UBS Income Solution

Quarterly investment report to 30-Jun-20
Performance

After fees and expenses, the portfolio rose by +2.81% over the quarter, outperforming the Reserve Bank of Australia - Daily Cash Rate Index which returned +0.06%.

This includes a positive performance impact associated with changes in the Fund’s sell spread, which was +1.15% over the quarter.

<table>
<thead>
<tr>
<th>% Return (Net)</th>
<th>Fund¹</th>
<th>Benchmark*</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 months</td>
<td>2.81</td>
<td>0.06</td>
<td>2.75</td>
</tr>
<tr>
<td>1 year</td>
<td>(0.30)</td>
<td>0.67</td>
<td>(0.97)</td>
</tr>
<tr>
<td>3 years</td>
<td>2.33</td>
<td>1.21</td>
<td>1.12</td>
</tr>
<tr>
<td>5 years</td>
<td>2.98</td>
<td>1.51</td>
<td>1.47</td>
</tr>
<tr>
<td>10 years</td>
<td>5.20</td>
<td>2.57</td>
<td>2.63</td>
</tr>
<tr>
<td>Calendar Year to Date</td>
<td>(1.79)</td>
<td>0.22</td>
<td>(2.01)</td>
</tr>
<tr>
<td>Since inception (04/02)</td>
<td>4.82</td>
<td>3.91</td>
<td>0.91</td>
</tr>
</tbody>
</table>

¹ Performance figures are net of ongoing fees and expenses.

* Reserve Bank of Australia - Daily Cash Rate

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

Having lagged offshore markets in April, Australian investment grade credit spreads enjoyed a material tightening over May and June, helped by improving investor sentiment through the quarter. Investor confidence within credit markets was further lifted by strong primary issuance both domestically and offshore that was met with healthy demand. The tightening in domestic credit spreads was to the benefit of fund performance given the portfolio is positioned largely within Australian investment grade credit. Active sector and security selection is playing an important role, with the portfolio biased towards defensive industries and issuers that are non-cyclical in nature. An active allocation to Australian major bank Tier 2 debt added to returns and has benefitted performance since the market upheaval in March. The fund’s small strategic allocation to Australian high yield exposures detracted from returns but was more than offset by positioning within US short-duration high yield securities that contributed positively to performance as offshore speculative markets saw a material tightening in spreads over the quarterly period.
Portfolio Positioning

The following chart sets out the asset allocation as at quarter end.

**Asset allocation (hedged)**

- Cash (effective): 12.18%
- Investment Grade: 73.58%
- High Yield: 12.59%
- Hybrids: 1.64%

Credit quality - effective positioning

- AAA: 0%
- AA: 2%
- A: 16%
- BBB: 59%
- BB: 10%
- B: 4%
- CCC and Below: 1%
- NR/Other: 0%
- Cash and Money Markets: 9%

The following chart sets out the credit allocation as at quarter end.
Market review

Economic

- Economic data sharply negative through the quarter but some positive data points in June offer optimism for markets
- Policy action continues to be a focus as authorities step up monetary and fiscal measures
- BOE and RBNZ consider negative rates, RBA sets out baseline forecasts and notes possibility that the ‘depth of the downturn will be less than expected’

Global Economies

The US FOMC kept the Fed funds rate target at 0-0.25% and forward guidance largely consistent through the second quarter. Commentary from the Fed centred on its readiness to act as necessary, noting that it ‘... was not out of ammunition by a longshot’ in its ability to support the US economy. Details of the Fed’s Primary and Secondary Market Corporate Credit Facilities as well as its Municipal Liquidity Facility were provided and it officially commenced corporate bond purchases in June. US economic data unsurprisingly took a sharp dive over the quarter, although there was a positive turn in data points into June. The first GDP reading for Q1 growth registered at -4.8%, the sharpest decline since 2008, and was followed by a revision to -5.0% later in the quarter. Employment data was similarly bleak, with non-farm payrolls initially showing a 701,000 decline in jobs, which preceded a sizeable 20.5m drop in May, but June saw some reprieve with an increase of 2,510,000. The official unemployment rate peaked at 14.7% in April before modestly improving to 13.3% in June. Following very weak data prints in April and May, consumer confidence managed to rise to a three-month high in June and manufacturing activity moved back into expansionary territory with the ISM Manufacturing index rising to 52.6% from 43.1%.

