be careful what you wish for.

The sequencing challenge – near-term considerations and longer-term realities

We are confident that if interest rates are left “higher for longer,” it is inevitable that troubles from the prior monetary policy era of financial engineering and financialisation will flare up. By impacting economic growth negatively and financial markets alike, it remains only a matter of time. On the other side, we are also quite sure that ongoing and increasing fiscal deficits require funding, and this is not limitless. Sooner or later this trajectory will create volatility in bond markets that will also impact economies and financial markets alike. The timing of which comes first, and when, is the challenge.

In attempting to address this conundrum, we firstly acknowledge that 2024 is an election year. Against this backdrop, where policymakers are most likely incentivised to maintain stability, the nearer-term risk is more likely that economies begin to slow and risk tipping into recession. Although, as we get closer to the US election in November, the risk of fiscal looseness causing volatility in longer-end bond markets begins to rise.

If economic weakness begins to reveal itself, we acknowledge that central banks do continue to play a significant supporting role in financial markets, with reaction being afforded quickly and amply when things strain or break (e.g. the response to stress in the US regional banking sector in March 2023). Hence in the post-QE world, typified by massive central bank balances sheets, and especially with an upcoming US election, more central banks are likely to join in monetary policy easing. Also likely are supports for financial markets with some form of new liquidity program if and when required, or perhaps an outright return to QE (although likely under some other naming convention). While we should not forget that it would be highly unusual for the Fed to ease interest rates without a growth or financial market dislocation catalyst, particularly when unemployment levels remain so low. This seems the more likely path in the coming months. Should economies continue to remain resilient, a shift to a stance that is more vigilant to bond market volatility will be appropriate.

Stepping back to summarise the path to date, developed economies – having already exhausted lower and lower rates, then ZIRP, and then unthinkable liquidity (monetary policy) – are now increasingly requiring fiscal policy to maintain their economic growth trajectories. Without it, economic growth will likely falter. Equally, economies that are more reliant on fiscal policy will require this to be funded – this is best done with much lower interest rates and significant demand (buyers) for government debt. If buyers do not appear in sufficient quantity, which seems very likely, central banks will be required to fill the void and return to being the largest buyers of government debt, i.e. engage in further abundant liquidity programs. As such, sooner or later a return to lower rates and more liquidity appears inevitable. Does the financial economy force a recession and get us there sooner? Or does the bond market react to inevitable fiscal looseness later? Higher for longer impacts, in one form or another, will lead us there.

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 late 2024 into 2025 and beyond the election cycle a period that perhaps incorporates greater bond yield curve volatility.



Sooner or later a return to lower rates and more liquidity appears inevitable.”

Investment implications

Since Issue 01 of our 2024 Strategic Forum series at the beginning of the year, positivity has continued to permeate markets. US economic resilience, the strength of corporate financial positions, and the continuing hype behind the AI revolution has seen the S&P 500 Index endure its trend upwards and credit spreads downwards. While stickier-than-expected inflation has also continued to spur the increase of US government bond yields.

Reflecting on our investment implications from Issue 01 of 2024, little has changed. The prevailing narratives outlined above are all a boon for risk assets and a drag for more defensive ones. And although we are now more cognisant of the potential power of these shorter-term drivers, the fact remains that market pricing is currently exuding optimism. Credit spreads nearing historic lows and stock markets hitting all-time highs leave little room for economic misstep – and hazards are abundant. Conversely, we see value in more defensive positioning given the balance of risks, and now, more attractive entry points for that positioning exist.

- **Rates:** Our previous Strategic Forum in January was retrospectively a turning point for bond yields. A rally in bonds in late 2023 was succeeded by sticky inflation prints and a wind back in aggressive rate-cutting expectations. Yields drifted higher and are consequently screening more attractive. Given inflation has come down meaningfully since its peak and interest rates remain in restrictive territory, we are constructive on duration and utilise it as our main lever to express our defensiveness. Geographically, we favour regions that are showing stronger signs of economic weakness and resultingly have central banks willing to cut before the Fed. Within the US, we prefer the shorter end of the curve, expecting some steepening as rate cuts finally eventuate and term premiums normalise.
- **Credit:** Investment grade credit has been supported by a benign fundamental backdrop, with earnings more resilient than feared and interest coverage declining, but from a high base and still above post-GFC lows. That said, rating upgrades have been increasing, leading to an improvement of credit quality at the index level. Meanwhile, technicals remain supported by demand from all-in yield buyers and expectations of lower issuance in the second half of 2024. Despite this mildly positive outlook, credit spreads are markedly tight, resulting in our neutral view on a credit duration basis. We prefer a position of yield advantage - utilising preferred securities and Additional Tier 1 bonds. We also favour BBB-rated industrials, given the macro backdrop and reach for higher yields. On a curve basis, we like the “wings” in non-financials, with a combination of higher coupon and lower priced bonds. We also favour select opportunities in banks.
- **Emerging markets debt:** Emerging markets (EM) have continued to show their resilience. Spreads are tight, but our outlook is that they will continue to trade in line with developed markets credit. At current spread levels, we have some caution but continue to seek out opportunities, seeing more improving outlooks in the BBB and BB rating buckets. For hard currency corporates, we favour those with strong balance sheets, issuing higher coupon bonds. Similarly for sovereigns, we prefer countries with sound economic policies and adequate buffers. We await a more favourable backdrop to step further into EM currencies.
- **Structured securities:** Spreads on structured securities have largely rallied since our previous Strategic Forum, though they have lagged their corporate credit counterparts. With value still on offer, we retain a constructive view on our preferred sectors. Namely higher-quality issues in the residential space (US non-agency and Australian residential mortgage-backed securities). We also view short duration prime AAA-rated asset-backed securities as attractive, given current underlying loan performance and yield profiles. We are wary of commercial real estate and sectors that are exposed to lower-quality borrowers, both of which continue to show signs of stress.
- **Currency:** We retain our view that the US dollar is likely to trend lower after its structural peak in late 2022. The exact trajectory is liable to be volatile, however, as expectations on interest rate differentials evolve. We have a broadly neutral view on the euro and British pound as while both central banks look likely to cut before the Fed, neither is likely to deviate too far from Fed policy. We are negative on the Swiss franc as the Swiss National Bank became the first major central bank to cut rates this cycle. Given the volatility in the Japanese yen, we expect the Swiss franc to become the funding currency of choice for carry trades going forward, which will weigh on the currency as long as volatility remains contained. On the Japanese yen, fundamentals remain negative but recent intervention by the Ministry of Finance / Bank of Japan add jeopardy to being short. We are positive on the Australian dollar, given its historically cheap valuation and potential to perform on positive risk sentiment.

