

UBS Diversified Fixed Income Fund

May 2024

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)	7.43	5.71
Spread duration ² (yrs)	3.67	3.14
Weighted avg maturity (yrs)	8.51	7.02
Average credit quality	A1	Aa2
Yield to maturity ³ (%)	4.35	4.23

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

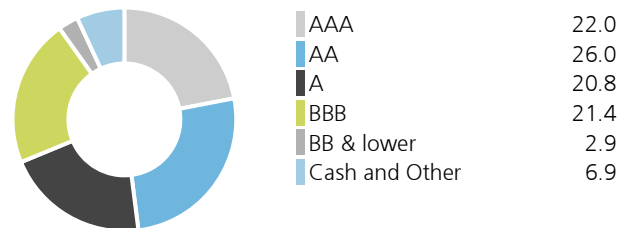
² Option adjusted spread duration ex Treasury.

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	\$ 421.6m
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	4.15	3.29
Government inflation-linked	0.06	0.00
Semi-government	0.84	0.95
Government related	0.44	0.44
Corporates	1.56	0.68
Financials	0.71	0.23
Industrial	0.67	0.37
Utility	0.18	0.08
Securitised	0.38	0.36

By country	Fund	Benchmark
Australia	3.03	2.50
USA	1.55	1.36
Japan	(0.07)	0.43
Canada	0.08	0.10
Euro area	1.27	0.71
UK	0.79	0.16
New Zealand	0.57	0.00
China	0.16	0.28
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	0.71	(0.85)	0.64	0.05	(2.87)	(1.06)	4.83
Benchmark**	0.58	(0.32)	1.30	0.42	(2.45)	(0.55)	5.27
Added Value	0.13	(0.53)	(0.66)	(0.37)	(0.42)	(0.51)	(0.44)

* 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 sovereign bond yields ended relatively flat across the term structure over May.
- Australian credit spreads tightened over the month.
- The RBA maintained the cash rate target at 435bps.

Global market review

Global Fixed Income markets had a positive month of May as macro data supported the US soft-landing narrative. April US Consumer Price Index (CPI) data moderated to a monthly 0.3% after holding steady at 0.4% in recent months. Hopes of a soft economic landing in the US were also lifted by data on economic growth, service sector activity, retail sales, and employment. US government bond markets ended the month tighter with 5-year and the 10-year yields declining by 21 and 18 basis points, respectively. Rates markets in Europe also followed a similar pattern but with a slight twist. 10-year German Bunds were wider by 8 basis points on the back of an improving growth outlook while 10-year UK Gilts were tighter by 3 basis points given the lower inflation print. On the credit side, US and European high-grade and high yield all generated positive returns with US investment grade and European high yield outperforming. Within emerging markets, spread return for both, sovereigns and corporates, continues to be the dominant driver of year-to-date total returns with the outperformance most notable in high yield rated sovereigns.

In the US, headline and core CPI were down to 3.4% and 3.6% year on year in April, reflecting a genuine slowdown from the previous month. Softer readings were driven by a 6.9% drop in used vehicle prices. PPI on the other hand was more mixed and came in above consensus expectations driven by financial services, portfolio management and air-fares. Labor market data further dispelled inflation concerns with non-farm payrolls at 175,000 coming in significantly below consensus expectations of 240,000, while the unemployment rate ticked up to 3.9%. Growth in aggregate labor income is still running comfortably above its pre-Covid trend, supporting consumer spending. Despite that, retail sales in April were unexpectedly weak even though the 3-month trend on this is ticking up. Consumer sentiment indicators showed a mixed picture in May. While the University of Michigan indicator showed a significant worsening in consumer expectations, the gauge by the Conference

Board improved for the first time in 2024. The former is more heavily skewed towards inflation expectations and might still show a lagged effect of negative inflation surprises in Q1, which could explain recent divergence. The rise in the 30-year mortgage rate from below 7% at the start of the year to 7.6% at the peak in April and 7.4% currently, is impacting the housing market. Building permits and housing starts generally softened and the NAHB Home Builders Index declined. The Fed's Senior Loan Officer Survey for Q1 confirmed that bank lending standards continued to tighten moderately, while demand for bank loans remained weak. This can be seen as another sign that current financial conditions are in restrictive territory. At its May 1st meeting the FOMC kept interest rates on hold as expected. In his press conference, Fed Chair Powell dispelled concerns that the central bank would have to hike the policy rate further to counter sticky inflation. Minutes published later in the month showed that various Fed committee members would be open to tighten policy further if necessary but the bar for rate hikes remains high.

