

# UBS Diversified Fixed Income Fund

June 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)	6.25	5.93
Spread duration <sup>2</sup> (yrs)	3.98	3.09
Weighted avg maturity (yrs)	6.96	7.23
Average credit quality	A1	Aa2
Yield to maturity <sup>3</sup> (%)	4.70	4.08

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

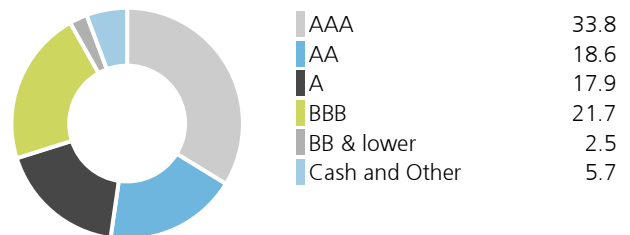
<sup>2</sup> Option adjusted spread duration ex Treasury.

<sup>3</sup> Yield to maturity (YTM) is 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	\$ 501.5m
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 (%)



## Fund positioning – modified duration contribution (yrs)

By sector	Fund	Benchmark
Government nominal <sup>4</sup>	2.66	3.56
Government inflation-linked	0.22	0.00
Semi-government	0.97	0.90
Government related	0.61	0.43
Corporates	1.39	0.67
Financials	0.57	0.22
Industrial	0.63	0.37
Utility	0.20	0.07
Securitised	0.40	0.38

By country	Fund	Benchmark
Australia	3.09	2.62
USA	1.76	1.39
Japan	(0.59)	0.54
Canada	(0.02)	0.10
Euro area	0.70	0.70
UK	0.33	0.16
New Zealand	0.75	0.00
China	0.21	0.26
Other	0.03	0.16

<sup>4</sup> 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	(1.97)	(2.98)	(0.43)	(5.81)	(4.10)	(0.36)	4.90
Benchmark**	(1.06)	(1.63)	0.05	(5.05)	(3.56)	0.36	5.36
<b>Added Value</b>	<b>(0.91)</b>	<b>(1.35)</b>	<b>(0.48)</b>	<b>(0.76)</b>	<b>(0.54)</b>	<b>(0.72)</b>	<b>(0.46)</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 rose across the term structure.
- Australian credit spreads tightened over the month.
- The RBA raised the cash rate target by 25bps in June.

## Global Market Review

Global markets priced out recession risk in June, particularly for the US, as data showed the continued resilience of the US economy amid more signals that disinflationary pressures in the world's largest economy would expand in the months ahead. US 10-year Treasury yields were largely rangebound through most of June, before rising briskly in the final sessions of the month on enhanced confidence that the move higher in initial jobless claims seen earlier in the month was an aberration and a reaffirmation of the Federal Reserve's intention to raise policy rates further. The Treasury 2-year, 10-year curve aggressively bear-flattened to near its flattest levels on record, below 100 basis points, as investors pushed back the timing for when and how much the Federal Reserve might cut interest rates down the road. High yield outperformed investment grade bonds in the US and Europe on improving risk sentiment and lower duration.

In the US, economic resilience continued in June, with a solid labour market and rebounding housing activity. The US non-farm payrolls report showed job growth exceeded economists' expectations for the 14th consecutive reading in May. Homebuilder sentiment for June as well as May housing starts, building permits, existing home sales, and new home sales all came in above expectations. High mortgage rates are disincentivising moving and weighing on the supply of housing more than demand, because labour markets are strong. Revisions to Q1 GDP data also showed growth expanded at a stronger pace than previously thought. Price pressures remain high, with both core CPI and core PCE inflation well above 2% on a three-month annualized basis. However, there were several welcome indications that inflation is poised to cool. The CPI, PPI, and import/export price data all came in below expectations for May. In mid-June, the Federal Reserve kept policy rates unchanged at 5.125%, as expected.

In Europe, the flash manufacturing PMI came in below 50 for the 12th consecutive month, with broad-based weakness throughout the biggest economies. More concerning was the slide in the Eurozone Services PMI to 52.4, with particular weakness in France which recorded a sub-50 reading. Retail sales also disappointed in April, falling for the third consecutive month, though revisions showed March's contraction was less severe than originally reported. The labour market remains tight with the unemployment rate of 6.5% at its lowest level in history, going back to 1998. In mid-June, the European Central Bank delivered another 25 basis point hike as expected, bringing the policy rate to 3.5%. In the UK, the unemployment rate slipped to 3.8% in April, with job growth beating estimates. Wage growth accelerated to 7.2% year-on-year, just one tick below its peak rate of growth in mid-2021. Core inflation surprised to the upside in May, rising 7.1% year-on-year versus 6.8% in the previous reading. As such, the BOE enhanced its tightening with a larger than expected 50 basis point hike to 5% in its late June meeting. Officials cited this strength of wage growth and services inflation as justification for this bigger hike.

