Global Fixed Income

October 2023

Quarterly strategy – rate cuts likely to be larger and faster than market expects.

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Executive Summary

We believe a mild recession is still on the cards. Both the consumer and corporate sectors have relatively strong balance sheets, but in recent data releases we have seen a modest deterioration in economic data, and we expect this to continue as the year progresses and we start to see more of an impact from interest rate hikes. We are expecting consumption to slow as we see signs of the support from excess savings decline and headwinds, such as the recommencement of student loan repayments, arise. The US labour market is still very tight, but the demand/supply imbalance has eased and, notwithstanding September's strong figures, we are seeing a trend of a reduction in non-farm payrolls. Inflation is still high but reducing with respect to core goods. Shelter inflation is slowing with the methodological lags we have previously highlighted. Core services inflation remains the focus for central banks.

The combination of robust consumption, tight labour markets and sticky inflation has resulted in interest rate cuts expectations in the US to be pushed out to mid-2024, along with recession expectations. We have a long duration position in our strategic bond portfolios. Presently we have 8 years duration (US 3.25 years, UK 1.5 years, Europe 2.5 years and New Zealand 0.75 years).

Credit spreads, the additional yield above the comparative sovereign bonds, have tightened since their post Covid zenith in October 2022. Even with recent rates market volatility, credit spreads have held in well. We believe credit spreads, as well as the total yield available in corporate bonds, are attractive for long-term investors but we do expect market volatility to create buying opportunities later in 2023. Our strategic portfolios currently have exposure to investment grade and high yield bonds of 50% and 20% respectively, levels that we deem to be neutral. We believe the aforementioned volatility, caused by the impending recession, could provide a good buying opportunity and is a time when we would look to increase our aggregate credit exposure.

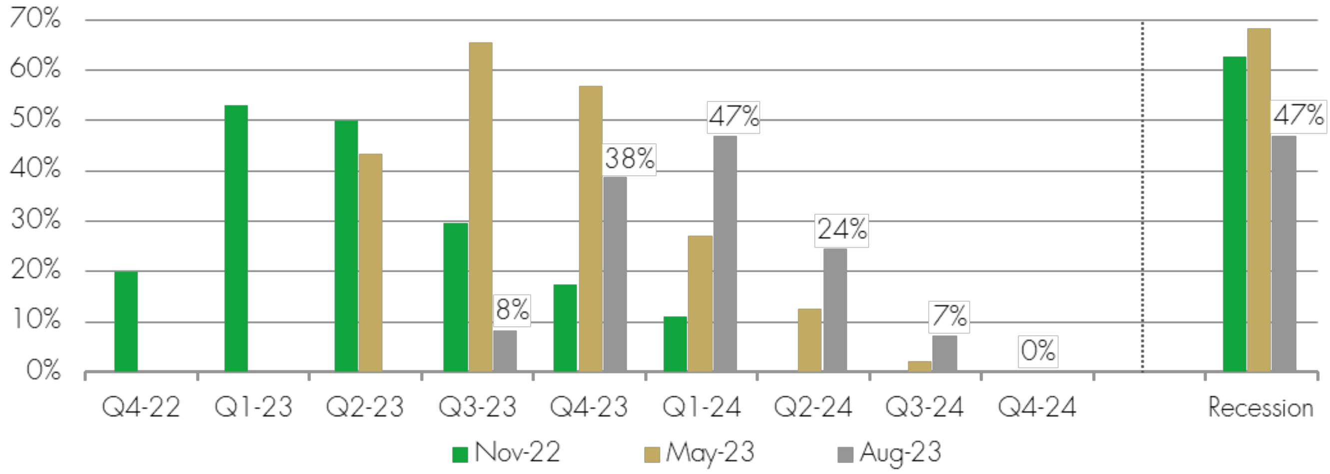
Macroeconomics

Recession

The US economy has remained stronger than one would normally expect after so much tightening in monetary policy. We believe that the same factors that are delaying the recession will conspire to make it a relatively mild one. However, we continue to assign a very low probability to the Federal Reserve successfully engineering a soft landing. 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.

Recessions have been comparatively rare in the "great moderation" of the past few decades. However, it has taken an extraordinary level of policy support to achieve this. Monetary policy has shifted to now be at restrictive levels and quantitative tightening is withdrawing liquidity from economies and markets. The fiscal side of the equation remains expansionary with the US running an outsized budget deficit. Interest costs are going to start taking up a much larger proportion of government spending and primary fiscal deficits will have to be reined in accordingly. We expect governments to keep running large deficits but anticipate that market forces will create pressure to be more prudent.

Percentage of economists polled on Bloomberg expecting negative growth each quarter and a recession



Source: Bloomberg Finance LP, Deutsche Bank

The chart above shows that a lower proportion of economists are predicting a recession than earlier in 2023. This is particularly clear after the collapse of Silicon Valley Bank, where the tightening in lending standards and fall in economic sentiment following this banking 'mini crisis' did some of the Federal Reserve's monetary tightening job for it. Those expecting a recession are pushing back their predictions to Q1 2024.