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In the UK, the controversial topic of negative interest rates as a policy tool took centre stage in May as the Bank of England (BOE) Governor, Andrew Bailey, refused to rule out the possibility of cutting rates below zero to boost the economy’s recovery from the impact of COVID-19. In June, the Monetary Policy Committee voted in favour of boosting its quantitative easing program by an additional GBP 100 million. Data prints were weak, with the latest readings for Q1 GDP registering at -2.2% for the quarter and -1.7% on an annual basis.

The Bank of Japan (BOJ) took several additional steps to add further stimulus through the quarter. In April, it increased its purchase caps for commercial paper and corporate bonds by 15 trillion yen and expanded its funding-for-lending program. In May the BOJ also announced the equivalent of USD280bn in additional lending to small firms. At its June meeting, forward guidance indicated a pause in any potential interest rate hikes until at least 2023, and the central bank increased its COVID-19 lending program to more than the yen equivalent of USD 1 trillion. Commentary from the BOJ made it clear that it would take additional measures if needed and indicated that there were still remaining tools that can be employed to support the Japanese economy.

In China, there was evidence of a moderate turnaround through Q2. Initial economic data points in April showed some weakness, with Q1 GDP registering at -6.8%, which is unprecedented since China started economic reforms in the late 1970’s. Industrial production fell 1.1% year-on-year. Retail sales declined by 15.8% over March while fixed asset investments shrank by 16.1%. However, there were signs of a positive shift into the remainder of the quarter. In June, manufacturing PMI printed above 50, investment growth picked up and turned positive and retail sales and industrial production growth also saw material improvement. Policy support was strengthened, with fiscal stimulus worth up to CNY 7-8 trillion.

The Reserve Bank of New Zealand (RBNZ) left rates unchanged through the quarter. In April it expanded its asset purchases to include Local Government Funding Agency debt and also released a proposal to remove LVR restrictions on
Market review

Global Economies (continued)

mortgage lending to provide greater access to credit through the crisis. In May it almost doubled its asset purchase program to NZD60bn. The central bank also indicated that further steps could be taken if needed, including scope for a further cut in the cash rate and the potential to go to negative rates, providing fixed term lending to banks and adding other investments to the large scale asset purchase program. The meeting in June was marked by signals that the recent rise in the NZD was placing ‘pressure on export earnings’ and the potential for additional policy tools to counter a firmer currency.

Australian Economy

The Reserve Bank of Australia (RBA) left policy settings unchanged, with the cash rate at 0.25% and the 3 year government bond yield target at 0.25%. In April, Governor Lowe broadcast the RBA’s first set of forecasts for the Australian economy since the COVID-19 lockdown measures were implemented in his speech ‘An Economic and Financial Update’. Growth was expected to fall ‘by around 10 per cent over the first half of 2020’ and the unemployment rate was seen to reach ‘around 10 per cent by June’. In May, these early forecasts were firmed through the RBA’s ‘baseline scenario’, with output expected to fall by around 10% over the first half of 2020 and by around 6% for the year. The unemployment rate is seen to peak at around 10% over coming months and to remain above 7% by the end of the year. In his testimony to the Australian Senate in May, Governor Lowe saw the economy as tracking slightly better than their baseline scenario and reiterated the importance of fiscal policy in facilitating the economy’s recovery. This was followed by a hint of optimism at the RBA’s meeting in June, with the official statement noting that ‘it is possible that the depth of the downturn will be less than earlier expected’.

