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Global Fixed Income

Q2 2024 review

Liontrust GF Absolute Return Fund

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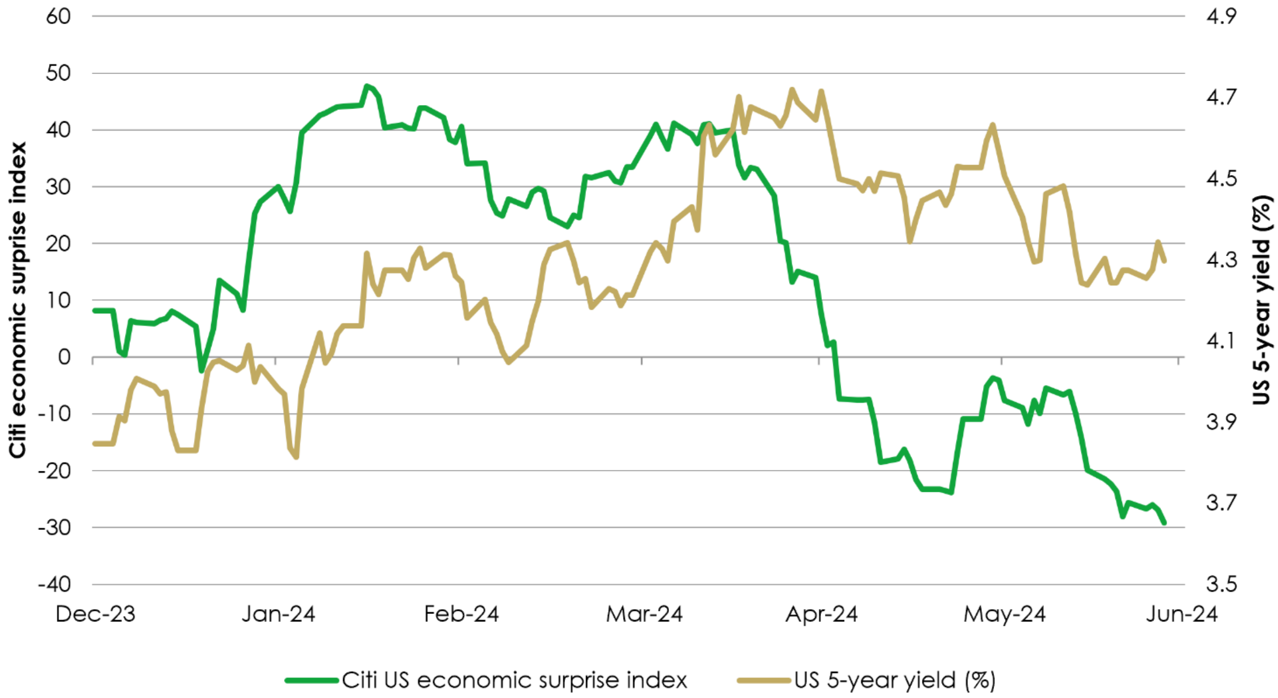
The Liontrust GF Absolute Return Bond Fund (C5 share class) returned 0.9%* in sterling terms in Q2 2024 and the IA Targeted Absolute Return, the Fund's reference sector, returned 1.1%. The Fund's primary US dollar share class (B5) returned 1.0%.

The yield carry on the Fund produced the largest positive impact during the quarter. Yields were higher during the quarter, but the carry easily offset this. Stock selection was muted; credit spreads are tight so there is little room for upside opportunities. We are focussed on avoiding losers and are not chasing risky investments for the Fund in this environment.

Market backdrop

The second quarter of 2024 has seen a shift in economic data and market sentiment compared to the earlier months in the year. The first quarter of 2024 saw various economic data coming in above expectations, with the US economy retaining strong momentum; this is shown by the Citi economic surprise index in the green line in the chart below. US treasury yields (5-year yields shown in the gold line) were driven upwards as the market repriced the timing of the rate cutting cycle. The second quarter saw more mixed economic data, hinting at a loss of the aforementioned economic momentum but not a complete rollover in activity. This has given central bankers and the markets more confidence that inflation will continue its bumpy trajectory towards official targets and monetary policy can be eased accordingly. The peak in 5-year US Treasury yields was towards the end of April, with yields being volatile but net lower since.