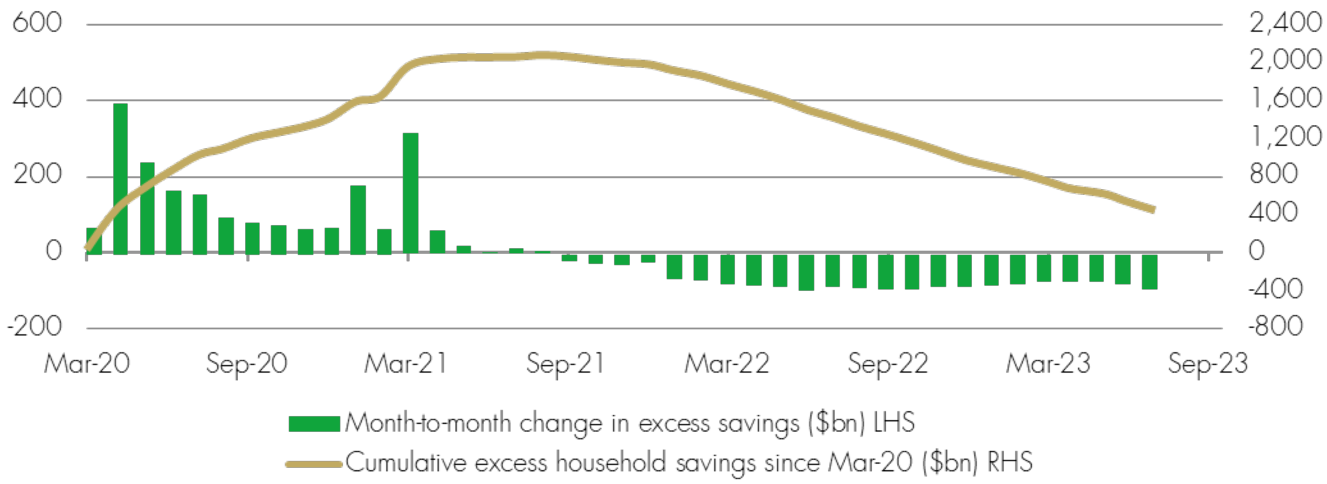
We cannot accurately predict when rate cuts will start, but we do expect them to be of a larger magnitude and faster than the market expects. We have a strategic long duration position; we think and hope that rates are not going back to zero, but US 10-year yields could easily get down to 3% in a recessionary environment.

Consumption

Consumption has been strong in the US, benefitting in the third quarter from a boost to spending on entertainment with Taylor Swift and Beyonce tours, as well as Barbie and Oppenheimer movie blockbusters. There are, however, clouds on the horizon for the rest of 2023.

Excess savings in the US has depleted, as shown below. This had provided huge support to consumption post-Covid period. Any remaining excess savings are assumed to be concentrated in the hands of the wealthier socio-demographic, which is where the marginal propensity to consume is low. The lower income households have utilised any excess savings to try to maintain living standards during the cost-of-living crisis. Additional signs of stress on some consumers can be seen in the rise in credit card delinquencies.

US excess savings

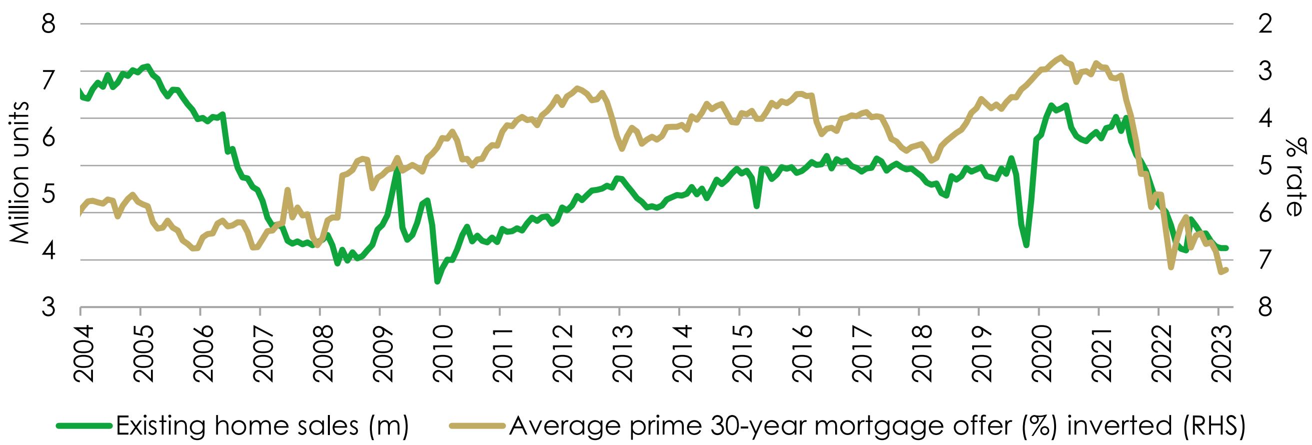


Source: Pantheon Macroeconomics 31.08.23

Another factor that will provide pressure on consumption is the expiry of the student loan moratorium that was put in place to provide some financial relief during the Covid period. The loans start accruing interest from 1st September 2023 and payments are to resume in October. Additionally, natural disasters earlier in the year led to delays in some tax submissions which are now scheduled for this quarter.

One other large driver of consumption is the housing market. Mortgage rates on offer are about four percentage points above the existing stock, therefore the US housing market is seeing people trapped in their existing homes as the cost to move is punitive. The supply of existing homes for sale is likely to remain low until people are forced into moving, unemployment being one potential key driver of this.

Existing home sales and mortgage rates

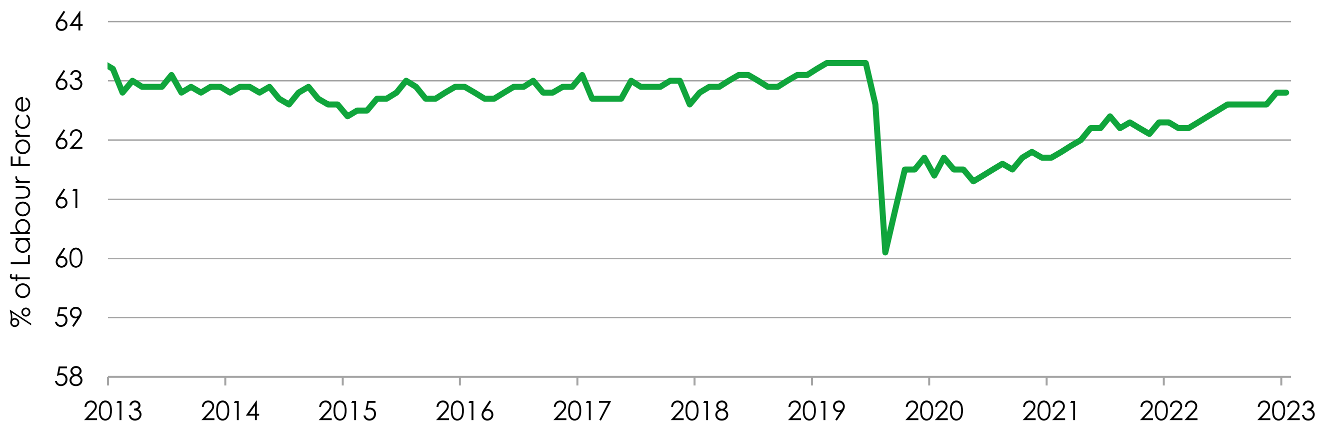


Source: Liontrust, Bloomberg 30.09.23

Employment/Labour market

Participation has picked up as people have been forced back to work in the US, mainly because of the increased cost of living. Some of the increased participation is linked to the depletion of savings, where people are needing to go back to work sooner than they planned.