Much like other regions around the world, economic data in Australian took a sharp downturn. Early warning signs were present in the employment reading for March, with only 5,900 jobs added and the unemployment rate stepping higher to 5.2%. This was followed by a marked decline of 594,300 jobs in April, taking the unemployment rate to 6.2%. In May, 227,700 jobs were lost and the unemployment rate rose to 7.1%, whilst the participation rate fell to 62.9%, the lowest level since January 2001. Data in June was headlined by a 0.3% contraction in Q1 GDP. The negative quarterly GDP print took the annual figure to 1.4%. Retail sales took a sharp dive over April, falling -17.7% and NAB business indicators turned and remained negative through the quarter, with conditions and confidence indicators in June registering at -24 and -20 respectively. The AUD/USD traded materially higher on the back of improving investor sentiment, gaining over 12.6% to close at 0.6903 by the end of June.
Market review

Bond Market

- Australian and global bond markets return positive performance over the quarter

- Government bond yields largely range-bound while credit markets enjoy a healthy turnaround following the sharp volatility in March

The Australian bond market, as represented by the Bloomberg AusBond Composite 0+Yr Index, returned 0.53% over the June quarter. The Credit Index was the best performing component of the index, returning 1.58%, followed by the Supra-Sovereign Index at 1.38%, the Semi-Government Index at 1.27%, and then the Treasury Index at -0.23%. The Bank Bill Index returned 0.06%.

The quarter was marked by a slow but steady return to normalcy with the partial re-opening of major economies and progressive easing of lockdown measures in many regions around the world. Investor sentiment improved with developing optimism around a sooner-than-expected rebound in economy activity, continued supported from central banks and governments from a policy perspective and progress around the development of a potential vaccine for COVID-19. This saw risk assets post gains over the quarterly period. The trend of gradual reopening of economies suffered a setback in June as fears mounted over a ‘second wave’ of COVID-19 cases particularly in certain heavily populated states in the US, Asia and Australia. Re-escalating US-China trade tensions also featured over Q2. Within bond markets, developed government bond yields were, for the most part, range-bound and positive performance in fixed income markets was driven by a healthy tightening in credit spreads cross regions and quality spectrum. Emerging markets also benefitted in the spread-tightening environment.

Australian front-end government bond yields remained understandably anchored, closing the quarter at 0.25%. Australian 10 year government bond yields modestly increased by 11bps to end June at 0.87%. US Treasury yields were similarly range-bound, with 2 year yields stepping lower 10bps to close the quarter at 0.15% while 10 year yields were largely unchanged quarter-on-quarter, closing June at 0.66%. The spread between Australian and US 10 year government bond yields rose 21bps to close at +27bps.

The Australian credit index returned 1.58% over the quarter while the spread of the BoA-Merrill Lynch Australian Corporate Index over the government yield tightened by 29bps to 133bps.
Market review

Market Yields

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>3yr</th>
<th>10yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>0.25% (-)</td>
<td>0.25% (+1bp)</td>
<td>0.87% (-11bps)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>2yr</th>
<th>10yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>0-0.25% (-)</td>
<td>0.15% (-10bps)</td>
<td>0.66% (-1bp)</td>
</tr>
</tbody>
</table>

(x) = change on the quarter

Australia Index Returns

<table>
<thead>
<tr>
<th></th>
<th>2nd Quarter 2020 %</th>
<th>1st Quarter 2020 %</th>
<th>Duration (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bloomberg AusBond Composite 0+ Yr Index</td>
<td>0.53%</td>
<td>2.99%</td>
<td>5.73</td>
</tr>
<tr>
<td>Bloomberg AusBond Treasury (CGL)</td>
<td>-0.23%</td>
<td>4.08%</td>
<td>6.67</td>
</tr>
<tr>
<td>Bloomberg AusBond Semi Government</td>
<td>1.27%</td>
<td>2.49%</td>
<td>5.50</td>
</tr>
<tr>
<td>Bloomberg AusBond Credit</td>
<td>1.58%</td>
<td>0.75%</td>
<td>3.77</td>
</tr>
</tbody>
</table>

Sector Returns
2nd Quarter 2020

- Bloomberg AusBond Treasury (CGL)
- Bloomberg AusBond Semi Government
- Bloomberg AusBond Credit
- Bloomberg AusBond Composite 0+ Yr Index
Outlook and strategy

