UBS Australian Bond Fund

July 2020

Fund description
The Fund is an actively managed, diversified portfolio of largely investment grade Australian fixed income assets.

Investment strategy
The strategy is managed employing both top-down research and bottom-up security specific analysis to build a portfolio exhibiting the core defensive characteristics of the Australian fixed interest asset class. We aim to hedge foreign currency exposures to the Australian dollar.

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

Key statistics
- Modified duration (yrs): Fund 6.52, Benchmark 5.75
- Spread duration (yrs): Fund 3.08, Benchmark 2.16
- Weighted avg maturity (yrs): Fund 7.70, Benchmark 6.55
- Average credit quality: Fund AA, Benchmark AA+
- Yield to maturity: Fund 1.07, Benchmark 0.76

1 Benchmark statistics do not reflect month end rebalancing for new issues and reinvestment of coupons.
2 Option adjusted spread duration ex Treasury.

Credit quality (%)
- AAA: 52.2
- AA: 20.0
- A: 6.4
- BBB: 15.0
- Below BBB: 0.5
- Cash and other: 6.0

Note: Credit ratings for physical holdings only, ‘cash and other’ includes the effect of derivatives.

Investment performance

<table>
<thead>
<tr>
<th>Fund</th>
<th>1 month</th>
<th>3 months</th>
<th>1 year</th>
<th>3 years</th>
<th>5 years</th>
<th>Since inception*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>% pa</td>
<td>% pa</td>
<td>% pa</td>
</tr>
<tr>
<td>Total return</td>
<td>0.55</td>
<td>1.78</td>
<td>3.17</td>
<td>5.38</td>
<td>4.49</td>
<td>7.87</td>
</tr>
<tr>
<td>Benchmark**</td>
<td>0.37</td>
<td>0.97</td>
<td>3.58</td>
<td>5.61</td>
<td>4.57</td>
<td>7.86</td>
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<tr>
<td>Added Value</td>
<td>0.18</td>
<td>0.81</td>
<td>(0.41)</td>
<td>(0.23)</td>
<td>(0.08)</td>
<td>0.01</td>
</tr>
</tbody>
</table>

*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 highlights
- Australian and global bond markets return positive performance over July
- Risk asset gain over the month, credit spreads tighten along with market optimism
- Fed extends emergency lending programs, EU agrees terms of the recovery fund
- RBA prepared to scale-up bond purchases and ‘will do whatever is necessary’ to keep bond markets functional

Performance review
After fees and expenses, the portfolio increased by 0.55% over the month outperforming its benchmark by 18bps. Risk assets marched higher in July buoyed by a combination of factors including continued fiscal and monetary easing by policy makers and optimism that a vaccine for COVID-19 could be made commercially available by year-end. In bond markets, both spread sensitive and rate sensitive assets performed well as most longer-dated government bond yields moved lower and credit spreads tightened. The Australian bond market returned positive performance with credit the main driver of total returns. Australian 3 year government bond yields remained anchored and 10 year government bond yields stepped lower over the month. We entered July with a long Australian duration position, held as an overweight position in the 10 year part of the curve. The position contributed positively to returns as Australian 10 year government bond yields traded lower over the month, closing at 0.82% by month-end. In the late part of July we took the opportunity to add a long duration exposure in the ultra-long end of the yield curve by participating in new issuance of 30 year Australian government bonds. These bonds rallied subsequent to their syndication, to the benefit of portfolio performance. Other exposures within the ultra-long-dated sector contributed positively to performance, as the yield curve flattened into the end-of-month benchmark extension.

Our credit positioning was a strong driver of positive excess returns over the month. Australian corporate credit spreads closed the month tighter again alongside other major offshore credit markets. Our selective overweight position to corporate credit was additive to excess returns, with a particular positive contribution from our positioning within financials and industrials. We continue to hold a bias for defensive exposures within corporate credit, with a preference for industries and issuers that have a non-cyclical profile. Our positions within Australian major bank covered bonds also added to relative performance over the month. We maintained an overweight allocation within semi-government bonds, continuing to prefer Western Australia and New South Wales over other state government exposures. This was broadly neutral for performance over the month. The portfolio remained underweight within sovereign, supranational and agency bonds which detracted from returns with government-related securities one of the better performing sectors over July.

Outlook
Concerns around a ‘second wave’ of infections have emerged just as the rate of COVID-19 mortality and infection rates appeared to have flattened in many regions globally. In response, authorities are winding back some of the relaxation in social distancing measures which may curb 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 continues to be the sustainability of a recovery in consumption and evolution of the unemployment rate where job losses have been severe. Geopolitics adds to the uncertain outlook with a potential re-escalation in US-China trade tensions and as the US Presidential race draws near.

In Australia, policy settings are at the effective lower bound. The RBA has reiterated its commitment to ensuring the normal functioning of bond markets through bond purchase programs and its yield target for 3 year government bonds at 0.25%. Front-end yields remain anchored while longer-dated bond yields trade alongside both fundamental and technical factors. Demand for the recent issuance of ultra-long dated Australian government bonds highlights investor appetite for yield in the current market environment. 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 7.4% with part-time roles replacing full-time positions. Headline inflation has moved to its lowest level since 1931, albeit driven by transitory factors. The ‘second wave’ of infections in Victoria and the reissue of lockdown measures in parts of the state, along with early signs of spread into states such as New South Wales and Queensland, is a set-back for early optimism around the recovery in the Australian economy and underscores the heightened uncertainty surrounding the medium-term outlook.

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. The latest GDP print is representative of the scale of the economic impact in the US, with growth shrinking 9.5% over Q2 – the steepest decline in quarterly records history dating back to 1947. In contrast, jobs growth has continued to surpass expectations. 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. The GDP print of 3.2% for Q2 is further evidence of the turnaround in conditions, accompanied by improving PMI indicators and industrial production data. Conditions are being support by a multi-faceted policy approach: announced fiscal stimulus package is now up to 7–8% of GDP, and the PBOC has cut the reserve requirement ratio (RRR) by 150–200bps year-to-date, with another 100–300bps of cuts expected by year-end.

Investment grade and high yield credit markets have rebounded strongly from the sharp volatility in late Q1. 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 offshore markets and in speculative grade credit. 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.