

UBS Diversified Fixed Income Fund

November 2022

Fund description

The Fund is an actively managed, diversified portfolio of Australian and global fixed income assets.

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.

Investment return objective

The Fund aims to outperform (after management costs) the Benchmark over rolling three year periods.

Key statistics

	Fund	Benchmark ¹
Modified duration (yrs)	5.82	6.04
Spread duration ² (yrs)	3.55	3.04
Weighted avg maturity (yrs)	6.36	7.25
Average credit quality	A1	Aa2
Yield to maturity ³ (%)	4.32	3.56

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

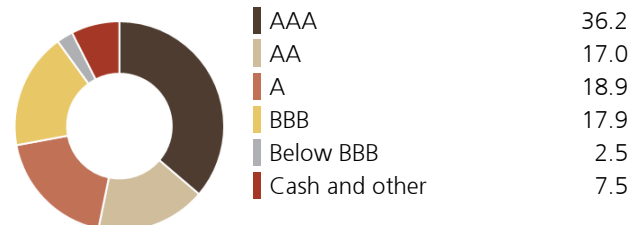
² Option adjusted spread duration ex Treasury.

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	31 January 1997
Fund size	\$ 565.4m
Management fee	0.55% pa
Minimum initial investment	\$ 50,000
Distribution frequency	Quarterly
Buy/sell spread	+ 0.00% / - 0.15%
APIR code	SBC0007AU

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	2.81	3.72
Government inflation-linked	0.16	0.00
Semi-government	0.78	0.88
Government related	0.66	0.41
Corporates	1.08	0.67
Financials	0.39	0.22
Industrial	0.56	0.38
Utility	0.13	0.07
Securitised	0.33	0.35

By Country	Fund	Benchmark
Australia	2.43	2.70
USA	1.45	1.39
Japan	-0.15	0.55
Canada	0.05	0.10
Euro area	0.72	0.70
UK	0.19	0.18
New Zealand	0.82	0.00
China	0.27	0.25
Other	0.04	0.15

⁴Includes derivatives.

Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	2.26	(0.49)	(9.93)	(3.32)	(0.07)	5.03
Benchmark**	1.96	(0.25)	(9.62)	(2.77)	0.48	5.48
Added Value	0.30	(0.24)	(0.31)	(0.55)	(0.55)	(0.45)

* Inception date: 31 January 1997.

** 50% Bloomberg AusBond Composite 0+ Yr Index / 50% Bloomberg Global Aggregate (hedged to \$A).

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 November.
- The RBA raised the cash rate target by 25bps in November.

Global Market Review

The yield on 10-year US government bonds declined to 3.61% by the end of November, having started the month at 4.05%. Meanwhile, the yield on the 2-year US Treasury, which is highly sensitive to Fed policy expectations, ended November at 4.31%, down from 4.48% at the start of the month. In Germany, the yield on the 2-year bund rose above the 10-year rate, a move that has historically been associated with slowing growth. A broad improvement in risk appetite over the month contributed to positive returns in credit, with US high yield gaining 1.9% in November, while euro high yield gained 3.7%. The Bloomberg US credit index returned 5% and the Euro Aggregate Corporate index gained 1.9%.

In the US, economic data for October was mostly weaker. The ISM Manufacturing PMI fell to 50.2 from 50.9 in September, while the Services PMI dropped to 54.4 from 56.7, both the lowest since May 2020. Nonfarm payrolls increased by 261,000, the smallest gain since December 2020, and the unemployment rate rose to 3.7%. JOLTS job openings fell by 353,000 to 10.3 million in October. Industrial production slipped 0.1% month-over-month. CPI inflation was lower than expected, slowing to 7.7% year-over-year from 8.2% in September. The Fed's Beige Book confirmed that rate hikes are starting to cool demand, including the demand for labour. The Fed raised rates by 75bps on 2 November, setting the federal funds target range at 3.75–4%. In a speech at the Brookings Institution on 30 November, Chair Jerome Powell signalled a likely downshift in the pace of rate hikes, which "may come as soon as the December meeting."

In the Eurozone, the S&P Global Flash Manufacturing PMI remained in contractionary territory for the fifth straight month at 47.3 in November. However, this was better than expected and an uptick from 46.4 in October. The Services PMI was unchanged at 48.6 in November, the fourth consecutive month of contraction. Eurozone consumer price inflation slowed to 10% year-over-year in November from 10.6% in October. In the UK, the S&P Global/CIPS UK Manufacturing PMI came in at 46.2 in November, unchanged from the previous month and ahead of market expectations for a fall to 45.8. The Services PMI was also unchanged in November, at 48.8, beating expectations for a fall to 48. Economic surprise indexes have jumped to levels not seen since the start of the year. Inflation continues to rise, reaching 11.1% year-over-year

in October after 10.1% in September. The Bank of England raised interest rates by 75bps at its November meeting, taking the base rate to 3%. Fiscal policy is also tightening: In his Autumn Statement, Chancellor Jeremy Hunt announced a GBP 55bn package of tax increases and spending cuts.

