



Global Fixed Income

September 2023 review

Liontrust GF Strategic Bond Fund



Phil Milburn

Co-Head Global Fixed Income Team



Donald Phillips

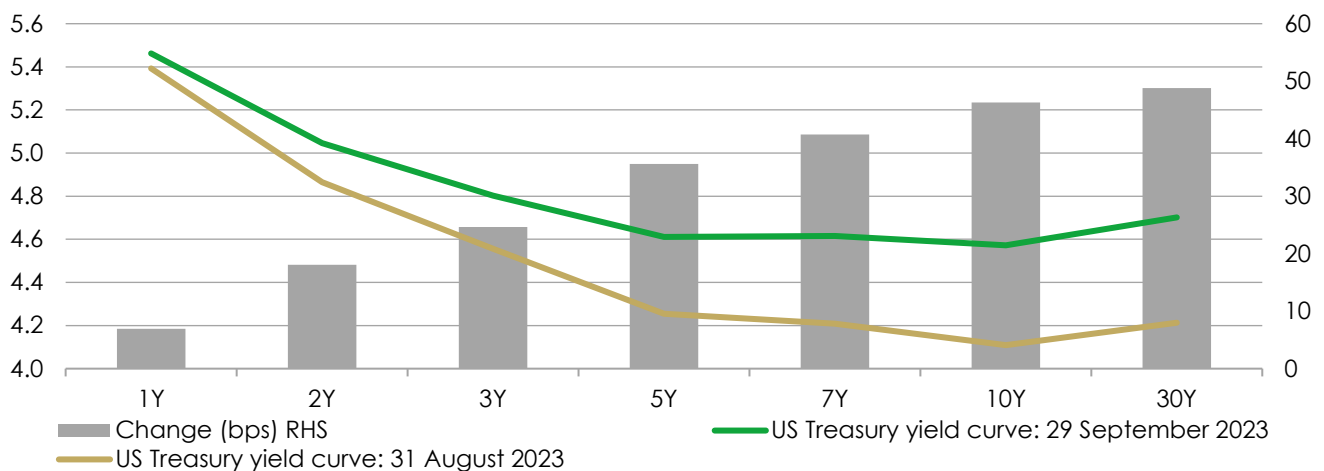
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The Liontrust GF Strategic Bond Fund returned **-1.7%*** in US dollar terms in September. The average return from the EAA Fund Global Flexible Bond (Morningstar) sector, the Fund's reference sector, was **-1.0%**.

Market backdrop

September witnessed a large 'bear steepening' in developed economy sovereign bond markets. The bear part of this jargon refers to the fact that yields rose, the steepening means that longer-dated bonds saw their yields rise by more than those with shorter maturity tenors. The chart below examines the change in the US Treasury yield curve during September.

US Treasury yield curve change, September 2023



Source: Bloomberg, Liontrust. As at 5 October 2023.

The gold line shows yields of Treasuries with various maturities at the end of August, with the green line representing the end of September; please do note that the horizontal axis scale is not linear. The grey bars show the difference between the two lines; 30-year yields rise by almost 50 basis points, whereas the increase in 1-year yields was under 10 basis points. The yield curve steepened over the month; the shape is still inverted with shorted dated bonds yielding more than longer tenors, but the size of the inversion reduced during September.

In my opinion there were three main inter-related factors that caused this movement in bond yields. Firstly, although economic data were mixed there were enough signs of economic robustness for the market to continue to delay, and sometimes cancel, forecasts of recession. Continued large fiscal deficits, combined with shrinking central bank balance sheets, have led the market to demand more 'term premium' to lend to governments over longer time horizons. Finally, the over-riding message from developed economy central banks has been that rates will be "*higher for longer*". Although interest rates may be at or near their peak, central bankers are stressing that policy will stay at these restrictive levels for a prolonged period.

In September the FOMC (Federal Open Market Committee) left Fed funds rates unchanged at the 5.25%-5.50% range in line with expectations. The statement retained its tightening bias referring to the "*...extent of additional policy firming that may be appropriate to return inflation to 2 percent over time.*" However, the real hawkish elements were all to be found in the Summary of Economic Projections (SEP).

The SEP saw real GDP forecasts revised upwards relative to June's assessment, 2023 is now 2.1% (prior 1.0%) and 2024 is 1.5% (prior 1.1%); 2025 remains unchanged at 1.8%. Unemployment was revised down for 2023 to 3.8% (prior 4.1%) which could be a little optimistic given that is where it presently resides; both 2024 and 2025 are now forecast at 4.1% against the prior 4.5% prediction. The forecast for core PCE (the Fed's preferred inflation measure) in 2023 was revised down to 3.7% (prior 3.9%), 2024 was left unchanged at 2.6%, and 2025 tweaked upwards to 2.3% (prior 2.2%).

The revisions to the dot plot were more hawkish than expected. The dots continue to show one more rate hike being desired in 2023, while the market is pricing in approximately a 50% chance of this. The FOMC is divided about whether it has already reached a policy stance that is "*sufficiently restrictive*". The bigger revision was in 2024, the median there is now 50bps higher at the 5.00% to 5.25% range; commentators had only been expecting an incremental 25bps upward move. The rate hike in 2023 is conditional on the forecasts of unemployment at 3.8% and core PCE of 3.7% being reached in Q4, the Fed remains data dependent. Taking some of the hawkish edge off in the press conference, Fed chairman Jerome Powell repeatedly stated that they would "*proceed carefully*".

