

UBS Diversified Fixed Income Fund

July 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)	5.51	6.22
Spread duration ² (yrs)	3.34	3.09
Weighted avg maturity (yrs)	6.56	7.42
Average credit quality	Aa3	Aa2
Yield to maturity ³ (%)	3.47	2.93%

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

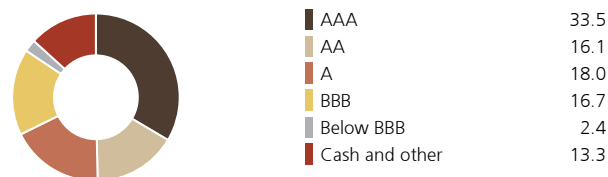
² Option adjusted spread duration ex Treasury.

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	\$ 644.6m
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 (%)



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	2.72	3.82
Government inflation-linked	0.11	0.00
Semi-government	0.74	0.87
Government related	0.66	0.43
Corporates	1.02	0.71
Financials	0.35	0.23
Industrial	0.54	0.41
Utility	0.14	0.08
Securitised	0.26	0.38

By Country	Fund	Benchmark
Australia	2.93	2.75
USA	1.02	1.44
Japan	-0.02	0.57
Canada	0.11	0.11
Euro area	0.53	0.74
UK	0.16	0.22
New Zealand	0.49	0.00
China	0.26	0.24
Other	0.03	0.15

⁴Includes derivatives.

Investment performance

Fund	1 month %	3 months %	1 year % pa	3 year % pa	5 years % pa	Since inception* % pa
Total return	3.04	0.00	(9.38)	(1.95)	0.88	5.22
Benchmark**	2.92	0.77	(8.64)	(1.41)	1.36	5.67
Added Value	0.12	(0.77)	(0.74)	(0.54)	(0.48)	(0.45)

*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 Review

- Australian Government bond yields fell across the term structure.
- Australian credit spreads tightened over July.
- The RBA raised the cash rate target by 50bps in both July and 2nd August.

Global Market Review

Fixed income markets had a better month in July. In general, High Yield bonds outperformed their Investment Grade counterparts. Elsewhere, apart from US High Yield bonds, European fixed income assets outperformed their US peers. The yield on 10-year US Treasuries fell from 3.01% at the start of the month to 2.65% at the end.

In the US, the Federal Reserve raised rates by 75 basis points on 27 July, setting the federal funds rate target range to 2.25–2.5%. In his post-FOMC meeting press conference, Fed Chair Jerome Powell noted that the Fed remains strongly committed to re-establishing price stability, hinting that another large rate hike might be implemented at the next meeting in September. GDP contracted at a 0.9% pace in 2Q22, the second consecutive quarter of negative growth. In data for June, the ISM Manufacturing PMI fell to 53, down from 56.1, while the Services PMI dropped to 55.3, down from 55.9. Job growth remained strong, as nonfarm payrolls increased by 372,000, and the unemployment rate was unchanged at 3.6%. CPI inflation increased to 9.1% year-over-year, the highest since 1981.

In the Eurozone, the ECB raised rates by 50 basis points, a more aggressive hike than had been expected. After Russia's decision in June to cut supplies through the Nord Stream 1 pipeline by around 60%, the pipeline closed altogether for 10 days of maintenance that started on 11 July and reopened on 21 July. However, supplies returned at just 20% of full capacity. Purchasing managers' index readings and economic sentiment indicators showed a sharp fall in July. In the UK, the search for a new prime minister threw uncertainty over the future path of fiscal policy, with implications for the Bank of England's battle to ease inflationary pressures. Inflation continued to surprise to the upside; rising fuel and food costs pushed the consumer prices 9.4% higher in the year to June. This was the highest rate among the G7 group of leading industrial nations, along with being a new 40-year high.

In China, data released during July showed that second-quarter GDP growth slowed more than expected to 0.4% year-over-year, the slowest pace since the first quarter of 2020, down significantly from 4.8% in the first quarter of this year. The slowdown was broad-based, led by consumption, reflecting the massive lockdown impact in April. Economic activity continued to pick up from the April troughs as supply chain bottlenecks eased gradually from late May.

In Japan, the central bank continued to buck the global trend of tightening, staying on hold at its July meeting. The Bank of Japan's core inflation forecasts was raised slightly to 2.3% for the 2023 fiscal year, from 1.9% previously, still lower than the inflation pressures affecting most of the world.

July was a mixed month for commodities, suffering from global growth concerns in the first half then recovering in the second half. The broad commodity index, the UBS CMCI Total Return index, fell by about 1% in July; energy and livestock rose, and agriculture and precious and industrial metals were fell. Year-to-date, the index is still up by about 15%.

Australian Market Review

The Australian sovereign yield curve flattened over July, in line with sentiment seen offshore. Australian Government bonds traded sideways early in the month before staging a strong rally in the last week of July. Australian 10-year Government bond rallied around 50bps in the last week to end the month at 3.06%. The spread against US 10-year Government bond yields tightened to 41bps (from +65bps at the end of prior month). The Bloomberg AusBond Composite 0+ year index returned +3.36% in July driven by both fall in bond yields and credit spreads tightening (Bloomberg AusBond Credit 0+ year index tightened from 147bps to 139bps), recovering some of the losses from the previous months.

