LIONTRUST
COURAGE · POWER · PRIDE

Global Fixed Income

June 2024

Quarterly strategy – Attractive yields reward patience in awaiting rate cuts

Phil Milburn
Co-Head Global Fixed Income Team

Donald Phillips
Co-Head Global Fixed Income Team

Executive Summary

Economic growth has been more robust than anticipated so far in 2024, mainly driven by the US. But the monetary cycle remains subject to elongated lags in its impact on the economy and we believe restrictive monetary policy will slow economic momentum, especially now that huge US fiscal stimulus is beginning to fade.

Current indicators of the US labour market show continued hiring, but at a slower pace as vacancies have reduced. Beneath the surface, forward looking indicators point towards softening. We expect unemployment to increase but to peak at a lower rate in than in many prior cycles.

Companies, having spent the last few years working hard to make hires, will be inclined to hoard labour. Our central case is that US unemployment will peak at levels similar to the early 2000s, somewhere in the 5% to 6% vicinity.

Inflation is coming down but services remains as the sticky last leg. "Supercore" services inflation – i.e. excluding housing – is most highly correlated to nominal wage inflation. This should ease due to the gradual loosening of labour market conditions, which themselves have been partly helped by net immigration.

One of the biggest risks to our funds' strategic long duration is a second term for President Trump. His threat to the independence of the Fed is more one of principle and reputation rather any meaningful ability to implement change. However, the fiscal situation is more concerning, with tax cuts likely to outweigh spending cuts at a time when the fiscal deficit is already unsustainable. Increased tariffs and lower immigration would also worry economists.

Nevertheless, we retain our duration positioning as we continue to believe developed market sovereign bond yields offer great long-term value with real yields looking attractive.

The exact timing of the first US and UK rate cuts, as well as further Eurozone cuts, does not matter as much as the fact that we are approaching the economic conditions that will allow for a more rapid return to neutral monetary policy. In the meantime, one is being paid an attractive yield as we await capital gains; patience is a rewarding virtue.

We have allocated our duration budget to short and medium-dated bonds (i.e. less than 15 years) as we expect the yield curve to steepen when rates are cut.

For corporate borrowers, fundamentals look healthy. Balance sheet leverage in both investment grade and high yield is at very comfortable levels. Interest coverage ratios are also strong but have been trending downwards due to higher interest rates increasing the debt financing burden. The problem is that credit valuations are priced for perfection. To be explicit, credit spreads are expensive but the yield on corporate bonds is still attractive due to high benchmark government bond yields.

Our strategy is therefore to be underweight credit risk, waiting for better valuations to increase exposure. Even though credit is expensive, we can still add value from stock selection. The spread dispersion across the US and European investment grade and high yield markets is elevated, creating alpha-generating opportunities.

Monetary policy drag outweighs fading fiscal impulse

Economic growth has been more robust than anticipated so far in 2024, mainly driven by the US. The US has seen upward revisions to growth forecasts over the last year, although more recent data releases point towards a slowing in momentum, as shown by the Citi economic surprises index. On this side of the Atlantic, the Eurozone and UK have gone from flirting with recession to a run rate of growth in real GDP a little above zero. Consensus forecasts for global real GDP growth in 2024 are around 2.6%, with developed markets at 1.5% and emerging markets 4.2%. The benign headline global growth figure masks a large divergence of fortunes within economies and building pressures from restrictive monetary policy. The US is a bifurcated economy between the wealthy and those struggling to make ends meet, as well as large companies with long term debt liabilities and smaller companies feeling the strain of higher rates.

This monetary cycle remains subject to elongated lags, as we discussed in our last quarterly strategy. For example, 88% of household debt is locked in at fixed rates compared to 75% during the last hiking cycle 20 years ago. Household interest burdens are slowly increasing as mortgages are refinanced and adjustable rate mortgages reach the end of their initial periods. Another transmission channel for monetary policy is through a rising cost of capital, which reduced capital expenditures. In the US, the boost from the misnamed Inflation Reduction Act, in particular the semiconductors (CHIPS) act, has subsidised capital expenditures over the last year; the impact of this is now fading. At the broader fiscal level, we continue to expect the government sector to be a small drag on economic growth in 2024; hugely loose fiscal policy will remain but will just not be quite as loose as last year. Furthermore, the interest expense on debt is absorbing more of government budgets, approaching 3% of GDP in the US. Governments will have a choice to run with larger fiscal deficits or tighten the purse strings on the primary fiscal balance.

