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Global Fixed Income

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Quarterly strategy – Rate cuts will be later and larger than the market expects.

Phil Milburn
Co-Head Global Fixed Income Team

Donald Phillips
Co-Head Global Fixed Income Team

Executive Summary

The full impact of restrictive monetary policy has not fully filtered through yet, with lags in this cycle higher than in many prior examples. Overall, we expect consumption growth to slow but not completely stall. This is one of the main reasons why we anticipate a mild recession rather than anything more sinister.

There is a trade-off between the amount of time that it will take to reach the economic environment in which the Federal Reserve will feel comfortable cutting rates, and the speed of cuts towards a neutral 2% to 3% vicinity once they do start.

Markets keep trying to price in an earlier easing cycle; we believe that cuts will start later but be larger than the market is currently assuming. We have a strategic long duration position in portfolios, but we have zero net duration in the 15+ years maturity as we think yield curves will steepen as rate cuts approach.

Corporate bond credit spreads are now priced for perfection. When credit spreads are this tight, it does not take a lot of spread widening to erode the extra yield one had garnered from investing in the corporate bond. Our credit weighting in portfolios is therefore slightly underweight. We don't expect a lurch higher in defaults and the permanent destruction of capital, but we do think market volatility could offer a better value opportunity to increase the credit weighting.

Overall, the coming year is likely to prove that fundamentals really do matter in leveraged finance. Interest coverage ratios are manageable for nearly all apart from the lower echelon of

the high yield universe. We expect a high degree of market bifurcation between the majority of companies that will be survivors and can easily manage paying investors a higher coupon, and the minority, whose business model or balance sheet cannot cope with a higher cost of capital.

Policy risks to economic growth

Consensus forecasts for global real GDP growth in 2024 are approximately 2.5%, with emerging economies doing most of the heavy lifting in the 4% growth vicinity and developed economies languishing at just above 1%. The long-awaited recession may materialise, but we think it will be mild in nature as consumption activity slows but does not stall.

The risks to the upside for growth forecasts emanate from continued strength in consumption or a rebound in manufacturing led by Asian economies. However, we see greater risk to the downside in consensus growth forecasts as economic headwinds continue to build. One of the main sources of those headwinds is public policy stance: fiscal, interest rates and money supply. Increased populism and protectionism are longer-term in nature, likely leading to higher neutral interest rates through the cycle.

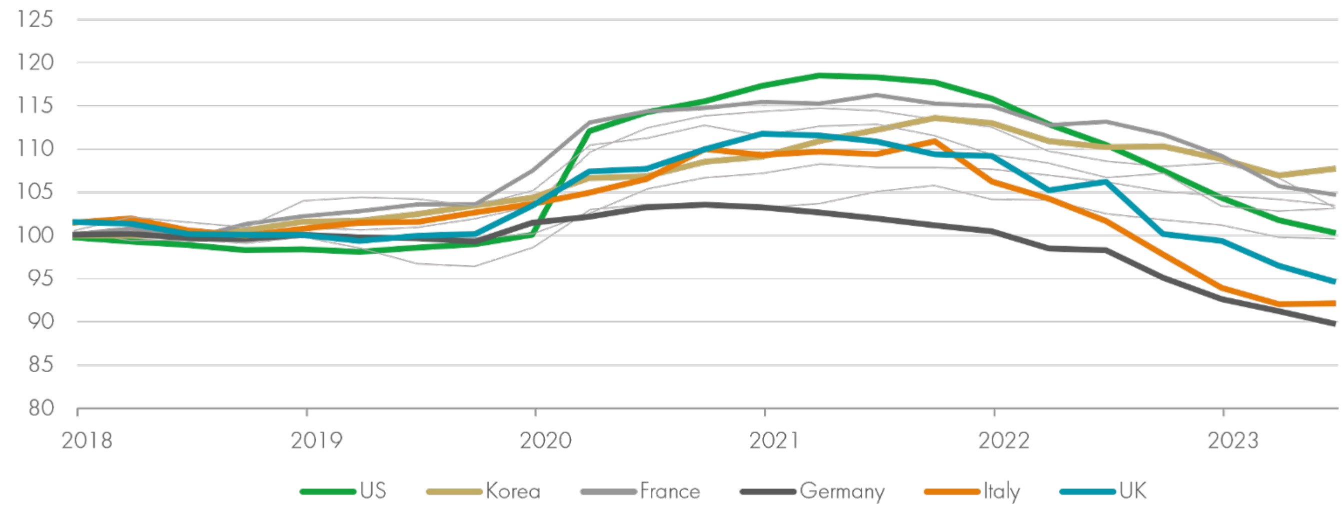
Firstly, fiscal policy is likely to subtract from growth this year, this is despite 2024 being a record year for electoral activity. Fiscal deficits will still be commonplace, reflecting a loose stance and hangover from the spending during the Covid crises; it is the reduction year-on-year in fiscal deficits that subtracts from growth. In the US this shrinking fiscal deficit – from an unsustainably high base – could shave up to 0.3% off GDP. Note that figure assumes no government shutdowns caused by budgetary impasse between Democrats and Republicans. Should Trump be re-elected in November, taxes would almost certainly be cut but it is debatable whether spending would be cut by more or less than the tax impact.

