

# UBS Australian Bond Fund

March 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 <sup>1</sup>
Modified duration (yrs)	5.83	5.18
Spread duration <sup>2</sup> (yrs)	4.44	2.06
Weighted avg maturity (yrs)	6.48	5.99
Average credit quality	AA	AA+
Yield to maturity <sup>3</sup> (%)	3.75	3.52

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

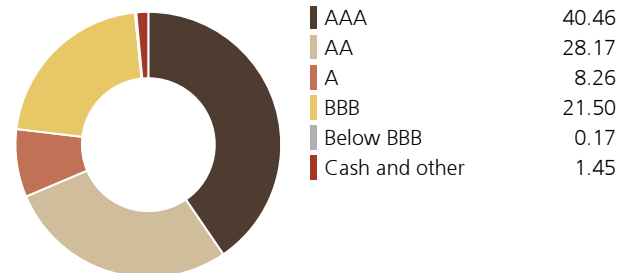
<sup>2</sup> Option adjusted spread duration ex Treasury.

<sup>3</sup> 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	\$ 923.7m
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 <sup>4</sup>	1.52	3.12
Government inflation-linked	0.00	0.00
Semi-government	2.35	1.51
Government related	0.62	0.33
Corporates	1.22	0.21
Financials	0.72	0.10
Industrial	0.32	0.08
Utility	0.18	0.03
Credit hedge <sup>5</sup>	0.00	0.00
Securitised	0.12	0.01
Cash and cash equivalents	0.00	0.00

By Tenor	Fund	Benchmark
0–3 years	0.66	0.40
3–5 years	1.08	0.74
5–7 years	1.04	0.88
7–10 years	0.93	1.65
10+ years	2.12	1.51

<sup>4</sup> Includes derivatives.

<sup>5</sup> Spread duration contribution.

## Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	3.31	5.14	0.35	(2.21)	1.03	6.95
Benchmark**	3.16	4.60	0.35	(2.37)	1.27	6.95
<b>Added Value</b>	<b>0.15</b>	<b>0.54</b>	<b>0.00</b>	<b>0.16</b>	<b>(0.24)</b>	<b>0.00</b>

\* 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 widened over March.
- The RBA raised the cash rate target by 25bps in March.

### Global Market Review

Worries over the health of the banking system on both sides of the Atlantic were the main preoccupation for investors in March. Market sentiment was undermined early in the month by the collapse of two mid-sized lenders in the US, followed by news a week later that UBS would acquire Credit Suisse, in a move that Swiss regulator FINMA said would "ensure stability for the bank's customers and the financial centre." Risk-off tone from a combination of these events contributed to a sharp fall in government bond yields, with investors assuming economic headwinds from the banking system would lead to an early end of central bank rate hikes. The yield on the 2-year US Treasury, which hit a peak of 5.06% prior to the turmoil in the banking sector, ended the month at 4.03%. The yield on the 10-year US Treasury declined from a high of over 4% to 3.47% by the end of the month. As a result of these sharp declines, government bonds outperformed corporates, with US treasuries outperforming other developed market sovereigns. Within corporates, Investment Grade outperformed High Yield. Investment grade corporate spreads did not widen as much as High Yield and benefitted from higher interest rate duration.

In the US, the US Federal Reserve hiked rates by 25 bps to 500 bps. With respect to the banking stress situation, the FOMC said that the "U.S. banking system is sound and resilient." But the fallout from these recent developments "are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation." Towards the end of March, overall market conditions improved as the peak concerns about banking system stress subsided.

In the Eurozone, the European Central Bank (ECB) raised rates by 50bps, lifting the deposit rate to 3%. The decision came against a backdrop of market stress that had been triggered over concerns about financial stability. In terms of inflation, headline fell to 6.9% from 8.5% in February (largely driven by negative base effects from falling energy prices), while Core climbed to 5.7% from 5.6%. Data released over the month showed the resilience of the Eurozone economy, as the flash Composite PMI rose to 54.1 in March, beating expectations, driven by the Services sector. In the UK, the Bank of England (BoE) raised rates by 25bps, lifting the Bank Rate to 4.25%. The decision to tighten policy rates further came after more evidence that prices remain sticky, as evidenced by a jump in inflation data, which saw Headline rise to 10.4%, and Core hit 6.2%. This month's PMI data

showed the Composite coming in softer than last month, but still in expansion territory (printing at 52.2), with the services PMI falling back to 52.8 (from 53.5 previously) while the manufacturing survey dropped to 48 (from 49.3). UK retail sales also came in strong, rising 1.2% from a month earlier.

In Japan, manufacturing PMI increased from 47.7 in February to 49.2 in March while Services PMI rose to 55.0 this month from 54.0 in February. The composite PMI rose from 51.1 to 52.9, reflecting the fastest pace of increase since June 2022. In China, the manufacturing PMI eased to a still solid 51.9 in March, reflecting some giveback after an overshoot to 52.6 in February. Non-manufacturing PMI jumped further to 58.2, the highest since May 2011. Services bounced further to 56.9 from 55.6 in February, led by the retail, transport, IT, and financial sectors. Construction PMI held up more strongly at 65.6, likely reflecting a continued infrastructure push and improving housing activity.

