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Liontrust GF Strategic Bond Fund

April 2023 review

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The Liontrust GF Strategic Bond Fund returned 0.5%* in US dollar terms in April. The average return from the EAA Fund Global Flexible Bond (Morningstar) sector, the Fund's reference sector, was 0.6%.

Just after month end, as was widely anticipated, the Fed hiked rates by 25bps to take Fed funds rates to the 5.0-5.25% range; the decision was unanimous. Going through the accompanying statement and press conference I would describe its approach as a conditional pause. The new sentence in the statement “...in determining **the extent to which additional policy firming may be appropriate** to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments” retains a small tightening bias but gives considerably more wiggle room than the prior statements “...anticipates that **some additional policy firming may be appropriate** in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time.” Stressing the data dependence, it says “...the Committee will **closely monitor** incoming information and assess the implications for monetary policy.”

Translating central bankers' language into more plain English, I would expect rates to stay on hold (hence the conditional pause description) unless there is significant strengthening in economic data between now and the 14th June meeting. With the economy slowly losing momentum, I think there is a very high hurdle for data to beat in order for the Fed to hike again. There was no mention of rates staying at restrictive levels for a sustained period, but I envisage this will materialise in the next statement or two along with a neutral outlook for rates. It is worth noting that quantitative tightening (QT) continues, acting as a further monetary policy tightening mechanism.

The ECB hiked rates by 25bps to 3.25% (deposit rate), also in line with market expectations. In my opinion, the hawks on the ECB's Governing Council who wanted a 50bps hike were placated by other measures – most noticeably the acceleration of quantitative tightening. The consensus was probably persuaded into opting for 25bps by the weak Eurozone BLS (bank lending survey) from earlier in the week. The ECB statement starts unambiguously “...the inflation outlook continues to be too high for too long.” On the slightly more dovish front the ECB states that “...past rate increases are being transmitted **forcefully** to euro area financing and monetary conditions, while the lags and strength of transmission to the real economy remain uncertain.” The emphasis on forcefully is obviously mine; in the press conference Lagarde was clear that the transmission of monetary policy into the banking system has been seen, but the ECB is not seeing the manifestation in activity levels in the real economy (those pesky long and variable monetary lags up to no good again). On the QT front, “...the Governing Council expects to discontinue the reinvestments under the APP as of July 2023”. This effectively will change the monthly QT run-rate from €15bn to €25bn – it would still take 15 years to completely wind down the APP (Asset Purchase Programme).

Addressing future monetary tightening, the statement emphasises the reliance on economic data. The ECB “...will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.” However, there is a slight contradiction to this in the guidance that “...future decisions will ensure that the policy rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to the

2% medium-term target and will be kept at those levels for as long as necessary." Lagarde elaborated on this in the press conference, emphasising that the ECB is *"not pausing [it is] very clear we have more ground to cover."* Furthermore, she put a real stress on the S at the end of *"future decisions,"* indicating strongly that the central case is for two more rate rises followed by holding rates at those restrictive levels for a sustained period. The market in early May is pricing for 45bps more so there is a very high probability of 50bps. There is now a strong central case that the ECB will raise rates by two more 25bps increments to reach a terminal rate of 3.75%. Similarly to the Fed, it would take a big shift in economic data to deter it from this path.

One resolutely dovish central bank remains: the Bank of Japan, which held interest rates at -0.10% and continued with its policy of yield curve control (YCC), both as expected. On the hawkish side of the equation, a sentence about the Bank of Japan expecting policy rates *"...to remain at their present or lower levels"* no longer appeared in its statement. However, the balance of developments was dovish in nature.

Firstly, the Bank's CPI (consumer price inflation) forecast for 2025 is only 1.6%, about 0.3% below consensus. Secondly, a monetary policy review has been announced; while this was anticipated, the elongated timetable was not: *"...the Bank has decided to conduct a broad-perspective review of monetary policy, with a planned time frame of around one to one and a half years."* In the press conference afterwards, Governor Ueda stated *"...we're not starting the review with the aim of normalising"* but left himself wiggle room to be able to end the YCC policy if he thinks conditions permit, saying *"...it's not zero chance we begin normalising during the review period."*

With Tokyo CPI coming in at 3.5% (consensus 3.3%, prior 3.3%) and the latest spring wage round looking like it will lead to a 3.8% increase, I would argue that Japan has created economic conditions where inflation can sustainably meet the 2% target. However, Ueda's opinion matters far more than mine and it looks like he will take his time before changing the YCC approach. We therefore decided to close out our short duration position in Japanese bond futures, with the potential to re-enter the trade if Ueda's opinion evolves. The position is offside in absolute terms but up in relative terms as Japanese government bonds have lagged other developed markets in the rally and the short enabled us to stay longer duration in core markets.

