UBS

UBS Asset Management
For professional / qualified / institutional investors only.
All data as at 30 September 2022

UBS Australian Bond Fund

September 2022

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

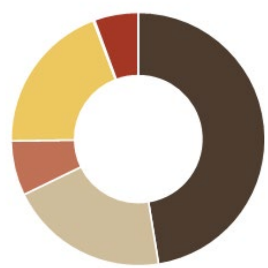
	Fund	Benchmark[1]
Modified duration (yrs)	5.31	5.18
Spread duration[2] (yrs)	3.34	2.00
Weighted avg maturity (yrs)	6.12	6.01
Average credit quality	AA	AA+
Yield to maturity (%)	5.14	3.99

[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	30 November 1989
Fund size	$957.3 m
Management fee	0.45% pa
Minimum initial investment	$50,000
Distribution frequency	Quarterly
Buy/sell spread	+ 0.025% / – 0.08%
APIR code	SBC0813AU

Credit quality (%)



AAA	47.4
AA	20.3
A	7.0
BBB	19.5
Below BBB	0.2
Cash and other	5.6

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]	2.10	3.18
Government inflation-linked	0.00	0.00
Semi-government	1.65	1.44
Government related	0.57	0.32
Corporates	0.90	0.23
Financials	*0.42*	*0.10*
Industrial	*0.34*	*0.10*
Utility	*0.13*	*0.03*
Credit hedge[5]	0.00	0.00
Securitised	0.08	0.01
Cash and cash equivalents	0.01	0.00

By Tenor	Fund	Benchmark
0–3 year	0.45	0.42
3–5 year	0.62	0.71
5–7 year	0.79	0.89
7–10 year	1.16	1.65
10+ years	2.28	1.51

[4] Includes derivatives. [5] Spread duration contribution.

Investment performance

Fund	1 month %	3 months %	1 year % pa	3 year % pa	5 years % pa	Since inception* % pa
Total return	(1.41)	(0.54)	(12.04)	(3.77)	0.45	6.89
Benchmark**	(1.36)	(0.64)	(11.36)	(3.42)	0.75	6.90
Added Value	**(0.05)**	**0.10**	**(0.68)**	**(0.35)**	**(0.30)**	**(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 highlights

- Australian Government bond yields rose across the term structure.
- Australian credit spreads widened over September.
- The RBA raised the cash rate target by 50bps in September and 25bps in October.

Global Market review

Fixed income markets faced further headwinds over the course of September, with the main drag from higher-than-expected inflation readings, especially in the US and Europe. Yields on government bonds moved higher over the month, with the 10-year US Treasury yield starting the month at 3.19% and ending at 3.83%. The German 10-year yield also increased, rising from 1.57% to 2.10%. The sharpest moves came in the UK gilts market, amid mounting concern over the fiscal sustainability of the UK following a package of tax cuts and spending increases. Credit spreads around the world also widened, as investors moved to price in rising risks of default as economies slow. Duration-sensitive high-grade bonds underperformed their high yield counterparts while emerging market hard currency sovereign bonds lagged those of developed markets.

In the US, the economic impact of the COVID-19 pandemic continued to fade with many people returning to more normal lifestyles. In September, air travel was 95% of 2019 levels. In data for August, the ISM Manufacturing PMI was unchanged at 52.8, while the Services PMI edged up to 56.9, up from 56.7 in July. Nonfarm payrolls increased by 315,000, but the unemployment rate rose to 3.7% as more people returned to the labour market. CPI slowed to 8.3% year-over-year from 8.5% in July as gasoline prices fell, but core inflation was stronger than expected. The personal consumption expenditures deflator (PCE), the Federal Reserve's preferred inflation measure, also showed price pressures persisting. The Federal Reserve raised rates by 75 basis points in September—its third consecutive hike of this magnitude and signalled at least another 100bps of hikes by year-end.

In the Eurozone Preliminary data showed that Eurozone consumer price inflation rose to 10% in September from 9.1% in August. The ECB lifted the deposit rate out of negative territory in July and followed up with a 75bps hike in September. On the political front, the centre-right coalition led by the Brothers of Italy (BoI) party emerged victorious in Italy's elections. During the campaign, BoI indicated that it was against an expansionary fiscal policy. In the UK, the Bank of England raised interest rates by 50bps at its September policy meeting, taking its key interest rate to 2.25%. The BoE also cut its growth forecasts, and now expects a GDP contraction of 0.1% in the third quarter. Additionally, the BOE announced it would intervene in the gilt market in response to market turmoil following Chancellor Kwasi Kwarteng's mini- budget.

Japan remained an outlier in the global trend toward monetary tightening, with the Bank of Japan maintaining its accommodative policy stance throughout the third quarter. In September, following a rapid weakening of the yen, the Ministry of Finance intervened in currency markets (by selling USD and buying JPY) for the first time since 1998. In China, economic activity broadly improved in August, but COVID-19 restrictions and concerns about the property sector continued to weigh on sentiment. Retail sales rebounded to 5.4% year-over-year, driven by autos and base effects. Fixed asset investment picked up slightly to 5.8% y/y year-to-date, with strong infrastructure and resilient manufacturing offsetting the decline in property.

