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Liontrust GF Absolute Return Bond Fund

Q2 2022 review

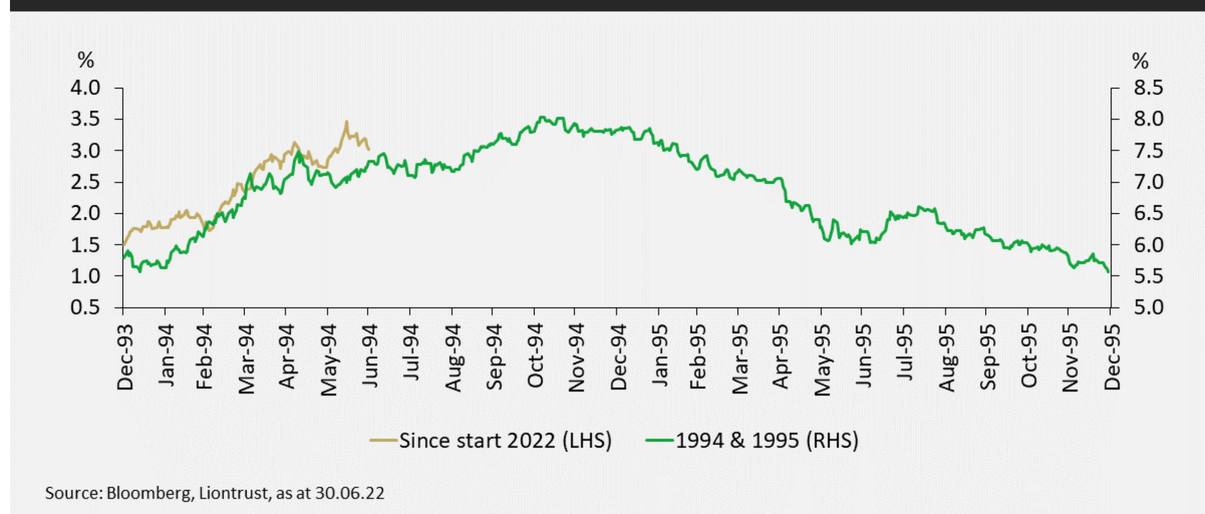
Fund managers: Phil Milburn and Donald Phillips

The Liontrust GF Absolute Return Bond Fund (C5 share class) returned -3.4% in sterling terms in Q2 2022 and the IA Targeted Absolute Return, the Fund's reference sector, returned -1.7%. The Fund's primary US dollar share class (B5) returned -3.2%.

There were two significant headwinds for the Fund during the quarter: higher short-dated government bond yields and much wider credit spreads, with the latter having almost three times the impact of the former. The yield carry on the Fund offset about a quarter of the impact of the two headwinds but still left the Fund down during the quarter. It is important to emphasise that this drawdown is driven by the embedded market risk, or "beta," within the Fund; the assets are now incredibly cheap and the Fund is well positioned to capture upside when corporate bond markets rebound from oversold levels.

The first half of 2022 has proven to be the worst for US Treasury returns since 1788. Bringing us more into the modern era I thought it instructive to compare the movement in yields now to that of the 1994 bond bear market:

US 10-year yield: 1994 versus today



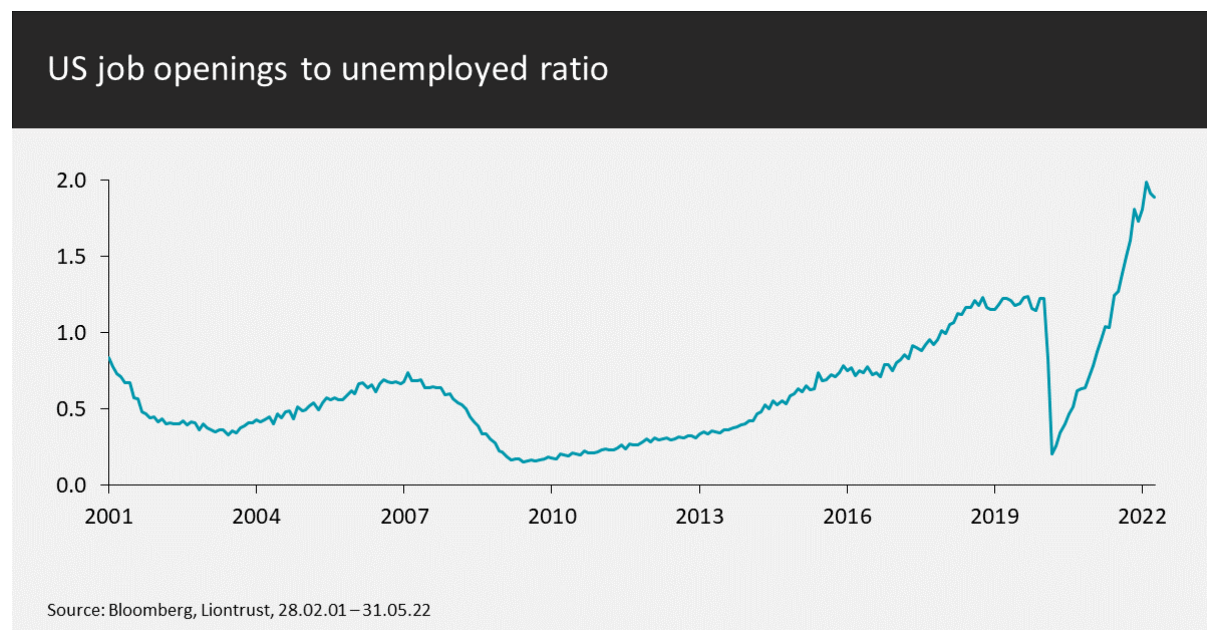
Source: Bloomberg, Liontrust, as at 30.06.22

The green line shows the progression of US 10-year yields in 1994 and 1995, plotted on the right-hand axis. The gold line, scaled to the left-hand axis, shows how yields have changed since the start of the year. The move is comparable in both scale and speed.

Where yields will head to now depends on the ongoing battle between sticky inflation and economies showing early warning signs of an impending slowdown. Bond markets spent the quarter oscillating between fears over continuing high inflation and a recession. There was plenty of evidence in June to support both of the worrying camps. May's US consumer price inflation (CPI) data, released in early June, saw a spike to a new cycle high of 8.6%. This proved to be the final catalyst for the Federal Reserve to raise rates by 75 basis points during the

following week. This is the first hike of this size since 1994. It is a close call whether the next hike in July will be 50bps or 75bps. If pushed, I'd say it will be the latter as the Fed tries to regain its hawkish credentials. It is worth remembering that the Fed has a dual mandate of price stability and maximum sustainable employment, but recent rhetoric has shifted such that regaining control over inflation takes precedence. A forecast rise in unemployment has been added to the Fed's economic projections, thereby creating a tacit admission that higher unemployment will almost certainly be needed to bring inflation back towards target.

Ultimately, it is not unemployment itself that the Fed wants to target, rather it is wage inflation. Our consistent view remains that wage inflation is the key factor that creates a self-perpetuating inflationary feedback loop; without wage inflation the rises in energy and agricultural prices lead to a wallet share substitution effect. Wage inflation is presently elevated for two reasons: firstly, because people want to offset the impact of the inflation they are seeing, and secondly because labour currently has strong bargaining power. A simplistic way of viewing this is to look at the number of job openings per person in unemployment, which was just below 2 (1.89) at the end of May.



The Fed can ease this labour market pressure through both the numerator (job openings) and denominator (unemployment level). The hit to business confidence that rate hikes and talk of recessions creates is likely to reduce hiring intentions. Furthermore, the rise in the cost of capital will make many prior expansionary plans uneconomic – this is one of the transmission mechanisms of monetary policy. On the supply side of labour, the creative destruction that capitalism cyclically creates will lead to some businesses sadly failing and their employees needing to search for alternative work. Additionally, labour force participation rates, outside of the over 55-year-old cohort, have been picking up again.

The quantum of unemployment required does depend on myriad factors, one of the largest determinants being how embedded the inflationary mindset has become in consumers. With developed market central banks having been way behind the curve, it is imperative that they now catch up. In my opinion, the faster rates go up now the lower the peak rate – or terminal rate in market parlance – will be. And the lower the terminal rate the less long-term damage that will be done to the real economy.

The bond market has already discounted a rapid hiking cycle; US rates are currently priced to finish 2022 around 3.25%. Prime 30-year mortgage rates have soared from 3.1% to 5.9% in the first half and this is already feeding through to lower housing market activity. More broadly, the US saw weak PMIs in June with the headline coming in at 51.2. Whilst the overall manufacturing and service numbers are still above the 50 level, the forward-looking measures (new orders in manufacturing and new business activity in services) exhibited larger falls.

