

UBS Diversified Fixed Income Fund

January 2022

Fund description

The Fund is an actively managed, diversified portfolio of Australian and global fixed income assets.

Investment strategy

The strategy is managed employing both top-down macroeconomic research and bottom-up security specific analysis to build a portfolio with the core defensive characteristics of the fixed interest asset class. Whilst the Fund seeks to be fully hedged to Australian dollars, we may invest in strategic foreign currency exposures that will not exceed 10% of the total portfolio.

Investment return objective

The Fund is actively managed, based on fundamental research that draws upon the investment insights of our fixed income teams. The approach employs both "top-down" research, including analysis of economic factors, market data and macro credit themes and "bottom-up" research in respect of particular securities including analysis of earnings and cash flow stability, balance sheet strength, industry and valuation.

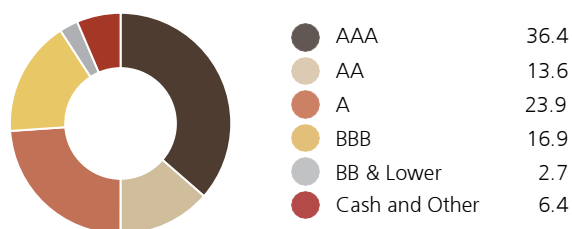
Key statistics	Fund	Benchmark ¹
Modified duration (yrs)	5.93	6.56
Spread duration ² (yrs)	4.16	3.21
Weighted avg maturity (yrs)	6.70	7.61
Average credit quality	A1	Aa2
Yield to maturity ³ (%)	1.92	1.57

¹ Benchmark statistics do not reflect month end rebalancing for new issues and reinvestment of coupons.

² Option adjusted spread duration ex Treasury.

³ Yield to Maturity (YTM) is the estimated annualised rate of return that would be received if the Fund's current securities were all held to maturity. Note that YTM does not account for fees or taxes. YTM is not a forecast, and is not a guarantee of the future return of the Fund.

Credit quality (%)



Note: Credit ratings for physical holdings only, 'cash and other' includes the effect of derivatives.

Fund information

Inception date	31 January 1997
Fund size	\$ 792.7 m
Management fee	0.55% pa
Minimum initial investment	\$50,000
Distribution frequency	Quarterly
Buy/sell spread	+ 0.05% / - 0.15%
APIR code	SBC0007AU

Fund positioning – modified duration contribution (yrs)

By sector	Fund	Benchmark
Government nominal ⁴	2.55	4.11
Government inflation-linked	0.21	0.00
Semi-government	0.86	0.92
Government related	0.84	0.51
Corporates	1.22	0.77
Financials	0.44	0.24
Industrial	0.61	0.45
Utility	0.17	0.08
Securitised	0.24	0.25

By Country

Australia	2.85	2.92
USA	0.76	1.41
Japan	0.50	0.62
Canada	-0.06	0.11
Euro area	0.82	0.84
UK	-0.03	0.26
New Zealand	0.41	0.00
China	0.65	0.23
Other	0.03	0.16

⁴Includes derivatives.

Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	(1.09)	0.34	(3.06)	1.99	2.70	5.60
Benchmark**	(1.33)	(0.11)	(3.00)	2.47	2.96	6.03
Added value	0.24	0.45	(0.06)	(0.48)	(0.26)	(0.43)

*Inception date: 31 January 1997. **50% Bloomberg AusBond Composite 0+ Yr Index / 50% Bloomberg Global Aggregate (hedged to \$A). Performance figures are net of ongoing fees and expenses. The performance figures quoted are historical, calculated using end of month redemption prices, and do not allow for the effects of income tax or inflation. Total returns assume the reinvestment of all distributions. Performance can be volatile and future returns can vary from past returns.

Market highlights

- Australian Government bond yield curve flattened with the front-end rising higher than the long-end.
- Australian credit spreads widened over January.
- The RBA maintained the cash rate target at 10 basis points and ceased further purchases under the bond purchase program.

Performance review

Virtually all major fixed income sectors generated negative returns in January. Developed market bonds in Europe and the US suffered from rising yields but generally outperformed corporate bonds and other spread sectors that were impacted by a combination of rising yields and widening spreads. EM local currency bonds were one of the best performing asset classes buoyed by gains in EM FX that largely offset losses in local rates. China Fixed Income posted a solid gain for the month as rates rallied and the currency held its own against the dollar. The US 10-year yield moved up around 27 basis points to 1.78% at the end of the month while the 2-year yield, which is more sensitive to Fed policy expectations, rose even more, up around 45 basis points to end the month at 1.18%.

