

UBS Income Solution Fund

May 2023

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.

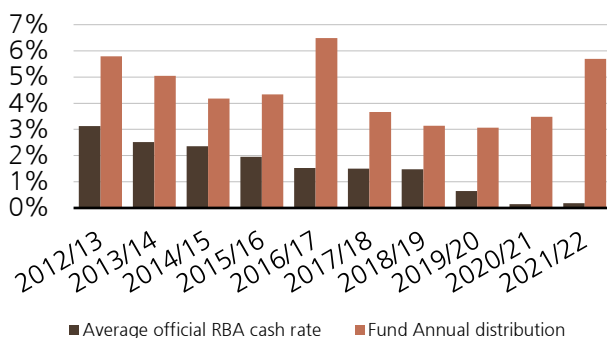
The Fund's investment strategy is to invest in a portfolio of Australian and global corporate credit, asset backed, and other fixed income securities, cash equivalents and cash.

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	\$ 330.5m
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

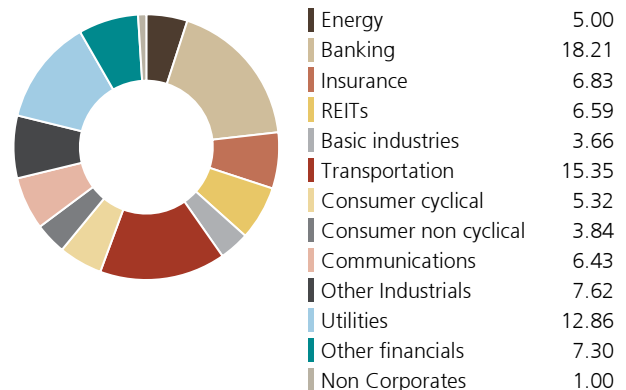
Modified Duration (yrs)	2.20
Spread Duration (yrs)	3.52
Yield to Maturity ¹ (%)	5.84
Official cash rate (%)	3.85
Average Credit Rating	BBB

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.

Credit quality (%)

Investment Grade	79.82
High Yield	18.08
Cash and other	2.10

Industry allocation (ex cash) (%)



Investment performance

Fund	1 month %	3 months %	1 year %	3 years % pa	5 years % pa	Since inception* % pa
Total return	(0.27)	1.30	3.82	2.04	1.76	4.39
Benchmark**	0.32	0.91	2.66	0.97	1.03	3.50
Added Value	(0.59)	0.39	1.16	1.07	0.73	0.89

* 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 modestly across the term structure.
- Australian credit spreads tightened over the month.
- The RBA raised the cash rate target by 25bps in May.

Global Market Review

Global markets wrestled with the dichotomies of continued strength in services versus weakness in factory activity, as well as receding US recession risk occurring alongside a loss of economic momentum in China. The yield on the 2-year US Treasury started the month at 4.01% and ended 39 basis points higher at 4.40%. The yield on the 10-year US Treasury ended April at 3.42% and stood 22 basis points higher at 3.64% at the end of May.

In the US, economic resilience continued in May, particularly in the labour market. The US non-farm payrolls report showed job growth exceeded economists' expectations for the 13th consecutive reading, with a pickup in wage growth and the unemployment rate dipping to the lowest level since the late 1960s. Price pressures remain high, with both core CPI and core PCE inflation well above 2% and failing to meaningfully decelerate in recent readings (on a three-month annualized basis). The Senior Loan Officer Survey pointed to a modest tightening in credit conditions in the aftermath of regional bank stress earlier in the year. Importantly, institutions cited concerns over the economic backdrop as the cause of tighter conditions, rather than concerns about ability to access liquidity or capital adequacy. The White House and Republican House Speaker came to an agreement to raise the US debt limit through Jan. 1, 2025. This deal involves to a modest amount of fiscal drag in the coming years, but significantly reduces near-term economic and financial left-tail risk. In early May, the Federal Reserve delivered a 25 basis point interest rate increase.

In Europe, the composite PMI edged lower from April to May, as did investor sentiment. Industrial production more than offset February's larger than expected increase with a bigger than expected decline in March. Retail sales declined for the second consecutive month. Revised data showed that Germany's economy contracted in back-to-back quarters through Q1. The European Central Bank's bank lending survey showed a further tightening in credit conditions, with corporate loan demand slumping due to high interest rates. In early May, the European Central Bank delivered a 25 basis point hike. President Christine Lagarde signalled that the central bank had not yet reached a sufficiently restrictive policy stance, and that more policy tightening would be in the offering. In the UK, the Bank of England hiked rates by 25 basis points, citing risks to inflation that were still skewed significantly to the upside, and no longer anticipates that the

economy will fall into recession in the near-term. Wage growth remains elevated, and employment grew by more than anticipated in the three-month period ending in March.