In the meantime, money supply is now back to trend levels, having absorbed the spike during Covid times. The US is still a little above trend, with the Eurozone below. We expect US money supply to keep contracting, driven by ongoing quantitative tightening (QT) – even at its tapered pace. The slower pace of QT does reduce the odds of a liquidity accident occurring; however, the efficacy of QT is set to increase. The shrinkage of the Fed's reverse repo facility (RRP) from a 2023 peak around $2,300 billion to below $400 billion today has effectively injected liquidity into the financial system; as there is a much lower RRP balance now outstanding, QT will feed more directly into liquidity withdrawal. Overall, we believe that the drag from restrictive monetary policy outweighs the (fading) fiscal impulse.

Consumption: real spending growth slowing

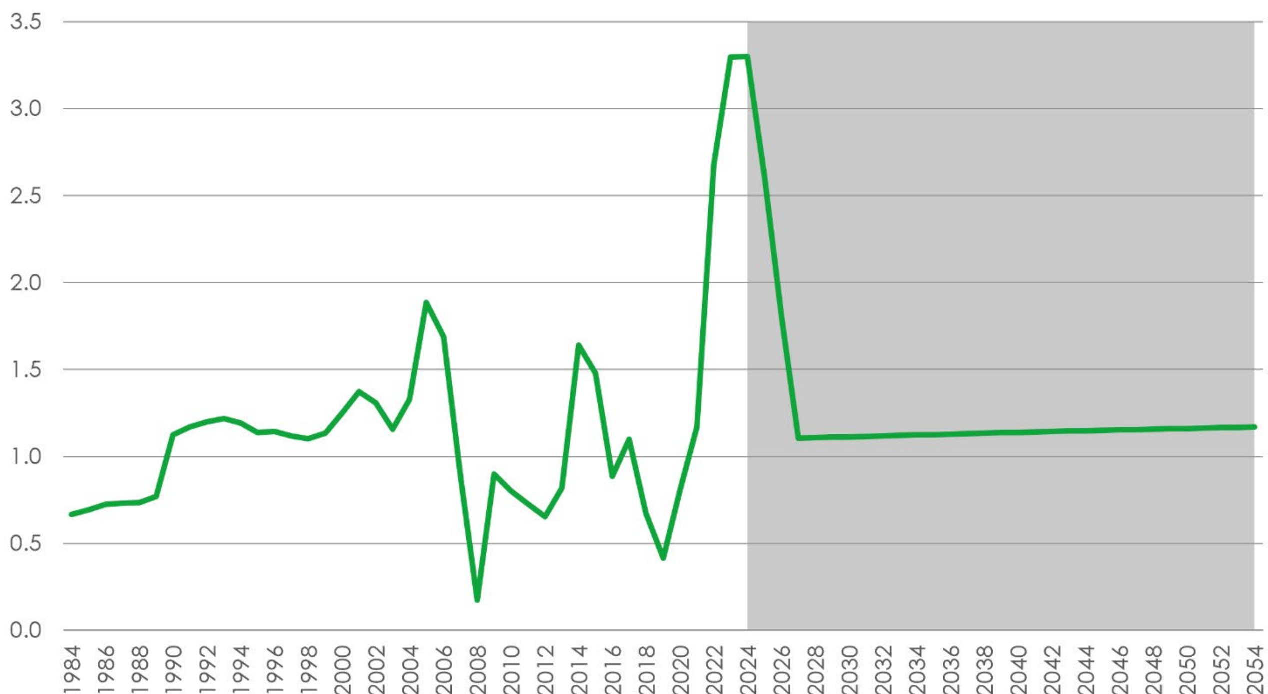
The majority of consumers are doing OK, with real wages growing again after catching up following the inflation hump. However, a growing number of people in lower socioeconomic groupings are struggling. For example, there has been a rise in delinquencies in credit cards and auto loans. There has also recently been an alarming rise in Freddie Mac serious delinquency rates for multifamily residences. In the US, fixed rate mortgages have helped to ameliorate most of the rate rise impact (monetary policy transmission of higher rates has been more forceful in countries such as Sweden). There are, however, consequences in the US; many people are trapped in their mortgage with prevailing current mortgage rates almost 4% above the average rate on the outstanding stock of mortgages. One should therefore expect existing home sales activity to continue to be subdued.

The US savings rate is very low at 3.6% of disposable income; we view this to be a headwind for future consumption. We note that the mix of spending between goods and services has evolved post Covid, with a pattern for the consumer desiring more experiences. Overall, real spending growth is slowing but not collapsing; a sharp fall in consumption would probably only happen if unemployment rose rapidly.

Immigration: disinflationary force via labour market easing

One phenomenon that has been supporting consumption in the US is the surge in net immigration since the Covid period. High net immigration also adds to the excess demand of the housing market. However, the contribution to the easing of the labour market conditions is the dominant economic impact. Earlier this year, the Congressional Budget Office (CBO) released updated net migration estimates, shown below:

US net immigration (million)



Source: Congressional Budget Office. As at 31.03.24. Shaded area is projected.