In Japan, October industrial production and November PMI data pointed to slower manufacturing activity. However, high-frequency data and the November services PMI indicated that the solid recovery in services consumption has continued. Core CPI inflation accelerated to 3.6% year-over-year in October from 3% in September, the highest level since 1982. In China, the government recalibrated its zero-COVID approach, announced further measures to support the property sector, and restarted dialogue with the Biden administration at top-level summits. Economic activity data in China weakened amid COVID curbs and property sector concerns. The official NBS Manufacturing PMI fell to 48 in November from 49.2 in October, indicating a second consecutive month of contraction in factory activity. October retail sales declined 0.5% year-over-year; investment growth moderated to 5.8% year-over-year from January-October, dragged by property; and exports slumped to -0.7% year-over-year on weaker demand in developed markets. Inflation stayed mild, with October CPI slowing to 2.1% year-over-year and PPI dipping to -1.3% year-over-year. With economic activity slowing, the Chinese government stepped up its policy support. The People's Bank of China announced a targeted 25bps cut to banks' reserve requirement ratio, effective 5 December, which will inject some CNY 500bn of liquidity.

November was another good month for broad commodities, with the UBS CMCI Total Return Index up by almost 5%. Metals were the main performance driver, with industrial metals up 13% and precious metals 8%. The agriculture sector advanced nearly 2%, while the energy was up nearly 1% and livestock sectors lost nearly 1% in November. With China accounting for about 50% of industrial metal demand, talk of reopening in the country lifted the sector this month. A weaker US inflation reading and lower Fed interest rate hike expectations lifted precious metals. Growth concerns due to the aggressive monetary policy tightening in Europe and the US, and rising COVID cases in China, weighed on oil and oil product prices.

Australian Market Review

Australian sovereign bond yields fell over November as investors remained concerned about the growth outlook. Australian 3-year Government bond yields fell 13bps, ending the month at 3.16% while the 10-year Government bond yield fell 23bps, to end the month at 3.53%. The spread of Australian 10-year Government Bond yields against US 10-year Government bond yields ended the month inverted at -8bps. Credit spreads tightened over the month (Bloomberg AusBond

Credit 0+ year index tightened from 169bps to 156bps). The Bloomberg AusBond Composite 0+ year index returned 1.55% in November.

In early November, the RBA raised the official cash rate target for the seventh consecutive month to a level of 2.85%. The decision to increase rates by a smaller increment of 25bp rather than the 50bps moves favoured earlier in the cycle came despite news that trimmed mean inflation rose by 1.8% in the September quarter, the largest quarterly increase since 1990. The RBA Board sees "returning inflation to target requires a more sustainable balance between demand and supply", recognising that monetary policy operates with a lag. The labour market remains very tight, the unemployment rate was 3.5% in September, around the lowest rate in almost 50 years. The RBA's central forecast is for the unemployment rate to remain around its current level over the months ahead, but to increase gradually to a little above 4 per cent in 2024 as economic growth slows. The Board "remains resolute in its determination to return inflation to target and will do what is necessary to achieve that".

On the data front, the Westpac Melbourne Institute Consumer Sentiment Index fell by 6.9%, from 83.7 in October to 78.0 in November. This figure is below the low point of the GFC (79.0) and only slightly higher than when the COVID pandemic first hit in April 2020 (75.6).

Australia ESG insights

We continue engagement with Australia's major banks on their respective climate strategies. With respect to NAB's financed exposures to high-emitting sectors, power generation exposure has increased slightly in the last year to \$7.36b, however this was driven by growth in renewable energy, which now forms 73% of the power generation portfolio. Direct coal-fired power generation has now reduced to zero within the portfolio, however NAB still has indirect exposure through gentailers, which have a mix of generation assets (including coal). Thermal coal mining now forms a very small part of lending at around \$420m and whilst exposure to Oil & Gas has increased from \$2.9b to \$3.6b in the year to 30 September 2022, this was driven by FX movements rather than an increase in underlying lending. NAB is making good progress with these high-emitting sectors but we note there are large exposures to other high-emitting sectors which have no emissions reduction targets yet set such as commercial and residential real estate, agriculture, transport and aluminium. We are of the belief that these sectors will be more of a challenge to reduce emissions and will take a number of years to achieve – engagement with borrowers in these segments is ongoing and we will in turn continue to engage with NAB and the other major banks' progress in achieving target reduction goals.

Portfolio

The portfolio's overall duration positioning delivered positive relative performance over the month. Within duration management, our short position in Australia and Canada detracted from relative performance, while our long duration position in New Zealand contributed positively to performance. Our short Japan 10-year position resulted in flat contribution to relative performance as the Bank of Japan maintains its ongoing zero interest rate policy.

On credit, our overweight position in the corporate sector was a contributor over November as credit spreads tightened. Credit positioning remained stable over the month.

Outlook

Bonds appear to be at an important inflection point as the global monetary policy tightening cycle approaches maturity. We 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. Further ahead, while the likelihood that global inflation will prove "sticky" to the upside appears to be a consensus view, we do not discount the potential for stronger disinflation in 2023 on the back of recessions in major developed economies as well as the risks that the significant tightening of financial conditions already delivered creates for pockets of the world economy with very high leverage. This scenario poses sizeable upside for duration as some of this year's tightening will need to be reversed.

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's downshift from 50bp to 25bp rate hike increments has been well-absorbed by the market. We do not expect a return to super-sized hikes and instead expect the RBA to cease raising the cash rate at a level close to 3.5% in early 2023. Rate hikes beyond Q1 are hard 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 – while the deceleration in global inflation and growth is likely to be clearly visible. Historically, the conclusion of a hiking cycle tends to be positive for duration and we are biased to increase long positions on any back-up in 10-year yields towards 4%.

We still hold the view that investment grade credit spreads globally will move wider into the new year 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

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