

UBS

Diversified Fixed Income Fund

July 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)	6.41	5.91
Spread duration ² (yrs)	4.02	3.10
Weighted avg maturity (yrs)	7.14	7.20
Average credit quality	A1	Aa2
Yield to maturity ³ (%)	4.44	4.04

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

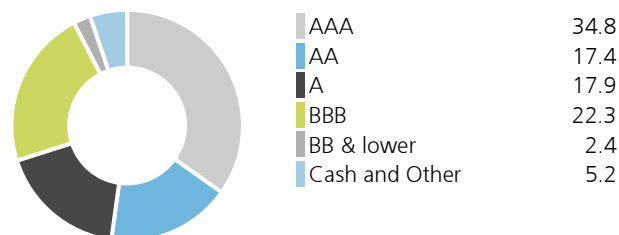
² Option adjusted spread duration ex Treasury.

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	\$ 493.1m
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 (%)



Fund positioning – modified duration contribution (yrs)

By sector	Fund	Benchmark
Government nominal ⁴	2.79	3.53
Government inflation-linked	0.19	0.00
Semi-government	1.01	0.91
Government related	0.59	0.43
Corporates	1.41	0.66
Financials	0.58	0.22
Industrial	0.64	0.37
Utility	0.20	0.07
Securitised	0.42	0.38

By country	Fund	Benchmark
Australia	3.15	2.61
USA	1.79	1.38
Japan	(0.59)	0.52
Canada	0.04	0.10
Euro area	0.67	0.71
UK	0.33	0.16
New Zealand	0.78	0.00
China	0.20	0.26
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	0.60	(2.65)	(2.80)	(6.14)	(4.17)	(0.27)	4.90
Benchmark**	0.24	(1.69)	(2.56)	(5.65)	(3.71)	0.39	5.35
Added Value	0.36	(0.96)	(0.24)	(0.49)	(0.46)	(0.66)	(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

- Australia's sovereign yield curve steepened over July with the front end declining and the long end rising modestly.
- Australian credit spreads tightened over the month.
- The RBA maintained the cash rate target at 410bps over July.

Global Market Review

Global markets reflected investors' increasing embrace of the potential for a soft landing in July, with a risk-on tone as data continued to signal US economic strength while inflation prints from most developed market showed price pressures ebbing by more than anticipated. US Treasury yields moved higher over the course of the month despite softening inflation, as labour market and production data continued to post solid results.

In the US, the advance reading for Q2 GDP growth beat estimates, rising an annualized 2.4% quarter-on-quarter compared to the 1.8% forecast, with strength in consumption driving the upside surprise. Non-farm payrolls came in below expectations in June for the first time in over a year, at 209,000, but this was still sufficient to lower the unemployment rate to 3.6%. The June inflation report showed price pressures dropping far quicker than anticipated. Core inflation rose at a pace of just 0.16% month-on-month, the lowest print since February 2021. Producer prices and export prices also came in lower than anticipated in June, while core PCE inflation moderated to a monthly pace of 0.2%. The Federal Reserve raised its policy rate to 5.375% at its July meeting, as expected. During the press conference, Fed Chair Jerome Powell emphasized that the central bank would be monitoring the "totality of the data, with a particular focus on inflation" when deciding whether further policy tightening would be warranted.

In Europe, the economy continues to show signs of softness, with signs that weakness in the manufacturing sector is bleeding through into services. The eurozone manufacturing PMI sank further into contractionary territory in July, with the services PMI pointing to a moderation of growth in the sector. Weakness in factory activity pulled the overall composite PMI below 50 for the second consecutive month. Higher interest rates and a stagnation in global goods demand are weighing on the outlook. A European Central Bank survey of bank lending

showed that corporates' appetite for loans dropped to the lowest level since at least 2002. Inflationary pressures remain relatively firm. Core inflation, which was forecast to moderate, held steady at 5.5% year-on-year in July. The ECB hiked rates by 25 basis points, as anticipated, bringing its policy rate to 3.75%. In the UK, labour market data remains hot, with wage growth quickening and employment rising more than expected in the three months through May. Production data was considerably less robust, pointing to a stagnation in GDP growth over the same period. June inflation surprised to the downside, with the year-on-year core rate dipping to 6.9% from 7.1%. This marked the first deceleration in annual core inflation since January. Core goods was the key driver of slower than anticipated inflation.

In Japan, monetary policymakers indicated a willingness to buy 10-year bonds at 1%, implying that this may be a new ceiling for yields in this maturity, for now. Inflation remains relatively strong, with June headline CPI and core CPI up 3.3% and 4.2% year-on-year, respectively, in line with expectations. However, the Bank of Japan still anticipates that price pressures will still fall below its target next year. Separately, the closely-watched Tankan surveys also showed that the outlook for large manufacturing and non-manufacturing firms improved in the second quarter.