In Japan, the flash manufacturing PMI dipped below 50 while flash services PMI also moderated but remained well in expansionary territory. Wage growth unexpectedly slowed in April, a signal that the very strong wage growth implied by the outcome of the Shunto wage negotiations is not being broadly felt across the economy yet. Services inflation held steady at an annual rate of 1.7% as of April. The Bank of Japan kept policy unchanged in June and expects that inflation will fall below 2% in the second half of 2023.

In China, official PMIs gave another sub-50 reading in the manufacturing survey and the non-manufacturing PMI moderated by more than anticipated. Exports fell by more than expected on an annual basis in May, with weakness widely spread across different regions. Aggregate financing rose at a smaller than expected rate from April to May, with industrial production, retail sales, fixed asset investment, and property investment all underwhelming relative to consensus. The youth unemployment rate edged up to 20.8% in May, the highest in series history (going back to 2018).

## Australia Market Review

Australian Government bonds sold-off sharply over June in-line with offshore bond markets due to persisting concerns over sticky core-inflation and a still resilient economy in the US. Australian 3-year Government bond yields rose 68bps, ending the month at 4.05% while the 10-year Government bond yields rose 42bps to end the month at 4.02%. Australian 10-year Government bonds underperformed US equivalents with the spread ending the month at 18bps from -4bps the previous month. Credit spreads tightened (Bloomberg AusBond Credit 0+ index tightened from 135bps to 127bps). The Bloomberg AusBond Composite 0+ year Index returned -1.95%.

In early June, the RBA raised the official cash rate target by 25bps, another surprising rate hike against the consensus and market expectation which only priced in 8bps of tightening prior to the meeting. 20 out of 30 economists surveyed by Bloomberg predicted a pause for this meeting. The RBA's main reasoning for this surprising rate hike was to "provide greater confidence that inflation will return to target". The RBA was mainly concerned over the stubborn services inflation and the rising unit labour costs. In fact, the April monthly Consumer Price Index was stronger than expected printing 6.8% YoY from 6.3% prior. In terms of forward guidance, there was no major changes in the language that "some further tightening of monetary policy may be required".

Elsewhere on the domestic economic data front, the Australian Bureau of Statistics unveiled its latest quarterly GDP statistics which was softer than expected (Q1 SA 0.2% QoQ vs C 0.3%). GDP per capita fell 0.2%, the first contraction since December 2018 if one excludes the periods affected by COVID-19. Household spending also continued slowing as it rose 0.2%, the weakest quarterly result since the decline recorded during the COVID-19 Delta-variant lockdowns in September 2021. The remaining domestic economic data series were mixed. The labour market showed little signs of easing as the unemployment rate declined again to 3.6% while the participation rate increased to 66.9% from 66.7% the previous month. The monthly May CPI, however, surprised the market to the downside printing 5.6% compared with the consensus of 6.1%, declining from 6.8% the previous month.

## Portfolio

The portfolio's overall duration positioning delivered negative relative performance over June, as global bond markets sold-off. Within duration management, our long positions in Australia, New Zealand and the US detracted, while the short position in Canada contributed. The short position in Japan was flat for the month, as the Bank of Japan's policy continues to diverge from those of other developed markets. Our yield curve positioning was mixed for the month, with front-end flatteners in Australia contributing and curve steepeners in the US detracting. Within credit markets, our overweight position in the AUD corporate sector contributed to relative performance over June as spreads tightened.

## Outlook

Our bias remains to be positioned long duration across our portfolios as the global monetary policy tightening cycle approaches maturity and we used the sell-off in June to add back duration at better entry levels. Ingredients that should buoy duration in the second half of the year include a continued easing of global inflation, heightened recession fears and tighter credit conditions in the US. 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.

In Australia, we are confident that inflation peaked in Q4 2022 at 7.8% y/y and is following the global trend lower. 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. While there is evidence of this playing out in the significant slowdown in consumption and tick up in mortgage arrears, the recent earlier than expected recovery in house prices and higher negotiated wages runs somewhat counter to policymakers' goals.

Accordingly, the RBA has recently signalled its resolve to get inflation back to target quicker than has been previously assumed, raising the cash rate in both May and June before pausing in July. Even if a further rate hike is delivered in Q3, as seems more likely than not, we think the bond market can look beyond this. The current cash rate of 4.10% is already restrictive meaning that any further tightening will increase the trade-off in terms of the severity of the downturn and the likelihood that these rate rises will have to be reversed next year. Ten-year bonds currently yield close to 4.0% which we believe will offer good medium to long term value in this environment.

We still hold the view that investment grade credit spreads globally are more likely to be biased wider through 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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