

UBS Australian Bond Fund

August 2023

Fund description

The Fund is an actively managed, diversified portfolio of largely investment grade fixed income securities, cash equivalents and cash.

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. The Fund's investment strategy is to invest in a portfolio of largely investment grade fixed income securities, cash equivalents and cash.

Investment objective

The Fund aims to outperform (after management costs) the Bloomberg AusBond Composite 0+Yr Index over rolling three year periods.

Key statistics

	Fund	Benchmark ¹
Modified duration (yrs)	5.87	5.09
Spread duration ² (yrs)	4.41	2.14
Weighted avg maturity (yrs)	6.56	5.92
Average credit quality	AA-	AA+
Yield to maturity ³ (%)	4.74	4.20

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

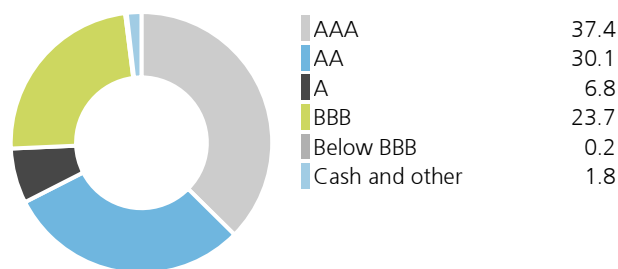
² Option adjusted spread duration ex Treasury.

³ Yield to maturity (YTM) is not a distributed yield nor reflects anticipated income to be earned by the fund. It may include the effect of some derivatives, including swaps and FX forwards, which can form a significant part of the investment strategy but do not pay a regular income. It is in the base currency of the master fund and not specific to a share class.

Fund information

Inception date	30 November 1989
Fund size	\$ 851.5m
Management fee	0.45% pa
Minimum initial investment	\$ 50,000
Distribution frequency	Quarterly
Buy/sell spread	+ 0.02% / - 0.08%
APIR code	SBC0813AU

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	1.60	2.94
Government inflation-linked	0.00	0.00
Semi-government	2.22	1.58
Government related	0.57	0.34
Corporates	1.27	0.21
Financials	0.70	0.10
Industrial	0.37	0.08
Utility	0.20	0.03
Credit hedge ⁵	0.00	0.00
Securitised	0.21	0.01
Cash and cash equivalents	0.00	0.00

By tenor	Fund	Benchmark
0–3 years	0.77	0.45
3–5 years	1.30	0.76
5–7 years	0.86	0.86
7–10 years	1.64	1.56
10+ years	1.30	1.46

⁴ Includes derivatives

⁵ Spread duration contribution

Investment performance

Fund	1 month %	3 months %	1 year %	2 years % pa	3 years % pa	5 years % pa	Since inception* % pa
Total return	1.00	(0.57)	2.30	(5.17)	(3.14)	0.37	6.81
Benchmark**	0.74	(0.72)	1.78	(5.09)	(3.09)	0.56	6.80
Added Value	0.26	0.15	0.52	(0.08)	(0.05)	(0.19)	0.01

* Inception date: 30 November 1989.

**Bloomberg AusBond Composite 0+ Yr Index.

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 August.
- The RBA maintained the cash rate target at 410bps.

Global Market Review

Global markets grappled with opposing forces in August: Treasury yields rising to fresh cycle highs across the curve amid continued strength in US production data, and more signs of economic weakness in China and global manufacturing.

In the US, retail sales rose 1% month-on-month in July, more than twice as fast as anticipated. Industrial production booked just as large of an increase in July, well above the 0.3% estimate. The S&P Global US Manufacturing PMI came in at 47, well below expectations, and the Services PMI shifted downwards to 51 versus an estimate of 52.2. Non-farm payroll growth for July rose 187,000, less than expected, with negative revisions to prior months. Job openings fell by more than anticipated to 8.8 million in July, with the private sector quits rate slipping to 2.5% -- below pre-pandemic levels. Headline and core CPI inflation both rose marginally less than expected in July on a month-on-month basis. However, the year-on-year headline inflation rate rose to 3.2% from 3%, its first increase since June 2022. Near the start of the month, Fitch downgraded the US government's credit rating to AA+ from AAA. The ratings agency cited a deteriorating long-term fiscal outlook and political brinkmanship as key reasons for this change. The July Senior Loan Officer Survey showed that financial institutions were tightening lending standards while demand for loans continued to deteriorate, suggesting that financing conditions will be a drag on growth going forward.

