

UBS Diversified Fixed Income Fund

February 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) | 6.09 | 5.90 |
| Spread duration ² (yrs) | 3.77 | 3.01 |
| Weighted avg maturity (yrs) | 7.10 | 6.81 |
| Average credit quality | Aa3 | Aa2 |
| Yield to maturity ³ (%) | 4.38 | 3.72 |

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

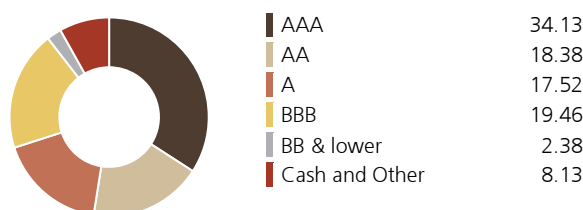
² Option adjusted spread duration ex Treasury.

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 | \$ 543.5m |
| 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 | 2.71 | 3.85 |
| Government inflation-linked | 0.22 | 0.00 |
| Semi-government | 0.97 | 0.86 |
| Government related | 0.63 | 0.41 |
| Corporates | 1.22 | 0.66 |
| Financials | 0.53 | 0.22 |
| Industrial | 0.54 | 0.36 |
| Utility | 0.16 | 0.07 |
| Securitized | 0.34 | 0.12 |

| By Country | Fund | Benchmark |
|-------------|--------|-----------|
| Australia | 2.97 | 2.61 |
| USA | 1.64 | 1.39 |
| Japan | (0.44) | 0.56 |
| Canada | 0.10 | 0.10 |
| Euro area | 0.67 | 0.66 |
| UK | 0.16 | 0.17 |
| New Zealand | 0.73 | 0.00 |
| China | 0.21 | 0.26 |
| Other | 0.04 | 0.15 |

⁴ Includes derivatives.

Investment performance

| Fund | 1 month % | 3 months % | 1 year % | 3 years % pa | 5 years % pa | Since inception* % pa |
|--------------------|---------------|---------------|---------------|-----------------|-----------------|--------------------------|
| Total return | (1.82) | (0.36) | (8.15) | (4.10) | (0.06) | 4.97 |
| Benchmark** | (1.56) | (0.87) | (7.88) | (3.73) | 0.43 | 5.39 |
| Added Value | (0.26) | 0.51 | (0.27) | (0.37) | (0.49) | (0.42) |

* 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.
- Australian credit spreads tightened over February.
- The RBA raised the cash rate target by 25bps in February.

Global Market Review

Fixed income assets mostly fell in value in February, amid renewed concerns over elevated inflation and central bank tightening. The yield on the 2-year US Treasury rose around 62 basis points to 4.82%, while the 10-year yield climbed 41bps to 3.92% as of the end of the month. Yields also climbed in Europe, with the 2-year German Bund increasing from 2.64% to 3.20%. US high grade delivered a negative total return of 2.3% over the month, with a loss of 1.9% for Bloomberg's Pan-Europe Aggregate Index. US and European investment grade credit also lost ground, after a strong start to the year in January. The main exception to this trend was in fixed income instruments with a floating rate feature, such as senior loans, which gained ground in February.

In the US, economic data for January was mostly stronger. The ISM Manufacturing PMI fell to 47.4 from 48.4 in December, but hard data on manufacturing output showed an increase of 1%. The Services PMI rebounded to 55.2, making the weak December reading of 49.2 appear to be a one-off. Nonfarm payrolls jumped 517,000 and the unemployment rate fell to 3.4%, the lowest since 1969. Headline CPI inflation slowed to 6.4%, down from a peak of 9.1% in June, but service prices continue to rise rapidly. Retail sales rose by 3% over December. Additionally, the Federal Reserve raised rates by 25 basis points on 1 February, setting the federal funds target range at 4.5-4.75%.

In the Eurozone, the economy proved to be more resilient than feared through the winter months, helped by a sharp fall in energy prices, and fiscal support. The S&P Global Eurozone Composite PMI increased to 52.3 in February from 50.3 in January, marking the strongest expansion in business activity since May 2022. Services activity picked up, though the manufacturing PMI remained in contraction territory (below 50). Inflation continues to moderate in the Eurozone, with annual consumer price inflation declining to 8.6% in January from 9.2% in December. In the UK, the economy has shown some signs of resilience over recent months, with a technical recession avoided at the end of last year. The flash S&P Global/CIPS UK Composite Purchasing Managers' Index rose to 53 in February from 48.5 in January, climbing into expansion territory for the first time since July. Meanwhile, consumer price inflation eased to 10.1% in January from 10.5% in December. The Bank of England raised interest rates by 50bps to 4% in February.