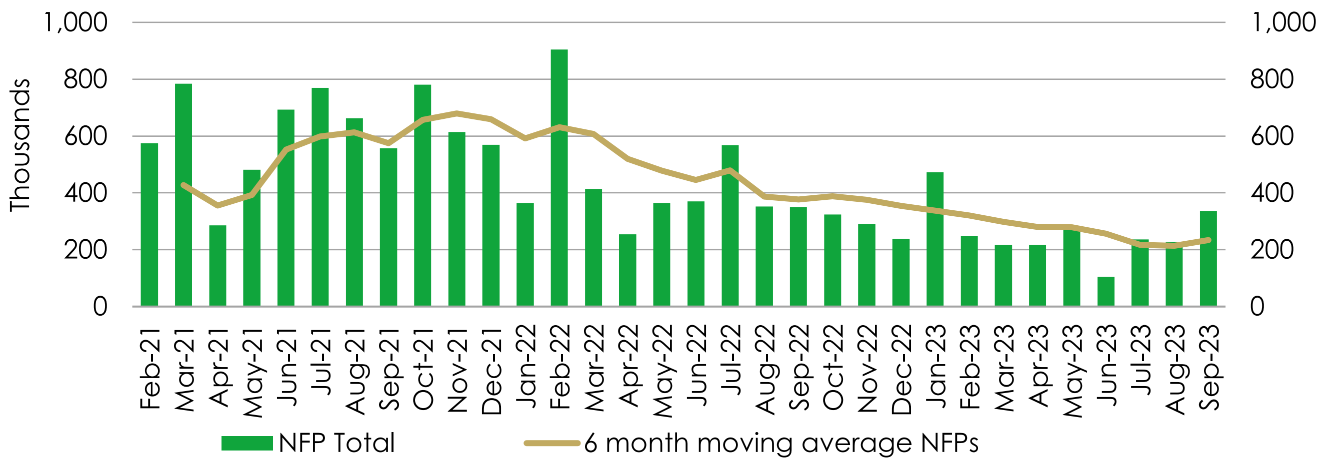
US Labour Force Participation Rate, seasonally adjusted



Source: Bloomberg 30.09.23

Notwithstanding September's exceptional figure, we are seeing a gradual decline in non-farm payrolls (see chart below) indicating a trend downwards.

Change in Nonfarm Payrolls

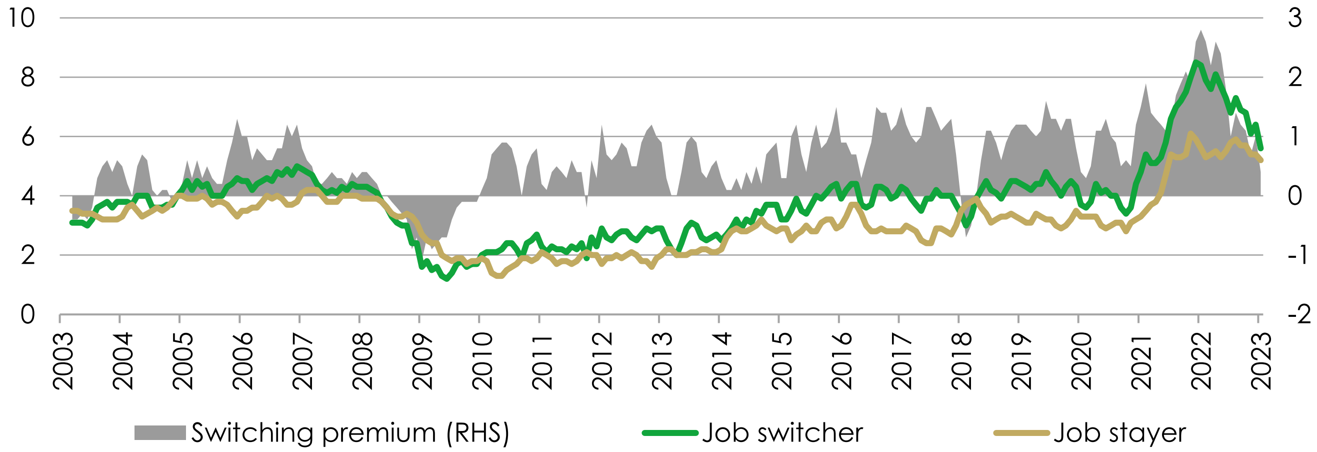


Source: Liontrust, BLS, Bloomberg 30.09.23

Another sign of the slight easing in labour market pressures manifests itself within the wage inflation data. The chart below shows that the wage increase you'd expect to get when switching jobs is only modestly higher, with 'switching premium' between staying or changing jobs decreasing. This is symptomatic of an easing in labour market pressures. The reduced incentive to leave your job is indicative of an easing of wage pressures and lower job openings.

The US labour market is still very tight, but the demand/supply imbalance has eased and is expected to continue to improve. Employment diffusion indices show that labour shortages have moved from being a generic phenomenon to just pertaining to industry specific issues. After so many difficulties with hiring, we believe that firms are likely to hoard labour in the impending downturn. Thus, unemployment is unlikely to peak at the high levels of some previous cycles but is likely to move up to the 5-6% vicinity.

