

UBS Australian Bond Fund

January 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)	5.40	5.22
Spread duration ² (yrs)	3.82	2.02
Weighted avg maturity (yrs)	6.05	6.03
Average credit quality	AA	AA+
Yield to maturity ³ (%)	4.41	3.70

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

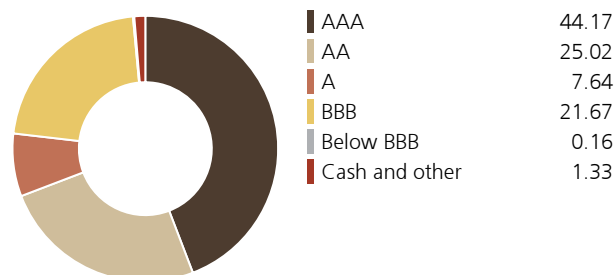
² Option adjusted spread duration ex Treasury.

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	\$ 977.1m
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 (%)



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	1.72	3.20
Government inflation-linked	0.00	0.00
Semi-government	1.97	1.48
Government related	0.59	0.31
Corporates	1.00	0.22
Financials	0.52	0.10
Industrial	0.31	0.09
Utility	0.17	0.03
Credit hedge ⁵	0.00	0.00
Securitised	0.12	0.01
Cash and cash equivalents	0.00	0.00

By Tenor	Fund	Benchmark
0–3 years	0.69	0.44
3–5 years	0.88	0.73
5–7 years	0.88	0.90
7–10 years	0.75	1.67
10+ years	2.20	1.48

⁴ Includes derivatives.

⁵ Spread duration contribution.

Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	3.11	2.86	(6.64)	(3.05)	0.85	6.92
Benchmark**	2.76	2.20	(6.26)	(2.74)	1.14	6.92
Added Value	0.35	0.66	(0.38)	(0.31)	(0.29)	0.00

* 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 January.
- The RBA maintained the cash rate target at 3.10%.

Global Market Review

The yield on the 10-year US Treasury declined from 3.84% at the start of the month to 3.53% at the end. The 2-year yield fell from 4.46% to 4.20%. Returns were positive across fixed income, with US credit returning 3.8%, high-grade gaining 2.5%, and US dollar emerging market sovereign debt up 3.2%. US dollar and euro high yield credit returned 3.9% and 3.2%, respectively, as spreads narrowed on improving risk appetite. The yield on 10-year German Bunds also declined from 2.55% to 2.27%.

In the US, economic data for December was mostly weaker as higher interest rates weighed on activity. The ISM Manufacturing PMI fell to 48.4 from 49 in November, while the Services PMI dropped sharply to 49.6 from 56.5. Manufacturing output fell by 1.3% month-over-month, and retail sales were down 1.1% month-over-month. Nonfarm payrolls increased by 223,000 in the month, the smallest rise since December 2020, while the unemployment rate fell to 3.5%, matching the pre-pandemic level at a 50-year low. Consumer price inflation slowed to 6.5%, down from a peak of 9.1% in June. The Fed raised rates by 50 basis points on 14 December, setting the federal funds target range at 4.25–4.5%.

In the Eurozone, GDP grew 0.1% quarter-over-quarter in the last three months of 2022, according to the preliminary estimate, ahead of consensus expectations for a slight contraction. The S&P Global flash composite PMI edged up to 50.2 in January, above the 50 level for the first time since June. Inflation eased to 8.5% year-over-year in January from 9.2% in December. In the UK, consumer price inflation fell to 10.5% in December from 10.7% in November. The S&P Global/CIPS flash composite PMI dropped to 47.8 in January from 49 in December.

In Japan, the global slowdown weighed on December exports and production, while domestic reopening spending supported consumption and retail sales. Nationwide core CPI (excluding fresh food) rose to 4% year-over-year in December, the highest since 1981. In China, activity has picked up as the economy reopens following the lifting of COVID restrictions. Based on Lunar New Year holiday and high frequency data, consumption has staged a solid recovery. Echoing this, January's official PMIs rebounded strongly into expansionary territory, with the services PMI up the most to 54 on reopening tailwinds. The cross-region seasonal travel did not cause a major relapse in COVID infections, as had been feared. According to the State

Council's Joint Prevention and Control Mechanism data, fever, emergency, and ICU cases all peaked in late December to early January.

Commodities, as measured by the broadly diversified commodity index (CMCI), rose by slightly more than 2% (total return) in January. Metals drove this performance, with industrial metals rising 8% and precious metals up nearly 5%. The agriculture sector contributed positively, while energy and livestock fell. China's reopening, with the country accounting for about half of global industrial metal demand, supported copper and aluminium prices. Strong central bank demand and a weaker dollar, meanwhile, lifted gold. In the energy sector, crude oil came under strong pressure at the start of the year but managed to pare some of its losses in the month. Mild weather, the third warmest January in the US, weighed heavily on US natural gas prices.

Australia Market Review

Australian Government bonds rallied over January in-line with offshore bond markets as markets priced in lower future policy rates given the backdrop of slowing US inflation. Australian 3-year Government bond yields declined 32bps, ending the month at 3.18% while the 10-year Government bond yield fell 50bps, to end the month at 3.55%. The spread of Australian 10-year Government bond yield against US 10-year Government bond yield narrowed, ending the month at 4bps. Credit spreads tightened over the month (Bloomberg AusBond Credit 0+ year index tightened from 149bps to 136bps). The Bloomberg AusBond Composite 0+ year returned 2.76% in January.