The figures need to be treated with some caution as undocumented migration is estimated, however, even if the total figure is 0.5 million out, the surge is undeniable. CBO forecasts for future years shown in the shaded area are currently calculated on the basis of no change to US government policy after the next election. This net immigration has helped to address some of the labour market supply/demand imbalance in the US and fill some of the hole caused by excess retirees during the Covid period. Current levels of net immigration

combined with low organic working age population growth means the equilibrium run rate for payroll job creation is around 200K per month.

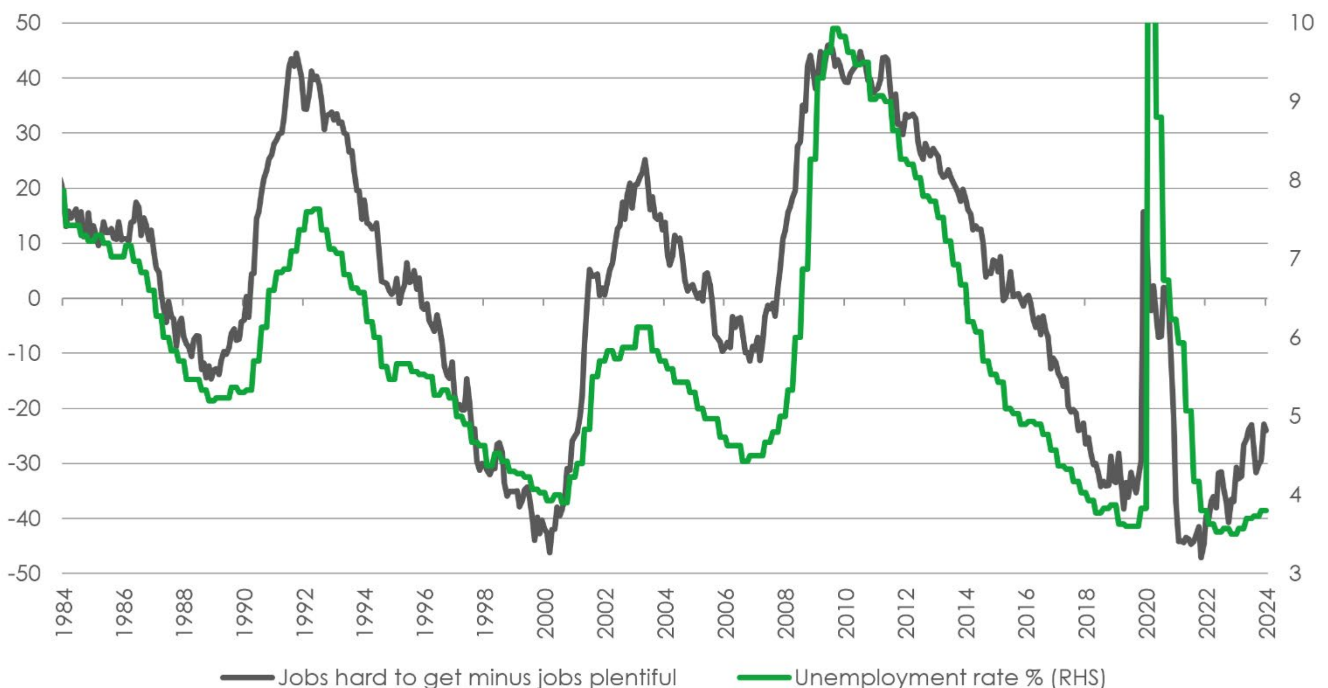
Labour market: current indicators strong but forward indicators point to weakening

Current indicators of the US labour market show continued hiring, but at a slower pace as vacancies have reduced. Beneath the surface, forward looking indicators point towards softening over the coming quarters. Layoff announcements have been increasing and there has been a pickup in WARN (Worker Adjustment and Retraining Notification) notices, but these are yet to feed through into claims data. On the hiring side of the equation, the NFIB (National Federation of Independent Business) hiring intentions has been trending downwards for the last two years to a net 15% of owners now in job creation mode from over 25%.

Job growth continues in the public sector with state and local government having added over half a million jobs in the last year and employment numbers above pre-Covid levels. At some stage saturation point will be reached. Similarly, private sector leisure and hospitality employment is back to its pre-Covid peak, with healthcare and social assistance employment up 1.5 million. Obviously, the latter is in structural growth mode with the growing and ageing population, but overall those two economic segments have represented 50% to 75% of monthly job creation over the last year, so any weakness will have a significant impact on headline figures.