Job switcher versus stayer wage inflation (non-seasonally adjusted, 3-month moving average, %)



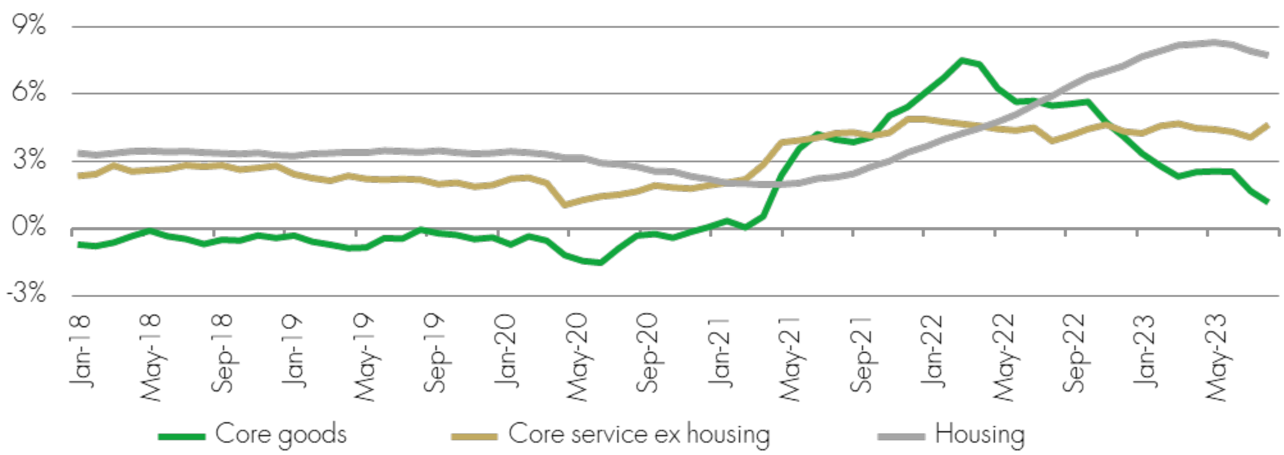
Source: Liontrust, Atlanta Fed, Bloomberg 31.08.23

Inflation

The increases in energy prices over the last few months will lift headline inflation figures relative to previous expectations of year-over-year decreases in energy prices. The second order impact of the energy price rises depends on corporate and consumer pricing power, respectively whether companies can pass price rises on to their customers and whether the consumer can push for higher wages to maintain other disposable income. Given the easing in the labour market, we view the current energy price rises as having more of a wallet share substitution effect for the consumer.

Focusing on core inflation in the US, core goods inflation has been reducing steadily as supply chains have healed; the used car price segment is the main driver of goods disinflation.

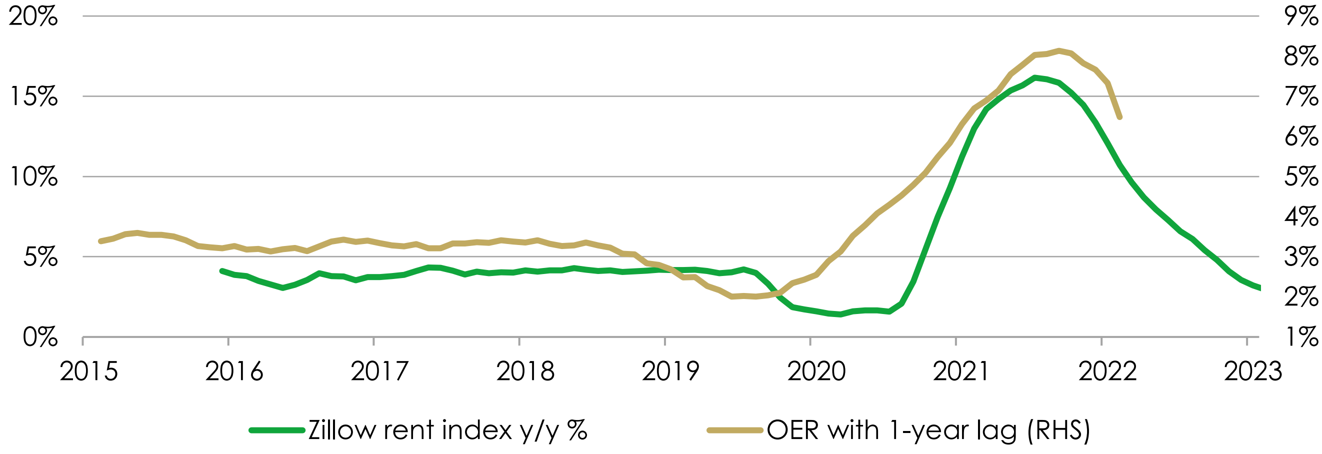
Personal Consumption Expenditure groups



Source: Deutsche Bank, BEA, Haver Analytics September 2023

Shelter inflation mainly consists of rents and owners' equivalent rents (OER). We have previously discussed the methodological reasons why OERs naturally lag market observed rents. The data is heading in the right direction as the chart below shows.

