UBS Australian Bond Fund

June 2024

Fund description

The Fund is an actively managed, diversified portfolio of largely investment grade fixed income securities, cash equivalents and cash.

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 largely investment grade fixed income securities, cash equivalents and cash.

Investment objective

The Fund aims to outperform (after management costs) the Bloomberg AusBond Composite 0+Yr Index over rolling three year periods.

Key statistics

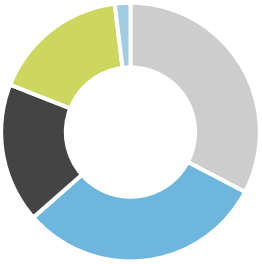
	Fund	Benchmark[1]
Modified duration (yrs)	6.11	4.91
Spread duration[2] (yrs)	4.02	2.33
Weighted avg maturity (yrs)	6.91	5.80
Average credit quality	AA-	AA+
Yield to maturity[3] (%)	4.94	4.53

[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	30 November 1989
Fund size	$ 796.6m
Management fee	0.45% pa
Minimum initial investment	$ 50,000
Distribution frequency	Quarterly
Buy/sell spread	+ 0.02% / – 0.08%
APIR code	SBC0813AU

Credit quality (%)



AAA	32.7
AA	30.9
A	17.4
BBB	17.1
Below BBB	0.0
Cash and other	1.9

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]	2.27	2.59
Government inflation-linked	0.00	0.00
Semi-government	1.86	1.68
Government related	0.31	0.38
Corporates	1.50	0.26
Financials	0.89	0.13
Industrial	0.45	0.10
Utility	0.16	0.03
Credit hedge[5]	0.00	0.00
Securitised	0.17	0.01
Cash and cash equivalents	0.00	0.00

By tenor	Fund	Benchmark
0–3 years	0.54	0.45
3–5 years	1.63	0.79
5–7 years	0.87	0.87
7–10 years	1.10	1.47
10+ years	1.98	1.33

[4] Includes derivatives
[5] Spread duration contribution

Investment performance

Fund	1 month %	3 months %	1 year %	2 years % pa	3 years % pa	5 years % pa	Since inception* % pa
Total return	0.91	(1.00)	4.63	3.05	(1.99)	(0.62)	6.73
Benchmark**	0.77	(0.84)	3.68	2.45	(2.06)	(0.60)	6.71
Added Value	**0.14**	**(0.16)**	**0.95**	**0.60**	**0.07**	**(0.02)**	**0.02**

* Inception date: 30 November 1989.
**Bloomberg AusBond Composite 0+ Yr Index.
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 sovereign bond yields were mixed over June with the yield curve twist flattening.
- Australian credit spreads widened modestly over the month.
- The RBA maintained the cash rate target at 435bps.

Global market review

Global Fixed Income markets had a positive month of June as resilient US economic data continued to support the soft-landing narrative. US Consumer Price Index (CPI) data for May was unchanged on a seasonally adjusted basis, after rising 0.3% in April. It kindled optimism that US inflation is indeed trending towards the Federal Reserve's target which might pave the way for rate cuts later this year. Financial markets are now pricing in slightly more rate cuts for second half of 2024 compared with that at the end of May. Yields on 5-year and 10-year US government bonds fell by 13 and 10 basis points, respectively. Rates markets in Europe followed a similar pattern with yields on the 10-year German Bund lower by 16 basis points on the back of the first rate cut by the European Central Bank. 10-year UK Gilt yields also declined by 15 basis points as headline inflation in the UK reached the Bank of England's 2% target for the first time in nearly three years.

Nevertheless, global rates rose strongly during the first half of the year as markets have been repricing the extent of rate cuts. 10-year government bond yields in the US and Germany were 52 and 48 basis points higher respectively, on a year-to-date basis. On the credit side, US and European high grade and high yield all generated positive total returns despite widening credit spreads, with US high yield outperforming investment grade and European high yield underperforming their investment grade counterparts. Within emerging markets, both sovereigns and corporates posted positive returns driven by tighter treasury yields, which more than offset the negative return from wider spreads. Year to date returns on all credit indices except for US investment grade are positive.

