

# UBS Income Solution Fund

December 2022

## Fund description

The Fund is an actively managed, diversified portfolio of corporate credit, asset backed and other fixed income securities, cash equivalents and cash. The Fund may hold up to 25% in high yield securities (which may include unrated securities).

## 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.

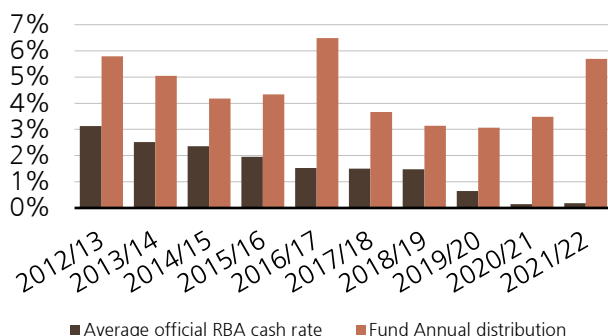
The Fund's investment strategy is to invest in a portfolio of Australian and global corporate credit, asset backed, and other fixed income securities, cash equivalents and cash.

## Investment objective

The Fund aims to outperform (after management costs) the Reserve Bank of Australia Official Cash Rate over rolling three year periods.

## Income history

As at financial year 30 June 2022



## Fund information

Inception date	17 April 2002
Fund size	\$ 338.0m
Management fee	0.60% pa
Minimum initial investment	\$ 50,000
Distributions	Monthly
Monthly distribution estimate cents per unit (CPU)	0.15
Buy/sell spread	+ 0.10% / - 0.20%
Currency management	Hedged to AUD
APIR code	UBS0003AU

## Key statistics

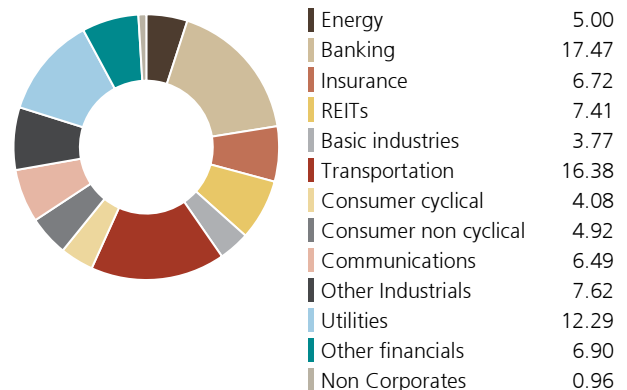
Modified Duration (yrs)	1.90
Spread Duration (yrs)	3.68
Yield to Maturity <sup>1</sup> (%)	6.04
Official cash rate (%)	3.10
Average Credit Rating	BBB

<sup>1</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.

## Credit quality (%)

Investment Grade	78.54
High Yield	17.57
Cash and other	3.89

## Industry allocation (ex cash) (%)



## Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	0.11	1.17	(2.36)	(0.07)	1.25	4.31
Benchmark**	0.25	0.70	1.27	0.56	0.87	3.50
<b>Added Value</b>	<b>(0.14)</b>	<b>0.47</b>	<b>(3.63)</b>	<b>(0.63)</b>	<b>0.38</b>	<b>0.81</b>

\* Inception date: 17 April 2002.

\*\* RBA Official Cash Rate, Prior to 1 February 2017 benchmark was Bloomberg AusBond Bank Bill Index.

Performance figures are net of ongoing fees and expenses. The performance figures quoted are historical, calculated using end of month 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. Growth returns are the returns due to change in initial capital value. Distribution returns are the returns due to the distributions paid. 1 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. 2 Source: RBA, 2019.

## Market Review

- Australian Government bond yields rose across the term structure.
- Australian credit spreads tightened over December.
- The RBA raised the cash rate target by 25bps in December.

## Global Market Review

Trading in the US bond market was less volatile than equities in December, with the yield on the 2-year US Treasury rising only 3 basis points over the month to 4.35%. The yield on the 10-year US Treasury rose around 10 basis points to 3.76%.