Zillow rents and lagged OER

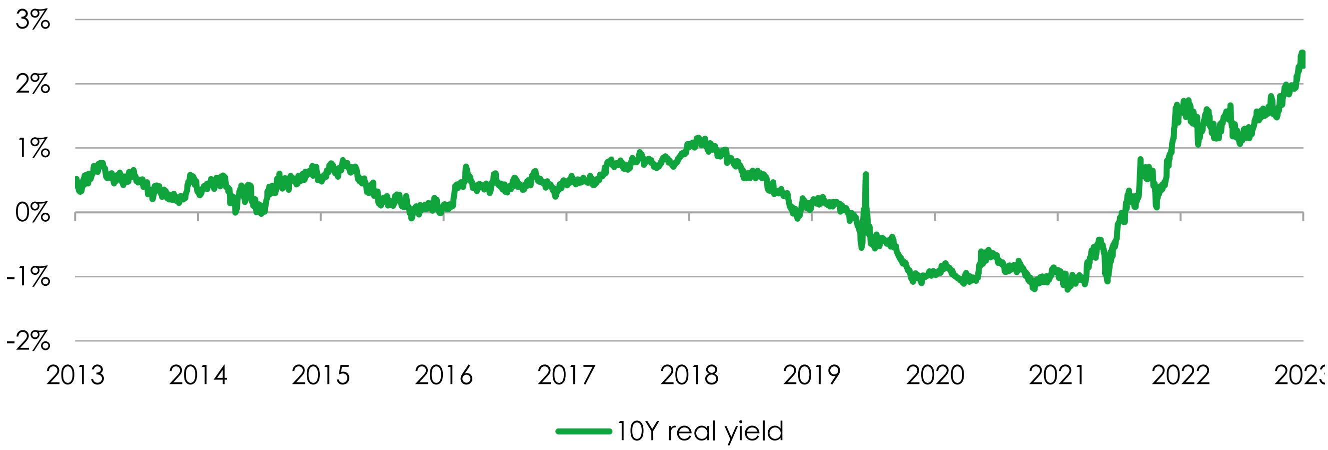


Source: Liontrust, BLS, Zillow, Bloomberg, 30.09.23

Within the personal consumption expenditures (PCE) measure, core services ex-housing inflation is still strong. The annual services inflation figures within the consumer price index (CPI) also remain high but recent monthly data have been more sanguine. Services is the part of the economy and CPI basket that is most correlated to nominal wage inflation, a factor that the Fed needs to tame. This is exactly why the Fed deemed it necessary to tighten monetary policy so much, creating a recession to rectify the imbalance in the labour market. Only when wage inflation then falls further will the Fed feel able to declare that they have tamed inflation.

Rates Positioning

10-year US Treasury real yield

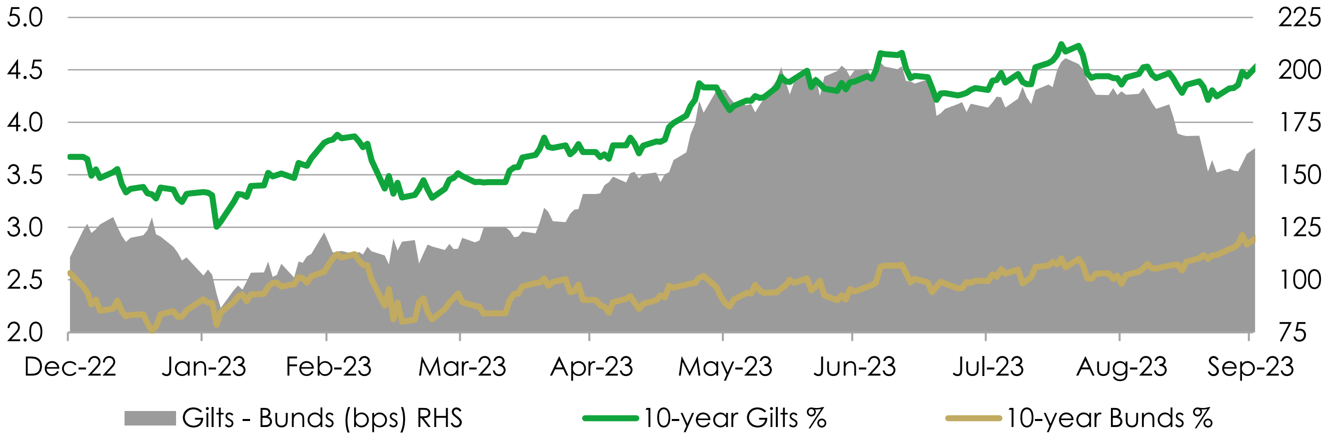


Source: Liontrust, Bloomberg 30.09.23

Both nominal and real yields on sovereign debt offer compelling value over the longer term. The duration of the strategic bond strategies is mandated to be between 0-9 years, where 4.5 years is a neutral position. Over recent months we have maintained duration at 8 years, but switched 1 year out of UK duration into an extra 0.5 years each in Germany and the US.

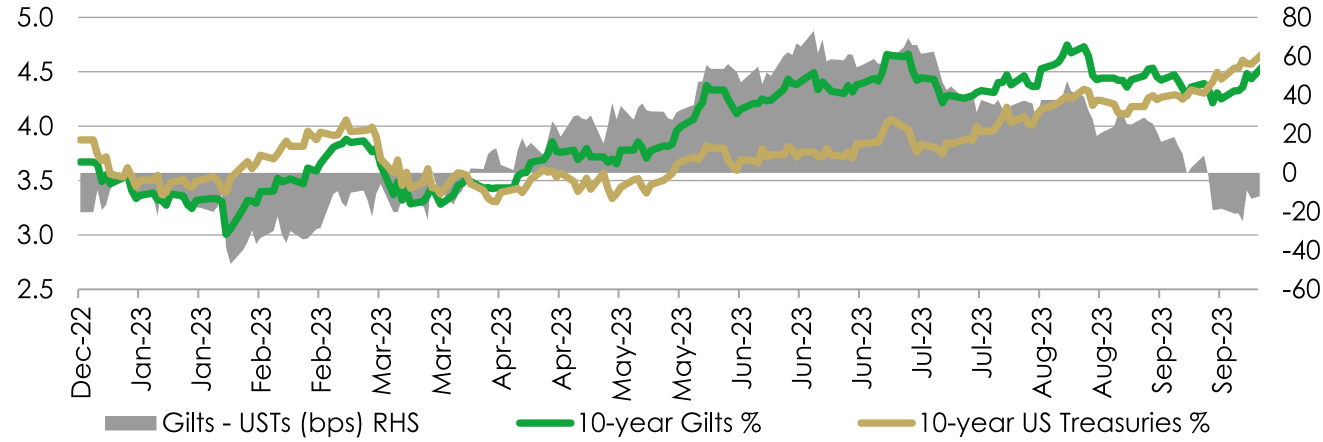
Geographically, the duration exposure is split between the US 3.25 years, UK 1.5 years, Europe 2.5 years and New Zealand 0.75 years. We decided to switch out some of the UK duration after the recent strong relative performance of gilts compared to Bunds and US Treasuries. The relative outperformance of gilts can be seen by looking at the shaded areas in the charts below.