In the US, May inflation data was softer than expected, an encouraging improvement after a concerning Q1. US headline CPI printed 0.0% month on month in May and core CPI printed 0.2% driven by lower new cars prices, transportation services and apparel. Core PPI also surprised with a flat reading in May versus the 0.3% consensus. More importantly, core PCE, which is the Federal Reserve's favorite measure of inflation rose just 0.08% in May, its smallest increase since 2020. At the June FOMC meeting, the committee revised down to its 2024 year-end dot to show just one cut this year, from three cuts previously, and revised up long-term rate to 2.8% in the Summary of Economic Projections. These hawkish elements were offset by a projected faster pace of easing in 2025 and 2026, alongside more dovish language during Powell's conference. Powell noted that members saw multiple potential outcomes for the economy and the decision to project one or two cuts was a very close calls for many members. The payrolls report was arguably the most positive release for the month, posting a 272K job gain versus 180K expected and amid a tick up in wage growth to 4.1% YoY. The household survey, which is much noisier, showed the unemployment rate unexpectedly ticking higher to 4.0% despite a declining labor force participation. Slightly more disconcerting was the JOLTS report, which showed a considerable further drop in the job openings rate. To be sure, the level of the jobs opening rates still remains healthy overall, but we are approaching levels where further deterioration in that metric has historically been associated with larger increases in the unemployment rate. The rest of the US data for the month was relatively weak. Retail sales in May slightly missed expectation and prior months were revised lower. The housing market continues to struggle amid an extended period of high mortgage rates. The homebuilders index and housing starts both declined over the month.

In Europe, European parliamentary elections led to a surprise in French politics, with President Macron calling snap elections on June 30 and July 7. European markets reacted negatively with concerns that a new parliamentary government could end up deteriorating the already-precarious fiscal stance in France. The first round of French elections confirmed that the most likely outcome is a "hung parliament", resulting in political gridlock. The risk of the far-right RN winning an absolute majority remains. In this scenario, risks for the French fiscal outlook as well for cross-EU collaboration increase. The European Central Bank cut the rates by 0.25% as expected and noted that the stability in their 2025 projections has been informative. This resilience of their forward-looking view ultimately guided them to easing policy despite domestic wages and services inflation that have been sticker than expected. In the UK, the Bank of England similarly

downplayed the upside services inflation surprise by saying the strength in prices are regulated and put more focus on their forward-looking indicators, most prominently of which are lower inflation expectations.

In Japan, the BoJ disappointed market expectations of a decrease in the asset purchases by announcing that it would begin to reduce bond buying only in July. Markets believed the BoJ would not be able to hike the policy rate and announce the details of the bond purchase cuts at the same time. However, BoJ's Summary of Opinions after the BoJ meeting revitalized possibility of a July hike with one member noting "if deemed appropriate, [the BoJ] should raise the policy interest rate not too late". Market-implied pricing indicates ~57% probability of a July hike, up from only 20% early this month.

In China, growth data showed slightly stronger industrial growth, with IP growth at 6% year on year, but activity continues to look unbalanced as retail sales growth still looked anemic at 3%. Deflationary pressures persisted. Excess supply plus higher tariffs continue to pressure margins for Chinese manufacturers.

Within commodities, oil rebounded by ~6% in June, mostly reflecting a reversal of the sharp move down after OPEC+ had announced it would wind back production cuts later this year, which triggered some short covering. A storm in the Gulf of Mexico also temporarily weighed on production, and the start of the US summer driving season boosted demand.

Australia market review

Australian sovereign bond yields were mixed over the month with the yield curve twist flattening. This was in some contrast to US Treasuries which saw lower yields across the term structure on the back of softer US economic data including the May CPI which came in significantly weaker-than-expected. Australian yields were tracking broadly in line with the US movements until the release of stronger-than-expected Australian inflation data towards the end of the month. The Australian 3-year Government bond yield ended up higher by 3bps, ending the month at 4.08% while the 10-year Government bond yield dropped 10bps to end the month at 4.31%. Credit spreads widened modestly (Bloomberg AusBond Credit 0+ Index widened from 99bps to 103bps). The Bloomberg AusBond Composite 0+ year Index returned 0.77%.