Examining the "jobs plentiful" and "jobs hard to get" series; the grey line on the graph below plots the difference between these series with a lower reading indicative of a tighter labour market. The loosening in labour market conditions from the post lockdown tights is clear to see even though the monthly data is volatile. The unemployment rate, the green line on the chart, tends to follow the trend in the job availability data.

Job availability versus unemployment rate



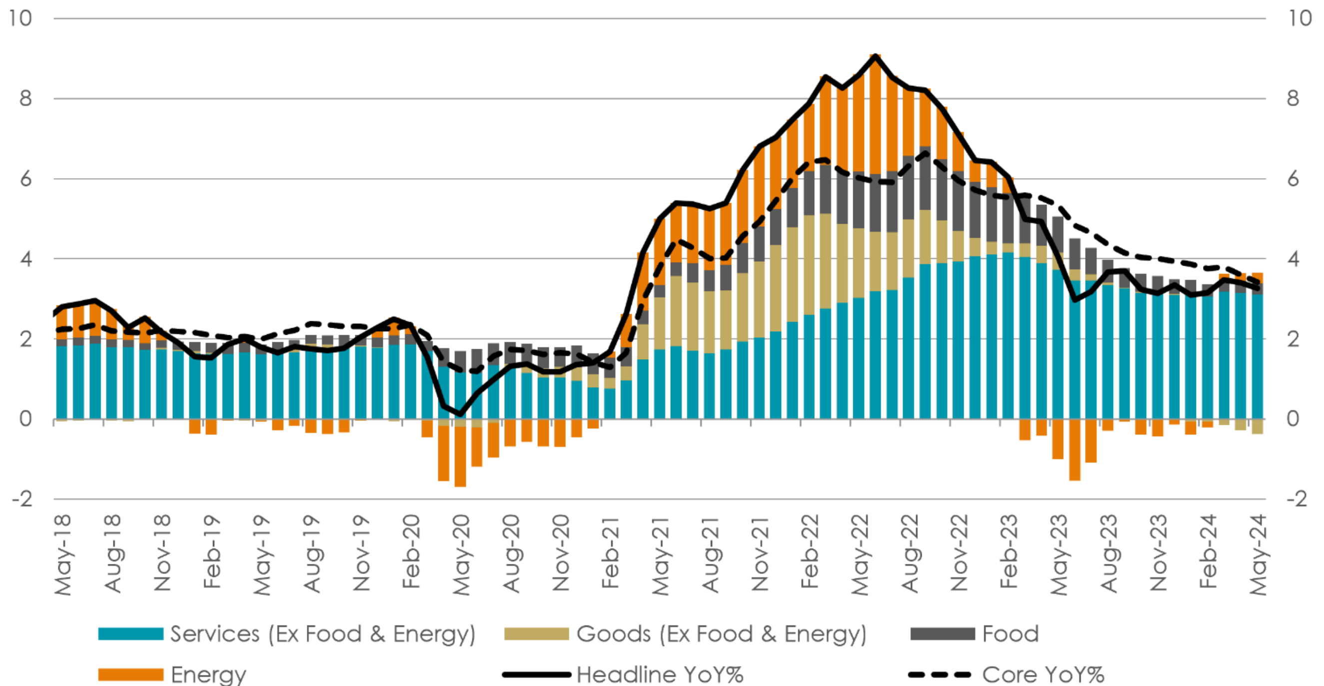
Source: Bloomberg, Liontrust 31.05.84 to 31.05.24

Once unemployment does start to increase significantly, we expect it to peak at a lower rate in this cycle than many prior ones. Companies, having spent the last few years working hard to make hires, will be inclined to hoard labour. Our central case is that US unemployment will peak at levels similar to the early 2000s, somewhere in the 5% to 6% vicinity.

Inflation: the sticky last leg

For understanding the path for inflation, we examine some of the detailed constituents as well as looking at the bigger picture. The chart below breaks down US consumer price inflation (CPI) into its main segments; the solid line is headline CPI and the dotted line is core CPI.

US Consumer Price Inflation



Source: BLS, Bloomberg, Liontrust 31.05.18 to 31.05.24

Core goods (gold bars) disinflation remains in place, but examining base effects and the current run rate of prices the annual rate will flip back to being positive in the second half of 2024. Supply chain stress is low but has increased at the margin, this is driven by low water levels in the Panama Canal as well as geopolitical issues in the Middle East.

Energy (orange bars) inflation remains volatile, while the hump in the food price (grey bars) inflation series has dissipated. This just leaves the sticky last leg of inflation as services inflation (blue bars).