In the Eurozone, as expected, headline CPI held steady at 2.4% year on year. Core inflation, excluding energy, food, alcohol and tobacco, slowed down to 2.7% from 2.9% in March. Service inflation, which had been stuck at 4% for five months in a row, decelerated to 3.7%, but bounced back to 4.1% in May on preliminary data. The initial estimate for Eurozone inflation in May suggests an uptick in headline CPI to 2.6% YoY and core CPI to 2.9%, both above expectations. Growth in negotiated wages across the region unexpectedly accelerated in Q1 to 4.7% from 4.5% with one-off wage payments for German public employees in Q1 being a key contributor. Preliminary Eurozone Composite PMI for May beat expectations, rising for the fifth consecutive month driven by a further improvement in the manufacturing sector. Business sentiment and consumer confidence indicators across the board point towards a brightening outlook for the region. Germany is still the weakest among Europe's main economies but is also showing an improvement.

UK inflation for April, especially wages, proved stickier than in other regions with average weekly earnings growth remaining elevated. While headline inflation dropped to 2.3%, services inflation decelerated only marginally. Growth momentum also picked up, with Q1 GDP beating consensus expectations and making a notable rebound from the contraction in late-2023. UK's corporate earnings have also improved materially. The

momentum in growth and inflation may make the BoE hesitant to cut rates at its next meeting in June.

Recent data from Japan was a mixed bag. Headline CPI contained no real surprises but core CPI was slightly softer than expected. However, inflation expectations in the survey rose and Shunto wage hikes are now spreading to small enterprises; this is likely to keep the BoJ on its hiking path throughout summer. This month, 10yr JGB broke through 1% for the first time in 5 years.

China rolled out more national stimulus following negative credit growth data, including sales of approximately \$140 billion in long-term bonds and the allowing local governments to buy unsold homes from developers directly. After an initial bounce in investor sentiment on the back of the measures, doubts about the relatively small size of the program caused a market reversal. There is an upside case for China, if strong execution of property purchases by local governments slows the negative trend in new home sales and property prices, ultimately lifting consumer sentiment. But for now, uncertainty remains high and data relatively weak. The latest official Manufacturing PMI unexpectedly dropped below the 50 threshold and retail sales for April surprised negatively too. Additionally, US President Biden announced hikes in US tariffs on certain Chinese goods which include a 100% tariff on electric vehicles (EV), 50% on EV batteries and 25% on certain steel and aluminum products. For now, these have a limited impact on US inflation or the Chinese economy as the increases only affect 4% of US imports from China and <1% of total China exports. But they highlight the geopolitical risks of investing in China, which will likely only get more severe as we approach US presidential elections in November.

Within commodities, metals generally trended upwards with gold and copper rallying by 1.4% and 1.0% respectively and continuing their strong performance since the start of the year. Oil, however, tumbled in May and WTI declined by 6%, likely responding to the recent slowdown in US economic data.

Australia market review

Australian sovereign bond yields ended relatively flat across the term structure over the month, in contrast with US Treasury yields which had grinded lower. The fall in interest rates in the US was mainly driven by softer US economic data for April as non-farm payrolls and the headline CPI came in weaker-than-expected. The Australian 3-year Government bond yield edged higher by 1bps, ending the month at 4.05% while the 10-year Government bond yield dropped 1bps to end the month at 4.41%. Credit spreads tightened (Bloomberg AusBond Credit 0+ Index tightened from 109bps to 99bps). The Bloomberg AusBond Composite 0+ year Index returned 0.39%.

In May, the RBA kept the official cash rate target unchanged at 4.35%. The statement by the Board acknowledged that while medium-term inflation expectations have been consistent with its inflation target, inflation is currently declining only gradually and will continue to remain vigilant to upside risks. In the near-term, persistence in domestic inflation continues to be driven in large part by the services sector. In terms of the labour market, while conditions remained tight, there had been some easing over the past year against the backdrop of softer consumption and economic growth. Going forward, the Board will continue to rely upon ongoing economic data and the evolving assessment of risks.

On the domestic economic data front, Australia's headline CPI for April came in stronger-than-expected (3.6% YoY vs. C 3.4%), mainly driven by price pressures from housing and food costs and a touch above the 3.5% increase reported for March. Elsewhere, labour market conditions continue to fluctuate with a stronger-than-expected change in employment for April (38.5k vs. C 22.4k), while the unemployment rate rose to 4.1% from 3.9% the previous month.