In June, the RBA kept the official cash rate target unchanged at 4.35%. The statement by the Board and press conference by the Governor conveyed a message of vigilance on inflation risks with nothing ruled "in or out" with regards to future changes in the cash rate. The RBA emphasized an uncertain economic outlook particularly around the outcomes for inflation and consumption growth. They noted that inflation is easing more slowly than it had previously anticipated and that getting it back to target in a reasonable timeframe was its highest priority.

On the domestic economic data front, Australia's CPI indicator for May came in stronger-than-expected (4.0% y/y vs 3.8% expected), leading some market commentators to forecast an August rate rise. Elsewhere, labour market data came in close to expectations with employment growing healthily in May (39.7k vs. 30.0k expected), while the unemployment rate fell to 4.0% from 4.1% the previous month.

Australia ESG insights

In the 2025 Budget, the Australian government has started to implement some policy changes based on recommendations outlined in the Australian Universities Accord Final Report (published February). If fully implemented, the proposed reforms in the Accord would weaken universities' governance and operating conditions (given government interference), a credit negative. In particular, the Accord calls for universities to pool their cash reserves and surplus revenue, which would undermine their autonomy and flexibility.

Additionally, government proposals to restrict student visas, if adopted, would reduce university income from international students, weakening credit quality if not offset by increased income from other sources such as domestic students. If implemented as currently proposed, we could see a one-notch downgrade (base case) of the sector in the medium term, with the group of eight universities (University of Melbourne, Australian National University, University of Sydney, University of Queensland, University of Western Australia, University of Adelaide, Monash University and UNSW Sydney) likely more impacted given they are relatively cash-rich and more exposed to higher margined foreign students. It remains unclear if (and exactly how) the Accord recommendations will be fully implemented and the risk 3+ years in nature.

Positioning and attribution

Duration, yield curve and inflation-linked strategies

The portfolio saw positive relative performance over June. Our long domestic duration positioning contributed positively over the month with short dated yields flat over the month but longer dated yields fell. We also used the intra-month volatility to actively trade our position which made a positive contribution to performance.

Overall, our global rates exposure contributed in terms of relative performance. Our outright long New Zealand 2-year position made a positive contribution as short dated New Zealand yields fell over the month. The US yield curve also steepened which resulted in a positive contribution from our US curve steepening trade.

Sector/security

Extra yields ("carry") from the portfolio's overweight position across Australian corporates contributed positively to relative performance, even though Australian credit spreads widened modestly. The portfolio's modest overweight position in Australian semi-government was a positive contributor as spreads contracted over the month.

During the month, we continued to reduce risk in supranationals (7y EFIC) and added risk into corporate credit (7y REGFIN).

Outlook

We continue to favour long duration strategies. The global easing cycle is set to broaden out in H2 to include most major central banks including the US Federal Reserve. It is well understood that the RBA will lag its peers, similar to the tightening phase, and we see Australian bonds as attractively valued with 10-year yields at or above 4%.

Australia is in the "last mile" of the inflation battle with underlying inflation now trending around 3.5-4.0%. We expect the disinflation trend to resume in the second half of the year and for the RBA to gain confidence that its 2-3% inflation target will be achieved. High inflation in non-discretionary services such as rents and insurance will take time to ease whereas there has been much faster progress in curbing price increases in discretionary sectors. Meanwhile, we continue to see evidence that the labour market is gradually loosening. Growth is set to stay below trend for the foreseeable future with an unhealthily reliance on government spending and migration as households continue to tighten their belts.

In the near-term, there is a risk of one more "insurance hike" in the RBA's cash rate given that the progress on inflation stalled in the first half of 2024. However, the bigger picture is that policy is restrictive, and we see better opportunities in positioning for an easing cycle likely starting early next year. This currently looks underpriced in rates, particularly versus peers such as New Zealand, Eurozone, US, and Canada where cutting cycles of 150-200bps are priced in.

Usually, credit spreads would move wider in the latter stages of the economic and rates cycle and as recession risks linger. However, high all-in yields continue to provide strong support to the Australian and global credit markets. Market technicals have also been positive for AUD credit as cash is being deployed amid relatively low issuance.

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