UBS Asset Management
For professional / qualified / institutional investors only.
All data as at 31 March 2022

UBS Diversified Fixed Income Fund

March 2022

Fund description

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

Target market

The Target Market Determination (TMD) for the Fund sets out the class of consumers for whom the product, including its key attributes, would likely be consistent with their likely objectives, financial situation and needs. To access to the TMD and other Fund documentation visit our website.

Investment strategy

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.

Investment return objective

The Fund aims to outperform (after management costs) the Benchmark over rolling three year periods.

Key statistics

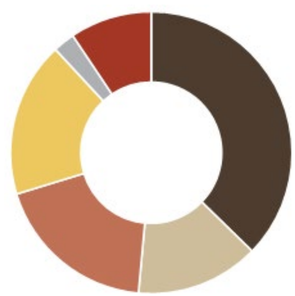
	Fund	Benchmark[1]
Modified duration (yrs)	6.32	6.37
Spread duration[2] (yrs)	3.77	3.17
Weighted avg maturity (yrs)	7.27	7.57
Average credit quality	A1	Aa2
Yield to maturity[3] (%)	2.81	2.36%

[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.

Fund information

Inception date	31 January 1997
Fund size	$ 731.3 m
Management fee	0.55% pa
Minimum initial investment	$50,000
Distribution frequency	Quarterly
Buy/sell spread	+ 0.05% / - 0.15%
APIR code	SBC0007AU

Credit quality (%)



AAA	37.3
AA	14.2
A	18.8
BBB	17.8
Below BBB	2.5
Cash and other	9.4

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

Fund positioning – modified duration contribution (yrs)

By Sector	Fund	Benchmark
Government nominal[4]	3.17	3.92
Government inflation-linked	0.12	0.00
Semi-government	0.83	0.89
Government related	0.73	0.45
Corporates	1.21	0.74
Financials	*0.44*	*0.24*
Industrial	*0.61*	*0.43*
Utility	*0.16*	*0.08*
Securitised	0.25	0.36

By Tenor	Fund	Benchmark
Australia	3.12	2.80
USA	1.00	1.40
Japan	0.45	0.60
Canada	0.05	0.11
Euro area	0.75	0.81
UK	0.16	0.25
New Zealand	0.50	0.00
China	0.25	0.23
Other	0.03	0.15

[4] Includes derivatives.

Investment performance

Fund	1 month %	3 months %	1 year % pa	3 year % pa	5 years % pa	Since inception* % pa
Total return	(2.95)	(5.29)	(4.79)	(0.14)	1.65	5.39
Benchmark**	(2.94)	(5.43)	(4.76)	0.27	1.93	5.81
Added Value	**0.01**	**0.14**	**(0.03)**	**(0.41)**	**(0.29)**	**(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 yields rose across the term structure.
- Australian credit spreads widened over March.
- The RBA kept cash rate target at 0.10% in the March meeting and continued with their longstanding "patient" narrative.

Performance review

Yields rose in March, especially at the front end of the curve, as investors positioned for a faster pace of central bank policy tightening in response to elevated inflation. 10-year US Treasury yields climbed 51bps to 2.34%. The 2-year/10-year portion of the curve inverted briefly for the first time since August 2019. In Europe, yields on 10-year German Bunds climbed 39bps to 0.55%. Most major fixed income sectors generated negative returns driven by higher yields despite tighter credit spreads during the month.

In the US, the focus in March was on Federal Reserve policy, with a first rate hike since 2018 and top officials pointing to a faster pace of tightening ahead. The median forecast from members of the Federal Open Market Committee was for seven rate hikes this year, implying an increase at each of the remaining meetings. Federal Reserve Chair Jerome Powell said the central bank would not shy away from raising rates to restrictive levels if needed to control inflation. That hawkish commentary prompted markets to adjust rate hike expectations for the remainder of 2022 up to around eight 25bps increases, implying a Fed Funds rate of roughly 2.4% by year-end. Expectations of faster policy tightening came as consumer price inflation hit a 40-year high of 7.9% year-over-year in February, while even core inflation—excluding volatile food and energy prices—rose to 6.4%.

The Australian bond market delivered negative return in March as domestic government yields rose strongly across the term structure with a larger impact on the front-end, and credit spreads widened. The Australian 3-year Government bond yields rose 80bps to 2.34% while 10-year bonds yields rose 70bps to 2.84% over the month. The spread between Australian 10-year and US 10-year Government bond yields widened, ending the month at +50bps (from +31bps at the end of the prior month). Domestic credit spreads referenced by the Bloomberg Ausbond Credit 0+Yr Index, widened 18bps from 90 to 108bps.

Our defensive duration positioning delivered a positive performance contribution over March, as bond yields continued to climb across the developed markets. We took advantage of these higher yields, increasing exposure to longer tenors in Australia and New Zealand at the expense of selected Asian markets. We also took profits on our underweight duration position in France relative to Germany. Offsetting this, our overweight position in investment grade credit detracted, particularly as the Australian market underperformed its counterparts in the US and Europe.

Outlook

We wrote at the start of the year that bond yields were more likely to be biased higher in the months ahead particularly at the front-end of government yield curves as central bank tightening gathers pace. This turned out to be an understatement as continued upside surprises in inflation has seen an aggressive re-pricing of rate hike expectations across the globe and some of the largest quarterly losses on major bond indices on record, including the Ausbond Composite (-5.88%).

Having been a better seller of duration in Q1, we assess the outlook to be much more balanced in Q2. To be sure the near-term outlook for the Australian economy remains strong with most COVID restriction gone while pre-election fiscal handouts and a high savings rate should support nominal household spending. At the same time, we are observing an acceleration and broadening out of inflation. Higher energy and food prices should contribute to another strong inflation release in Q1 after a bumper 1.0% q/q increase in the RBA's preferred trimmed mean measure in Q4. All told, we expect the coming months to see the unemployment rate fall through 4% - the level thought to represent full employment – underlying inflation to comfortably breach the upside of the RBA's 2-3% target band and wages to also show stronger upside momentum.

As a result, it looks like a matter of time before the RBA drops its patient approach to the cash rate and follows in the footsteps of other Anglo-Saxon central banks in hiking, potentially as early as June. Yet we don't think this tightening will outpace the Federal Reserve, which is now openly entertaining moving in 50bps increments, nor reach the 3%-plus terminal rate that is currently baked into the forwards given the high sensitivity of households to mortgage rates. We also note that the 10-year yield is sitting close to 3%, a level that it hasn't breached since 2015. All told, ACGBs are beginning to look cheap, although high global rate volatility means we prefer to express this view in cross-market positions for now.

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, as well as conflict in Ukraine provides a more challenging outlook for corporate credit than 2021. The recent moves wider in spreads to the 2018/19 wides restores some risk premium and puts spreads back closer to what we'd categorise as fair value. We continue to think the relatively low duration and high quality of Australian credit should see it outperform other markets such as the US.

Client Services

Telephone: (03) 9046 4041 Freecall: 1800 572 018 Email: ubs@unitregistry.com.au www.ubs.com/am-australia

UBS