

UBS Australian Bond Fund

February 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)	5.83	5.12
Spread duration ² (yrs)	4.14	2.02
Weighted avg maturity (yrs)	6.60	5.94
Average credit quality	AA	AA+
Yield to maturity ³ (%)	4.77	4.05

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

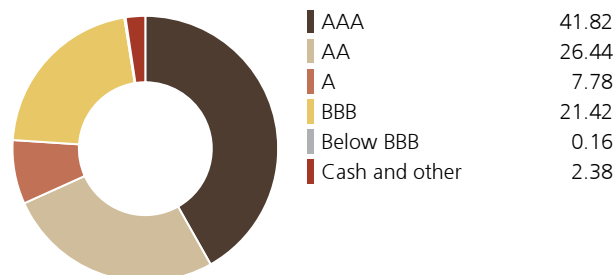
² Option adjusted spread duration ex Treasury.

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	\$ 954.3m
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	1.82	3.10
Government inflation-linked	0.00	0.00
Semi-government	2.14	1.47
Government related	0.63	0.32
Corporates	1.12	0.22
Financials	0.65	0.10
Industrial	0.31	0.09
Utility	0.17	0.03
Credit hedge ⁵	0.00	0.00
Securitised	0.11	0.01
Cash and cash equivalents	0.00	0.00

By Tenor	Fund	Benchmark
0–3 years	0.66	0.43
3–5 years	0.99	0.73
5–7 years	1.09	0.91
7–10 years	0.81	1.60
10+ years	2.27	1.45

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	(1.30)	(0.28)	(6.66)	(3.72)	0.53	6.86
Benchmark**	(1.32)	(0.69)	(6.37)	(3.44)	0.82	6.87
Added Value	0.02	0.41	(0.29)	(0.28)	(0.29)	(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 rose across the term structure.
- Australian credit spreads tightened over February.
- The RBA raised the cash rate target by 25bps in February.

Global Market Review

Fixed income assets mostly fell in value in February, amid renewed concerns over elevated inflation and central bank tightening. The yield on the 2-year US Treasury rose around 62 basis points to 4.82%, while the 10-year yield climbed 41bps to 3.92% as of the end of the month. Yields also climbed in Europe, with the 2-year German Bund increasing from 2.64% to 3.20%. US high grade delivered a negative total return of 2.3% over the month, with a loss of 1.9% for Bloomberg's Pan-Europe Aggregate Index. US and European investment grade credit also lost ground, after a strong start to the year in January. The main exception to this trend was in fixed income instruments with a floating rate feature, such as senior loans, which gained ground in February.

In the US, economic data for January was mostly stronger. The ISM Manufacturing PMI fell to 47.4 from 48.4 in December, but hard data on manufacturing output showed an increase of 1%. The Services PMI rebounded to 55.2, making the weak December reading of 49.2 appear to be a one-off. Nonfarm payrolls jumped 517,000 and the unemployment rate fell to 3.4%, the lowest since 1969. Headline CPI inflation slowed to 6.4%, down from a peak of 9.1% in June, but service prices continue to rise rapidly. Retail sales rose by 3% over December. Additionally, the Federal Reserve raised rates by 25 basis points on 1 February, setting the federal funds target range at 4.5-4.75%.

In the Eurozone, the economy proved to be more resilient than feared through the winter months, helped by a sharp fall in energy prices, and fiscal support. The S&P Global Eurozone Composite PMI increased to 52.3 in February from 50.3 in January, marking the strongest expansion in business activity since May 2022. Services activity picked up, though the manufacturing PMI remained in contraction territory (below 50). Inflation continues to moderate in the Eurozone, with annual consumer price inflation declining to 8.6% in January from 9.2% in December. In the UK, the economy has shown some signs of resilience over recent months, with a technical recession avoided at the end of last year. The flash S&P Global/CIPS UK Composite Purchasing Managers' Index rose to 53 in February from 48.5 in January, climbing into expansion territory for the first time since July. Meanwhile, consumer price inflation eased to 10.1% in January from 10.5% in December. The Bank of England raised interest rates by 50bps to 4% in February.

In Japan, fourth-quarter GDP growth rebounded to 0.2% q/q from -0.3% in the third quarter, thanks to some recovery in private consumption. Additionally, Kazuo Ueda was nominated as the new Bank of Japan governor. His policy stance appears well-balanced. In China, consumption continued to recover in February, stronger and at a faster pace than expected. Signs of the rebound were evident over the Chinese New Year holiday, and domestic tourism recorded the strongest visitor and revenue levels since the pandemic. Manufacturing activity also picked up. China's official manufacturing PMI rose to 52.6 in February from 50.1 in January.

February was a challenging month for commodities, with the broad commodity index (UBS Constant Maturity Commodity Total Return Index) falling by nearly 4% and giving up all the gains it achieved in January. Better than-expected US economic data pushed up interest rate expectations and supported the US dollar, which has been a drag for precious and industrial metals and the energy sector. Both metal sectors lost more than 7%, while the energy sector declined almost 3%. Agriculture and livestock held up better, with the former dropping a bit more than 1% and the latter gaining almost 1%. Within the agriculture sector, soft commodities such as sugar, coffee, and cocoa did well, despite risks of a slowdown in discretionary consumption.