In Japan, preliminary manufacturing and services PMIs came in above 50 for May. Capital spending rose 11% year-on-year as of Q1, far surpassing expectations for a 6% rise. Services inflation, which has been 0.5% or lower throughout the history of the series (excluding the impact of tax increases), is currently running at 1.7% year-on-year as of April.

In China, concerns about the vigour of China's economic recovery mounted amid a slate of data affirming a material loss of momentum. Growth in industrial production of 5.6% year-on-year for April was quite weak, considering the Shanghai lockdown one year ago. The youth unemployment rate was over 20% in April, the highest in series history (going back to 2018). Activity in the property market has been weakening since the start of April. Sluggish imports underscored concerns about industrial activity going forward. Purchasing managers' indexes painted a more mixed picture, with the CFLP Manufacturing PMI at 48.8 and the Caixin Manufacturing PMI at 50.9 in May.

Australia Market Review

Australian Government bonds sold-off sharply over May in-line with offshore bond markets as renewed concerns over persistent inflation as well as uncertainty about a debt ceiling deal. Australian 3-year Government bond yields rose 37bps, ending the month at 3.37% while the 10-year Government bond yields rose 27bps to end the month at 3.61%. Australian 10-year Government bonds underperformed US equivalents with the spread ending the month at -3bps from -9bps the previous month. Credit spreads tightened (Bloomberg AusBond Credit 0+ index tightened from 143bps to 135bps). The Bloomberg AusBond Composite 0+ year Index returned -1.21%.

In early May, the RBA raised the official cash rate target by 25bps, a surprising hike against the consensus and market expectation which only priced in 3bps of tightening prior to the meeting. The RBA's main reasoning behind the rate hike despite the pause in the April meeting focused on the stickiness of global services inflation and rising labour costs even as productivity growth remain subdued. The Q1 CPI release actually came in softer, with headline inflation coming down to 1.4% QoQ from 1.9% the previous quarter, and the trimmed mean core CPI at 1.2% QoQ from 1.7% in Q4 versus the consensus of 1.4%, indicating disinflationary pressure. On the forward guidance, RBA Governor Lowe noted in his post-meeting statement "some further tightening of monetary policy may be required".

Elsewhere, the domestic economic data was mostly weaker over the month. The labour market showed some easing for April as the unemployment rate rose to 3.7% from 3.5% as

employment fell in the month. The quarterly wage price index also came below the market consensus and printed 0.8% leading to a partial easing of concerns over a wage-price spiral in the economy. Housing-related indicators such as April building approvals (-8.1% MoM) came in considerably lower than market consensus amid rising mortgage rates, showing the effect of the RBA tightening so far. The April monthly Consumer Price Index was, however, stronger than expected printing 6.8% YoY from 6.3% prior.

Australia ESG insights

Late last year, Downer EDI Ltd identified accounting irregularities in its Australian Utilities business involving historical misreporting of revenue and work in progress on one of its maintenance contracts. Control weaknesses appear to have allowed for the recognition of service revenues in advance of those services (and costs) having been performed. As such, approximately A\$40mn of overstated profits (pre-tax) had been accumulated in WIP over FY20-23. Whilst financial immaterial, we recently engaged with the CFO and Treasurer focusing on governance and seeking assurance that this control deficiency was not indicative of a more widespread issue. We came away with increased confidence that the accounting issues were confined to one contract. Management has been cleansed, with the appointment of a new Chairman, CEO (Internal appointment) and CFO. Looking forward the plan from here involves resetting the operating model and cost base, continued simplification, and a focus on operational excellence and risk management. Whilst we feel the worst is probably behind them, the proof will be in the pudding (only the passage of time will confirm). We will look to re-engage with the company once the new CFO settles into his seat.

Portfolio

The portfolio underperformed the benchmark over May. Australian Government bond yields sold-off across the term structure, resulting in negative relative performance against the lower duration bank bill index.

Within Credit management, the portfolio's overweight position in Australian corporates benefited largely from the extra yields ("carry") as credit spreads tightened modestly and was the biggest contributor to relative performance over May, although insufficient to offset impact from duration. Credit spreads widened in the US high yield market which was also a detractor to relative performance.

Outlook

Our bias remains to be positioned long duration across our portfolios as the global monetary policy tightening cycle approaches maturity, although we used the rally in March and April to tactically trim our positions awaiting 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 will follow the global trend lower in the coming quarters. 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 this is largely playing out in the aggregate data, 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. 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. We continue to believe that longer-term bond yields at or above 3.5% will ultimately 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 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

Client Services

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