Portfolio report

UBS Australian Bond Fund
Australian Bond
Client report from 01.04.2024 to 30.06.2024

Summary

as at 30-Jun-24

Performance

After fees and expenses, the portfolio decreased by 1.00% over the quarter, underperfoming the Bloomberg AusBond Composite 0+Yr Index, which decreased by 0.84%.

% Return (Net)	Fund[1]	Benchmark*	Difference
3 months	(1.00)	(0.84)	(0.16)
1 year	4.63	3.68	0.95
3 years	(1.99)	(2.06)	0.07
5 years	(0.62)	(0.60)	(0.02)
10 years	2.08	2.19	(0.11)
Calendar Year to Date	0.10	0.18	(0.08)
Since inception (11/89)	6.73	6.71	0.02

[1] Performance figures are net of ongoing fees and expenses.
* Bloomberg AusBond Composite 0+Yr Index
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.
Source: UBS Asset Management. These figures refer to the past. Past performance is not a reliable indicator of future results.

Performance review

The portfolio saw a modest negative relative performance over Q2, predominately due to our long domestic duration positioning. The dramatic rise in Australian sovereign bond yields over April led to this detraction and offset the fall in bond yields later in the quarter in May and June. Our curve positioning was broadly flat over the quarter.

Overall, our global rates exposure detracted slightly in terms of relative performance over Q2. Our US 5/30-year steepener position had a neutral impact over the quarter, while our short 10-year Japanese bond position added positively to relative performance as bond yields rose to 1%. The main detractor was our outright long New Zealand 2-year position as 2-year NZD swap rates rose substantially over April, before retracing somewhat over May and June).

Australian corporate credit spreads tightened over Q2, whereas spreads widened marginally in semi-government bonds. In addition to the extra yields (“carry”), this contributed to a strong positive relative performance from our overweight positioning across Australian corporates. On the other hand, the portfolio’s slight overweight position across Australian semi-government bond made a modest negative relative performance over the quarter.

During the quarter, we reduced risk in our supranational exposure (2y, 7y and 10y), switching into longer dated semis (10y NTTC and 12y AUSCAP) and corporates (3y ETSA and 7y Registry Finance).

Fixed Income analytics

as at 30-Jun-24

Portfolio Positioning

	31-Mar-24	30-Jun-24
Portfolio Market Value (AUD)	830,352,979.93	797,851,686.40
Portfolio Book Value (AUD)	1,280,654,054.43	1,137,456,365.73
Portfolio Modified Duration	5.70	6.11
Benchmark Modified Duration	4.95	4.91
Portfolio Average Rating	AA-	AA-
Benchmark Average Rating	AA+	AA+
Portfolio Yield to Maturity	4.87%	4.94%
Benchmark Yield to Maturity	4.13%	4.53%
Portfolio Average Term to Maturity	6.35	6.92
Portfolio Average Coupon	3.63%	3.96%
Benchmark Average Coupon	2.76%	2.81%
Portfolio Spread Duration	4.44	4.32
Benchmark Spread Duration	2.24	2.32

Fixed Income analytics

as at 30-Jun-24

Yield Curve Distribution

	Portfolio	Benchmark	Difference
0-1 years	1.65%	9.98%	-8.33%
1-2 years	8.82%	10.28%	-1.46%
2-3 years	7.57%	10.62%	-3.05%
3-4 years	22.71%	10.17%	12.54%
4-5 years	13.42%	10.99%	2.43%
5-6 years	7.31%	7.90%	-0.59%
6-7 years	8.68%	7.88%	0.81%
7-8 years	4.14%	7.30%	-3.15%
8-9 years	5.90%	6.56%	-0.66%
9-10 years	5.16%	6.06%	-0.90%
10+ years	14.60%	12.26%	2.35%
N/A	0.03%	0.00%	0.03%
Total	**100.00%**	**100.00%**	

Yield Curve Distribution

	Modified Duration Contribution		
	Portfolio	Benchmark	Difference
0-1 years	-0.02	0.05	-0.07
1-2 years	0.44	0.15	0.29
2-3 years	0.12	0.25	-0.13
3-4 years	0.76	0.34	0.42
4-5 years	0.87	0.45	0.42
5-6 years	0.36	0.40	-0.04
6-7 years	0.51	0.48	0.03
7-8 years	0.26	0.51	-0.25
8-9 years	0.43	0.48	-0.04
9-10 years	0.41	0.48	-0.07
10+ years	1.98	1.33	0.65
N/A	0.00	0.00	0.00
Total	**6.11**	**4.91**	**1.20**