The over-riding message is higher for longer, but I suspect part of this is compensating for the farce of calling inflation transitory in the first place. It is worth remembering that these dot plots are not a plan, they merely represent the collective thoughts of 19 Fed officials. In my opinion, if rates are held at such restrictive levels for a few quarters the economy will weaken rapidly enough for core inflation to approach the 2% target much sooner, and that's before one accounts for the lagged effect of the cumulative tightening we have already witnessed and the ongoing quantitative tightening (QT). A mild recession remains our central forecast, it has been delayed along with Fed rate cuts, but as the economic data weakens the Fed officials' rates assessments will evolve.

The Bank of England's Monetary Policy Committee (MPC) kept rates on hold at 5.25%; this was a surprise relative to economists' forecasts, and a smaller surprise to markets which had moved to price in just over a 50% chance of a hike after the inflation data. It was a close vote with the split being 5-4, the dissenters all preferring a 25bps hike; those voting against were Greene, Haskel, Mann, and Cunliffe, for the latter it was his final meeting so the hawk count on the MPC will probably reduce.

As with the Fed above, the emphasis is shifting to the length of time rates are held at restrictive levels; the statement retained the mantra "...sufficiently restrictive for sufficiently long", regarding returning inflation to the 2% target. At a conference in Cape Town in August, Huw Pill described this as the Table Mountain approach, as opposed to the Matterhorn. The hawkish bias for interest rates has been maintained, "...further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures."

The European Central Bank (ECB) was the outlier during September as it hiked rates by 25bps, taking the deposit rate to 4.0%. Forecasts for the meeting predicted that it was a very close call whether it hiked or held, economists were split about 48/52% respectively and the market had priced in a 65% chance of an increase. I would characterise the move as a dovish hike, the ECB has almost certainly reached its terminal (peak) interest rates for this cycle, but it has left some wiggle room to hike again in the unlikely circumstance that economic conditions materially improve. During the press conference Lagarde did reveal that some members of the Governing Council would have preferred a pause, but the "solid majority" was for a hike.

The key sentence in the ECB press release is "...Based on its current assessment, the Governing Council considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target." Regarding the outlook for monetary policy, the focus is now more on the length of time rates are held at restrictive levels rather than the level itself. Although there is no clarity yet on the duration which the ECB thinks will be long enough to hold deposit rates at 4.0%, it is clear that the data dependency will be tested against future economic projections. Lagarde joked that the word "cut" is a word that the ECB has "not pronounced", if the next quarterly set of economic forecasts see further downward revisions to growth, core inflation forecasts will surely follow and Lagarde will be pronouncing cut sooner than the ECB currently envisages.

Fund positioning and activity

Rates

Duration was maintained at 8 years, having been increased in August; as a reminder we deem 4.5 years to be neutral and have a limit of 9 years. Within the geographic split of duration, the most significant change was a reduction in UK duration after the recent strong relative performance of gilts compared to bunds and US treasuries. In particular, with 10-year gilt yields now below 10-year US treasury yields we believe it is a good time to redeploy some of our duration risk budget elsewhere. The UK does have lower economic growth, but it also has higher inflation as well as some risk premium needed for the institutional instability we have seen over the last few years of political chaos. We have reduced UK duration by 1 year, investing 0.5 years each into Germany and the US; we still think there remains some relative value in UK duration and retain 1.5 years' exposure. The Fund's duration split is 3.25 years in the US, 1.5 years in the UK, 2.5 years in Europe, and 0.75 years in New Zealand.

Given the moves in the yield curve, we took profits in the Fund's remaining 0.25 years of 2s10s steeper exposure. I do expect this part of the yield curve to be upward sloping again sometime in the next year or two, but it is far more likely to occur once rates start being cut. The Fund retains zero net duration exposure in the 15+ year maturity bucket.

Allocation

Asset allocation was unchanged during September as we await a better opportunity to add to credit. Investment grade exposure is around 50%, a weighting we view as being neutral. The Fund's high yield weighting in bonds is 24%; there is a 6% overlay in place to reduce risk using the iTraxx Xover credit default swap index, thus net high yield exposure of 18% is just below our 20% neutral level.

Selection

There was one new credit purchased in September, Coty, a beauty company with a \$10 billion market capitalisation. Coty has a strong spectrum of brands across various pricing points, this helps to provide a buffer against any trading down by consumers during an economic slowdown. We like the clear path to deleveraging the balance sheet and see potential for the company to be a “rising star” (get upgraded to investment grade) in a few years' time. We deem the 5-year BB-rated euro-denominated debt with a yield of 5.75% to be a very attractive bond investment.

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

Past Performance does not predict future returns

	Sep-23	Sep-22	Sep-21	Sep-20	Sep-19
Liontrust GF Strategic Bond B5 Acc	5.33	-15.71	3.18	6.40	7.39
EAA Fund Global Flexible Bond - USD Hedged	5.80	-12.11	4.21	3.41	6.67

*Source Financial Express, as at 30.09.23, 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).

Key Features of the Liontrust GF Strategic Bond Fund

Investment objective & policy ¹	<p>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.</p>
Recommended investment horizon	5 years or more
Risk profile (SRI) ²	3
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 PRIIP KID of the fund; 2. SRI = Summary Risk Indicator. Please refer to the PRIIP KID 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/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.

Any performance shown represents model portfolios which are periodically restructured and/or rebalanced. Actual returns may vary from the model returns. There is no certainty the investment objectives of the portfolio will actually be achieved and no warranty or representation is given to this effect, whether express or implied. The portfolios therefore should be considered as long-term investments.

- The fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.
- 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.
- Overseas investments 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 the Fund.
- The Fund can invest in derivatives. Derivatives are used to protect against currency, credit or 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 Fund uses 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.
- The Fund invests 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 fund over the short term.
- The Fund may encounter liquidity constraints from time to time. Participation rates on advertised volumes could fall reflecting the less liquid nature of the current market conditions.
- Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

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