Gilts versus Bunds



Source: Liontrust, Bloomberg 30.09.23

Gilts versus US Treasuries



Source: Liontrust, Bloomberg 30.09.23

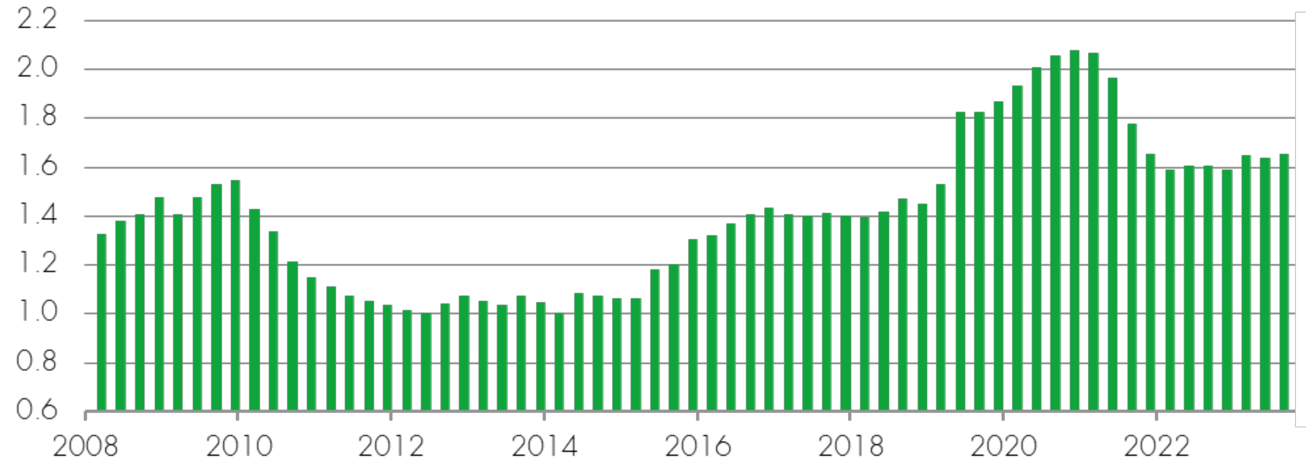
In particular, with 10-year gilt yields now below 10-year US Treasury yields, we believe it is a good time to redeploy some of our duration risk budget elsewhere. The UK does have lower economic growth, but it also has higher inflation as well as some risk premium needed for the institutional instability we have seen over the last few years of political chaos.

We prefer short-dated and mid-dated duration exposure; the portfolios have net zero duration exposure to the 15+ year maturity bucket and government bond futures are used to hedge out any duration contribution from long-dated company credits. As the interest rate cycle turns, we expect the yield curve to steepen, with short-dated tenors outperforming their longer-dated cousins.

Spread product

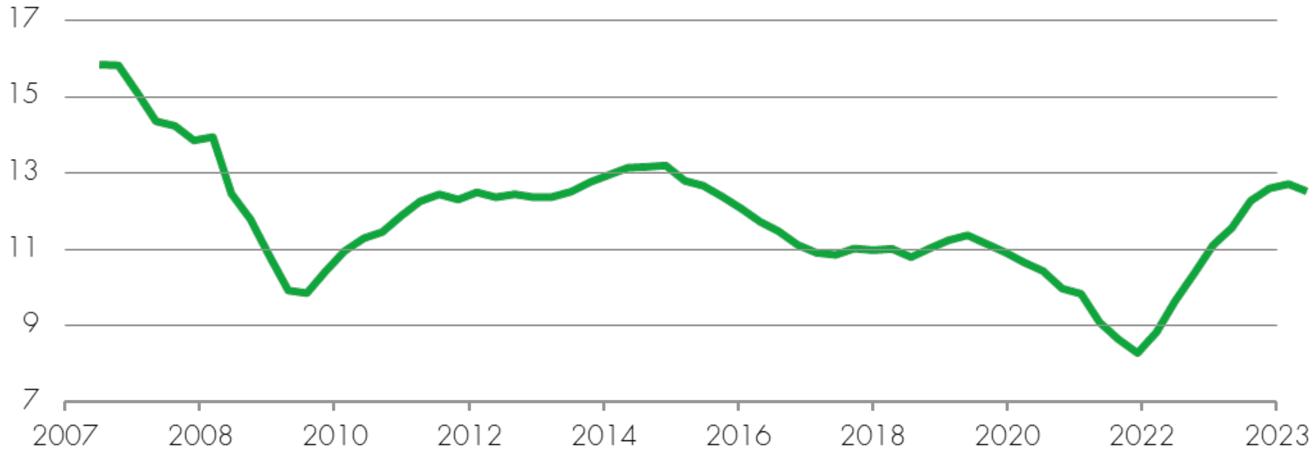
Corporate fundamentals remain strong, with net leverage close to pre-pandemic levels but modestly rising. Interest cover ratios remain healthy; we'd expect this to change as and when companies have the need to refinance in this higher interest rate environment. We are seeing a steady increase in coupons from issuers, but for now issuance is broadly from companies that can cope with higher interest costs. As refinancing walls get closer, the companies with less liquidity or lower down the ratings spectrum may fall into difficulty trying to refinance upcoming maturities and have to pay a hefty increase in interest costs in order to have access to the bond market. We expect default rates to continue to rise, albeit from a low base. Distressed exchanges of debt have already been seen within the riskiest part of the market: CCC rated bonds.