Sector Diversification

Sector	Portfolio	Benchmark	Difference
Commonwealth*	13.56%	49.16%	-35.60%
Semi-govt	23.88%	30.54%	-6.66%
Gov- Related	9.57%	11.54%	-1.97%
Corporate*	45.14%	8.22%	36.92%
Asset Backed	5.89%	0.54%	5.34%
Cash, Money Market & Other*	1.96%	0.00%	1.96%
Total	**100.00%**	**100.00%**	

* Effective exposure may include derivatives

Sector Diversification

	Modified Duration Contribution		
Sector	Portfolio	Benchmark	Difference
Commonwealth*	1.97	2.59	-0.62
Semi-govt	1.86	1.68	0.18
Gov- Related	0.31	0.38	-0.06
Corporate*	1.50	0.26	1.24
Asset Backed	0.17	0.01	0.16
Cash, Money Market & Other*	0.31	0.00	0.31
Total	**6.11**	**4.91**	**1.20**

* Effective exposure may include derivatives

Fixed Income analytics

as at 30-Jun-24

Credit Diversification

Credit Rating	Portfolio	Benchmark	Difference
AAA	32.66%	61.20%	-28.54%
AA+	17.12%	19.39%	-2.27%
AA	4.62%	9.50%	-4.89%
AA-	9.11%	3.83%	5.29%
A+	3.87%	1.12%	2.75%
A	2.24%	0.62%	1.62%
A-	11.33%	1.38%	9.95%
BBB+	6.07%	1.73%	4.34%
BBB	7.40%	1.04%	6.37%
BBB-	3.62%	0.17%	3.45%
HY	0.00%	0.00%	0.00%
NR	0.00%	0.03%	-0.03%
A1+/A1 - Cash, Money Market & Other	1.96%	0.00%	1.96%
Total	**100.00%**	**100.00%**	

Credit Diversification

	Modified Duration Contribution		
Credit Rating	Portfolio	Benchmark	Difference
AAA	2.03	2.98	-0.94
AA+	1.17	1.05	0.11
AA	0.34	0.54	-0.20
AA-	0.31	0.13	0.18
A+	0.11	0.03	0.08
A	0.11	0.02	0.09
A-	0.36	0.05	0.31
BBB+	0.24	0.06	0.17
BBB	0.20	0.04	0.16
BBB-	0.10	0.01	0.10
HY	0.00	0.00	0.00
NR	0.00	0.00	0.00
A1+/A1 - Cash, Money Market & Other	1.15	0.00	1.15
Total	**6.11**	**4.91**	**1.20**

Market review

Economic

- Australian sovereign bond yields rose over the quarter with a flattening bias in the medium to long end of the curve.
- Australian credit spreads tightened modestly over the quarter.
- The RBA maintained the cash rate target at 435bps.

Global Economies

The second quarter of 2024 saw some losses in the global Fixed Income markets, as measured by the Bloomberg Global Aggregate index. The negative performance was mainly driven by the sell-off in April as investors grew cautious on the outlook for Fed rate cuts given a higher-than expected US inflation print and stronger jobs numbers. The downturn in global Fixed Income markets reversed over May and June, following a moderation in the US CPI which kindled optimism that inflation is indeed trending towards the Federal Reserve's target which might pave the way for rate cuts later this year. Resilient US economic data also continued to support the soft-landing narrative. Markets are now pricing in slightly more rate cuts for second half of 2024 compared with that at the end of May. Government bond yields mostly rose across the board with 10-year US Treasury yields rising 20bps to 4.40%. On the credit side, both investment grade and high yield generated positive total returns despite a widening in credit spreads, with high yield notably outperforming its investment grade peers.

In the US, the Federal Reverse held interest rates unchanged at a range of 5.25-5.50% throughout the quarter during its two meetings in late April and mid-June. May's inflation data was softer-than-expected, an encouraging improvement after a concerning first quarter. 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 faster pace of easing projected for 2025 and 2026, alongside more dovish language during Powell's conference. In terms of economic data, the recent payrolls report for May posted 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. The rest of the US data for May was relatively weak, with retail sales slightly missing expectation while the housing market continues to struggle amid an extended period of high mortgage rates.

In Europe, the European Central Bank initiated a rate cut of 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. On other notable news, European parliamentary elections had 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 a political gridlock. In the UK, the Bank of England recently downplayed the upside services inflation surprise by saying the strength in prices are regulated and had put more focus on their forward-looking indicators, most prominently of which are lower inflation expectations.

In Japan, core CPI was slightly softer-than-expected in May while the headline CPI contained no real surprises. However, inflation expectations in the survey rose and Shunto wage hikes are now spreading to small enterprises, which is likely to keep the BoJ on its hawkish path throughout summer. The BoJ had 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, the BoJ's recent Summary of Opinions after its 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 May, the 10-year JGB broke through 1% for the first time in 5 years.

