A UBS Asset Management
For Professional / Qualified / Institutional Investors only
All data as at 30 September 2023

UBS
Diversified Fixed Income Fund

September 2023

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 objective

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

Key statistics

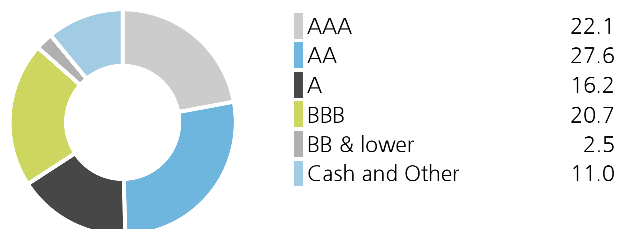
	Fund	Benchmark[1]
Modified duration (yrs)	6.16	5.75
Spread duration[2] (yrs)	3.61	3.04
Weighted avg maturity (yrs)	6.96	7.02
Average credit quality	A1	Aa2
Yield to maturity[3] (%)	4.61	4.33

[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 not a distributed yield nor reflects anticipated income to be earned by the fund. It may include the effect of some derivatives, including swaps and FX forwards, which can form a significant part of the investment strategy but do not pay a regular income. It is in the base currency of the master fund and not specific to a share class.

Fund information

Inception date	31 January 1997
Fund size	$ 512.1m
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 (%)



AAA	22.1
AA	27.6
A	16.2
BBB	20.7
BB & lower	2.5
Cash and Other	11.0

Fund positioning – modified duration contribution (yrs)

By sector	Fund	Benchmark
Government nominal[4]	2.88	3.40
Government inflation-linked	0.15	0.00
Semi-government	0.89	0.90
Government related	0.50	0.42
Corporates	1.33	0.64
Financials	0.58	0.22
Industrial	0.57	0.35
Utility	0.18	0.07
Securitised	0.40	0.38

By country	Fund	Benchmark
Australia	3.08	2.54
USA	1.66	1.35
Japan	(0.66)	0.51
Canada	0.21	0.09
Euro area	0.61	0.67
UK	0.35	0.15
New Zealand	0.69	0.00
China	0.18	0.27
Other	0.04	0.16

[4] Includes derivatives

Investment performance

Fund	1 month %	3 months %	1 year %	2 years % pa	3 years % pa	5 years % pa	Since inception* % pa
Total return	(2.17)	(1.30)	0.16	(6.50)	(4.80)	(0.71)	4.80
Benchmark**	(1.68)	(1.22)	1.08	(5.72)	(4.22)	0.06	5.26
Added Value	**(0.49)**	**(0.08)**	**(0.92)**	**(0.78)**	**(0.58)**	**(0.77)**	**(0.46)**

* 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 rose across the term structure with a steepening bias.
- Australian credit spreads tightened over September.
- The RBA maintained the cash rate target at 410bps.

Global Market Review

Fixed income markets came under pressure in September, reflecting concerns that the Federal Reserve will keep rates higher for longer. US Treasury yields surged during the month on resilient activity and reduced expectations for Federal Reserve easing in 2024. 10-year yields rose 46 basis points on the month, with cooler than expected core PCE inflation at the end of the month providing little relief to the bond market. Despite a smaller rise in yields, European sovereign bonds underperformed Treasuries on higher duration. A larger than expected projected budget deficit for Italy also contributed to the weakness. Japanese 10-year yields rose 11 basis points over the course of the month, while UK 10-year gilt yields were virtually flat. US and European high yield outperformed investment grade credit on the month, suggesting that duration risk was a bigger factor in broad cross-asset weakness than concerns about economic deterioration.