US net leverage (Net debt/EBITDA)



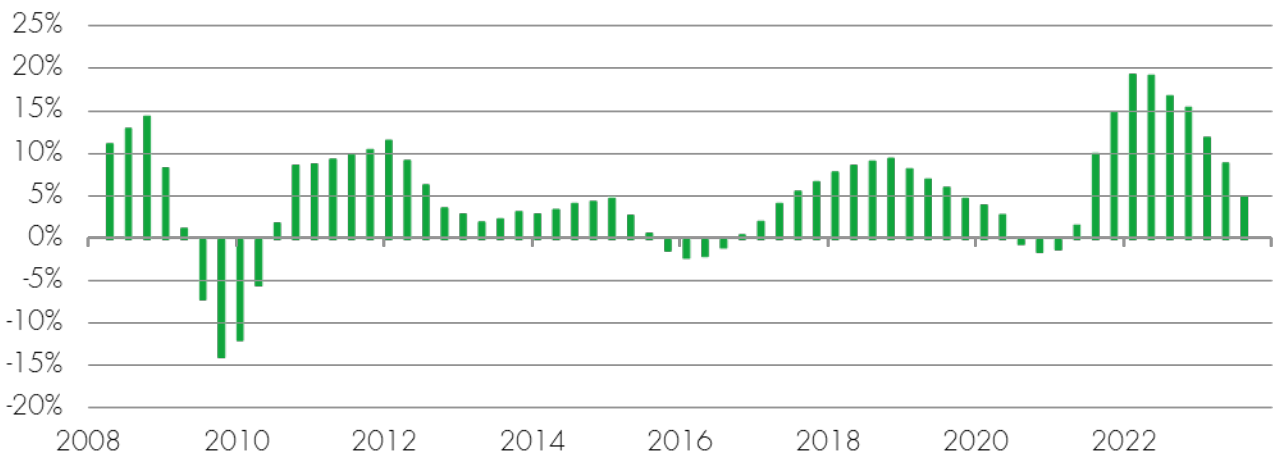
Source: Deutsche Bank, Bloomberg Finance LP, Capital IQ
Note: Using the Russell 1,000 eligible members with 75% of the sample made up of $IG rated issuers

US interest coverage



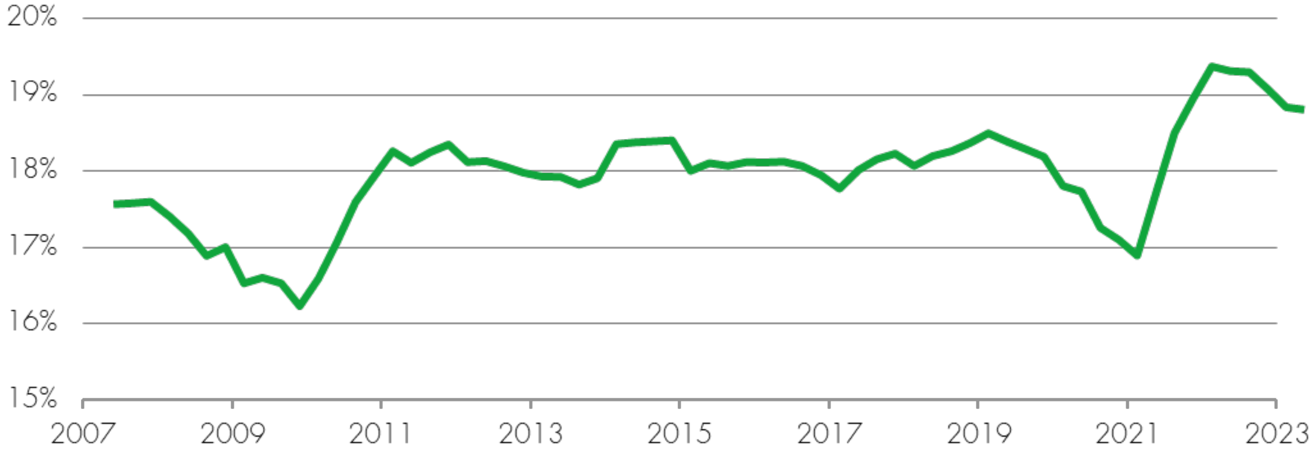
Source: Deutsche Bank, Bloomberg Finance LP, Capital IQ
Note: Using the Russell 1,000 eligible members with 75% of the sample made up of $IG rated issuers

US revenue growth (Y/Y)



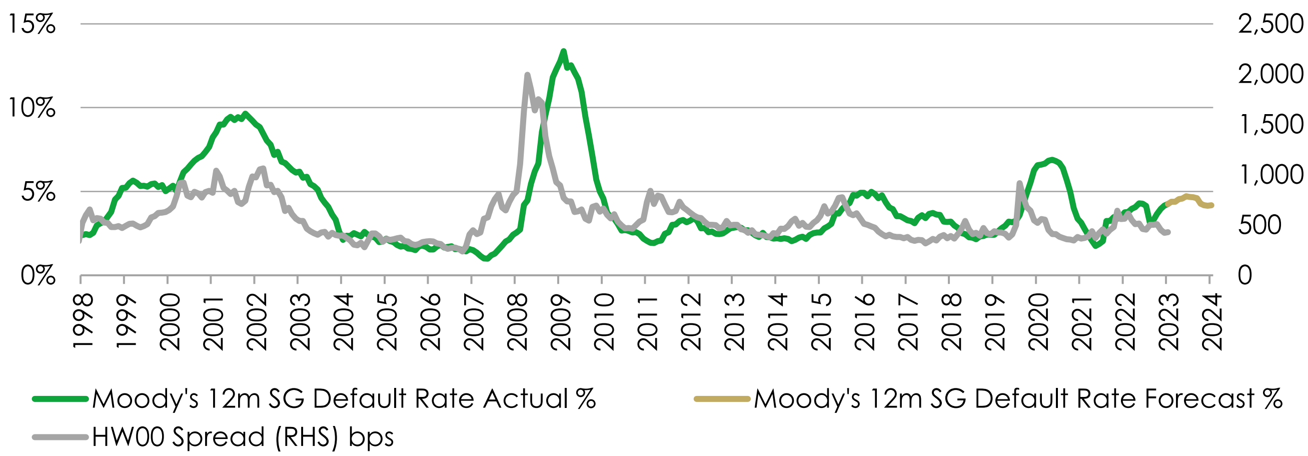
Source: Deutsche Bank, Bloomberg Finance LP, Capital IQ
Note: Using the Russell 1,000 eligible members with 75% of the sample made up of $IG rated issuers

US EBITDA margins



Source: Deutsche Bank, Bloomberg Finance LP, Capital IQ
Note: Using the Russell 1,000 eligible members with 75% of the sample made up of $IG rated issuers

