UBS
Australian Share Fund

June 2023

Fund description

The Fund is an actively managed fund investing in a portfolio of 30–70 listed Australian equity securities listed on the Australian Securities exchange.

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 objective

The Fund aims to outperform (after management costs) the S&P/ASX 300 Accumulation Index over rolling five-year periods.

Fund information^

Inception date	15 July 1992
Fund size	$ 237.2m
Management fee*	0.80% pa
Minimum initial investment	$ 50,000
Typical number of holdings	30 to 70
Distributions	Semi-annually
Buy/sell spread	+/- 0.25%
APIR code	SBC0817AU

^ The UBS Yarra Australian Share Fund has been renamed the UBS Australian Share Fund, effective as at 9 November 2022.
* The management fees and costs for the fund have been reduced from 0.90% p.a. to 0.80% p.a effective as at 9 November 2022.

Sector allocation (%)

Materials	25.2
Financials	21.0
Communication Services	11.4
Information Technology	8.6
Industrials	8.2
Consumer Discretionary	7.5
Energy	5.3
Health Care	4.3
Utilities	3.2
Consumer Staples	2.6
Real Estate	1.8
Cash	0.9

Active security positions

Overweight	Underweight
QBE Insurance Group Limited	CSL Limited
Reliance Worldwide Corp. Ltd.	National Australia Bank Limited
United Malt Group Ltd.	Macquarie Group, Ltd.
Origin Energy Limited	Wesfarmers Limited
Worley Limited	Woolworths Group Ltd

Active industry positions

Overweight	Underweight
Software & Services	Banks
Capital Goods	Pharmaceuticals Biotechnology & Life Sciences
Media & Entertainment	Financial Services
Telecommunication Services	Consumer Staples Distribution & Retail
Insurance	Commercial & Professional Services

Investment performance

Fund	1 month %	3 months %	1 year %	2 years % pa	3 years % pa	5 years % pa	Since inception* % pa
Total return	1.12	2.05	21.27	5.98	13.72	6.37	9.63
Benchmark**	1.73	0.99	14.40	3.27	11.07	7.12	9.21
Added Value	**(0.61)**	**1.06**	**6.87**	**2.71**	**2.65**	**(0.75)**	**0.42**

* The UBS Asset Management price/value equities process was adopted on 1 April 1996.
** S&P/ASX 300 Accumulation Index. All Ordinaries Accumulation Index prior to June 2000.
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.

Performance/attribution comments

After fees and expenses, the Portfolio increased by 1.12% during the month, underperforming its benchmark by 62 bps.

The largest positive contributors were CSL, Sims Metals and QBE Insurance. Our underweight to the globally focused biotechnology company CSL contributed positively to performance in June following the company updating earnings guidance which came in below market expectations (approximately 10% lower than consensus for Group FY24 NPATA). The weaker operating outlook was driven by lower growth in its core blood plasma business, Behring, as cost pressures push out the margin recovery story. Sims Metals outperformed during the month with US scrap steel margins remaining strong, supporting earnings from the company's US business SA Recycling. QBE Insurance was a source of outperformance due to ongoing strength in the premium rate environment. The company has substantially improved its underwriting discipline and product focus over the last five years, and we believe its 10.2 times FY23 earnings multiple excessively discounts the risks inherent in its business model.

The largest negative contributors were Link Group, Fortescue Metals and Northern Star. Link Group fell at month-end after a large superannuation client (representing ~4% of revenue) elected not to renew its contract for FY25. Fortescue Metals traded higher as iron ore prices continued to rise, where the benchmark 58% Fe Index rebounded to close at US$96.70/t at month-end on expectations of Chinese economic stimulus. Northern Star underperformed in June as gold prices declined ~3% to close at US$1,908/oz at month-end and the market was disappointed with the announced US$1.5bn capital cost to expand the KCGM Mill. In spite of the market sentiment, Northern Star remains our preferred gold exposure given its asset quality and strong cost control.

Market review

The Australian large cap market generated a positive return in June, while the small cap equities market was flat. The Australian 10-year government bond yield continued to rise, up 42 bps to 4.0% as did the shorter end the curve following the RBA's 25 bps increase to the cash rate in June.

The S&P/ASX 300 Accumulation Index returned +1.7% for the month, taking its 12-month performance to +14.4%. Similarly, the S&P/ASX 200 Accumulation Index generated a +1.8% return in June. Globally, the MSCI World Index climbed by +6.1%.

Materials (+4.6%) was the top performing sector during the month, with BHP (BHP, +7.1%) being a substantial positive contributor. Fortescue Metals (FMG, +15.4%) was also influential in reinforcing the sector's return after the benchmark 58% Fe Index rebounded +11% to close at US$96.70/t on expectations of economic stimulus in China.

Utilities (+2.9%) was another strong sector contributor in June with AGL (AGL, +15.1%) being a key contributor. The electricity generator continued to rally in June after releasing an improved earnings outlook, guiding to better-than-expected profits in FY23 and FY24 reflecting strengthening wholesale prices.

Conversely, Health Care (-6.4%) was the weakest performing sector with with CSL (CSL, -9.5%) the main detractor following an update to FY24 earnings guidance which was ~10% lower than consensus. The weaker outlook was mainly driven by prolonged cost pressures in its core blood plasma business, Behring, and concern around increased future competing products for its Behring and Vifor businesses.