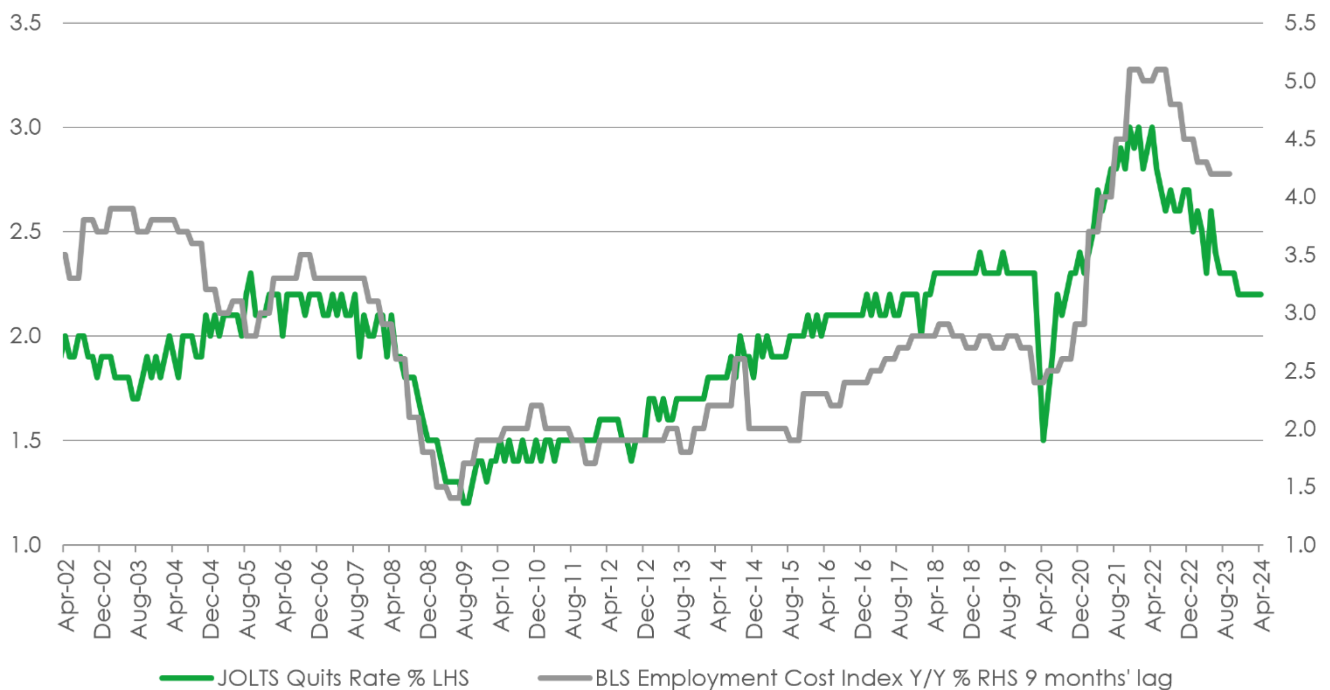
It is informative to split the services segment into shelter related inflation and other core services. The main constituents within shelter are rents and owners' equivalents rents (OER). These two data series were at a run rate of 0.7% - 0.8% inflation per month at the start of last year and have gradually faded to be nearer 0.4%. OERs naturally lag current realised rents due to the Bureau of Labor Statistics (BLS) methodology; their inflationary rate should start to fall further in the second half of 2024 due to both lags and the washing through of the mix effect between single and multi-family dwellings. It is worth noting that core inflation excluding shelter would already be at target.

The Federal Reserve would probably be comfortable looking through the shelter inflation if other basket constituents were being well behaved. The first quarter of 2024 saw some alarming data in "supercore" services inflation, which is the services inflation measure that excludes housing. The recent data has been more benign but there are a few idiosyncrasies that inject volatility into the figures. Firstly, portfolio management inflation has been high, but this is related to market levels as opposed to signs of pricing power in the US funds industry. Secondly, medical services continue to play catch up with prior employee wage inflation. Thirdly, airfares are volatile both seasonally and based on fuel costs. Finally, one of the largest drivers of supercore inflation over the last year has been auto insurance. There was a rogue low number with motor vehicle insurance down 0.1% in May compared to a run rate of 1.8% on average for the first four months of

2024, so we expect some payback here next month as there are still higher insurance premia to be passed through in various states. However, with the annual rate still at 20.3%, down from 22.4% in April's data, most of the increases have occurred and the worst of this will be behind us by the autumn. The inflation here is a lagged reaction to the rise in the cost of cars and servicing; insurance premia are being increased to bring combined operating ratios back below 100% as opposed to price gouging. This is likely to be a tax on consumption rather than symptomatic of demand strength.