The Bank of England did not have a monetary policy meeting during April – the next rates decision is due on 11th May. There were, however, various data releases that point towards a high likelihood of another 25bps rate hike at the next meeting. Firstly, on the employment front, jobs growth was strong at 169K, although the mix of this was biased to self-employed and part-time work. However, the bad news for the Bank of England's Monetary Policy Committee (MPC) was that weekly earnings ex-bonuses (measured as 3 months year-on-year) were up 6.6% (consensus 6.2%, prior 6.6%). Revisions to the historic data for December and January, combined with bumper February uplifts, have helped to shift the path for pay back to levels the MPC will not be comfortable with.

If the majority of the MPC was left in any doubt post the labour market data, then the inflation data should assuage them. UK consumer price inflation (CPI) rose 10.1% on a year-on-year basis in March (consensus 9.8%, prior 10.4%). Transport, due to falling fuel prices, provided the largest downward impact on annual inflation. On the flipside, food price inflation (19.1%) continues to leap upwards at a rate that is well beyond that implied by global agricultural commodity prices. As the ONS points out, *"...the annual rate for this category in March 2023 is the highest seen for over 45 years"* its calculations are that the food price inflation rate in August 1977 was 21.9%. Core CPI remained at 6.2% (consensus 6.0%, prior 6.2%). Services CPI was at 6.6%; it is the services sector inflationary figures that have the highest correlation to wage inflation, although the exact match to the weekly earnings ex-bonus figure is only a coincidence. Given the extent of real wage cuts people are seeing, it is no surprise that industrial action has been on the rise with 3 million workdays now lost to recent disputes. The pressure on living standards is accentuated by the fact that the highest inflationary rates have been seen in necessities: energy (which is within household services) and food.

Some of the UK's inflation problem is due to global supply issues, but we have homemade factors that have made it worse. The Bank of England cut rates too far and printed too much money (through quantitative easing) during lockdowns, using mainly demand based measures to tackle a supply problem. They were then far too cautious raising rates; if it had acted sooner or faster then the peak would not have needed to be as high. Furthermore, food price inflation is hitting the UK harder than our neighbours due to post Brexit trade restrictions. It has been easier for other countries to source alternative supplies during the recent fruit and vegetable shortages. This is just one example of how erecting trade barriers leads to higher prices.

There is, however, some good news in that the UK's inflation outlook should start to improve from here; partly due to base effects from a year ago and partly because the current rate is so high! Energy prices are soon going to be up against higher comparable figures from 2022. If wholesale gas prices stay where they are then energy bills should start falling. By the July Ofgem review the average household bill cap should be falling to about £2,000. This would take year-on-year energy inflation to zero, assuming lower wholesale prices continue to be passed through then by October 2023 energy's contribution should be markedly disinflationary. Given the overshoot in UK food price inflation, we should soon start to see a reversal there too. This will be accelerated as fruit and vegetable shortages ease; I hope the UK supermarkets pass on the price falls as rapidly as the rises went through.

So, there are some strong disinflationary tailwinds building for headline inflation. Core inflation will remain stickier and the combination of this CPI data with the wages data will force the MPC to hike rates again. Markets have priced in a 25-basis point increase at both the May and June MPC meetings. It would be a major shock if the MPC does not raise rates again in May, but there is enough time for the inflationary data to be refreshed before the June meeting. In my opinion, the Bank of England has already overshoot with monetary policy tight enough to cause a significant slowdown later this year. I am not alone in this thinking as the MPC's most dovish member Tenreyro during April compared her hawkish colleagues to a "*fool in the shower*," who scalds himself by being too impatient to wait for the water to reach the right temperature, saying interest rates are already too high for the economy to bear. The problem is that the Bank of England needs to regain inflation fighting credibility; if it had acted sooner they could be pausing or cutting now.