In the US, the Fed raised interest rates by 50bps on 14 December, taking the federal funds rate target range to 4.25-4.5%. The "dot plot," which indicates expectations of FOMC members for the future path of interest rates, showed 17 of the 19 dots above 5% at the end of 2023. The ISM Manufacturing PMI fell to 49, below the neutral reading of 50 and the lowest level since the start of the current expansion, which began in May 2020. Consumer spending has been resilient, despite the impact of higher prices on household budgets. In recent months, the savings rate has fallen to just over 2%, near its record low, as households use their credit cards to help maintain spending. Consumers have been supported by the strong labour market. Nonfarm payrolls increased by 263,000 in November, the smallest gain since April 2021 but still well above historical norms. Inflation has been slowing in recent months, with CPI rising by only 0.1% month-over-month in November.

In the Eurozone, the European Central Bank raised rates by 50bps in December. ECB President Christine Lagarde said that rates would "still have to rise significantly and at a steady pace," adding that further 50bps increases were possible at each of the next three meetings. In addition, the ECB laid out its plans for quantitative tightening to begin in March at a pace of EUR 15bn per month within the Asset Purchase Program (APP). In the UK, the Bank of England raised rates by 50bps to 3.5%, following a broader global trend toward slowing the pace of tightening after a 75bps hike in November. But the policy committee warned that further increases "may be required for a sustained return of inflation to target" and said that it would "respond forcefully" if inflationary pressures start to look more persistent. Inflation slowed from a 41-year high in October of 11.1%, to 10.7% in November. Average pay in Britain, excluding bonuses, increased at an annual rate of 6.1% in the three months to October. While this is lagging inflation, it is still inconsistent with the Bank of England's inflation target.

In Japan, the central bank caught investors off guard at their policy meeting by indicating that they would allow the yield on 10-year bonds to rise as high as 0.5% instead of the previous 0.25% cap. Bank of Japan governor Haruhiko Kuroda argued that the shift should not be viewed as a tightening of monetary policy, saying "this measure is not a rate hike" and did not signal the end of Japan's efforts to prevent yields from rising. Following the move, the yield on Japan's 10-year government bond rose 15bps to 0.41%. In China, the government moved faster than expected to unwind its zero-COVID policy. Policymakers have downgraded COVID management controls and scrapped quarantine and PCR testing requirements for inbound travellers from 8 January, removing two of the last tenets of zero-COVID. COVID was also renamed as an "infection" (from "pneumonia") to reflect omicron's reduced severity.

In December, the UBS Constant Maturity Commodity Index (CMCI) delivered total returns of around 0.3%, bringing the 4Q22 performance to 8.4% and the 2022 performance to 17%. Commodities have been the best-performing asset class for two years in a row now. Sector wise, energy lost the most ground in December, down by 3.4% suffering primarily from a drop in US natural gas prices due to milder temperatures. In contrast, a weaker US dollar made precious metals the best performing sector, up by 5.3%. The other three sectors— industrial metals, agriculture, and livestock —were up by 1.5–3.2% in December.

## Australia Market Review

The Australian sovereign yield curve sold-off over December in-line with offshore bond markets largely due to the Bank of Japan's adjustment of its YCC program and concerns over inflationary pressure as China ditched its Zero-Covid measures. Australian 3-year Government bond yields rose 34bps, ending the month at 3.50% while the 10-year Government bond yield increased by 52bps, to end the month at 4.05%. The spread of Australian 10-year Government bond yield against US 10-year Government bond yields – which was inverted at the end of November - turned positive, ending the month at +17bps. Credit spreads tightened over the month (Bloomberg AusBond Credit 0+ year index tightened from 156bps to 149bps). The Bloomberg AusBond Composite 0+ year returned -2.06% in December.