Putting aside these idiosyncrasies, supercore inflation is most highly correlated to nominal wage inflation. The gradual loosening of labour market conditions, partly caused by high net immigration, is helping to ease wage pressures. The differential in wage rises between those staying in their existing jobs versus those that switch jobs is a good indicator of labour market strength, from a peak of 2.8% in summer 2022 the gap is now down to 0.7%. Another signal arises from the jobs quits rate (green line on the chart below); this is a good indicator of confidence in the labour market as most people only tend to quit their job if they have a better opportunity elsewhere. The quits rate is now at a level commensurate with the one prevailing before the Covid labour market distortions. The grey line shows the Employment Cost Index (ECI) lagged by nine months; the ECI has tended to follow the direction of quits which suggests that nominal wage inflation will keep slowing over the coming months.

Quits versus ECI



Source: Bloomberg, Liontrust 30.04.2002 to 30.04.2024, ECI shown with a 9-month lag

Trump: the fiscal risk

One of the biggest threats to our strategic long duration positioning is a second term for President Trump. A divided Congress presently looks likely regardless of who is in the White House. Trump has denigrated the Fed and would want to make changes in personnel; however, this is much harder than it first appears due to the current terms of governors. In 2026 Powell could lose his place as Chair of the Fed under Trump but his term as a governor does not expire until 2028; before then there is only one other expiry. The threat to the independence of the Fed is therefore more one of principle and reputation rather than Trump having the ability to implement meaningful change.

The fiscal side of the equation matters more: the tax cut impact is likely to outweigh spending cuts. The US fiscal deficit is already unsustainable, so the proverbial bond market vigilantes might raise their heads around US election time. Finally, increased tariffs and reduced immigration are other areas of concern for economists

should Trump win. We will be looking for valuation opportunities over the coming quarters to switch some US duration into Europe.

Rates: paid to be patient

Developed market sovereign bond yields offer great long-term value. The chart below shows the real yield on US 10-year Treasury bonds. This highlights that even after accounting for market expectations for inflation, one is earning an attractive yield. We retain a long duration strategy but prefer short and medium dated bonds to those with a maturity of over 15 years; in bond parlance we think the yield curve will steepen when rates are cut.

US 10-year real yields

Source: Bloomberg, Liontrust 12.06.14 to 12.06.24

The exact timing of the first US and UK rate cuts, as well as further Eurozone cuts, does not matter as much as the fact that we are approaching the economic conditions that will allow for a more rapid return to neutral monetary policy. In the meantime, one is being paid an attractive yield as we await capital gains; patience is a rewarding virtue. We think neutral policy will be in the 2% - 3% interest rate range in the US and UK. Rates are unlikely to go much lower as large macroeconomic forces such as deglobalisation, heightened inflationary fears and ageing populations prevent a return to ultra-low interest rates.

Compared to historical relationships, bond volatility remains elevated relative to equity volatility. The correlation between bond and equity returns is still positive, which is also unusual over longer time periods. For mean reversion in relative volatility and correlations to occur, we believe the markets will need to start focusing more on the growth outlook rather than the inflationary backdrop. An exogenous shock, that causes a risk off period in markets, would also help to re-establish historic bond and equity relationships.