In the eurozone there is a return to adjusted Stability and Growth Pact rules, with debt sustainability and deficit resilience safeguards giving a lot of wiggle room. After the disastrous consequences of the Truss/Kwarteng brief fiscal experiment in the UK, governments will be more cognisant of the risk of losing financials markets' confidence. Furthermore, as governments' interest costs increase there will be greater pressure to cut primary fiscal deficits, or, for some countries, to run with larger primary fiscal surpluses.

The second policy dragging on growth is higher interest rates, in particular higher real interest rates now that inflation has significantly fallen. The full impact of restrictive monetary policy has not fully filtered through yet, with lags in this cycle higher than in many prior examples. We expand upon the rationale for these lags in the next section.

The final policy drag is the rare phenomenon of rapidly shrinking money supply. As the graph below illustrates, the shock to the financial system and economy of the enormous jump in money supply during the Covid crisis has now been absorbed in real terms.

Index, real broad money versus 2010-2019 trend



Source: Oxford Economics, 05.12.23

The Federal Reserve continues with quantitative tightening (QT) at a pace of $95 billion per month. The Fed's reverse repo facility (RRP) continues to shrink, currently standing at just under $600 billion from its 2023 peak around $2,300 billion. The RRP shrinking makes QT more potent, as more liquidity is drained from the system. Insufficient liquidity could cause an accident, albeit not necessarily in the US given the dollar's global role. The Fed is well aware of the risks of causing a liquidity crunch accident, so is likely to begin signalling towards a tapering of QT as 2024 progresses.

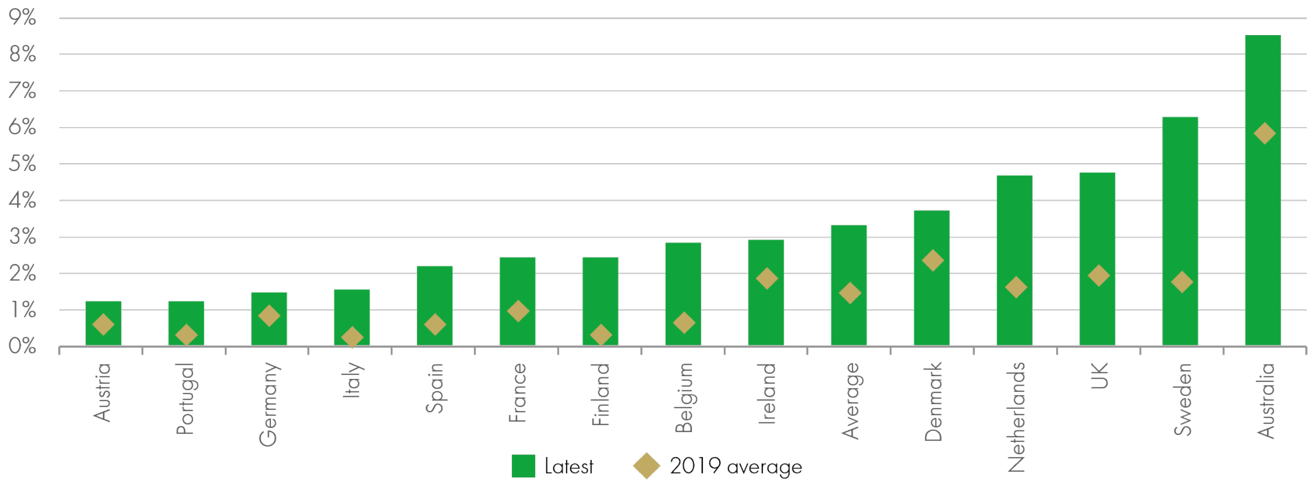
Monetary policy transmission: later than usual

The current delay between the first hike in a rates cycle and a subsequent recession is not yet an outlier, but monetary policy transmission has been slower than in many prior cycles. The rationale for this is that a far higher proportion of debt is at fixed rates, which take far longer to reprice. A good example is the US consumer, where approximately 88% of household debt is locked in at a fixed rate compared to about 75% during the 2004-06 rate hiking cycle.