The monetary policy tightening overshoot was necessary to fight the inflationary impulse that the Bank of England helped to create. Exactly where base rates peak is of less concern to me than the anticipated deterioration in economic activity that the cumulative monetary tightening will cause. Unemployment will start to rise more meaningfully later this year and the MPC will probably be slow to cut rates as it will still have one eye on the inflationary battle. Having disliked the gilt market for years until Truss/Kwarteng created a valuation opportunity, the Fund now has 1.75 years of duration exposure.

Rates

The Fund started the month with 5.25 years of core duration exposure. Having added to European duration early in April, the Fund then maintained 5.5 years' exposure throughout the rest of the month. As mentioned in the commentary above, the short position in Japan was closed out. Duration by geography is split between 2.0 years in the US, 1.75 years in the UK, European duration of 1.25 years and 0.5 years in New Zealand.

The Fund retains a yield curve steepening position. Net duration exposure in the 15+ year maturity bucket is zero. As base rates plateau and then, eventually, begin their descent, we should see a significant steepening in yield curves in which short-dated bond yields rally more than very long maturities.

Allocation

Investment grade exposure is a little under 50% and net high yield exposure is 20%. The stock specific additions to high yield described below were offset by increasing the size of the credit default swap index overlay (iTraxx Xover). There is good long-term value in credit, but there is recessionary risk and the upcoming US debt ceiling

impasse to overcome; there will inevitably be further volatility in credit markets. If credit spreads widen enough to make valuation levels become very compelling again, then we will increase allocations significantly.

Selection

A natural market implication of increased yields is a gradual re-coupling of debt as issuers refinance their liabilities. As old low-coupon debt gradually matures over the coming years, companies will have to pay a much higher coupon, commensurate with today's market yield levels, to attract capital. The downside to this is a deterioration in interest coverage ratios and free cash flow for the companies. This is another reason why we avoid those issuers with the most fragile balance sheets. The upside is that bond investors receive a significant boost to the running yield from the higher coupons and that lifts future expected returns from the asset class.

There were two good examples of existing issuers paying up to access the bond markets in April, both issuing senior secured debt. Firstly, Loxam issued 5-year Euro denominated debt with a 6.375% coupon. We really like this equipment rental business as they have great local economies of scale and can flex the size of its fleet during downturns to manage cashflow. Secondly, Cheplapharm, a specialist pharmaceutical company, issued 7-year Euro denominated debt with a 7.5% coupon. Both represent great opportunities to lend to quality companies at a senior secured level with attractive yields.

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

Past Performance does not predict future returns

	Mar-23	Mar-22	Mar-21	Mar-20
Liontrust GF Strategic Bond B5 Acc	-3.89	-3.96	13.15	-0.40
EAA Fund Global Flexible Bond - USD Hedged	-3.09	-2.98	13.23	-1.88

*Source Financial Express, as at 31.03.23, total return, B5 share class.

**Source Financial Express, as at 31.03.23, total return, B5 share class. Discrete data is not available for ten full 12-month periods due to the launch date of the portfolio (13.04.18).

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.

Key Features of the Liontrust GF Strategic Bond Fund

Investment objective & policy ¹	The investment objective of the Fund is to maximise total returns over the long term through a combination of income and capital. The Fund will seek to achieve its objective by investing in bond and credit markets worldwide. The Fund invests in a wide range of bonds issued by corporates and governments, from investment grade through to high yield. The Fund invests in developed and emerging markets, with a maximum of 40% of its net assets invested in emerging markets. Investments may be made in "hard" currencies, such as US Dollar, Euro and Sterling, and up to 25% of the net assets of the Fund may be invested in soft currencies, such as those of emerging markets. Where the Fund invests in non-US Dollar assets, the currency exposure of these investments will generally be hedged back to 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). In addition, the Fund may invest in cash or cash equivalents, such as deposits and Money Market Instruments, for cash management purposes. Within the limits stated above, there are no geographical or economic sector restrictions on the Fund's investments. 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 (SRRRI) ²	4
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. SRRRI = Synthetic Risk and Reward Indicator. Please refer to the KIID for further detail on how this is calculated.

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 Strategic 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 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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