Credit: spreads expensive, yields cheap

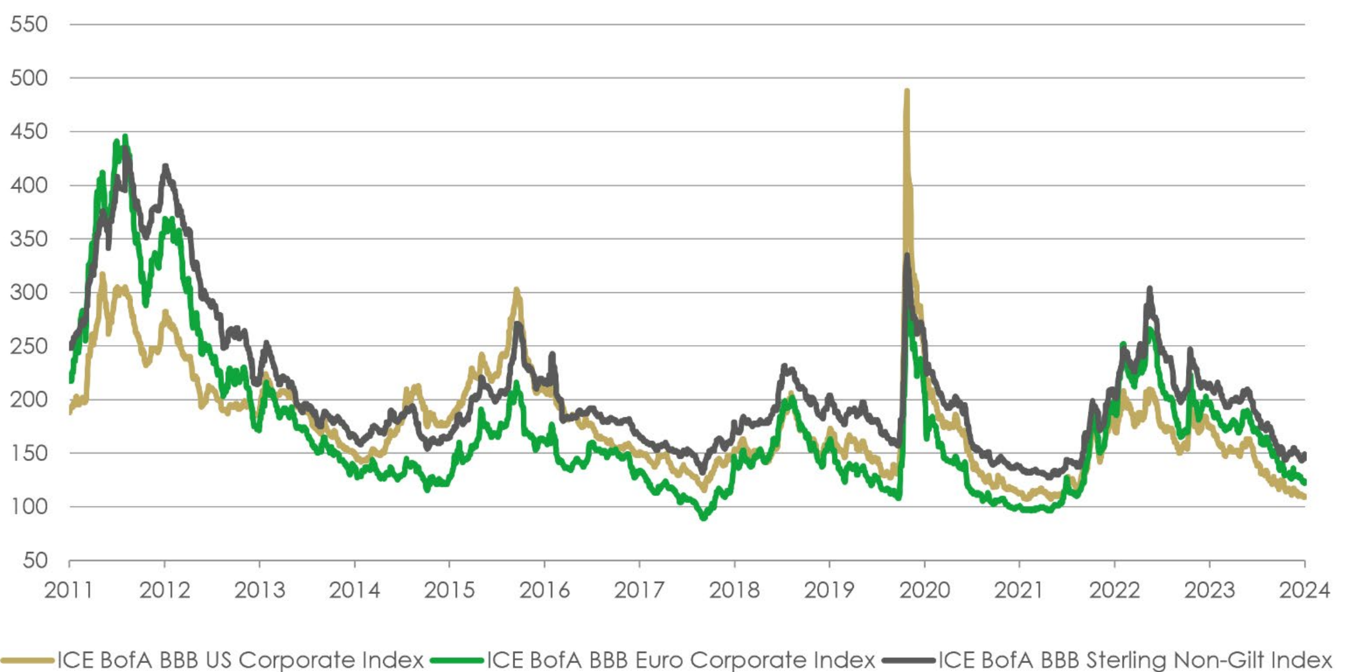
One should expect a slowdown in nominal sales and profit growth for companies due to the macroeconomic backdrop, particularly falling inflation; the impact on margins will depend on companies' pricing power. The current aggregate situation is fundamentally supportive for credit, with balance sheet leverage in both investment grade and high yield at very comfortable levels. Interest coverage ratios are also strong but have been trending downwards due to higher interest rates increasing the debt financing burden. Re-couponing of

debt is a gradual process for issuers of corporate bonds; companies that rely solely on bank financing have already felt the squeeze. To give context, if market conditions stay exactly as they are over the next 10 years, then average coupons in the US will increase about 2% from their nadir; investment grade from 3.5% to 5.5%, high yield from 6% to 8%.

Moody's forecast the global speculative grade default rate to fall from its current level of 5.2% to be just below 3.0% in a year's time. Other lead indicators for credit are also showing a benign fundamental backdrop with distressed ratios at low levels, below 10%.

The problem is that credit valuations are priced for perfection. To be explicit, credit spreads are expensive but the yield on corporate bonds is still attractive. The chart below shows the progression of credit spreads for BBB-rated corporate bonds, the lowest rating band of the investment grade category; except for euro corporates (which are nevertheless still expensive) valuations are close to their tightest levels of the post financial crisis period.

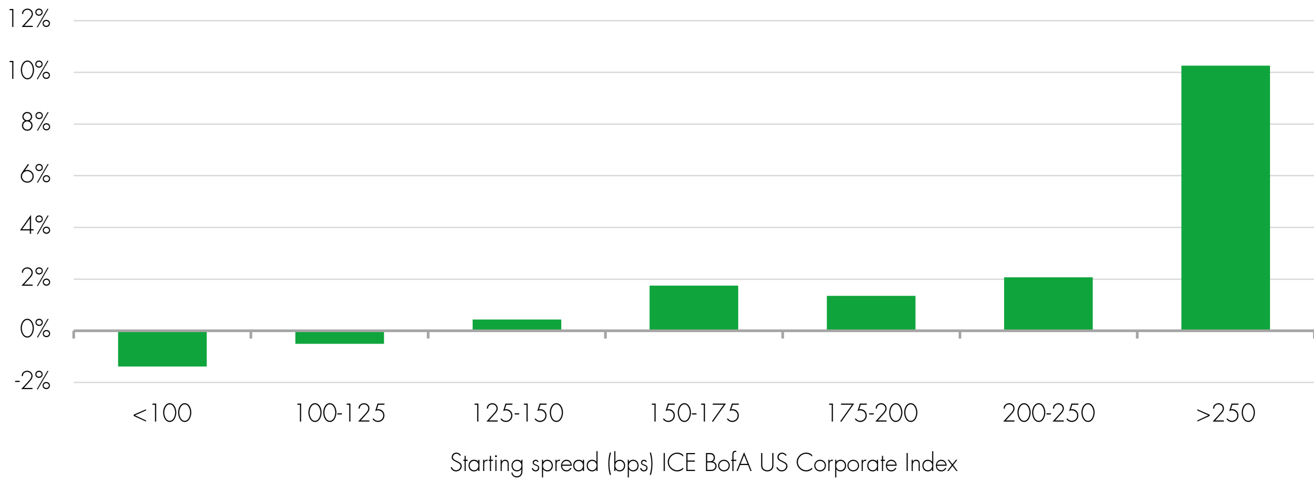
Investment Grade BBB Rated Index credit spreads (bps)