Portfolio

Duration positioning was moderately positive for performance in May. Our key duration positions remain concentrated at the front-end of the Australian, NZ and US markets, while other long positions in the UK and Canada sit around the 10-year tenor. Given that yields in selected markets such as the US and UK fell, this delivered a positive relative performance over the month. This was also supported by the portfolio's bias towards a steeper US curve between the 5-year and 30-year maturities as front-end yields fell further. On the other hand, the portfolio had also benefitted from its short Japan 10-year position as the benchmark yield rose above 1% for the first time since 2012, and we took some profits on the position.

Within credit management, the portfolio's overweight position across Australian corporates benefited from the extra yields ("carry") and a tightening in Australian credit spreads over the month.

Outlook

We continue to favour long duration strategies, using the back-up in yields over the last couple of months to tactically add risk. The resurgence of a “higher for longer” narrative runs counter to our expectations that most major central banks (ex. Bank of Japan) will start to unwind restrictive policy from mid-2024 amid ongoing disinflation, softer growth and looser labour markets.

Australia is in the “last mile” of the inflation battle with underlying inflation now trending around 3.5%. 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. Inflation is proving persistent in non-discretionary services such as rents and insurance whereas there has been substantial progress in curbing price increases in discretionary sectors. Meanwhile, we continue to see evidence that the labour market is gradually loosening while growth is set to stay below potential for the foreseeable future led by the consumer as the squeeze in real disposable income continues to work its way through the economy.

The RBA’s cash rate is likely at its peak based on our reading of the inflation trend and already restrictive nature of current policy settings. We believe Q4 is the earliest opportunity for the first cash rate cut. The market no longer expects rate cuts this year and continues to see a considerably shallower ~50bps easing cycle than peers such as Eurozone, US and Canada where cutting cycles of 150-200bps are priced in. Given this, current Australian bond yields look attractive, and we think 3-year bond yields can trend down towards 3% this year in anticipation of easing.

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.

Client Services

www.ubs.com/am-australia

Telephone: +612 9324 3034

Freecall: 1800 075 218

Email: clientservices-ubsam@ubs.com

This document is intended to provide general information only and is not an invitation to subscribe for units in the Fund. When making a decision about your investments, you should seek the advice of a professional financial adviser or qualified expert. Any materials that constitutes financial product advice is general financial product advice only and is not advice about a particular financial product (other than the Fund). It has been prepared without taking into account the objectives, financial situation or needs of any particular person. Before making an investment decision, you should consider whether this information is appropriate having regard to your objectives, financial situation or needs. Refer to UBS Asset Management (Australia) Ltd’s financial services guide on our website for more information. Your investment in the Fund does not represent deposits or other liabilities of UBS AG or any member company of the UBS Group including UBS Asset Management (Australia) Ltd (ABN 31 003 146 290) (AFS Licence No. 222605), the issuer of the Fund. Your investment is subject to investment risk, including possible delays on the repayment of withdrawal proceeds and the loss of income or the capital invested. The repayment of capital or the performance of the Fund or rate of return is not guaranteed by any company in the UBS Group. Any potential investor should obtain and consider the Fund’s product disclosure statement (PDS) before deciding whether to acquire, or continue to hold, units in the Fund. UBS has also issued a target market determination (TMD) that describes the class of consumers that comprises the target market for the Fund and matters relevant to its distribution and review. A copy of the PDS, PDS addition information booklet and TMD is available from UBS Asset Management (Australia) Ltd, the issuer of the UBS Funds, on our website www.ubs.com.au or by calling (02) 9324 3034 or 1800 075 218. Unless specifically stated otherwise, all price and performance information is indicative only. Past performance is not a reliable indicator of future performance. No allowance has been made for taxation. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the content in this document.

The PDS for this Fund is only available to persons receiving the PDS (electronically or otherwise) in Australia, unless expressly authorised by us in writing. The offer does not constitute an offer or invitation in any place in which, or to any person to whom, it would be unlawful to make such an offer or invitation. This Fund (or the PDS) has not been registered under the laws of any jurisdiction outside Australia. The Fund may not be offered or sold in the United States of America or to ‘U.S. Persons’ (as defined in ‘Regulation S’ of the Securities Act of 1933, as amended) and the PDS is not for use in, and may not be delivered to or inside, the United States of America.

This document may not be reproduced or copies circulated without prior authority from UBS Asset Management (Australia) Ltd.

© UBS 2024. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