In China, trade data disappointed, with both imports and exports falling more than forecast in June, and the youth unemployment rate rose to above 21%. On the bright side, industrial production surprised modestly to the upside in June, and growth in total social financing also exceeded expectations. More importantly, Chinese authorities outlined measures to buttress activity at, and leading up to, the Politburo meeting. Leadership struck a more cautious tone on the economic outlook, which justifies the need for more policy support for consumption, local governments, and capital markets. Policymakers also dropped the phrase "housing is for living, not for speculation," which may signal a more permissive stance towards property purchases.

Australia Market Review

Australia's sovereign yield curve steepened over July with the front end declining and the long end rising in-line with the offshore bond markets due to some signs of cooling core inflation in both the US and Australia. Australian 3-year Government bond yields fell -18bps, ending the month at 3.87% while the 10-year Government bond yields increased 4bps to end the month at 4.06%. Australian 10-year Government bonds outperformed US equivalents with the spread ending the month at 10bps from 18bps the previous month. Credit spreads tightened (Bloomberg AusBond Credit 0+ index tightened from 127bps to 125bps). The Bloomberg AusBond Composite 0+ year Index returned 0.52%.

In early July, the RBA left the official cash rate target unchanged at 4.10%, citing the need to provide the Board with more time to assess the economic situation. Market pricing prior to the meeting implied slightly less than a 50/50 probability of a 25bp change in the policy rate. In terms of inflation, the Board didn't change the wording that "inflation in Australia has passed its peak" and that it is "still too high", although adding a dovish tone that "monthly CPI indicator for May showed a further decline". As for forward guidance, the Board kept its wording that "some further tightening of monetary policy may be required" and reiterated data dependency. Later in the month, the Minutes of the RBA's July Board meeting showed the Board considered two options: to hold the cash rate steady or hike by 25bps. It noted the former case is the stronger one on the grounds of "uncertainty around the outlook and the significant increase in interest rates to date". In contrast, although the RBA delivered a 25bps rate hike at the June meeting, the Minutes noted the two options were "finely balanced" and that there was "considerable uncertainty regarding the outlook".

The domestic economic data over July was mixed. In the same manner as last month, the labour market showed little signs of easing as the unemployment rate declined to 3.5% and surprised the market consensus of 3.6%. Employment change was stronger than the market had expected too – reconfirming a still resilient labour market. The monthly and quarterly CPI prints, however, showed some additional cooling. The monthly June CPI was in line with market expectation printing 5.4%, declining from 5.6% the previous month. Later in the month Q2 CPI release came in softer, with headline inflation coming down to 0.8% QoQ from 1.4% the previous quarter, and the trimmed mean core CPI at 0.9% QoQ from 1.2% in Q1 versus the consensus of 1.1%.

Portfolio

The portfolio's interest rate positioning delivered positive relative performance over July. Our short duration position in Japanese 10-year futures was positive as the Bank of Japan introduced much greater flexibility in its yield curve control program, effectively raising the upper limit of the 10-year JGB yield target from 0.5% to 1.0%. Futures prices declined as bond yields rose, benefiting the portfolio. Our US curve steepener was also positive for relative performance, as 30-year US Treasury yields rose by more than 5-year yields. Elsewhere, we also increased our long positioning in New Zealand 2-year rates, as the RBNZ held the official cash rate steady at 5.50% and signaled that its tightening cycle was likely finished.

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

Outlook

Our bias remains to be positioned long duration across our portfolios as the global rate hike cycle reaches maturity, inflation continues to ease and recession fears linger. The exception is Japan where we expect yields to move higher as the BoJ belatedly loosens its grip on the bond market and as the debate shifts to the potential for the end of negative interest rate policy.

In Australia, we maintain high conviction that inflation will continue to follow the global trend and fall further from its Q4 2022 peak of 7.8% y/y. In fact, the latest quarterly release showed both headline and underlying measures are now annualising at half this rate (3.5-4.0%) which is a good indication of where y/y inflation is likely to end the 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 significant slowdown in consumption and uptick in mortgage arrears.

The RBA has now left the cash rate unchanged at 4.1% for two consecutive meetings. It is now 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, particularly as more low-rate fixed mortgages roll off. 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 close to 4.0% which we believe will 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. Australian credit spreads also look comparably 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 as cash is being deployed amid low issuance.

Client Services

www.ubs.com/am-australia

Telephone: (03) 9046 4041

Freecall: 1800 572 018

Email: ubs@unitregistry.com.au

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