Outlook

We have been of the view that the June quarter 2023 will mark the top of the interest cycle for most of the developed world, however, global central banks are seemingly prepared to continue hiking interest rates despite evidence inflation is moderating, lending availability tightening and economic growth faltering. With respect to the latter, we have received confirmation that the Euro Area entered recession and the Federal Reserve staff have retained their forecast that a modest recession in the US is likely. Nevertheless, it seems the appetite for policy makers to persist with the tightening cycle into Q3 has remained, with central bankers seemingly perplexed at why services inflation has yet to ease and why the labour market has yet to ease appreciably. It is possible that a pause in the hiking cycle in June by the Fed will set the scene for a pause across most of the developed world, however, the risk of overtightening and even weaker economic activity is now a real prospect. We believe the US labour market is set to post more modest employment gains from mid-23 which in concert with improving labour supply will continue to moderate wage growth and help underwrite the commencement of a gradual easing cycle in the US by the end of 2023. However, we have to acknowledge that the message from most central banks is that further hikes may be required and an interest rate easing cycle is not in prospect.

This weak economic growth narrative in concert with enthusiasm over the potential impacts from AI has seen large cap 'growth' stocks drive a narrow but strong equity market rally. This has largely hidden from view an ongoing negative earnings revision cycle which in concert with rising bond yields is leaving aggregate market valuations looking more challenging.

Economic growth has also slowed in Australia, recording just 0.3%qoq growth in the March quarter and much of this growth can merely be traced to strong population growth and ongoing engineering construction projects. It is clear the prior tightening of monetary policy is having a material impact on the interest rate sensitive parts of the economy. Nominal retail sales have slowed to 0% six - month annualised, following on from declining volumes in recent quarters. Building approvals continue to decline and are likely to decline further in coming months as declining housing affordability outweighs the impact of an under supplied housing market. Moreover, it is also clear that despite the Federal Budget forecast to return to surplus, that government demand growth is waning even faster than private demand growth.

Nevertheless, after describing the May decision to increase interest rates as finally balanced, the Reserve Bank of Australia (RBA) followed up with a further hike in June and a pause in July, but has flagged that further tightening may be required. The RBA has clearly shifted its focus to worrying about weak productivity growth and high unit labour costs as the main reason for fearing inflation may be higher than it forecasts. We think this ignores the fact that average compensation per hour has not risen sharply, and the main reason for high unit labour costs is a surge in hours worked and employment as the influx in immigration is absorbed into a slowing economy. While this shift in the RBA's focus risks a further hike in August, in our view the RBA would have been better served to pause after the May rate hike, rather than risking a harder economic landing.

Australia should still be able to avoid a technical recession due to four key reasons:

1. Australia has been a net beneficiary of global commodity shortages and the prior surge in commodity prices. Commodity prices are now off their peaks, and although they remain very elevated from a historical perspective, the impact of moving through the peak will be for nominal GDP growth will slow quickly over the next 6 months, removing some of the cushion that has protected corporate profits, tax receipts and wage growth.
2. The household sector continues to hold a significant buffer of excess savings which can be used to smooth consumption growth amid acute cost of living pressures. Nevertheless, our analysis suggests that the residual of the savings buffer skews to older households, leaving younger and more indebted households exposed. As such we remain particularly cautious on discretionary retail spending.
3. Australia remains incredibly well placed to benefit from the global energy transition. Lithium is already a A$10bn export industry for Australia and Australia is the world's dominant producer. Electric Vehicle sales are forecast to increase 10 times by 2030 and Australia has the world's 2nd largest copper resource. LNG is an important energy transition fuel, and currently accounts for 23% of global electricity generation. Australia just happens to be the world's equal largest exporter of LNG. The limiting factor nearer term is that escalating costs and project delays risk pushing out the economic benefits.
4. Net migration into Australia contracted in 2021 for the first time since 1945. However, a very strong recovery was recorded through 2022 and a record level of net migration has occurred in recent months, ensuring that Australia's population growth will exceed 2% in 2023. This will be the primary mechanism keeping Australia out of recession, yet it comes with the complication of exacerbating the rental shortage evident across all capital cities.

While the RBA has been later than most other developed nations, we believe financial conditions are now firmly in the restrictive zone. From our perspective, the RBA's focus on global growth, trends in household spending and the outlook for inflation and labour markets in informing their future decisions suggest that multiple additional hikes are unlikely to be required. While interest rate hikes in Australia will remain a month-to-month proposition for the next six months, our bias is that the RBA should have concluded its hiking cycle, yet an ever-shifting RBA framework suggest they may hike again in August. It is unlikely that policy easing will be delivered in 2023, however, we do expect that the RBA will commence a modest easing cycle in 1H24.

The A$/US$ had been under downward pressure as markets grappled with a seemingly more hawkish Fed and a relatively more dovish RBA. However, the RBA has recently sounded more hawkish than the Fed the A$ has started to appreciate. With Australia's external accounts remaining in excellent health, our expectation that Australia's economic growth will prove more robust, and the prospect the US$ down trend will persist as the Fed pivots from its hiking strategy to an easing cycle in 2023, we expect the A$/US$ will appreciate to the mid-70s towards the end of 2023.

We are most overweight stocks within the Communication Services, Information Technology and Utilities sectors and are underweight Financials, Health Care and Real Estate.

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