Banking stress and concerns about the economic growth outlook weighed on the commodity sector in the first half of March, though broad commodity indexes regained ground toward the end of the month. The UBS Bloomberg Constant Maturity Commodity Index (CMCI Total Return) was almost flat in March (+0.1%) but lost 1.1% in the first quarter. The more cyclical commodities like energy underperformed, while gold outperformed thanks to its safe-haven status, and reached a 12-month high in March.

### Australia Market Review

Australian Government bonds rallied over March in-line with offshore bond markets as concerns over the banking sector mounted and markets quickly priced in rate cuts within this year primarily in the US. Australian 3-year Government bond yields declined 66bps, ending the month at 2.94% while the 10-year Government bond yields fell 55bps, to end the month at 3.30%. Australian 10-year Government bonds outperformed US equivalents with the spread ending the month at -17bps from -7bps the previous month. Credit spreads widened over the month (Bloomberg AusBond Credit 0+ index widened from 131bps to 148bps). The Bloomberg AusBond Composite 0+ year returned 3.16%.

In early March the RBA raised the official cash rate target by 25bps in-line with market consensus, the 10th consecutive hike to a level of 3.60%. Yields declined after the meeting as the market primality focused on the dovish language in the statement. The statement clearly stated that "monthly CPI indicator suggests that inflation has peaked in Australia", and that there is "lower risk of a cycle in which prices and wages chase one another". In terms of forward guidance, the statement amended "further increases" in the February statement to "further tightening" and refrained from using plural. The RBA would also assess "when" and how much further tightening is needed, implying a possible pause – which was delivered in the April meeting.

On the economic data front, the Australian Bureau of Statistics unveiled its latest quarterly GDP statistics which was softer than expected (Q4 SA 0.5% QoQ vs C 0.8%). GDP growth slowed in each of the last two quarters, and the 0.3% growth in household spending was the weakest quarterly rise since the delta-variant lockdowns in September 2021. Later in the month, the February labour force survey showed continuous tightness in the labour market. The unemployment rate fell again to 3.5% versus the consensus of 3.6%, still at historically low level. In terms of the monthly CPI series, inflation surprised to the downside in January at 7.4% YoY versus the consensus of 8.1%. The February CPI of 6.8% YoY was also below the consensus of 7.2%, mainly driven by a sharp decline in travel and accommodation prices, strengthening the view of market participants that inflation has peaked in Australia.

## Australia ESG insights

ESG Engagement forms a core part of our fixed income credit process and is key to identifying the most material risks and opportunities. Importantly, engagement helps uncover areas for improvement and allows investors to encourage issuers to address areas of concern. We recently undertook an engagement exercise with Ampol Ltd in order to better understand the nature of the scope 1&2 emissions and plans to redesign the core business given the increasing (albeit long term) risks relating to scope 3 emissions. Ampol operates in a classic 'hard to abate' sector, hence decarbonisation efforts in the refining business are limited. However, Ampol is taking a multiple pronged approach to addressing the long term expected decline in combustion engines, the core external risk. Projects are in place around hydrogen and EV but are still early stage. Fortunately, time is on their side, with EV penetration in Australia currently in the mid-single digits (~4%-5%).

## Positioning and Attribution

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

Australian Government bonds rallied across the term structure in March. The portfolio's sizeable long domestic duration positioning was a strong contributor to relative performance, and we were able to take some profit by trimming duration after the banking turmoil erupted and bonds rallied globally. Our 3/5-year curve flattener position was flat to relative performance.

Our overall global rates exposure contributed positively to relative performance over March. The outright long New Zealand position was another strong contributor to relative performance as the 2-year NZD swap rates declined. Our short Japan 10-year positioning detracted from relative performance as the 10-year Japanese Government bond yields fell below the upper limit of the +/-50bps target band set by the BoJ as investors covered shorts amid anxiety about the US banking system. Later in the month, we initiated a US 5/30-year steepener position that detracted slightly from relative performance.

### *Sector/security*

As Australian credit spreads widened over the month, the portfolio's overweight position across Australian semi-government, supranational and corporates detracted from relative performance. During the month we added spread risk to semi-government (14y TCV) and corporates (5y Telstra and 3y Korean Housing Finance).

## Outlook

The first quarter saw the Bloomberg AusBond Composite index record its most positive quarterly return since 2011 (+4.6%). We expect the positive tailwinds for fixed income to persist and retain a core long duration position.

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. Meanwhile the likelihood of stronger disinflation than the consensus expects and tighter credit conditions in the US 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.

We are confident that inflation peaked in Australia in Q4 2022 at 7.8% y/y and will follow the global trend lower in the coming quarters, even if recent data out of the US shows that this is unlikely to be a straight-line process. On growth, our core thesis is that the lagged impact of the 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 have already observed clear 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. These pressures are set to intensify as the full impact of the tightening flows through.

Given this, we consider the RBA's current 3.6% cash rate as sufficiently restrictive and more likely than not to represent the peak of the cycle. Even if a further rate hike is delivered, as some expect, we think the bond market can look beyond this to what comes next. On average we observe that the cash rate has spent ~10 months at the peak during the RBA's inflation-targeting era and a maximum of a year and a half. Against this, market pricing currently implies a shift to a "higher-for-longer" regime with the five-year forward cash rate close to the current 3.6% level. This implies that there is still juice to be squeezed from duration if expectations shift towards the need for less restrictive rates in the coming years.

We still hold the view that investment grade credit spreads globally are more likely to be biased 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](mailto:ubs@unitregistry.com.au) [www.ubs.com/am-australia](http://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.