Market review

Global Economies (continued)

In China, the government rolled out more national stimulus over the quarter 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. Recent 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 while excess supply plus higher tariffs continue to pressure margins for Chinese manufacturers.

Market review

Australian Economy

The Australian 3-year Government bond yield rose 46bp to end the quarter at 4.08% while the 10-year Government bond yield rose 35bp to end the quarter at 4.31%. Australian 10-year Government bonds underperformed US equivalents with the spread ending June close to flat from -24bps the previous quarter. Credit spreads tightened modestly (Bloomberg AusBond Credit 0+ index tightened from 110bps to 103bps). The Bloomberg AusBond Composite 0+ year Index returned -0.84%.

The RBA kept the official cash rate target unchanged at 4.35% over the quarter. Communication from the Board and the Governor has looked to convey a message of vigilance on inflation risks with nothing ruled "in or out" with regards to future changes in the cash rate. Minutes from policy meetings continue to reveal that the Board has been discussing the case for a rate hike before ultimately concluding that the case for keeping rates steady was stronger. The bias in this communication, amid signs that the RBA inflation forecasts are more likely to be surprised to the upside in the Q2 data yet to be released, contributed to the rise in front-end yields through the quarter as the market has repriced about a 50/50 probability of one more 25bp rate increase.

In terms of economic data, Australia's Q1 headline and core CPI came in stronger-than-expected at 3.6% and 4.0% y/y respectively, albeit both still representing a deceleration in the annual growth rate from previous quarters. Services inflation continues to prove sticky particularly in non-discretionary sectors such as rents and insurance. The timelier monthly CPI indicator also surprised to the upside in April and May, with the latest read at 4.0% y/y for May (vs. 3.8% expected) indicating that the disinflation process seems to have paused. Elsewhere, GDP growth decelerated to a new cycle low of 1.1% y/y in Q1. Meanwhile seasonal quirks continue to make the labour market data volatile, although the data released in the quarter did show a clearer rising trend in the unemployment rate from 3.7% to 4.0%.

Market review

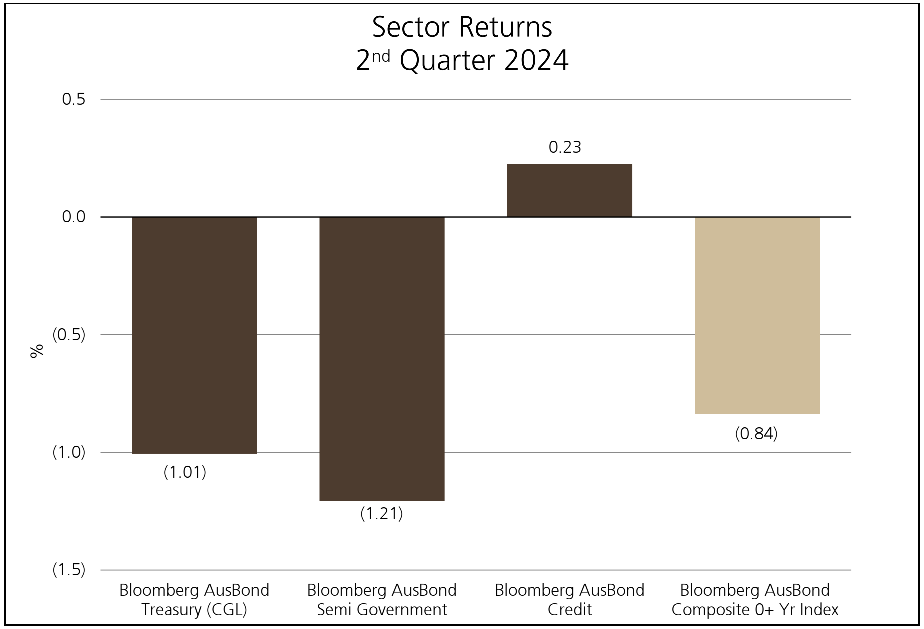
Market Yields

	Cash	3yr*	10yr
Australia	4.35% (--)	4.08% (+46bp)	4.31% (+35)
	Cash	**2yr**	**10yr**
US	5.25-5.50% (--)	4.75% (+14bps)	4.40% (+20bps)

(x)= change on the month

Australia Index Returns

	2nd Quarter 24 %	1st Quarter 24 %	Duration (years)
Bloomberg AusBond Composite 0+ Yr Index	-0.84%	1.03%	4.92
Bloomberg AusBond Treasury (CGL)	-1.01%	0.95%	5.28
Bloomberg AusBond Semi Government	-1.21%	1.01%	5.50
Bloomberg AusBond Credit	0.23%	1.37%	3.17



Outlook and strategy

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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