

# UBS Diversified Fixed Income Fund

January 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 <sup>1</sup>
Modified duration (yrs)	5.93	6.00
Spread duration <sup>2</sup> (yrs)	3.67	3.03
Weighted avg maturity (yrs)	6.81	6.90
Average credit quality	A1	Aa2
Yield to maturity <sup>3</sup> (%)	4.07	3.38

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

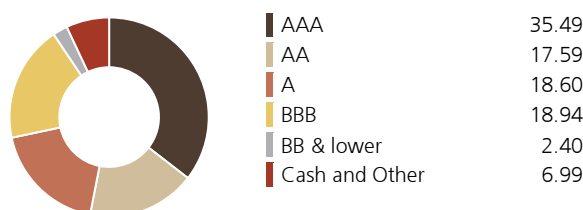
<sup>2</sup> Option adjusted spread duration ex Treasury.

<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	31 January 1997
Fund size	\$ 559.8m
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 <sup>4</sup>	2.65	3.93
Government inflation-linked	0.23	0.00
Semi-government	0.88	0.87
Government related	0.67	0.41
Corporates	1.18	0.67
Financials	0.48	0.22
Industrial	0.54	0.38
Utility	0.16	0.07
Securitized	0.33	0.12

By Country	Fund	Benchmark
Australia	2.63	2.67
USA	1.65	1.41
Japan	(0.21)	0.56
Canada	(0.09)	0.10
Euro area	0.67	0.68
UK	0.18	0.18
New Zealand	0.78	0.00
China	0.27	0.26
Other	0.04	0.15

<sup>4</sup> Includes derivatives.

## Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	2.64	3.78	(7.69)	(3.22)	0.30	5.06
Benchmark**	2.43	2.68	(7.60)	(2.89)	0.75	5.47
<b>Added Value</b>	<b>0.21</b>	<b>1.10</b>	<b>(0.09)</b>	<b>(0.33)</b>	<b>(0.45)</b>	<b>(0.41)</b>

\* 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 January.
- The RBA maintained the cash rate target at 3.10%.

### Global Market Review

The yield on the 10-year US Treasury declined from 3.84% at the start of the month to 3.53% at the end. The 2-year yield fell from 4.46% to 4.20%. Returns were positive across fixed income, with US credit returning 3.8%, high-grade gaining 2.5%, and US dollar emerging market sovereign debt up 3.2%. US dollar and euro high yield credit returned 3.9% and 3.2%, respectively, as spreads narrowed on improving risk appetite. The yield on 10-year German Bunds also declined from 2.55% to 2.27%.

In the US, economic data for December was mostly weaker as higher interest rates weighed on activity. The ISM Manufacturing PMI fell to 48.4 from 49 in November, while the Services PMI dropped sharply to 49.6 from 56.5. Manufacturing output fell by 1.3% month-over-month, and retail sales were down 1.1% month-over-month. Nonfarm payrolls increased by 223,000 in the month, the smallest rise since December 2020, while the unemployment rate fell to 3.5%, matching the pre-pandemic level at a 50-year low. Consumer price inflation slowed to 6.5%, down from a peak of 9.1% in June. The Fed raised rates by 50 basis points on 14 December, setting the federal funds target range at 4.25–4.5%.

In the Eurozone, GDP grew 0.1% quarter-over-quarter in the last three months of 2022, according to the preliminary estimate, ahead of consensus expectations for a slight contraction. The S&P Global flash composite PMI edged up to 50.2 in January, above the 50 level for the first time since June. Inflation eased to 8.5% year-over-year in January from 9.2% in December. In the UK, consumer price inflation fell to 10.5% in December from 10.7% in November. The S&P Global/CIPS flash composite PMI dropped to 47.8 in January from 49 in December.

In Japan, the global slowdown weighed on December exports and production, while domestic reopening spending supported consumption and retail sales. Nationwide core CPI (excluding fresh food) rose to 4% year-over-year in December, the highest since 1981. In China, activity has picked up as the economy reopens following the lifting of COVID restrictions. Based on Lunar New Year holiday and high frequency data, consumption has staged a solid recovery. Echoing this, January's official PMIs rebounded strongly into expansionary territory, with the services PMI up the most to 54 on reopening tailwinds. The cross-region seasonal travel did not cause a major relapse in COVID infections, as had been feared. According to the State

Council's Joint Prevention and Control Mechanism data, fever, emergency, and ICU cases all peaked in late December to early January.