A half of two halves



Source: Citi, Bloomberg, Liontrust 29.12.2023 to 28.06.2024

Examining the economic fundamentals, the trend in US employment data has been stronger than anticipated. For example, hiring in May (released in June) was robust with nonfarm payrolls at 272k compared to expectations of 180k. Additionally, wage inflation ticked up; the monthly average hourly earnings were above expectations at 0.4% which takes the annual number to 4.1% compared to expectations of 3.9%. The Fed wants to see wage inflation in the 3.0% - 3.5% ballpark area for it to be consistent with its inflation target. The JOLTS quits rate was unchanged at 2.2%, a level consistent with falling inflationary pressures on wages. Leading indicators for the labour market point to softening, but this is going to have to feed through more consistently into the payrolls data to persuade the Federal Reserve to start cutting interest rates.

US consumer price inflation (CPI) had been particularly worrisome in the first quarter as fears arose that there was a re-acceleration in the data; developments during the second quarter have helped to allay these fears. Core CPI in May undershot at 0.2% compared to expectations of 0.3% consistent with April's rate. As always, the details matter, some of the undershoot was due to airfares which are volatile; but the broad picture was the most encouraging it has been so far this year. It is services inflation that has been the sticky last leg of inflation and the key concern for the Fed. Core services inflation was 0.2% during May, taking the annual rate to 5.3% and contributing 3.1% of the overall CPI basket. Within the monthly services inflation figure for May, shelter was the dominant driver. Rents were up 0.39% and owners' equivalent rents (OER) up 0.43%; shelter inflation is 5.4% over the last 12 months. OERs naturally lag current realised rents due to the 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.

The good news was found in core services excluding shelter, referred to as "supercore." The change in May was -0.04%, taking the annual supercore inflation rate back down to 4.83%. Supercore was flattered by a 3.6% fall in airfares, but prices elsewhere were well behaved. One other exceptional was motor vehicle insurance, which was down 0.1% in May compared to a run rate of +1.8% on average for the first four months of 2024. I'd expect some payback here next month as there are still higher insurance premia to be passed through in various states, but with the annual rate still at 20.3% (it was 22.4% last month) the worst of this will be behind us by the autumn. For most parts of supercore services inflation it is nominal wage inflation that is the biggest driver; this is where the interplay between employment and inflation data is at its strongest. The Fed will be encouraged by this latest inflation data but want to see more of the same to attain greater confidence that this sticky last leg of the inflation problem is being ameliorated by restrictive monetary policy.

The Federal Open Markets Committee (FOMC) moved to a median dot of only one rate cut this year. Most market participants had expected the FOMC to move from three cuts at the prior Summary of Economic Projections (SEP) in March to two. The median for 2024 might be for one cut, but the mode is still for two cuts; it would only take two FOMC participants to switch to shift the median. With the Fed down to only one cut forecast for this year it sets up the bond market nicely for positive surprises, e.g. lower inflationary data that could nudge the Fed into two cuts.

The European Central Bank (ECB) cut rates by 25 basis points to 3.75% as was expected by everyone and fully priced into markets. The rationale for the cut was as follows: "*…based on an updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, it is now appropriate to moderate the degree of monetary policy restriction after nine months of holding rates steady.*" Thereafter the statement and forecasts were mildly hawkish, which is consistent with the recent wage and inflation data. Most notably the statement deleted the sentence about conditions being "*…appropriate to reduce the current level of monetary policy restriction.*" The emphasis is on data dependence; this keeps September's ECB meeting in play but makes a July cut incredibly unlikely. Overall, I would view this ECB rate cut as moderating the level of restriction as opposed to the start of a rapid cutting cycle. I continue to believe that once the economic conditions are in place for more cuts, then they will be larger than the market is pricing for, but one needs patience as services inflation has not yet fallen enough.

Finally, the Bank of England's Monetary Policy Committee (MPC) held interest rates steady at 5.25% as was unanimously anticipated. The vote split remained at 7-2. The latest MPC minutes suggested enough members were more sanguine about recent high services inflation data than one would have expected, describing it as "*…somewhat higher than projected in the May Report.*" For a few, probably three, MPC members the data did not alter "*…the disinflationary trajectory that the economy was on,*" thus the decision to hold rates steady rather than cut was described as "*…finely balanced.*" I would interpret this as the MPC being really keen on cutting rates in August, but it just needs that pesky real-life data to not deviate quite so much from its projected view of the inflationary outlook. Key to this will be June's consumer price inflation data due out on 17th July and May's wage data due out the day afterwards.