The dominant component of the fixed rate debt is mortgages. Many homeowners are effectively trapped in their existing borrowing arrangements with prevailing rates on a new mortgage 2.5% to 3.0% above what they are currently paying. A consequence of this is that US housing market activity is likely to remain subdued for a prolonged period.

With shorter tenors on mortgages, there has been more forceful transmission of monetary policy in Europe. There is still a lot of debt repricing to come; interest rates on household liabilities have fed through more slowly than those on assets. The chart below shows how interest payments are absorbing a larger proportion of disposable income; the diamonds represent the proportion before the Covid crisis, while the bars are the current percentage burden. This burden will continue to rise.

Household interest payments as share of disposable income



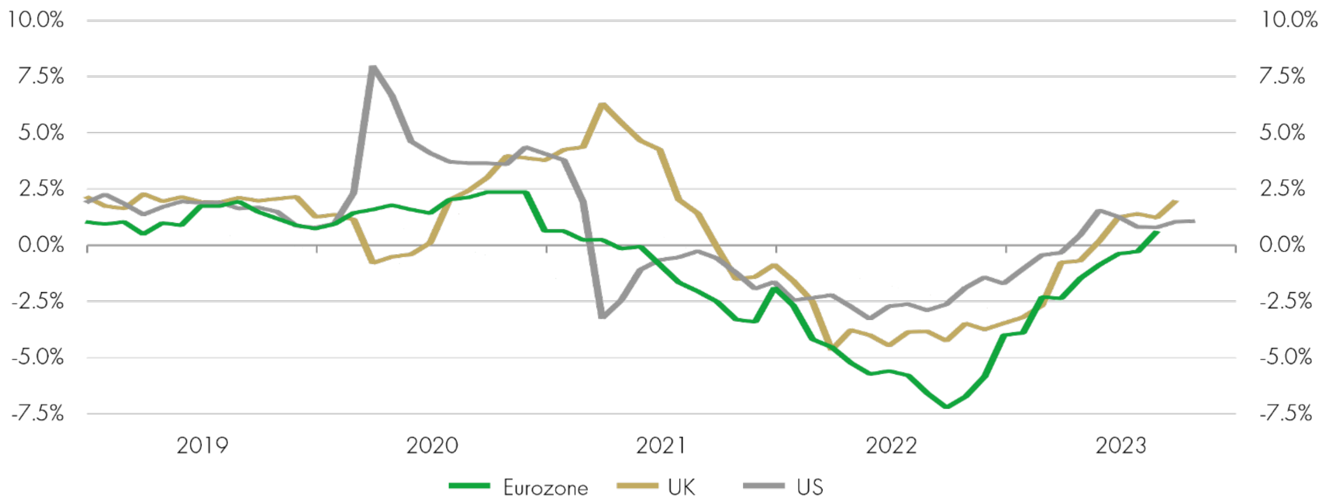
Source: OECD, HSBC 03.01.24

So far during this cycle, monetary policy has achieved greater efficacy via the business sector. With the cost of capital and working capital significantly higher, companies have responded by reducing capital expenditure. Hiring plans have also reduced, albeit from an elevated starting point. Finally, bankruptcies among small and medium sized enterprises have increased.

Consumer to slow not stall

US household excess savings built up during lockdowns are effectively gone. The remaining savings are so skewed towards the richer households that they are probably just considered wealth by now. For less fortunate households the interest burden is gradually increasing. There are signs of weaknesses, with increased delinquencies in credit card and auto loans. However, there is also a tailwind for consumption as real wages are now increasing, as can be seen on the chart below.

Real wages



Source: Macrobond. Eurozone figures use negotiated wages 03.01.24

Wages rather than employment are likely to be the bigger driver of any consumption changes in 2024; though obviously there is a risk to the downside if unemployment lurches higher. Overall, we expect consumption growth to slow but not completely stall. This is one of the main reasons why we anticipate a mild recession rather than anything more sinister.