In early December the RBA raised the official cash rate target by 25bps, the 8th consecutive hike, to a level of 3.10%. According to the minutes however, this was the first meeting the board explicitly considered holding the cash rate since the RBA started its rate hiking cycle in May. However, the minutes' reasoning for deliver another 25bp hike instead was to maintain consistency amid no contrary signal from the incoming data. The labour market continued to be very tight: the unemployment rate remained at 3.4% in November, around the lowest rate in almost 50 years. Employment

change in Australia accelerated to 64k in November from 43.1k in October versus the market expectation of only 19.0k. Participation rate also increased to 66.80%, beating the market expectation of 66.60%. Looking forward, the Board “expects to increase interest rates further over the period ahead”, noting that “it is not on a pre-set course”.

Elsewhere on the data front, the Australian Bureau of Statistics unveiled its latest quarterly GDP statistics. The Australian economy expanded at a quarterly pace of 0.6% in Q3, the fourth consecutive quarter of growth since the outbreak of the Delta variant in Q3 2021, albeit a deceleration from the previous quarter. The main contributor to growth was household spending which grew 1.1% over the quarter. This could also be seen in the household saving ratio declining to 6.9% this quarter versus 8.3% in Q2.

## Australia ESG insights

Volkswagen AG (“VW”) - via its financial services subsidiary - has been an active issuer in the AUD corporate bond market over many years. The company has been the subject of material ESG related concerns, primarily centering on the Dieselgate controversy that has hung over the issuer. More recently, there have also been allegations of VW employing forced labour within a joint venture auto plant. Regarding Dieselgate, we have observed improved compliance, reporting and control mechanisms in recent years, culminating with the Chief Compliance officer now residing at Executive Level. Integrity now also forms an explicit part of the company's strategy and emissions related financial settlement risks have abated somewhat. However, whilst these actions have a positive directional influence on the company's ESG profile, the UNGC failure regarding forced labour weighs heavily on social risk management practices and highlights the perils of operating in certain jurisdictions. Given the aforementioned ESG gyrations, we have maintained a long standing cautious approach to the VW credit, reflected in underweight positions across the active AUD fixed income portfolios. Our views are not static however, so if we see clear evidence of VW taking credible corrective action on the UNGC failure we may become more constructive on the credit and related portfolio positioning.

## Portfolio

The portfolio produced positive absolute return but underperformed the benchmark over December. Australian Government bonds sold-off at the front end of the curve, thus causing a detraction to the fund's performance against the lower duration bank bill index.

Within credit management, Australian corporate credit spreads tightened over the month which contributed to the portfolio's relative performance while widening credit spreads in US high yield market was a small detractor.

## Outlook

We expect 2023 to be a much better year for fixed income than 2022. 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 many central banks including the Federal Reserve, European Central Bank and the RBA downshifting to smaller rate hike increments. This is a more positive environment for bonds as it narrows the range of probable peak cash rate outcomes with an outright halt to rate hikes likely to be appropriate for most developed markets in the first half of the year. Meanwhile the potential for stronger disinflation than the consensus expects could see some tightening reversed. 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.

Like elsewhere, we expect the extent of disinflation and recession risks to be the dominant macro drivers of the Australian market this year. On inflation, we continue to observe that Australia is a laggard with headline CPI only expected to peak in the Q4 print released this month (around 7.5-8% 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 are closely monitoring 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 300bp of rate hikes delivered since May 2022 will have a significant negative impact on consumption this year, something that we are already starting to observe in the plateauing out of retail spending in Q4.

Given this, our expectations are that the RBA is close to the end of its hiking cycle. We do not expect a return to super-sized RBA rate hikes and continue to see two more 25bp increases in February and March to a peak cash rate of 3.6% as the most likely outcome. 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 – while the deceleration in global inflation and growth is also likely to be clearly visible. At current bond yields we think rate hikes are fully priced in, hence our current long duration positioning.

We still hold the view that investment grade credit spreads globally will move wider in 2023 driven by tighter financial conditions, increased new issuance 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.

## Client Services

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