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Liontrust SF Corporate Bond Fund: Q4 2022 review

Fund managers: Stuart Steven, Aitken Ross, Kenny Watson and Jack Willis

The Fund returned 9.0%*† over the quarter, compared with the 7.2% return from the iBoxx Sterling Corporate All Maturities Index comparator benchmark and the average return from IA Sterling Corporate Bond sector, also a comparator benchmark, of 5.7%.

Market backdrop

Despite improved performance over the final quarter of the year, 2022 proved to be one of the worst years for asset returns in the last 20 years. Central banks struggled to control persistently high inflation, with significant interest rate increases dominating markets in 2022.

In the final quarter, investor optimism focused on the belief that peak inflation had been achieved, following weaker inflation data. This led to a reduction in expectations for where interest rates would finally peak. This saw all of the US Federal Reserve, Bank of England and European Central Bank deliver reduced rate increases of 50bps in December. However, the accompanying hawkish commentary from the US Federal Reserve and European Central Bank resulted in yields moving higher towards the end of the quarter.

The exception was the UK, where yields fell as the political landscape stabilised following the inevitable regime change amidst the turmoil following September's disastrous mini-budget announcement.

In October, Rishi Sunak was appointed as the new Prime Minister, with Jeremy Hunt the new Chancellor, who swiftly reversed almost all of the fiscal stimulus measures announced in the mini-budget, while also promising further fiscal tightening to come. This reassured market concerns about the scale of unfunded government spending plans, with equities and bonds staging large rallies in mid and late October, recovering much of the previous month's underperformance, as 10-year gilt yields fell sharply from a decade high of 4.5%. The pound also recovered against the US dollar.

This positive sentiment was somewhat tempered by the latest inflation print, which, despite falling from 11.1% in October to 10.7% in November, remains more persistent than in the US and Europe. This saw the Bank of England maintain a more hawkish approach despite the drop in headline inflation.

The Bank of England now expects UK GDP to decline by 0.1% in 2022 Q4, 0.2% better than expected in the November Report. Inflation, however, is expected to fall sharply from mid-2023 to below the 2% target in years two and three of the projection.

On a similar trend, labour demand has begun to ease, with the unemployment rate rising slightly to 3.7%, however it still remains tight. Despite a somewhat resilient labour market, we have seen a clear deterioration in the real economy, with household consumption weak and most housing market indicators continuing to soften.

Q4 finally showed some encouraging signs that inflation might have peaked in the US which saw relief rallies in bonds, as Federal Reserve Chair Jerome Powell hinted that future interest rate hikes would be dialled down. Headline inflation fell to just over 7%, having peaked above 9% in June, following consecutive downside surprises, leading markets to start pricing in interest rate cuts as soon as late 2023.

Whilst there has been some softening in the economic data the labour market continues to be resilient with unemployment remaining at 3.6%. This Fed remains focussed on this and is watching for signs that the labour market is easing.

Similarly to the US, inflationary pressures have also started to alleviate in Europe, with euro area inflation falling from a peak of 10.6% to 10.1% in November. This was despite heavy reliance on Russian gas, as a milder than expected winter saw falling gas prices help to alleviate inflation pressures.

This was positive for risk assets, as investors grew more hopeful that we are approaching the end of monetary tightening. The ECB now expects average inflation of 8.4% in 2022, 6.3% in 2023, 3.4% in 2024 and 2.3% in 2025. It sees recession in the region being relatively short lived and shallow.

Fund review

The Fund's strong relative performance was primarily driven by its long duration position, which delivered notable outperformance as UK gilts rallied strongly from recent lows.

This was further bolstered by outperformance from the Fund's overweight credit position, as corporate bonds also rallied strongly amidst a risk-on tone as investors grew increasingly optimistic that we are approaching the end of the monetary policy tightening cycle.

This was driven by a combination of strong sector allocation and stock selection across our core sectors, with Financials being the biggest outperformers, as our allocations to the Banks and Insurance sectors benefited from a strong recovery on improved macro-economic sentiment, particularly given our overweight allocation to higher beta subordinated bonds.