The domestic economic data were mixed over January. Housing-related indicators such as building approvals (-9.0% MoM) and new home loans (-3.7% MoM) continued to show the effects of the RBA policy tightening. November retail sales on the other hand, surprised to the upside (1.4% MoM versus the consensus of 0.6%), although the weakness in December retail sales (-3.9% MoM) revealed later in the month suggests that Black Friday sales is creating seasonal distortions. Around mid-month, weaker than expected labour data pushed down the Australian sovereign yield curve as the 10-year Government bond yield declined by 23bps to 3.32% on the same day. Monthly jobs growth fell abruptly to -14,600 against the consensus of 25,000, signaling an easing domestic labour market. The unemployment rate worsened to 3.5% compared with a consensus of 3.4%, although still at a historically tight level. Adding to the market volatility, the Q4 CPI release surged to 1.9% QoQ (7.8% YoY), the highest annual CPI print since 1990, versus the consensus of only 1.60% MoM. In term of contribution to change, Recreation and culture was the main driver of the upside surprise. The Australian bonds sold-off with a curve flattening bias the same day.

Australia ESG insights

In line with our approach on corporates and financials, the Australian states and territories are also subject to our ESG Risk Recommendation process. We recently undertook an update at the semi-government level, with environmental and social factors being the main distinguishing variables. Governance risk across the regional governments is considered low given the existence of a strong institutional framework with a stable and responsive cash transfer equalisation system with the Commonwealth, supported by strong policy, transparency and disclosure, and budget management. Whilst social aspects are important, environmental issues are the prime differentiator amongst the group. The State of Tasmania continues to rank the highest due to its high reliance on renewable energy and low dependence on commodity exports. Consequently emissions apportion to the state are the lowest on a per capita, land mass and square metre basis. At the other end of the spectrum is Queensland which has high physical risks (floods, droughts, heatwaves and bushfires), global warming sensitivity given the importance of the Great Barrier Reef to Queensland's economy, and a reliance on mining royalties. South Australia currently sits in the middle of the pack, but we see an improving profile developing given its strong net zero commitments.

Positioning and Attribution

Duration, yield curve and inflation-linked strategies

Australian Government bonds rallied across the term structure in January. The portfolio's slight long domestic duration positioning contributed positively to relative performance.

Our overall global rates exposure also contributed positively to relative performance over January. The outright long New Zealand position was a strong contributor to relative performance as 2-year swap rates declined 46bp and we had opportunistically closed out the remaining short Australian 3-year position that was paired against this position early in the month. Our short Japan 10-year position, to which we added risk during the month, detracted slightly from relative performance as the Bank of Japan kept its monetary policy unchanged at its latest monetary policy meeting.

Sector/security

As Australian credit spreads tightened over the month, the portfolio's overweight position across Australian semi-government, supranational and corporates contributed positively to relative performance. During the month, we were very active in adding spread risk to semi-governments (12y TCV and 12y NSWTC), supranational (5y International Bank for Reconstruction & Development) and corporates (5y CBAAU and 5y Origin Energy Finance).

Outlook

We expect 2023 to be a positive year for fixed income. Our clear bias on duration is to position on the neutral-to-long side, using any back up in bond yields as a buying opportunity, such as that presented to us in December.

The global monetary policy tightening cycle appears to be approaching maturity with most central banks likely to stop hiking rates in the first half of the year. This is a more positive environment for bonds as it means a narrower range of likely peak policy rate outcomes and lower rate volatility. Meanwhile the likelihood for stronger disinflation than the consensus expects could see some tightening reversed as early as the end of the year, especially if labour markets loosen. Japan is an outlier where the risks to bond yields remain to the upside given inflation is appearing later and the BoJ is potentially only at the beginning of adjusting its policy settings.

Australia remains a laggard when it comes to inflation with headline CPI only likely to have peaked in the Q4 print (7.8% y/y), coming 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. As a result, we remain focused on high frequency global indicators, which continue to point to easing inflationary pressures. On growth, a strong external sector – supported by China's exit from zero-COVID – and the return of net inward migration should lessen the probability of a technical recession relative to other economies. However, we expect it to feel like a recession for parts of the highly interest rate sensitive household sector. This is in line with our core thesis that the lagged impact of 325bp of rate hikes delivered since May 2022 will have a significant negative impact on consumption by the second quarter.

Given this, our expectation is that the RBA is close to the end of its hiking cycle. We continue to see one more 25bp increases in March to a peak cash rate of 3.6% as the most likely outcome, with the risk skewed towards another 25bp in Q2. Rate hikes beyond Q1 are harder to envisage as it should be apparent 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. At current bond yields we think rate hikes are fully priced in and there is upside for bonds if growth and inflation decelerate faster than expected, hence our current long duration bias.

We still hold the view that investment grade credit spreads globally will move wider in 2023 driven by tighter financial conditions and increasing risks of recession. However, we expect high all-in yields to provide strong support to the Australian credit market and also note that spreads look comparatively 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 at the start of the year as cash is being deployed amid low issuance.

Client Services

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