Australia Market Review

Australian Government bonds sold-off over February in-line with offshore bond markets against the backdrop of markets once more pricing in higher future policy rates due to unexpectedly strong US economic data. Australian 3-year Government bond yields rose 42bps, ending the month at 3.60% while the 10-year Government bond yields surged 30bps, to end the month at 3.85%. The spread of Australian 10-year Government bond yields against US 10-year Government bond yields turned negative again, ending the month at -7bps. Credit spreads tightened over the month (Bloomberg AusBond Credit 0+ year index tightened from 136bps to 131bps). The Bloomberg AusBond Composite 0+ year returned -1.32%.

In early February the RBA raised the official cash rate target by 25bps, the 9th consecutive hike to a level of 3.35%. The RBA's reasoning for the decision was largely focusing on the persistence of high inflation. Notably, the decision came shortly after the Q4 CPI release which surprised forecasters to the upside with the RBA's preferred core inflation measure – the Trimmed Mean Index – rising 1.7% QoQ (6.9% YoY). According to the RBA minutes, the board considered two options of hiking 50bps and 25bps, which was deemed to be hawkish given that in the last meeting the discussion covered the possibility of pausing rate hikes altogether. The forward guidance was seen as hawkish too as the statement emphasized "further increase in interest rate will be needed",

excluding the phrase from the Dec. meeting that “it is not on a pre-set course”.

Elsewhere on the data side, labour market and wages releases came in weaker than expected in February. The labour force survey showed that the unemployment rate unexpectedly increased to 3.7% in January versus the market expectation to hold steady at 3.5%, although still at a historically tight level. Wage growth also came in softer than expected in Q4 at 0.8% QoQ (3.3% YoY) versus expectations of 1.0% QoQ. Retail sales on the other hand rose to 1.90% later in the month, partially recovering the large contraction reported in December.

Positioning and Attribution

Duration, yield curve and inflation-linked strategies

Australian Government bonds sold-off across the term structure in February. The portfolio’s long domestic duration positioning detracted from relative performance, while we added duration during the month.

Our overall global rates exposure was a detractor from relative performance over February due to our long exposure in New Zealand. 2-year NZD swap rates increased amid further monetary policy tightening and as the market weighed up additional inflationary pressure caused by the recent severe weather event. Our short Japan 10-year position was flat to relative performance as the 10-year Japanese Government bond yields remained at 0.5%, the top end of the Bank of Japan’s policy band.

Sector/security

As Australian credit spreads tightened over the month, the portfolio’s overweight position across Australian semi-government and corporates was a strong contributor to relative performance. During the month we were very active in adding spread risk to semi-governments (6y QTC, 15y SAFA, 7y WATC and 11y AUSCAP), supranationals (5.5y European Investment Bank and 5y Export Development Canada) and corporates (5y Westpac Banking Corp and 5y Svenska Handelsbanken AB).

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, and we have used the recent back up in bond yields as a buying opportunity.

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 Q4 2022 (7.8% y/y), coming two quarters after the peak in the US CPI (9.1% y/y). As a result, we remain focussed on high frequency global indicators which continue to point towards disinflation, although recent data releases in the US show that this is not going to be a straight-line process. On growth, our core thesis is that the lagged impact of 350bp of rate hikes delivered since May 2022 will have a significant negative impact on consumption by the second quarter, making it feel like a recession for parts of the highly interest rate sensitive household sector. We can already see evidence of this squeeze occurring in the recent Q4 GDP release, which showed consumption decelerating to a sub-trend growth rate alongside a sharp fall in the household savings ratio.

Given this, our expectation is that the RBA is close to the end of its hiking cycle. The RBA delivered an expected 25bp hike in March taking the cash rate to 3.6%. Another 25bp hike in April is possible but any further tightening does not seem warranted given the likelihood that consumption weakens further as the lagged impact of higher mortgage rates flows through and inflation eases off from here. At current levels, this presents upside for bonds as the market pricing for the peak RBA cash rate looks too high at 4.2%, 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

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

Investors should consider the PDS and seek professional financial and taxation advice before deciding whether the product is appropriate for them and whether to acquire, or to continue to hold the investment. Your investment in the Fund does not represent deposits or other liabilities of UBS or any member company of the UBS Group including UBS Asset Management (Australia) Ltd (ABN 31 003 146 290) (AFS Licence No. 222605), the issuer of the Fund. Your investment is subject to investment risk, including possible delays in repayment and loss of income and capital invested. The repayment of capital or income is not guaranteed by any company in the UBS Group. Offers of interests in the Fund are contained in the Product Disclosure Statement dated 26 September 2022. Any potential investor should consider the relevant product disclosure statement (PDS) in deciding whether to acquire, or continue to hold, units in a fund. UBS has also issued a target market determination (TMD) that describes the class of consumers that comprises the target market for each UBS fund and matters relevant to their distribution and review. A copy of the PDS, PDS addition information and TMD is available from UBS Asset Management (Australia) Ltd, the issuer of the UBS Funds, on our website <https://www.ubs.com/au/en/asset-management.html> or by calling (03) 9046 4041 or 1800 572 018.

The PDS for this fund is only available to persons receiving the PDS (electronically or otherwise) while physically in Australia, unless expressly authorised by us in writing. The offer does not constitute an offer or invitation in any place in which, or to any person to whom, it would be unlawful to make such an offer or invitation. This Fund (or the PDS) has not been registered under the laws of any jurisdiction outside Australia. The Fund may not be offered or sold in the United States of America or to ‘U.S. Persons’ (as defined in ‘Regulation S’ of the Securities Act of 1933, as amended).

This document may not be reproduced or copies circulated without prior authority from UBS Asset Management (Australia) Ltd.

© UBS Group AG 2023. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