In early July, the RBA raised both cash rate target and interest rate on Exchange Settlement balances by 50bps as widely anticipated by market participants after series of inflation prints. Inflation is forecasted by the bank to peak later this year. Rates were largely unchanged and muted in reaction to the hike.

In mid-July, the unemployment rate printed at 3.5%, a continued decline from previous month, reaching the lowest rate in almost 50 years. Job vacancies and job ads are still at elevated levels which we can expect further decline in unemployment and tighter labour markets. Inflation remains a concern with Q2 printing at 6.1% YoY (headline) and the RBA preferred trimmed mean CPI printing at 1.5% QoQ (vs 1.4% previous quarter). Global offshore factors such as supply chain disruptions contributed to the high inflation print but so did domestic factors such as widespread upward pressures on prices from strong demand, tight labour market and capacity constraints in some sectors of the economy.

Post the data releases in mid-July, the Australian Government bonds staged a relief rally similar to global markets, in part due to offshore sentiment as global recession fears grew on the back of declining growth indicators. Outlook for global economic growth deteriorated due to pressures on real incomes from higher inflation. The RBA then once again hiked rates by 50bps on 2nd August in line with consensus. Maintaining their stance, they highlighted future size and timing of hike will be data dependent without providing much guidance while being committed to combating inflation.

Australia ESG insights

Westpac, Australia's 2nd largest bank, has reiterated its Scope 1, 2 & 3 net zero target of 2050. Along the way, they have also committed to net zero carbon emissions from their own operations by 2025, mainly through the procurement of 100% renewables. Westpac is taking a targeted approach in achieving net zero from its financed emissions by reducing direct lending over time to the highest emissions intensive sectors. For example, Westpac will cease lending to companies with >5% revenue sourced directly from thermal coal mining by 2030 and, in terms of the oil and gas sector, will only consider financing greenfield projects that are in accordance to the International Energy Agency's net zero by 2050 scenario or where a given project is necessary for national energy security. Other reduction measures and targets are in place for the power generation and manufacturing sectors. Overall we think these measures are sound and are relatively more competitive compared to similarly-sized banks in the Asia-Pacific region. Other major Australian Banks are due to report progress and further initiatives to achieve net zero carbon emissions and we would expect similar progress to Westpac and further detail on sector-specific emissions reductions initiatives.

Portfolio

Our duration positioning delivered mixed performance contribution over July as government bond yields across most markets largely traded lower than the start. Within duration management, overweight duration positioning in Australia, New Zealand and Canada contributed positively to the fund's relative performance while underweight duration positions in US, UK and Germany detracted. Over July, we took profits on cross-market positions that had favoured AUD and CAD rates relative to those in the US. We also increased our conviction in the outlook for short-end rates in both Germany and New Zealand, adding a spread trade between those two markets. On credit, our overweight position in corporate credits was a contributor over July as spreads moved to our advantage.

Outlook

There are encouraging signs of stability in fixed income including the possibility that global government bond yields peaked in June. Two-way volatility is however likely to persist in the near-term amid competing economic narratives. Bonds sit on a seesaw with concerns about inflation driving yields higher only for recessionary fears to bring them back down to earth. On the former, the US has been at the forefront of the inflation cycle and it is still too early to call a peak. While there are strong signs that durable goods inflation is rolling over, services and inflation expectations may still be biased upwards requiring an ongoing hawkish response from the Federal Reserve. Meanwhile the global growth outlook has deteriorated as financial conditions tighten, European energy crunch concerns build and the US consumer falters.

Australia is experiencing the same themes but with a lag of one or two quarters thanks to the later re-opening of the economy and the slower response from the RBA. Headline CPI inflation is currently running at 6.1% y/y and we see sufficient momentum and breadth in prices to expect the annual rate to accelerate further into year-end with most forecasters seeing a peak close to 7.75%. At the same time, accumulated household savings, robust retail sales data and a near 50-year low on the unemployment rate provides some comfort about

the near-term outlook for economic activity. However, more forward-looking indicators such as consumer confidence surveys and house prices, which are deflating, are consistent with an economic slowdown that will likely see growth slow well below its potential rate into next year.

The RBA has followed in the footsteps of global central banks, shifting its focus to regaining credibility in fighting inflation that has become more pervasive than they had expected. While 175bp of cash rate hikes have already been delivered, we expect more front-loading of tightening this year, including a further 50bp rate hike in September before the RBA steps down to smaller increments in Q4 ending the year at a rate of around 2.75-3%. The market pricing of the terminal cash rate has fallen from a peak of close to 4.5% in June to below 3.5% now. For now, we are keeping outright domestic duration positioning relatively neutral, favouring expressing our views on the curve instead.

The widening of Australian credit spreads has eased recently having reached aggregate levels that were wider than at the outset of the pandemic. It is our expectation that spreads are more likely to drift wider so long as monetary conditions continue to tighten, including a reversal of the flow of central bank QE and higher real yields, and recessionary concerns build. Longer-term, the relatively wide level of spreads and all-in yields as well as the low duration and high quality of Australian credit should ensure it fares better than other markets such as the US.

Client Services

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