September was a difficult period for commodity investors, with the UBS CMCI Total Return Index down 5.5% in September and 6.4% in 3Q22. All the commodity sectors delivered a negative performance, with energy down the most and precious metals holding up the best. Aggressive monetary policy tightening in the US and Europe sparked recession fears, weighed on cyclical commodities in the energy and industrial metals sectors. That said, even precious metals were not immune, suffering from rising interest rates and a stronger US dollar.

Australia Market review

Australian sovereign bonds sold-off across the curve over September in line with moves in offshore bond markets as global investors remained concerned about the inflation outlook and pace of central bank hikes. Australian 3-year Government bond yields rose 32bps, ending the month at 3.52% while the 10-year Government bond yield increased by 29bps, to end the month at 3.89%. The spread of Australian 10-year Government Bond yields against US 10-year Government bond yields tightened versus the prior month with the spread coming in from 41bps to 6bps. Credit spreads widened over the month (Bloomberg AusBond Credit 0+ year index widened from 137bps to 148bps). The Bloomberg AusBond Composite 0+ year index returned -1.36% in September, driven by both rising treasury yields and spreads widening.

In early September, the RBA raised the official cash rate target by 50bps to reach 2.35%, a move that was widely anticipated by market participants. The tone of the RBA's Statement aligned with the market's expectations for further tightening, though there was a hint at slowing down the pace of hikes with text referencing "the full effects of higher interest rates yet to be felt in mortgage payments" and the removal of the description of rate rises as "normalisation."

On the data front, the Westpac consumer confidence survey for September reported a bounce in confidence, with the index printing 3.9%. However, with the index at 84.4, it remains at near historic lows. The Australian labour market remains extremely tight, with the unemployment rate printing at 3.5% and job growth at 33.5k in August. The Australian Bureau of Statistics also unveiled its new monthly CPI series, which showed headline inflation printing at a historically elevated 6.8% y/y. Yet, market participants are likely to place more weight on the established quarterly series, with the Q3 release due on 26 October, to guide rate hike expectations..

Australia ESG insights

The recent, highly publicised, Optus data leak involved the theft of millions of customers' personal information - including names, DOBs, addresses, contact details, drivers license, etc - from a cyber-attack perpetrated by an as-yet unknown entity. Cyber risk is often cited as the most consequential ESG risk aside from climate given the potential for reputational damage, high remediation costs and regulatory fines. For Optus, these can come in the form of lost customers to competitors (or operating margin pressure from offering discounts), increased costs from remediation, compensating customers or class actions. Given the failure in cyber risk management, the subsequent poor management and the aforementioned risks, we downgraded our ESG Risk Recommendation on Optus from a '3' to '4' in September. A return to a recommendation of '3' in future will require us to have clarity on the materiality of these risks, a clear path toward remediation of the systems and processes which gave rise to the breach and changes in corporate governance - all of which will take time.

Positioning and Attribution

Duration, yield curve and inflation-linked strategies

Australian Government bonds sold-off across the term structure in September. The portfolio's neutral domestic duration positioning resulted in flat relative performance for the month.

Our overall global rates exposures detracted from relative performance over the month. We took profits on our German 2-year Schatz positions – both an outright short position and the short leg that was paired against a long in New Zealand 2-year interest rate swaps. We also took profit by closing out the US leg of the other existing spread tightener trade - long New Zealand 10-year interest rate swaps against short US 10-year duration. This left us with an outright long New Zealand 2-year and New Zealand 10-year position, which detracted from performance as yields increased in New Zealand

Sector/security

As Australian credit spreads across all sectors widened over the month, the portfolio's overweight position across Australian semi-government, supranational and corporates (particularly financials and utilities), detracted from relative performance. During the month, we added risk in the semi-government sector (12-year NSW Treasury Corporation).

Outlook

A focus on outsized rate hikes from most global central banks in September has increased the yield on government bonds and with it improved the entry point for duration. On inflation, the US has been at the forefront of the cycle and there are promising signs that energy, food and durable goods inflation is rolling over. While services inflation will likely remain sticky, over time, we expect the bond market to gain more confidence on central banks resolve and ability to tame inflation. Our medium-term outlook places more emphasis on the sizeable slowdown in global growth well underway and the risks that the significant tightening of financial conditions already delivered creates for pockets of the world economy with very high leverage.

Australia is experiencing the same macro 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 there is 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 8%. 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 growth slowing well below its potential rate into next year.

The RBA has followed in the footsteps of global central banks, delivering a rapid 250bps of rate hikes since May in an effort to restore credibility in the fight against inflation. The RBA's downshift to a smaller 25bp hike increment in October is in line with our prior expectations for the cash rate to end the year close to 3%. As recently as the end of September the market had been pricing a cash rate peak above 4%, with rates expected to stay near that level for years to come. We continue to believe that such a path is unlikely to be realised given the significant adverse impact it would have on household's debt servicing costs. Accordingly, we have begun to scale into a long duration position with 10-year yields above 3.5%, a level we have previously flagged as offering value.

We still hold the view that investment grade credit spreads globally will move wider into year-end driven by tighter financial conditions, increased new issuance and increasing risks of recession. Also, we expect firms to have less flexibility to pass higher input costs through to consumers leading to a deterioration in corporate fundamentals. Australia credit should however offer relative value in this environment as spreads have moved wider point for point with the US, whereas in the past the local market had traded with a beta of 0.30 to 0.60. In fact, aggregate OAS levels are now the same as the US for a shorter duration and better-quality market.

Client Services

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