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

# UBS Australian Bond Fund

## October 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

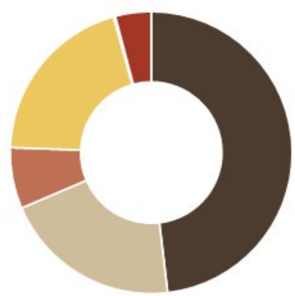
| | Fund | Benchmark[1] |
|---|---|---|
| Modified duration (yrs) | 5.45 | 5.19 |
| Spread duration[2] (yrs) | 3.33 | 2.00 |
| Weighted avg maturity (yrs) | 6.25 | 6.00 |
| Average credit quality | AA | AA+ |
| Yield to maturity (%) | 4.64 | 3.87 |

[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 | $ 965.1m |
| 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 | 48.1 |
| AA | 20.4 |
| A | 7.0 |
| BBB | 20.1 |
| Below BBB | 0.2 |
| Cash and other | 4.1 |

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] | 2.25 | 3.19 |
| Government inflation-linked | 0.00 | 0.00 |
| Semi-government | 1.64 | 1.45 |
| Government related | 0.57 | 0.32 |
| Corporates | 0.91 | 0.22 |
| *Financials* | *0.45* | *0.10* |
| *Industrial* | *0.33* | *0.09* |
| *Utility* | *0.13* | *0.03* |
| Credit hedge[5] | 0.00 | 0.00 |
| Securitised | 0.07 | 0.01 |
| Cash and cash equivalents | 0.00 | 0.00 |

| By Tenor | Fund | Benchmark |
|---|---|---|
| 0–3 year | 0.44 | 0.40 |
| 3–5 year | 0.58 | 0.72 |
| 5–7 year | 0.84 | 0.91 |
| 7–10 year | 1.18 | 1.63 |
| 10+ years | 2.41 | 1.53 |

[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 | 0.53 | (3.29) | (8.16) | (3.45) | 0.32 | 6.89 |
| Benchmark** | 0.93 | (2.98) | (7.24) | (2.97) | 0.72 | 6.91 |
| **Added Value** | **(0.40)** | **(0.31)** | **(0.92)** | **(0.48)** | **(0.40)** | **(0.02)** |

*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 fell across the term structure.
- Australian credit spreads widened over October.
- The RBA raised the cash rate target by 25bps in October and 25bps in November.

### Global Market review

Government bond markets had a mixed month in October. The yield on the 10-year US Treasury rose from 3.83% at the start of the month to 4.05% at the end. The 2-year yield climbed from 4.28% to 4.48%. But this was off from intraday peaks of 4.34% and 4.63% during the month for the 10-year and 2-year bonds, respectively. The yield on the 10-year German bund was volatile over the month, starting at 2.11%, before rising to an intra-day peak of 2.53% and ending at 2.12%. US high yield and Euro high yield credit returned 2.8% and 1.7% respectively for the month. The UK gilts market was especially volatile, as investors continued to process swings in UK fiscal policy. The yield on the 30-year gilt, which had reached an intraday peak of 5.1% in mid-October, fell back to 3.6% by the end of the month.

In the US, the core Consumer Price Index measure of inflation, excluding food and energy, rose by 0.6% for the second consecutive month in September, well above levels consistent with the Fed's inflation goal, and unemployment fell back to a 50-year low of 3.5%. The fed funds futures markets moved from pricing a peak in rates of around 4.4% by May 2023 at the start of October, to pricing close to 5% by the end of the month. On growth, GDP data turned positive in the third quarter, with the economy growing at an annualized 2.6%, following two consecutive quarters of contraction. However, the positive result was driven largely by trade performance and economic headwinds are mounting as higher borrowing costs feed through into the economy. The average cost of a 30- year fixed rate mortgage in the US hit 6.94%, the highest since 2002, while mortgage applications have been contracting at the fastest pace since 1997.