Meanwhile our overweight to the Telecommunications sector also delivered strong positive contribution over the period, particularly our higher beta and longer spread duration holdings.

This outweighed the drag on performance from our exposure to the Real Estate sector as the combination of high inflation, tightening financial conditions, rising yields and the growing threat of recession have weighed on the property market, particularly amongst higher beta names, such as Aroundtown and Canary Wharf. There was also negative contribution from our more defensive allocation to Gilts.

Rates positioning was proactive as we continued to actively manage the Fund's duration over the quarter.

After the move to neutral duration in late September as the disastrous Autumn mini-budget drove yields higher, we decided to take the Fund 1 year long duration relative to its benchmark, with 10-year gilts offering attractive value after yields hit a decade high 4.5%. The high all-in levels of yields, easing inflationary pressures, fiscal tightening, and the Bank of England's reluctance to excessively raise monetary policy amidst the weak economic backdrop provides conviction to our overweight position

As yields rose again over December, we increased the size of the long duration position to 1.25 years relative to the benchmark.

After a muted Q3, fund activity picked up over the quarter. Issuance recovered as yields fell from their highs, with poor sentiment and technicals over the quarter providing us with ample opportunity to secure high quality bonds at discounted valuations.

Financials, banks in particular, was the sector where we were most active. We rotated out of low coupon paper from NatWest, BNP and Santander, in order to participate in high coupon, longer dated new issues from Barclays, NatWest, as well as Credit Agricole. This recently issued, higher coupon paper is expected to be more defensive in a weak market, given it has lower extension risk given the higher spread resets and came to market at wider spreads to existing bonds.

We also re-entered and built a position in BPCE over the quarter, having not held it since 2017. BPCE is a mutually owned, retail-focused bank that has improved its sustainability credentials since last held. This was evidenced by their progress against demanding targets.

Against these new additions, we exited our remaining position in Haleon, having already reduced it during Q3. Despite litigation fears on the drug Zantac, positive developments led to a recovery in the bond's spread valuations to levels broadly in-line with before the controversy. This removed further potential upside in our

opinion, whilst the negative overhang of the lawsuits remains. Therefore, we decided to divest the rest of our position.

Regarding relative value trades, we switched out of sterling denominated Aroundtown bonds into similar maturity Euro denominated ones. Underperformance in the European real estate market caused a high spread differential between the two, despite the same pool of assets being linked to both bonds and the similar maturity.

Outlook

As we enter 2023, the market is approaching a potentially important transition period that could see the 2022 headwinds ease in the months ahead.

Inflation has shown definitive signs of peaking, and while still too high in an absolute sense, it could prove a positive surprise if price pressures ease faster than expected.

On a monetary policy level, the hiking campaign is likely near complete. In December, the Fed signalled that it expected the peak interest rate to be 75bps higher than current rate, which could easily be reached in the first few months of 2023.

Economic growth and corporate earnings are indeed expected to decline in 2023, but these expectations now seem to have been fully priced into equities and bonds at current levels. We believe the focus of the market should turn to single name issuers and fundamentals and move away from monetary policy tracking.

Declines of the magnitude we saw in 2022 are usually followed by strong recoveries. Bonds, as represented by the Bloomberg US Aggregate bond Index, have never experienced two consecutive years of negative returns. Therefore, we think market declines seen in 2022 have ultimately yielded substantial long term opportunities in the fixed income markets. Slower growth should be constructive for fixed income securities, which, coupled with current attractive valuations and well positioned corporate balance sheets, presents an opportunity for the sector and offers investors attractive compensation.

Discrete years' performance*, to previous quarter-end: Past performance does not predict future returns

	Dec-22	Dec-21	Dec-20	Dec-19	Dec-18
Liontrust Sustainable Future Corporate Bond 2 Inc	-19.1%	-2.0%	7.0%	11.8%	-3.6%
iBoxx Sterling Corporate All Maturities	-18.4%	-3.2%	8.6%	11.0%	-2.2%
IA Sterling Corporate Bond	-16.1%	-1.9%	7.8%	9.5%	-2.2%

*Source: FE Analytics, as at 31.12.22, primary share class, total return, net of fees and interest reinvested.

Key Risks and Disclaimer

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