Evidence of a slowing in economic activity has also appeared in Europe. June's Euro area composite PMI was 51.9 against a market consensus forecast of 54.0. Overall manufacturing was at 52.0, but manufacturing output

slipped to 49.3, which is into contractionary territory. Services were stronger (52.8) but have lost momentum with May's number having been at 56.1. This data catalysed a fall in 10-year Bund yields of over 20bps on the day, the largest daily yield decrease in over 10 years! It is a volatile time in the bond markets as the wrestling match between inflation and recessionary fears continues. This is unlikely to conclude until there are clear signs of a downward trajectory in inflation.

In July the ECB will finally start to increase interest rates. Quantitative easing will also be stopped; explicitly it is the new flow of purchases that will expire, the stock (i.e. the size of the ECB's balance sheet) will be maintained. Regarding the PEPP (pandemic emergency purchase programme) the ECB "…intends to reinvest the principal payments from maturing securities purchased under the programme until at least the end of 2024." To give an idea of scale, this should be about €200bn per annum; it is the PEPP that the ECB is presently using to help avoid what it refers to as fragmentation. This means fragmentation of monetary policy, or ineffective transmission of monetary policy across the entire currency bloc. The bond market was disappointed that there was no new anti-fragmentation scheme, and this manifested itself in underperformance of the peripherals relative to Germany. The ECB promptly announced that there would be a further anti-fragmentation tool created. It is still working on this; it must be "proportionate" under European law and will have to be sterilised or it will be at odds with stopping balance sheet expansion. If the combination of the PEPP and the new tool do help to cap peripherals' spreads, then that should empower the ECB to raise rates more rapidly to tackle inflation.

June was a brutal month for corporate bonds with global investment grade credit spreads 30 basis points wider and global high yield credit spreads over 150bps wider. Corporate bonds are now very good value when measured in yield terms and incredibly cheap if one looks at credit spreads. If credit valuations were a true reflection of the fundamental outlook, then all other risk assets are overvalued still. Of course, credit spreads should be significantly wider year-to-date, but they have overshot due to horrendous market technicals. Namely, outflows from the asset class meeting a broking community with no desire to expand their balance sheets. So, if a stock or sector gets in the cross hairs of the market then bonds can hit an air pocket. The opposite side of the equation is where there is a Street short or ongoing buying, such as >15-year maturity euro single-A credit, where insurers are actively allocating new capital as yields have reached their target for new purchases. It is a tough environment in credit, but in the long-term fundamentals do win out and there are bound to be a lot of bargains to be had over the next few months.

Carry Component

We split the Fund into the Carry Component and three Alpha Sources for clarity in reporting, but it is worth emphasising we manage the Fund's positioning and risk in its entirety. As a reminder, the Carry Component invests in investment grade bonds with <5 years to maturity. Within this there is a strong preference for investing in the more defensive sectors of the economy.

The Carry Component provides a low-risk yield backbone for the Fund; even though the beta to the broad market is low, it is still directional. Thus, with government bond yields rising at the same time as credit spreads significantly widening, the Fund could not avoid a drawdown.

Alpha Sources

Rates

During the first quarter of 2022 we reduced the Fund's exposure to Rates positions, preferring to allocate more to the Carry Component. In the second quarter the main change to Rates' positioning was to increase the duration of the Fund to neutral, 1.5 years, after valuations became attractive. This is the first time the Fund has been at its neutral level since launch, a reflection of the value that has returned to the short end of the US Treasury market. The 1.5 years of duration exposure is split 1.25 years in the US and 0.25 years in Europe.

Allocation

The weighting in the Carry Component was increased by a further 5% during the second quarter to finish June at 82%. On a cross-market basis, Europe has more compelling credit spreads, reflective of a closer proximity to Putin's war on Ukraine and the energy problems this creates, as well as weaker technicals. The Fund has a slight bias to euro-denominated credit within Carry at 42% versus 40% in US dollars; although the European CDS (credit default swap) investment grade index is significantly wider than its US counterpart, we have not entered a CDS position as we do not currently want to compound the allocation risk already taken in physical bonds.