In the Eurozone, the European Central Bank delivered a second consecutive 75-basis point hike at its October meeting, taking the Eurozone deposit rate to 1.5%, the highest level since 2009. Eurozone inflation in October climbed higher than expected according to data from Eurostat, accelerating to 10.7% from 9.9% in the previous month. Inflation in the euro region has now hit a record-high figure for the 12th consecutive month and is over five times the European Central Bank (ECB)'s 2% target. The eurozone's gross domestic product figures indicated an expansion of 0.2% in the third quarter, down from 0.8% in the second quarter. In the UK, Rishi Sunak's appointment as UK Prime Minister helped stabilize sterling after a swift rise and fall in yields that occurred during the 44-day premiership of his predecessor Liz Truss. The yield on the 30-year gilt, which had already fallen from a peak of 5.1% earlier in October due to the appointment of the fiscally cautious finance minister Jeremy Hunt, declined further to end the month around 3.58%. Sterling, which reached an intraday low of against the US dollar below 1.04, ended the month at 1.15.

In Japan, excluding the impact of consumption tax hikes, the core CPI rate is now at its highest level since June 1982. The increase in the core CPI mainly reflected four factors; 1) strong non-fresh food prices, (2) the drop out of the base effect from reduced mobile phone charges, (3) planned increases in property & casualty insurance premiums and medical consultation fees, (4) an increase in prices for clothing & footwear. In China, data released after the Party Congress, indicated that GDP grew by 3.9% in the third quarter from a year before, above a consensus forecast for 3.4% but below the official target of 5.5%.

Broad commodity indices recovered in October, with the UBS CMCI Total Return Index up 3%. The performance was driven by the energy sector, which was up by 8.1%, and livestock up by 7.1%. Industrial metals were up 0.5%, agriculture flat and precious metals down by 1.1%. Within the energy sector, mild weather and strong supply growth weighed on US natural gas prices, while the early October decision by OPEC and its allies (OPEC+) to reduce the production quota by 2mbpd from November supported crude oil and refined products. Low inventories in the US harbor of New York strongly supported heating oil, the best performing commodity on a spot basis in October. Meanwhile, gold suffered from the aggressive monetary policy tightening of the US Federal Reserve and the stronger US dollar.

### Australia Market review

Australian sovereign bond yields fell over October as investors remained concerned about the growth outlook. Australian 3-year Government bond yields fell 23bps, ending the month at 3.29% while the 10-year Government bond yield fell 13bps, to end the month at 3.76%. The spread of Australian 10-year Government Bond yields against US 10-year Government bond yields inverted, reaching -29bps from +6bps the month prior, a significant outperformance as US yields continued to rise. Credit spreads widened over the month (Bloomberg AusBond Credit 0+ year index widened from 148bps to 169bps). The Bloomberg AusBond Composite 0+ year index returned 0.93% in October.

In early October, the RBA raised the official cash rate target by 25bps to reach 2.60%, a shift from the previous four 50bps hikes. The RBA is aiming to deliver both lower inflation and a soft landing for growth, with their statement noting that they had increased the cash rate 'substantially in a short period of time'. The Board had slowed the pace of hikes in part to 'assess' their impact on the inflation and growth outlook. Given the tight labour market and the upstream price pressures, the Board will continue to pay close attention to both the evolution of labour costs and the price-setting behaviour of firms in the period ahead. Looking forward, the Board commented that ‘further increases are likely to be required over the period ahead’.

On the data front, the Q3 CPI print came in above market expectations, with headline inflation printing 1.8% QoQ (7.3% y/y), and the trimmed mean core at 1.8% QoQ (6.1% y/y). Key contributors to the rise were housing (utilities and dwelling construction) and food. There was however, evidence of strong inflation across the rest of the consumer basket. Over the month the 2022-23 October Federal Budget was announced. S&P’s post-Budget announcement noted that from a credit rating perspective, “A humming economy and high commodity prices are delivering a large windfall in today's budget. This windfall should improve fiscal outcomes that underpin our rating on the sovereign (AAA/Stable/A-1+). In line with the better budget projections, the Australian Office of Financial Management (AOFM) revised its bond issuance plan down from AUD125bn to AUD95bn for this fiscal year.