In Europe, the economy remains sluggish, with more signs that the slump in factory activity is weighing on activity more broadly. The Eurozone manufacturing PMI improved somewhat in August, with the flash reading rising to 43.7 versus expectations of an unchanged reading from July at 42.7. However, this was overshadowed by softness in the services sector where the PMI fell below 50 for the first time in 2023. But labour markets continue to be tight, with the unemployment rate holding steady at 6.4% in July and

few signs that annual wage growth is rolling over. Inflationary pressures remained stuck at 5.3% year-on-year in August, though analysts anticipated a deceleration to 5.1%. However, core inflation did move lower to 5.3% year-on-year, as expected. There was also a noticeable deceleration in services inflation, which moderated to 3.4% on a three-month annualised basis. In the UK, the Bank of England delivered a 25-basis point hike. PMI data weakened across both manufacturing and services. The preliminary August manufacturing print weakened to 42.5 from 45.3, a worse showing than the expected 45. The services PMI also unexpectedly dipped below 50 to 48.7, versus a projected 50.4. Labour market signals are mixed. The unemployment rate ticked up to 4.2% in the three months ending June, while economists had predicted that it would hold steady at 4%. Employment also contracted by 66,000 over this period. However, wage pressures continued to intensify, with average earnings excluding bonuses up 7.8% year-on-year for the three months ending June.

In Japan, second-quarter growth massively exceeded expectations, rising 6% on a seasonally adjusted and annualised rate versus an expected 2.9%. Inflation remains elevated relative to history, but the 3.3% year-on-year rise in headline inflation and 3.1% year-on-year increase in core inflation were both in line with expectations. At Jackson Hole, Bank of Japan Governor Kazuo Ueda noted that core inflation is expected to continue to slow and that underlying price pressures were still a bit below the central bank's 2% inflation target.

In China, economic conditions continue to deteriorate, with July data underwhelming across all facets of the economy. Industrial production, fixed asset investment, credit growth, consumer spending, property investment, and the unemployment rate all disappointed, while new home prices also fell month-on-month. The economic stress became apparent following defaults from a major real estate developer as well as an asset manager with deep links to the property sector. China is increasing up its efforts to support the economy, but steps taken to date still appear measured. Policymakers delivered interest rate cuts that were not as large as expected, suggesting that monetary stimulus is constrained by other considerations like bank profitability and currency weakness. The minimum downpayment for first-time homebuyers has also been reduced to 20%, and the authorities are also encouraging lenders to lower rates on existing mortgages.

Australia Market Review

Australian sovereign bond yields fell over August as investors started to price-in a lower terminal rate given gradually declining domestic inflation. In contrast, US sovereign bond yields rose with a steepening bias amid a repricing of policy rate expectations for next year due to a continuously resilient economy. Australian 3-year Government bond yields fell -13bps, ending the month at 3.74% while the 10-year Government bond yields declined -3bps to end the month at 4.03%. Australian 10-year Government bonds outperformed US equivalents with the spread ending the month at -8bps from +10bps the previous month. Credit spreads also tightened (Bloomberg AusBond Credit 0+ index tightened from 125bps to 115bps). The Bloomberg AusBond Composite 0+ year Index returned 0.74%.

In August, the RBA left the official cash rate target unchanged at 4.10% at the second consecutive time, citing again the need to provide the Board with further time to assess the economic environment. This decision was against the narrow consensus amongst economists of a 25bps rate hike although largely in-line with the implied rate priced-in by market participants. In terms of domestic inflation, the Board changed its wording from "inflation has passed its peak" to further stating that inflation is "declining". The Board also noted the services inflation to be "rising briskly" and acknowledged the possibility that "surprisingly persistent" services inflation overseas "could occur in Australia" as well. In terms of the labour market, there were no material changes to the expression that the "condition in the labour market remain very tight, although they have eased a little". Regarding forward guidance, the Board kept saying "some further tightening of monetary policy may be required" and reiterated data dependency. Later in the month, the Minutes of the RBA's August Board meeting stated that "inflation was heading in the right direction" showing some sort of satisfaction by the Board.