In the US, the news agenda for investors was dominated by the more hawkish shift in Federal Reserve rhetoric, with Jerome Powell saying the “economy no longer needs sustained high levels of monetary policy support” and refusing to rule out a faster pace of rate rises or moving in larger increments. On the data side, US economy grew by 6.9% in the fourth quarter of 2021 on an annualized basis, ahead of a consensus forecast for 5.5%. For the full year 2021, the US economy grew 5.7%, the fastest pace since 1984. However, other economic data was mixed with inflation remaining high. The ISM PMIs fell, although they are still at levels consistent with strong growth. Nonfarm payrolls increased by only 199,000, far below consensus expectations, but the unemployment rate fell to a post-pandemic low of 3.9% due to the millions of Americans that have left the labour force since pre-pandemic. CPI rose 7% year-on-year in December, the highest inflation rate since 1982 although there are some preliminary signs that the peak may be near.

The Australian bond market delivered negative return in January as global and domestic government bond sold off. The Australian 3-year Government bond yields rose 40bps to 1.31% while 10-year bonds yields rose 23bps to 1.90% over the month. The spread between Australian 10-year and US 10-year Government bond yields narrowed, ending the month at +12bps (from +16bps at the end of the prior month).

Similar to global bond markets, domestic credit spreads mostly widened. The semi-government sector referenced by the Bloomberg Ausbond Semi-government 0+Yr Index, widened 3bps from 26 to 29bps.

Our defensive duration positioning delivered positive performance over January, as bond yields rose across the developed markets, particularly in the US and the UK. Our underweight duration positions in the US, UK and Canada contributed positively to relative performance, while the overweight position in Chinese sovereign bonds was also additive to relative returns. In Australia, we had neutralized our overweight to AUD duration late last year and so did not register any underperformance from the rise in Australian bond yields, particularly subsequent to the stronger-than-expected CPI outcome for Q4 2021. Elsewhere, our overweight position in AUD credit also made a small positive contribution largely from “carry”.

Outlook

2022 is shaping up to be a volatile year for financial markets. Last year’s negative returns on benchmark bond indices such as the AusBond Composite were a result of a slow and steady realisation that higher-than-expected inflation will require higher interest rates. This year represents the next phase, with the outlook depending on how far financial conditions can tighten without jeopardizing the recovery. Initially we think government bond yields will continue to be biased higher, led by the front-end. Yet there comes a point where tighter conditions will collide with overleveraged economies. These episodes are often associated with large drawdowns in risky asset prices, leaving bonds to once again provide the ballast in investors’ portfolios.

We remain confident that the Australian economy will continue to rebound strongly amid high vaccine coverage, stronger political will to avoid future lockdowns and a high household savings rate. We do however expect Omicron to at least temporarily jolt the low inflation consensus, which is already showing signs of cracking after a bumper Q4 inflation release (i.e. trimmed mean CPI at 1.0% q/q). The lesson from western countries that have been “living with the virus” for some time has been that disruptions to labour and goods supply have been at least as significant and often longer lasting than the negative impact to demand. As a result, we expect the coming months to see the unemployment rate fall below 4% - the level thought to represent full employment – underlying inflation breach the upside of the RBA’s 2-3% target band and wages to also show stronger upside momentum.

The RBA has already wound down Yield Curve Control and QE since October 2021 but has so far communicated that it is willing to take a patient approach to raising the cash rate. Yet the incoming data will test this resolve and we expect the bank to follow in the footsteps of other Anglo-Saxon central banks in hiking rates, potentially as early as mid-year. Tactically we favour positioning short duration in the front-end of the yield curve as hikes come into view. Long-dated bond yields can remain comparatively stable, and our expectation is that 10-year ACGBs find support with yields in a 2-2.5% range.

It is our view that this tightening of monetary conditions, including a drying up of the flow of central bank QE and higher real yields, provides a more challenging outlook for corporate credit than 2021. Spreads are more likely to drift wider as markets demand some return of risk premium that had been compressed in the QE era, even if the relatively low duration and high quality of Australian credit should see it outperform other markets such as the US.

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