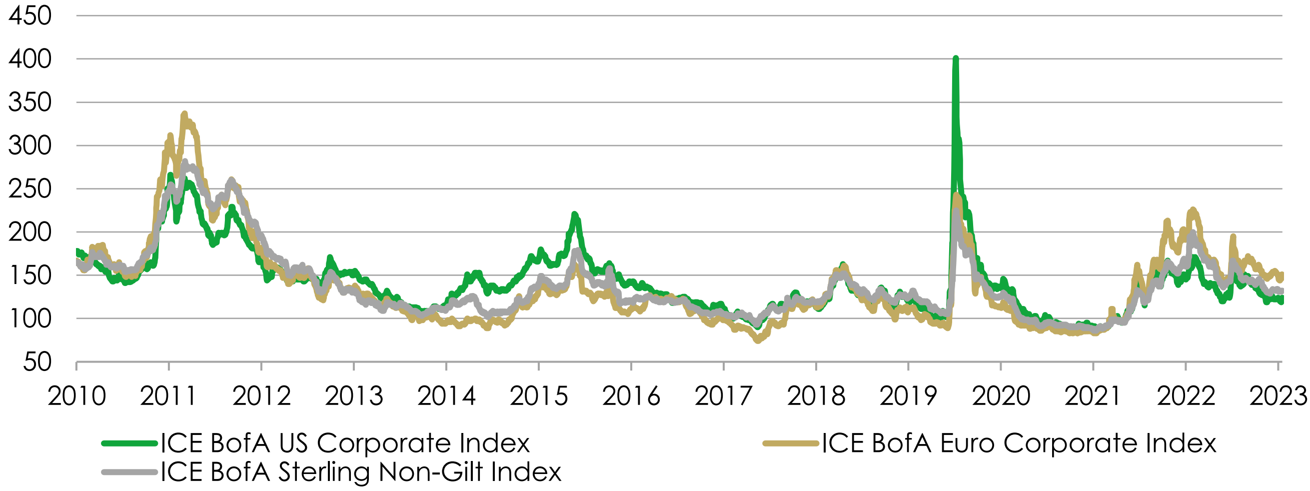
High yield credit spreads versus default rates



Source: Liontrust, ICE BofA Indices and Moody's 30.09.23

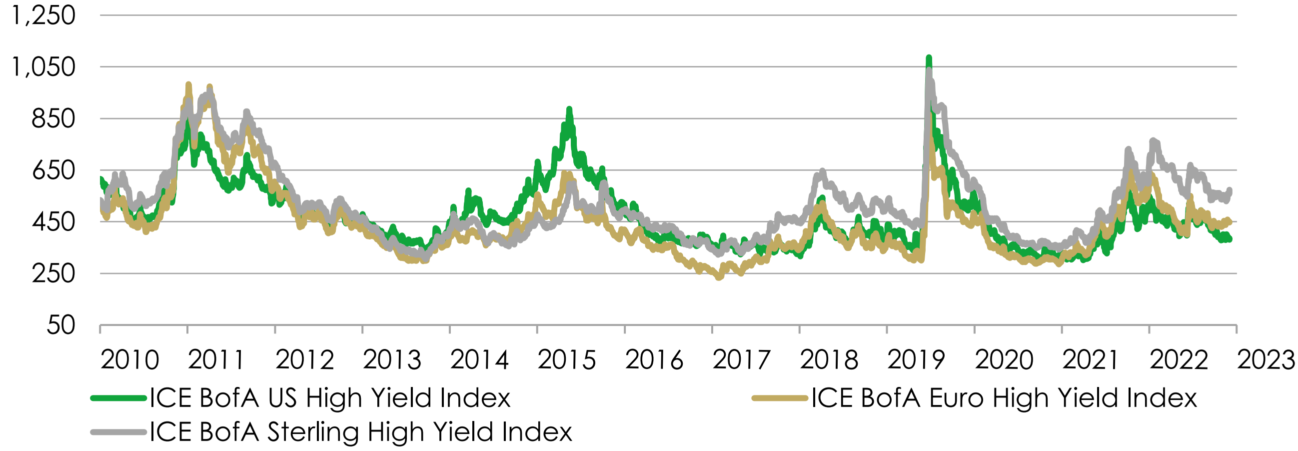
Moving on to valuations, below we have graphs showing how investment grade and high yield credit spreads have evolved in the period since the financial crisis. Credit spreads have contracted since their most recent peak in October 2022. While they do offer good long-term value, and a decent liquidity premium above the credit spread required to compensate for default risk, we would require a higher cushion for recessionary risk so are currently neutrally positioned in investment grade credit (50%) and high yield (20%). We maintain a quality bias within credit, manifested in more defensive sectors and companies, as well as an avoidance of CCC-rated bonds in the strategic portfolios.

Investment Grade Index credit spreads (bps)



Source: Liontrust and ICE BofA Indices 30.09.23

High Yield Index credit spreads (bps)



Source: Liontrust and ICE BofA Indices 30.09.23

In terms of technicals, the market is supportive of an increased level of issuance from last year. The high level of demand for bonds suggests to us that yields have reached a level where new money is being allocated to credit. The supply has mainly been from non-financials, investment grade credits. The pace of high yield issuance is still relatively slow.

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 Funds managed by the Global Fixed Income Team:

- Consider environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Funds.
- May hold overseas investments that 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 a Fund.
- Hold Bonds. 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.
- May encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.
- May, under certain circumstances, invest in derivatives, but it is not intended that their use will materially affect volatility. Derivatives are used to protect against currencies, credit and 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 use of derivatives may create leverage or gearing resulting in potentially greater volatility or fluctuations in the net asset value of the Fund. 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. The use of derivative contracts may help us to control Fund volatility in both up and down markets by hedging against the general market.
- The use of 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.
- May invest 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 funds over the short term.
- May be exposed to Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.
- May target an absolute return. There is no guarantee that an absolute return will be generated over the time period stated in the fund objective or any other time period.

The risks detailed above are reflective of the full range of Funds managed by the Global Fixed Income Team and not all of the risks listed are applicable to each individual Fund. For the risks associated with an individual Fund, please refer to its Key Investor Information Document (KIID)/PRIIP KID.

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