Elsewhere, the domestic economic data was mostly weaker over the month. The labour market showed some cooling as the unemployment rate rose to 3.7% and surprised the market consensus of 3.6%. The monthly change in employment also turned into negative territory to -14.6k. while the participation rate slightly declined to 66.7% from 66.8% the previous month. The inflation data was again encouraging as the monthly July CPI release came in softer printing 4.9%, a further decline from the previous month's 5.4% and below the consensus of 5.2%.

Australia ESG insights

NBN Co priced an A\$850m 5-year green bond with a 5.20% (105bps over swap) in August. There was healthy demand (A\$1.2b book) from a wide range of investors and countries. This was NBN's third green bond issuance, with the use of proceeds directed toward new or existing green projects that meet the criteria of energy efficiency or renewable energy. Eligible projects under the energy efficiency category include network technologies, i.e., fibre optic, that are significantly more energy efficient (on a kWh/GB basis) compared to legacy technology, i.e., copper. We are still of the view that this bond is of the 'lighter green' variety because the use of proceeds is not going above and beyond NBN's ordinary course of business, which is to build out Australia's fibre network and replace the legacy copper network. We therefore think that the bonds would price minimal, if any, 'greenium' and this would appear to be the case given the minimal spread difference compared NBN's non-green A\$ June 2028 bond.

Positioning and Attribution

Duration, yield curve and inflation-linked strategies

Australia's sovereign yield curve steepened over August with the front end declining more than the long end. The portfolio's sizeable long domestic duration positioning was positive to relative performance. Our 3/5-year curve flattener position detracted slightly from relative performance as the front end of the curve steepened.

Our global rates exposure contributed to relative performance over the month. Our US 5/30-year steeper position was a positive contributor to relative performance, as well as the outright long New Zealand position where the 2-year NZD swap rate slightly declined over the month. Our short Japan 10-year positioning was flat over the month.

Sector/security

As Australian credit spreads continued to tighten over the month, the portfolio's overweight position across Australian semi-government, supranational and corporates benefited strongly, and was the biggest contributor to relative performance over August. During the month we switched risk in corporates (from 5y QAN into 4y CPIFAU) while adding risk in supranational (5y CLFCAP).

Outlook

Our bias remains to be positioned long duration across our portfolios as the global rate hike cycle reaches maturity, inflation continues to ease and recession fears linger. The exception is Japan where we expect yields to move higher as the BoJ belatedly loosens its grip on the bond market and as the debate shifts to the potential for the end of negative interest rate policy.

In Australia, inflation continues to follow the global trend, falling quickly from its Q4 2022 peak of 7.8% y/y. In fact, the latest quarterly release showed both headline and underlying measures are now annualising at half this rate (3.5-4.0%) which is a good gauge of where y/y inflation is likely to end the year. Disinflation, particularly in the service sector, may proceed more slowly into 2024, although early signs of loosening in the labour market are encouraging. On growth, our core thesis has been that the lagged impact of the record rate hike cycle delivered since May 2022 will have a significant negative impact on consumption by the middle of the year, making it feel like a recession for parts of the highly interest rate sensitive household sector. This appears to be playing out judging by the further slowdown in household consumption evident in the national accounts (just 0.1% q/q in Q2), declining savings rate and uptick in mortgage arrears.

The RBA has now left the cash rate unchanged at 4.1% for three consecutive meetings. It is hard to see what will trigger a restart in the hiking cycle given the economy is on a slowing trend, inflation is heading in the right direction and, even with rates standing still, household cash flows continue to get squeezed through higher utility bills and the ongoing roll-off of low-rate fixed mortgages. While one more rate hike cannot be fully discounted, we continue to believe that the better opportunities arise in positioning for restrictive policy to be reversed next year. Ten-year bonds currently yield more than 4% which we believe offer good medium to long term value in this environment.

Usually, credit spreads would move wider as concerns over the likelihood of a recession increase. However, high all-in yields continue to provide strong support to the Australian and global credit markets. Australian credit spreads also look comparably cheap with aggregate OAS levels above the US for a shorter duration and better-quality market. Market technicals have also been positive for AUD credit as cash is being deployed amid low issuance.

Client Services

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