Concerns around a ‘second wave’ of infections have emerged just as the rate of COVID-19 mortality and infection rates appear to have flattened in most regions globally. This may see authorities wind back some of the relaxation in social distancing measures and dent developing optimism around a faster-than-expected economic recovery. Aggressive easing in monetary and fiscal policy continues to providing essential near-term support for economic activity and has underpinned a strong recovery in risk assets. Bond yields remain anchored at low levels reflecting near zero or negative policy rates, asset purchase programs and liquidity provisions. The key uncertainty is the sustainability of a recovery in consumption and evolution of the unemployment rate where job losses have been severe. US politics remain an area of uncertainty as the Presidential race draws near.

The Australian official cash rate is at the effective lower bound of 0.25% and the RBA is employing unconventional monetary policy tools, setting a target yield for 3 year government bonds at ‘around 0.25%’ and purchasing government and semi-government securities ‘across the yield curve’ as required. Significant fiscal measures provide income support and remain crucial to assisting the recovery process. Recent data points are showing the extent of the pandemic impact, with GDP growth registering a negative print of -0.3% over Q1 and expectations of a deeper contraction for the second quarter. Unemployment has risen to 7.1% but more telling has been the sharp decline in the participation rate, which is at the lowest level since January 2001. The RBA’s ‘baseline scenario’ for growth and employment conditions in Australia sees GDP falling by ‘around 10%’ at its worse and the unemployment rate peaking at 10%. Governor Lowe has offered some optimism, noting possibility for the depth of the downturn to be ‘less than earlier expected’. This comes as Australia continues to see a declining rate of spread that has allowed selective relaxation of lockdown measures, although ‘second wave’ concerns have arisen with newly reported infections in some parts of the market.

The US Fed has employed its full range of policy tools, with cash rates at the zero bound and a wide range of quantitative easing measures implemented. Open-ended purchases of Treasuries and agency mortgage-backed securities accompany selective purchases of corporate securities and targeted lending facilities. US economic data, for the moment at least, appears to have bottomed out as lockdown measures have been eased, and jobs growth has continued to surpass expectations. But there is still significant uncertainty about the pace of the US economic recovery, particularly in light of increased infections and renewed lockdowns in some states. Fiscal policy is providing strong support to households and businesses, and a new stimulus package is likely to pass Congress in the coming month. Investor focus is expected to shift towards November’s elections in the months to come. A resurfacing of US-China trade tensions adds to geopolitical risks.

Europe is on the path to normalization as COVID-19 restrictions are being eased. Fiscal support has been plentiful thus far, and an EU recovery fund of EUR 750 billion is being finalised. The ECB has increased its bond-purchase program, enabling it to continue buying bonds into the middle of 2021. At EUR 1.35 trillion, this should be large enough to absorb the surge in bond issuance that will accompany national fiscal plans. These measures should facilitate the recovery in the second half of 2020, even if the recovery is likely to take time as households and firms adapt to the post-COVID-19 world.

Economic activity in China has recovered from the trough in the first quarter of the year. Manufacturing indicators show an expansion driven by domestic demand. Investment growth has picked up and turned positive, while retail sales have also seen improvement. Announced fiscal stimulus package is now up to 7-8% of GDP, and the PBOC has cut the reserve requirement ratio (RRR) by 150bps to support economic recovery. These measures should facilitate the recovery in the second half of 2020, even if the recovery is likely to take time as households and firms adapt to the post-COVID-19 world.

Investment grade and high yield credit markets have rebounded strongly from the sharp volatility in March. US and European markets have led much of the retracement given the sizeable intervention in corporate bond markets by the Fed and ECB. The Australian credit market has managed to follow suit despite the absence of RBA support, with domestic credit spreads tightening over the last few months. Primary issuance activity has helped lift overall sentiment and confidence. Corporate solvency issues emerge at a time where leverage is elevated, particularly in the US, and top line revenue growth is weakened. The weak earnings outlook ahead and the risk of downgrades will be a challenge but the significant policy accommodation from central banks and governments should be supportive for credit markets over the medium term.