Commodities, as measured by the broadly diversified commodity index (CMCI), rose by slightly more than 2% (total return) in January. Metals drove this performance, with industrial metals rising 8% and precious metals up nearly 5%. The agriculture sector contributed positively, while energy and livestock fell. China's reopening, with the country accounting for about half of global industrial metal demand, supported copper and aluminium prices. Strong central bank demand and a weaker dollar, meanwhile, lifted gold. In the energy sector, crude oil came under strong pressure at the start of the year but managed to pare some of its losses in the month. Mild weather, the third warmest January in the US, weighed heavily on US natural gas prices.

### Australia Market Review

Australian Government bonds rallied over January in-line with offshore bond markets as markets priced in lower future policy rates given the backdrop of slowing US inflation. Australian 3-year Government bond yields declined 32bps, ending the month at 3.18% while the 10-year Government bond yield fell 50bps, to end the month at 3.55%. The spread of Australian 10-year Government bond yield against US 10-year Government bond yield narrowed, ending the month at 4bps. Credit spreads tightened over the month (Bloomberg AusBond Credit 0+ year index tightened from 149bps to 136bps). The Bloomberg AusBond Composite 0+ year returned 2.76% in January.

The domestic economic data were mixed over January. Housing-related indicators such as building approvals (-9.0% MoM) and new home loans (-3.7% MoM) continued to show the effects of the RBA policy tightening. November retail sales on the other hand, surprised to the upside (1.4% MoM versus the consensus of 0.6%), although the weakness in December retail sales (-3.9% MoM) revealed later in the month suggests that Black Friday sales is creating seasonal distortions. Around mid-month, weaker than expected labour data pushed down the Australian sovereign yield curve as the 10-year Government bond yield declined by 23bps to 3.32% on the same day. Monthly jobs growth fell abruptly to -14,600 against the consensus of 25,000, signaling an easing domestic labour market. The unemployment rate worsened to 3.5% compared with a consensus of 3.4%, although still at a historically tight level. Adding to the market volatility, the Q4 CPI release surged to 1.9% QoQ (7.8% YoY), the highest annual CPI print since 1990, versus the consensus of only 1.60% MoM. In term of contribution to change, Recreation and culture was the main driver of the upside surprise. The Australian bonds sold-off with a curve flattening bias the same day.

## Australia ESG insights

In line with our approach on corporates and financials, the Australian states and territories are also subject to our ESG Risk Recommendation process. We recently undertook an update at the semi-government level, with environmental and social factors being the main distinguishing variables. Governance risk across the regional governments is considered low given the existence of a strong institutional framework with a stable and responsive cash transfer equalisation system with the Commonwealth, supported by strong policy, transparency and disclosure, and budget management. Whilst social aspects are important, environmental issues are the prime differentiator amongst the group. The State of Tasmania continues to rank the highest due to its high reliance on renewable energy and low dependence on commodity exports. Consequently emissions apportionment to the state are the lowest on a per capita, land mass and square metre basis. At the other end of the spectrum is Queensland which has high physical risks (floods, droughts, heatwaves and bushfires), global warming sensitivity given the importance of the Great Barrier Reef to Queensland's economy, and a reliance on mining royalties. South Australia currently sits in the middle of the pack, but we see an improving profile developing given its strong net zero commitments.

## Portfolio

The portfolio's overall duration positioning delivered positive relative performance over the month. Within duration management, our long positions in New Zealand and the US contributed to relative performance, as yields declined, while short positions in Canada, Japan and Germany detracted. During the month, we adjusted our duration positioning in Australia from a small short back to neutral.

On credit, our overweight position in the AUD corporate sector was a contributor over January as credit spreads tightened, while underweights in the US detracted at the margin.

## 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, using any back up in bond yields as a buying opportunity, such as that presented to us in December.

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 the Q4 print (7.8% y/y), coming 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. As a result, we remain focused on high frequency global indicators, which continue to point to easing inflationary pressures. On growth, a strong external sector – supported by China's exit from zero-COVID – and the return of net inward migration should lessen the probability of a technical recession relative to other economies. However, we expect it to feel like a recession for parts of the highly interest rate sensitive household sector. This is in line with our core thesis that the lagged impact of 325bp of rate hikes delivered since May 2022 will have a significant negative impact on consumption by the second quarter.

Given this, our expectation is that the RBA is close to the end of its hiking cycle. We continue to see one more 25bp increases in March to a peak cash rate of 3.6% as the most likely outcome, with the risk skewed towards another 25bp in Q2. Rate hikes beyond Q1 are harder to envisage as it should be apparent 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. At current bond yields we think rate hikes are fully priced in and there is upside for bonds if growth and inflation decelerate faster than expected, 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](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.