## Australia ESG insights

The aviation sector is often in the headlines for it’s greenhouse gas emissions (GHGs), arguably disproportionately relative to the contribution it makes to global emissions at ~2%. Emissions of GHGs largely come from energy, industry, road transport, agriculture and changes in land-use (such as deforestation) which combined generate around two-thirds of all GHGs. Nevertheless, every industry needs to make a contribution to limiting global warming, and aviation is no exception. As it currently stands, aviation is classified as a hard-to-abate sector for which the transition is not nearly so straightforward, because they either lack the technology or its cost remains prohibitive.

For aviation, whilst there are alternative fuels, increases in production are unlikely to be sufficient to meet the demands of the industry by 2050. Hence, for companies such as Qantas, carbon offsets will need to play a big role in meeting their 2050 net zero targets. Increasing the blended mix of alternative over jet fuels will play a role in the interim, as will investing in more fuel efficient aircraft, in order for Qantas to meet their the 25% reduction in emissions targeted by 2030 (vs. 2019 levels). In the meantime, whilst not in its wheelhouse, Qantas has recently pledged $100m for the development of alternative fuels. In the recent Federal Budget, a jet fuel council has been established to focus on sustainable aircraft fuels. So, momentum is starting to build. However, many sustainable aviation fuels are agriculturally based (corn, sugarcane), highlighting how the E&S of ESG are often interlinked (fuel competing with the food chain). We’ve recently engaged with Qantas on these issues and ongoing engagement will be required to track their progress. This feeds into ESG integrated approach we take in our analysis, investment decision making and ultimately portfolio construction.

## Positioning and Attribution

### *Duration, yield curve and inflation-linked strategies*

Australian Government bonds rallied across the term structure in October. The portfolio’s neutral domestic duration positioning resulted in flat contribution to relative performance for the month.

Our overall global rates exposures detracted from relative performance over the month. The outright long New Zealand 2-year and New Zealand 10-year positions, detracted from performance as yields increased in New Zealand. Our short Japan 10-year position also detracted as the Bank of Japan maintains its ongoing zero interest rate policy.

### *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), detracted from relative performance. During the month, we added high-rated risk in the corporate sector (3 year Suncorp-Metway Ltd covered bond).

## Outlook

A Bonds appear to be at an important inflection point as the monetary policy tightening cycle enters a new phase. While inflation continues to surprise to the upside across most regions, our medium-term outlook places more emphasis on the sizeable slowdown in global growth and the risks that the significant tightening of financial conditions already delivered creates for pockets of the world economy with very high leverage. We are encouraged that global central banks are starting to appreciate these risks and strongly suspect that others will soon follow the likes of the RBA and the Bank of Canada in downshifting their historically large rate hikes to smaller increments.

Of course, inflation remains a problem in Australia, as it does globally. The Q3 release revealed a headline CPI rate of 7.3% y/y and a 6.1% y/y reading on the RBA’s preferred trimmed mean measure. We continue to expect annual inflation to peak in the Q4 release as further price increases in components such as household energy costs and food prices are yet to flow through and are likely to push the headline rate to 8%. This would be two quarters after the peak in the US CPI (9.1% y/y) consistent with the later re-opening of the Australian economy from COVID. Nonetheless our expectation is that going into next year the more important driver for the bond market will be the degree that demand weakens as households’ budgets come under increasing pressure, particularly from the lagged impact of higher mortgage rates.

The RBA has now delivered two successive 25bp rate hikes and we believe the bar to returning to super-sized 50bp increments is very high. Another quarter-point hike in December should see the cash rate end the year at 3.1%, while a couple more increases in Q1 – putting the cash rate close to the 3.5% upper end of the RBA's neutral rate estimates – appears more likely than not at this stage. Further tightening beyond Q1 is harder to envisage as it should be clear by then that tighter policy is biting – especially when combined with the shrinking of the RBA's balance sheet and reset of low-rate fixed mortgages – and the deceleration in global inflation and growth is likely to be more visible. With 10-year bond yields and terminal cash rate pricing both currently close to 4% we prefer to position duration in our portfolios neutral to long.

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 with a higher beta than 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 above the US for a shorter duration and better-quality market**.**


**Client Services**

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




UBS