Selection

Names added to Carry during the quarter included Universal Music, HSBC, Julius Baer, Anheuser Busch, Toyota and Haleon – the consumer products business being spun out of Glaxo.

None of the bonds in Selection were immune from the spread widening, which is why we limit the overall exposure to this alpha source. The weakest performer was Castellum, a Swedish property company, with all real estate companies' bonds coming under pressure. An aggressive short seller has attacked some other companies in the sector for stock-specific rather than industry-wide reasons, but Castellum has been caught in the downdraft that has enveloped the whole sector. We have spoken to the company and reviewed the position and we remain very comfortable with its fundamentals. We anticipate a rebound in its bond price along with the other affected real estate bonds in the Fund (CPI Property, Vonovia, Heimstaden Bostad, Aroundtown) as the technical overhang clears and fundamentals reassert themselves.

Discrete 12 month performance to last quarter end (%):**

	Jun-22	Jun-21	Jun-20	Jun-19
Liontrust GF Absolute Return Bond C5 Acc GBP	-5.6%	1.5%	2.1%	1.9%
IA Targeted Absolute Return	-0.7%	7.2%	-0.4%	0.4%

Past Performance does not predict future returns

Discrete data is not available for five full 12 month periods due to the launch date of the portfolio.

*Source: Financial Express, as at 30.06.22, total return (net of fees and interest reinvested), C5 class.

**Source Financial Express, as at 30.06.22, total return, C5 class. Discrete data is not available for ten full 12-month periods due to the launch date of the portfolio

Key Features of the Liontrust GF Absolute Return Bond Fund

Investment objective & policy[1]	The investment objective of the Fund is to generate positive absolute returns over a rolling 12 month period, irrespective of market conditions. There is no guarantee the investment objective will be achieved over this or any other time period. The Fund aims to achieve its investment objective through investment in corporate and government fixed income markets worldwide, including developed and emerging markets. In achieving its objective, the Fund also aims to minimise volatility and reduce the possibility of a significant drawdown (i.e. a period where the Fund is worth less than the initial investment at the start of a 12 month period). The Fund invests in a wide range of bonds issued by companies and governments, from investment grade through to high yield. The Fund invests in developed and emerging markets, with a maximum of 20% of its net assets invested in emerging markets. Investments are made in US Dollar denominated assets or non-US Dollar denominated assets that are predominately hedged back into US Dollar. Up to 10% of the Fund's currency exposure may not be hedged (i.e. the Fund may be exposed to the risks of investing in another currency for up to 10% of its assets). The Fund may invest both directly, and through the use of derivatives. The use of derivatives may generate market leverage (i.e. where the Fund takes market exposure in excess of the value of its assets). The Fund has both Hedged and Unhedged share classes available. The Hedged share classes use forward foreign exchange contracts to protect returns in the base currency of the Fund. The fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.
Recommended investment horizon	5 years or more
Risk profile (SRRI)[2]	2
Active/passive investment style	Active
Benchmark	The Fund is actively managed without reference to any benchmark meaning that the Investment Adviser has full discretion over the

	composition of the Fund's portfolio, subject to the stated investment objectives and policies.
Sustainability profile	The Fund is a financial product subject to Article 8 of the Sustainable Finance Disclosure Regulation (SFDR).

Notes: 1. As specified in the KIID of the fund; 2. SRRI = Synthetic Risk and Reward Indicator. Please refer to the KIID for further detail on how this is calculated.

Fund positioning data sources: UBS Delta, Liontrust.

† *Adjusted underlying duration is based on the correlation of the instruments as opposed to just the mathematical weighted average of cash flows. High yield companies' bonds exhibit less duration sensitivity as the credit risk has a bigger proportion of the total yield; the lower the credit quality the less rate-sensitive the bond. Additionally, some subordinated financials also have low duration correlations and the bonds trade on a cash price rather than spread.*

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

Key Risks:

Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested.

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.

Investment in the GF Absolute Return Bond Fund involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The value of fixed income securities will fall if the issuer is unable to repay its debt or has its credit rating reduced. Generally, the higher the perceived credit risk of the issuer, the higher the rate of interest. Bond markets may be subject to reduced liquidity. The Fund may invest in emerging markets/soft currencies and in financial derivative instruments, both of which may have the effect of increasing volatility. The Fund may invest in derivatives. The use of derivatives may create leverage or gearing. 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.

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