As a reminder for all of these central banks, the exact timing of cuts does not matter to us as bond managers that much; what does matter is that the economic conditions are in place for the cuts. We remain strategically long duration and believe it is a good time to be locking in attractive bond yields.

Fund performance

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 yield carry on the Fund produced the largest positive impact during the quarter. Yields were higher during the quarter, but the yield carry easily offset this. Stock selection was muted; credit spreads are tight so there is little room for upside opportunities. We are focussed on avoiding losers and are not chasing risky investments for the Fund in this environment.

Alpha sources

Rates

The Fund spent most of the quarter with duration around 2.0 years; the Fund's permitted range is 0-3 years with a neutral level of 1.5 years. The split at the end of June was 1.0 years in the US, -0.5 years in Canada, 0.6 years in New Zealand, 0.8 years in Europe, and 0.2 years in the UK.

Yields finished the quarter a little higher than they began; the majority of the upward move was in April with a net rally since. Rates was a small negative contributor to performance but the extra carry, from the duration exposure effectively offset this impact. Regarding cross market rates positions, the short Canadian duration relative to the US was offside during the quarter but did improve towards the end of June when Canadian inflationary data was above expectations.

Allocation

The weighting in the Carry Component has been in the mid 80s percentage area throughout the quarter due to the compelling yield on short dated defensive investment grade. As credit spreads are expensive, we have further reduced exposure to other credit in Selection, which is now below 5%. This was driven by a couple of bond maturities taking the high yield weighting to 0.5%, some bonds reaching the maturity criteria to be classified in the Carry Component, and two new purchases discussed below.

Selection

Stock selection had a negligible impact on performance during the quarter; performance from credit spread tightening or widening at the individual bond level was very muted. The Fund is mainly positioned for avoiding losers with few potential winning opportunities available given tight credit spreads.

Within Selection, Intesa and Saga bonds matured, and 3i Group's bonds have migrated into the Carry Component. There were two new purchases, firstly Rothesay Life issued a new lower tier 2 bond in US Dollars – a 7% yield for this well capitalised life insurance company was deemed to be attractive. The other new addition was euro denominated bonds issued by Global Switch; the company is up for sale either in its entirety or piecemeal and, should a transaction occur, it is likely to trigger a change of control clause in the bonds. The credit spread is tight but there is potentially 10% of capital price upside if a change of control does occur. Crucially we do like the company's fundamentals if it does walk away from takeover activity.

Within the Carry Component the process of re-couponing continues both as maturities occur and we actively switch the Fund's assets into new bonds. A low coupon Becton Dickinson bond matured, and we bought a new 2029 maturity dollar bond with a coupon just above 5%. We switched some Dell bonds in Euros from a 2026 maturity with a 0.5% coupon into a 2029 maturity with a 3.625% coupon. Finally, a cross market switch was undertaken in the Japanese telecommunications company NTT, moving from a euro bond with a 0.01% coupon into a dollar bond with a 5.11% coupon. The evolution of the Fund's yield will continue in this way with the mix shifting from the pull-to-par capital upside into a higher running yield.

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 (SRI)[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 PRIIP KID of the fund; 2. SRI = Summary Risk Indicator. Please refer to the PRIIP KID for further detail on how this is calculated.

Discrete years' performance (%) to previous quarter-end:

	Jun-24	Jun-23	Jun-22	Jun-21	Jun-20
Liontrust GF Absolute Return Bond C5 Acc GBP	6.7%	2.5%	-5.6%	1.5%	2.1%
IA Targeted Absolute Return	8.0%	1.5%	-0.7%	7.2%	-0.4%

	Jun-19
Liontrust GF Absolute Return Bond C5 Acc GBP	1.9%
IA Targeted Absolute Return	0.4%

*Source: Financial Express, as at 30.06.24, total return (net of fees and interest reinvested), C5 class. Discrete data is not available for ten full 12-month periods due to the launch date of the portfolio.

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 fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.

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.

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.

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.

There is no guarantee that an absolute return will be generated over a rolling 12 month period or any other time period

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