In the US, the labour market is undergoing a gentle cooling, with non-farm payroll growth of 187,000 in August, better than expected and above negatively revised July figures. The unemployment rate unexpectedly rose to 3.8% from 3.5%, but this was mainly driven by higher labour force participation as more people stayed in the workforce. Initial jobless claims linger near record lows, pointing to enduring tightness in the labour market. The preliminary S&P Global US manufacturing purchasing managers' index improved by more than anticipated to 48.9 in September, though it is still below the 50 threshold that separates expansion from contraction. The August CPI inflation report was largely in-line with expectations, with headline rising 0.6% month-on-month and core up 0.3% on a monthly basis. PCE inflation data released late in the month painted a slightly more subdued picture for price growth, with headline and core up 0.4% and 0.1%, respectively. Both figures were lower than anticipated. The Federal Reserve kept rates unchanged at a range of 5.25 to 5.5% at its September meeting, as expected.

In Europe, the flash manufacturing PMI for September came in at 43.4, below forecasts and slightly lower than the August reading. However, the services PMI improved by more than expected to 49.8, nearly back into expansionary territory. Real incomes are growing again in Europe thanks to the deceleration in inflation. The European Central Bank raised its deposit rate to 4%, but hinted in its policy statement that the level of rates may be sufficiently restrictive to get inflation back to target. The preliminary CPI inflation estimate for September showed a larger than anticipated deceleration in both headline (4.3% year-on-year, estimated 4.5%) and core (4.5% year-on-year, estimated 4.8%) inflation. In the UK, pay growth remains hot, with average weekly earnings up 8.5% year-on-year for the three months ending July. Other indicators, however, point to softening in labour market conditions. Employment contracted by 207,000 in the three months ending July, with the unemployment rate ticking higher to 4.3%. August inflation data released the day before a Bank of England policy announcement came in far cooler than expected, with core CPI up 6.2% year-on-year compared to an estimate of 6.8%. The central bank held its policy rate unchanged at 5.25%. The preliminary manufacturing and services PMIs for September were both below 50. Manufacturing came in at 44.2, above the August print and higher than the 43.2 estimate. However, the services PMI was weaker than expected at 47.2 versus the 49.4 projection.

In Japan, annual headline inflation of 3.2% was a tick above July's reading, but higher than the 3% estimate. Core inflation remained unchanged at 3.1% year-on-year versus the 3% projection. However, labour cash earnings continued to show a marked deceleration from the strong growth seen in May. As of July, labour cash earnings increased 1.3% year-on-year, far below the consensus call for 2.4%, and are deeply negative in real terms. The Bank of Japan kept policy unchanged at its September meeting. Preliminary PMIs for September pointed to a deceleration in service sector growth and a slightly deeper rate of contraction in manufacturing.

In China, economic conditions are showing signs of stabilising and improving as measured steps to support growth appear to be bearing fruit. August data showed higher than anticipated credit growth as well as industrial production and retail sales posting a faster pace of annual growth. While risks linked to property sector retrenchment and embattled developers continue to linger, higher frequency macro data for September point to a modest increase in Chinese economic momentum. In

September, China's official and private purchasing managers' indexes showed both the manufacturing and non-manufacturing sectors were above 50 (which separates expansion from contraction) for the first time since March.

Australia Market Review

Australian sovereign bond yields surged across the yield curve with a steepening bias over September, along with the US where market participants priced in concerns that the Federal Reserve will keep rates higher for longer. Australian 3-year Government bond yields rose 34bps, ending the month at 4.08% while the 10-year Government bond yields surged 46bps to end the month at 4.49%. The spread between the Australian 10-year Government bonds and their US equivalents ended the month unchanged at -8bps from the previous month. Credit spreads tightened (Bloomberg AusBond Credit 0+ index tightened from 115bps to 113bps). The Bloomberg AusBond Composite 0+ year Index returned -1.53%.