Source: ICE BofA indices 31.05.2011 to 31.05.2024

As we discussed in our last quarterly strategy, the best predictor of future returns in fixed income is current valuations. Within credit we look at excess returns – whether a corporate bond returns more or less than the same maturity government bond. When credit spreads are tight it does not take a lot of spread widening to erode the extra yield one had garnered from investing in the corporate bond. The bar chart below shows the average excess return over the next 12 months when the current credit spread is at various levels. When index credit spreads are tight, less than 100 basis points, or 100-125 basis points, the excess return has on average been negative. At higher index credit spreads, the future excess return gets progressively more positive – one is rewarded for buying credit during stressed times. The starting point at the time of writing is an index spread of 95 basis points.

Excess return: subsequent 12 months



Source: Liontrust, ICE BofA US Corporate Index (C0A0), monthly data 31.12.1996 to 31.12.2023, buckets calibrated to have at least 20 data points

Our strategy is to be underweight credit risk, waiting for better valuations to increase exposure. Within our strategic bond portfolios this is manifested by underweight allocations in investment grade and high yield as well as the credit quality bias that is pervasive throughout our fund range. Within our high yield strategy, we have been increasing the average credit quality of the issuers in the portfolio from an already strong starting point. Finally, in our absolute return portfolio, which focuses on short-dated credit, the underweight credit strategy is captured by reducing the small allocation to any longer dated credit, thereby reducing spread duration. For all strategies we want to maintain yield; proceeds from credit sales are being reinvested in both short-dated credit and US Treasuries that have imminent maturities.

Even though credit is expensive, we can still add value from stock selection. The spread dispersion across the US and European investment grade and high yield markets is elevated. This dispersion creates alpha-generating opportunities which will be driven by bond selection rather than a heavy overweight allocation towards a particular sector or ratings bucket.

LIONTRUST
COURAGE · POWER · PRIDE

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

The Funds managed by the Global Fixed Income Team:

- Consider environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Funds.
- May hold overseas investments that may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of a Fund.
- Hold Bonds. Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result; The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay.
- May encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.
- May, under certain circumstances, invest in derivatives, but it is not intended that their use will materially affect volatility. Derivatives are used to protect against currencies, credit and interest rate moves or for investment purposes. There is a risk that losses could be made on derivative positions or that the counterparties could fail to complete on transactions. The use of derivatives may create leverage or gearing resulting in potentially greater volatility or fluctuations in the net asset value of the Fund. A relatively small movement in the value of a derivative's underlying investment may have a larger impact, positive or negative, on the value of a fund than if the underlying investment was held instead. The use of derivative contracts may help us to control Fund volatility in both up and down markets by hedging against the general market.
- The use of derivative instruments that may result in higher cash levels. Cash may be deposited with several credit counterparties (e.g. international banks) or in short-dated bonds. A credit risk arises should one or more of these counterparties be unable to return the deposited cash.
- May invest in emerging markets which carries a higher risk than investment in more developed countries. This may result in higher volatility and larger drops in the value of the funds over the short term.
- May be exposed to Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.
- May target an absolute return. There is no guarantee that an absolute return will be generated over the time period stated in the fund objective or any other time period.

The risks detailed above are reflective of the full range of Funds managed by the Global Fixed Income Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

Disclaimer

This document is issued by Liontrust Fund Partners LLP (2 Savoy Court, London WC2R 0EZ), authorised and regulated in the UK by the Financial Conduct Authority (FRN 518165) to undertake regulated investment business.

It should not be construed as advice for investment in any product or security mentioned, an offer to buy or sell units/shares of Funds mentioned, or a solicitation to purchase securities in any company or investment product. Examples of stocks are provided for general information only to demonstrate our investment philosophy. The investment being promoted is for units in a fund, not directly in the underlying assets.

This information and analysis is believed to be accurate at the time of publication, but is subject to change without notice. Whilst care has been taken in compiling the content, no representation or warranty is given, whether express or implied, by Liontrust as to its accuracy or completeness, including for external sources (which may have been used) which have not been verified.

This is a marketing communication. Before making an investment, you should read the relevant Prospectus and the Key Investor Information Document (KIID) and/or PRIIP/KID, which provide full product details including investment charges and risks. These documents can be obtained, free of charge, from www.liontrust.co.uk or direct from Liontrust. If you are not a professional investor please consult a regulated financial adviser regarding the suitability of such an investment for you and your personal circumstances.