In Japan, fourth-quarter GDP growth rebounded to 0.2% q/q from -0.3% in the third quarter, thanks to some recovery in private consumption. Additionally, Kazuo Ueda was nominated as the new Bank of Japan governor. His policy stance appears well-balanced. In China, consumption continued to recover in February, stronger and at a faster pace than expected. Signs of the rebound were evident over the Chinese New Year holiday, and domestic tourism recorded the strongest visitor and revenue levels since the pandemic. Manufacturing activity also picked up. China's official manufacturing PMI rose to 52.6 in February from 50.1 in January.

February was a challenging month for commodities, with the broad commodity index (UBS Constant Maturity Commodity Total Return Index) falling by nearly 4% and giving up all the gains it achieved in January. Better than-expected US economic data pushed up interest rate expectations and supported the US dollar, which has been a drag for precious and industrial metals and the energy sector. Both metal sectors lost more than 7%, while the energy sector declined almost 3%. Agriculture and livestock held up better, with the former dropping a bit more than 1% and the latter gaining almost 1%. Within the agriculture sector, soft commodities such as sugar, coffee, and cocoa did well, despite risks of a slowdown in discretionary consumption.

Australia Market Review

Australian Government bonds sold-off over February in-line with offshore bond markets against the backdrop of markets once more pricing in higher future policy rates due to unexpectedly strong US economic data. Australian 3-year Government bond yields rose 42bps, ending the month at 3.60% while the 10-year Government bond yields surged 30bps, to end the month at 3.85%. The spread of Australian 10-year Government bond yields against US 10-year Government bond yields turned negative again, ending the month at -7bps. Credit spreads tightened over the month (Bloomberg AusBond Credit 0+ year index tightened from 136bps to 131bps). The Bloomberg AusBond Composite 0+ year returned -1.32%.

In early February the RBA raised the official cash rate target by 25bps, the 9th consecutive hike to a level of 3.35%. The RBA's reasoning for the decision was largely focusing on the persistence of high inflation. Notably, the decision came shortly after the Q4 CPI release which surprised forecasters to the upside with the RBA's preferred core inflation measure – the Trimmed Mean Index – rising 1.7% QoQ (6.9% YoY). According to the RBA minutes, the board considered two options of hiking 50bps and 25bps, which was deemed to be hawkish given that in the last meeting the discussion covered the possibility of pausing rate hikes altogether. The forward guidance was seen as hawkish too as the statement emphasized "further increase in interest rate will be needed",

excluding the phrase from the Dec. meeting that “it is not on a pre-set course”.

Elsewhere on the data side, labour market and wages releases came in weaker than expected in February. The labour force survey showed that the unemployment rate unexpectedly increased to 3.7% in January versus the market expectation to hold steady at 3.5%, although still at a historically tight level. Wage growth also came in softer than expected in Q4 at 0.8% QoQ (3.3% YoY) versus expectations of 1.0% QoQ. Retail sales on the other hand rose to 1.90% later in the month, partially recovering the large contraction reported in December.

Portfolio

The portfolio’s overall duration positioning delivered negative relative performance over the month. Within duration management, our long positions in Australia, New Zealand and the US detracted from relative performance as yields rose, while the short position in Japan was flat to relative performance. During the month, we adjusted our duration positioning in Australia from a neutral to long, in Canada from a short back to neutral, and topped up risk in the Japan short position.

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

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, and we have used the recent back up in bond yields as a buying opportunity.

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 Q4 2022 (7.8% y/y), coming two quarters after the peak in the US CPI (9.1% y/y). As a result, we remain focussed on high frequency global indicators which continue to point towards disinflation, although recent data releases in the US show that this is not going to be a straight-line process. On growth, our core thesis is that the lagged impact of 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 can already see 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.

Given this, our expectation is that the RBA is close to the end of its hiking cycle. The RBA delivered an expected 25bp hike in March taking the cash rate to 3.6%. Another 25bp hike in April is possible but any further tightening does not seem warranted given the likelihood that consumption weakens further as the lagged impact of higher mortgage rates flows through and inflation eases off from here. At current levels, this presents upside for bonds as the market pricing for the peak RBA cash rate looks too high at 4.2%, 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

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