In September, the RBA left the official cash rate target unchanged at 4.10% for the third consecutive time, while also keeping the justification that further time will allow the Board to examine the impact of the cumulative rate hikes. This decision was largely in-line with the economists' consensus and the implied rate priced-in by market participants. In terms of domestic inflation, there was little amendments in the wording and the statement re-confirmed the still too high inflation. As for the labour market, the Board slightly changed the comments to a softer tone to "tight" labour market instead of a "very tight" one. Regarding the economic prospect, the statement pointed out the "increased uncertainty around the outlook for the Chinese economy due to ongoing stresses in the property market." Concerning forward guidance, the Board repeated that "some further tightening of monetary policy may be required" and reiterated data dependency. Later in the month, the Minutes of the RBA's August Board meeting stated the recent data were "consistent with inflation returning to target within a reasonable timeframe".

On the economic data front, the Australian Bureau of Statistics unveiled its Q2 GDP statistics which was in-line with the economists' expectation at 0.4% QoQ. GDP growth further slowed on a YoY basis to 2.1% from 2.3% the previous quarter. Household spending growth also continued to decline to just 0.1% in the quarter, the weakest quarterly rise since the delta-variant lookdowns in September 2021. The impact of inflation and interest rate rises could be also observed from the household saving ratio which fell to 3.2%, the lowest level since June 2008 given that household consumption had been exceeding disposable income. Elsewhere, the domestic economic data was mostly mixed over the month. The labour market remained tight as the unemployment rate was unchanged at 3.7% in-line with market consensus. The volatile monthly August CPI data was also in-line with the market expectation, lifting to 5.2% from the previous month's 4.9% largely on the back of higher fuel prices.

Portfolio

The portfolio's overall interest rate positioning delivered negative relative performance over September as global bond markets sold-off.

Our overweight positioning in Australia, New Zealand and US detracted from relative performance as yields rose in the respective markets over the month. Against this, our US 5/30-year steepener position made a positive contribution to relative performance, as did the short Japan 10-year positioning. As European sovereign spreads drifted wider over the course of the month, we also moved to neutralize our underweight position in the European periphery.

Within credit markets, our overweight position in the AUD corporate sector contributed to relative performance over September as spreads tightened.

Outlook

September has been a challenging month for long-dated bonds as global term premium has increased. Nevertheless, we retain conviction in our long duration positioning as the global rate hike cycle concludes amid ongoing disinflation and recession risks, only using the market volatility to increase curve steepening exposure. The exception is Japan where we still see bond yields as too low given the risks that the dismantling of deflation-era policies, including negative rates, accelerates in the next 3-6 months.

Australian bonds have been dragged along with the global sell-off despite supportive domestic macro trends. Inflation continues to follow the global trend, falling quickly from its Q4 2022 peak of 7.8% y/y to now annualising at about half this rate in Q2. The recent rise in fuel prices represents a blip in this trend that the RBA should see through. In fact, the recent signs of loosening in the labour market should bode well for disinflation in stickier services prices into next year. On growth, our core thesis has been that the lagged impact of the record rate hike cycle delivered since May 2022 will have a significant negative impact on consumption by the middle of the year, making it feel like a recession for parts of the highly interest rate sensitive household sector. This appears to be playing out judging by the further slowdown in household consumption evident in the national accounts (just 0.1% q/q in Q2), declining savings rate and uptick in financial hardship.

The RBA has now left the cash rate unchanged at 4.1% for four consecutive meetings. It is hard to see what will trigger a restart in the hiking cycle given the economy is on a slowing trend, inflation is heading in the right direction and, even with rates standing still, household cash flows continue to get squeezed through higher utility bills and the ongoing roll-off of low-rate fixed mortgages. While one more rate hike cannot be fully discounted, we continue to believe that the better opportunities arise in positioning for restrictive policy to be reversed next year. Ten-year bonds currently yield more than 4% which we believe offer good medium to long term value in this environment.

Usually, credit spreads would move wider as concerns over the likelihood of a recession increase. However, high all-in yields continue to provide strong support to the Australian and global credit markets. Market technicals have also been positive for AUD credit as cash is being deployed amid low issuance.

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