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Diversification may not protect against market risk.

Fixed income securities are subject to credit risk, which 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.

Fixed income securities are also subject to interest rate risk, which is the risk that the prices of fixed income securities will increase as interest rates fall and decrease as interest rates rise. Interest rate changes are influenced by a number of factors, such as government policy, monetary policy, inflation expectations, and the supply and demand of securities. Fixed income securities with longer maturities or duration generally are more sensitive to interest rate changes.

Fixed income securities may also be subject to prepayment risk, which is 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.

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.

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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.

Investment strategies that hold securities issued by companies principally engaged in the infrastructure industry have greater exposure to the potential adverse economic, regulatory, political, and other changes affecting such entities.

Infrastructure companies are subject risks including increased costs associated with capital construction programs and environmental regulations, surplus capacity, increased competition, availability of fuel at reasonable prices, energy conservation policies, difficulty in raising capital, and increased susceptibility to terrorist acts or political actions.

Mortgage-backed securities (MBS) and asset-

backed securities (ABS) are subject to credit risk and interest rate risk and may also be subject to prepayment risk and extension risk. In addition, MBS and ABS may decline in value, become more volatile, face difficulties in valuation, or experience reduced liquidity due to changes in interest rates or general economic conditions. Certain MBS, such as collateralized mortgage obligations, real estate mortgage investment conduits, and stripped MBS may be more susceptible to these risks than other MBS.

Additional Tier 1 (AT1) Bonds serve as capital instruments that banks utilize to augment their core equity base. Unlike conventional bonds, AT1 Bonds are perpetual and thus, the investors are not paid the principal amount.

The CHIPS (Creating Helpful Incentives to Produce Semiconductors) and Science Act of 2022 was signed into law by President Joe Biden on Aug. 9, 2022. The law received bipartisan approval and strong support from the research and business communities. The act appropriated approximately \$52 billion to support semiconductor research and manufacturing. In addition, approximately \$200 billion was allocated for investments in semiconductor and other scientific research, technology, education, and training, with a significant portion of the appropriations – along with incentive tax credits for business – intended to fund the federal share of public-private partnerships. An additional \$20 million appropriation was provided to enhance security for members of the U.S. Supreme Court and their families.

Duration measures a bond's sensitivity to interest rates, by indicating the approximate percentage of change in a bond or bond fund's price given a 1% change in interest rates.

Firendshoring, a cousin of "reshoring" and "onshoring" and a sibling to "nearshoring," is shorthand for the practice of relocating supply chains to countries where the risk of disruption from political chaos is low.

The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

The Group of Seven (G-7) is an intergovernmental organization made up of the world's largest developed economies: France, Germany, Italy, Japan, the United States, the United Kingdom, and Canada. Government leaders of these countries meet periodically to address international economic and monetary issues, with each member taking over the presidency on a rotating basis.

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.

The Inflation Reduction Act of 2022 (H.R. 5376) was designed to reduce the deficit and lower inflation while investing in domestic energy production and lowering healthcare drug costs. The bill became law with President Biden's signature on Aug. 16, 2022. In essence, the law is a scaled-down version of the Build Back Better Act proposed by the Biden administration in 2021.

"The Magnificent Seven" refers to a group of seven high-performing and influential stocks in the technology sector, borrowing from the meaning of a powerful group. Bank of America analyst Michael Hartnett coined the phrase in 2023 when commenting on the seven companies commonly recognized for their market dominance, their technological impact, and their changes to consumer behavior and economic trends: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

Quantitative easing (QE) 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.

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

A Treasury yield refers to the effective yearly interest rate the US government pays on money it borrows to raise capital through selling Treasury bonds, also referred to as Treasury notes or Treasury bills depending on maturity length.

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 US 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.

Yield curve inversion is when coupon payments on shorter-term Treasury bonds exceed the interest paid on longer-term bonds.

ZIRP is a method of stimulating growth while keeping interest rates close to zero. The governing central bank can no longer reduce interest rates under this policy, rendering conventional monetary policy ineffective. Unconventional monetary policy such as quantitative easing is used to increase the monetary base as a result.

The **Institute for Supply Management (ISM®) Manufacturing Purchasing Managers' Index (PMI®)** is an indicator of the economic health of the manufacturing sector. The Manufacturing PMI is a composite of five indices with equal weights: New Orders, Production, Employment, Supplier Deliveries, and Inventories. A Manufacturing PMI reading above 50% indicates that the manufacturing economy is generally expanding; below 50% indicates that it is generally contracting.

The **S&P 500® Index** measures the performance of 500 mostly large-cap stocks weighted by market value and is often used to represent performance of the US stock market.

The **US Industrial Production Index (IPI)** measures the real output of all relevant establishments located in the United States, regardless of their ownership, but not those located in U.S. territories.

Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Economic trend information is sourced from Bloomberg unless otherwise noted.

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