Labour markets softening

Unemployment rates remain low by historic standards in most countries, but signs of labour market softening are increasing. In the US there has been a marked reduction in the use of temporary workers. Another signal of labour market imbalance arises from the "jobs plentiful" and "jobs hard to get" series; the green line on the graph below plots the difference between these series with a lower reading indicative of a tighter labour market.

Job availability versus unemployment rate

Source: Bloomberg, Liontrust 31.12.83 to 31.12.23

The loosening in labour market conditions from the post lockdown tights is clear to see in 2023. The unemployment rate, the gold line on the chart, tends to follow the trend in the job availability data.

Labour force participation has recovered in most age cohorts, but many early retirees are not being enticed back; compared to prior trends there is now an excess of 1.7 million to 2 million retired people in the US. This reduction in labour capacity has partly been offset by a rise in immigration. Despite what some populist newspapers might lead people to believe, net migration into developed market economies has helped to ease inflationary pressures.

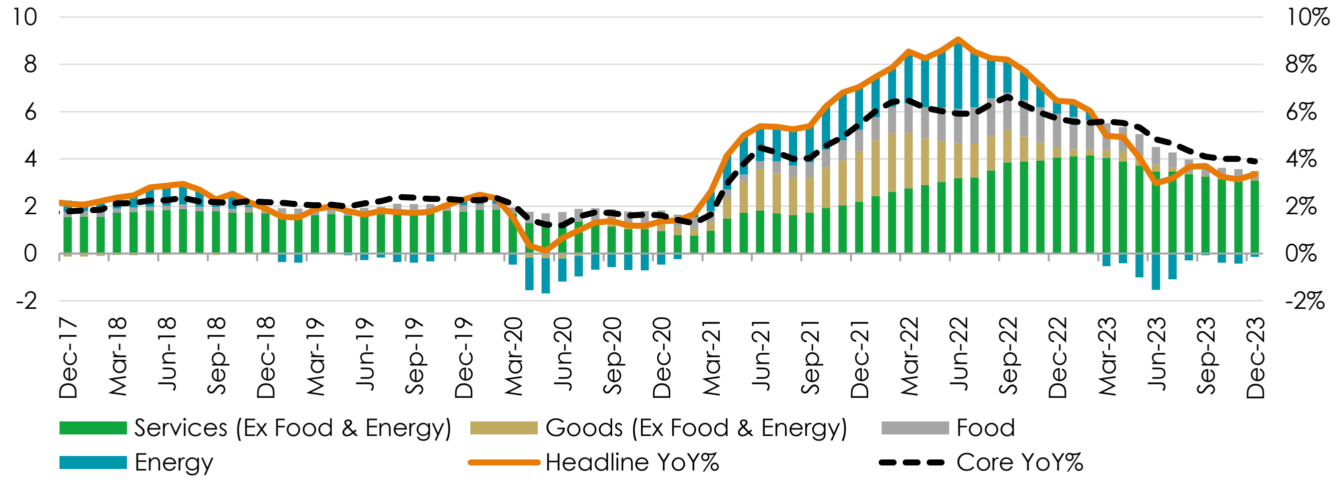
Nonfarm payrolls in the US have slowed but have not fallen off a cliff. Over the last few quarters, the diffusion of hiring has reduced and job growth has become very sector specific. Private sector hiring is concentrated in the post-Covid catchup sectors: leisure, hospitality, education, and health. Outside of these sectors, the net private sector hiring is now zero. Hiring intentions surveys suggest that something approximating the current pace of payrolls will continue for at least another three months.

Once unemployment does start to increase significantly, we expect it to peak at a lower rate in this cycle than many prior ones. Companies, having spent the last few years working hard to make hires, will be inclined to hoard labour. Our central case is that US unemployment will peak at levels similar to the early 2000s, somewhere in the 5-6% vicinity.

Inflation, the sticky last leg

Looking at the constituent categories of inflation in the chart below, it is clear that the energy (blue bars) and food (grey bars) sectors have helped to drive down headline consumer price inflation (orange line). The other contributing factor has been disinflation in goods prices (gold bars). Note that a continuation of this disinflation cannot be taken for granted for the whole year – freight rates have taken a significant fillip upwards due to the attacks in the Red Sea. It is not troublesome yet for global goods prices, and the leap is small compared to the post Covid period, but it still needs to be watched carefully over the coming months. To bring core consumer price inflation (dotted black line) back to 2% the focus now must be on the services (green bars) segment.

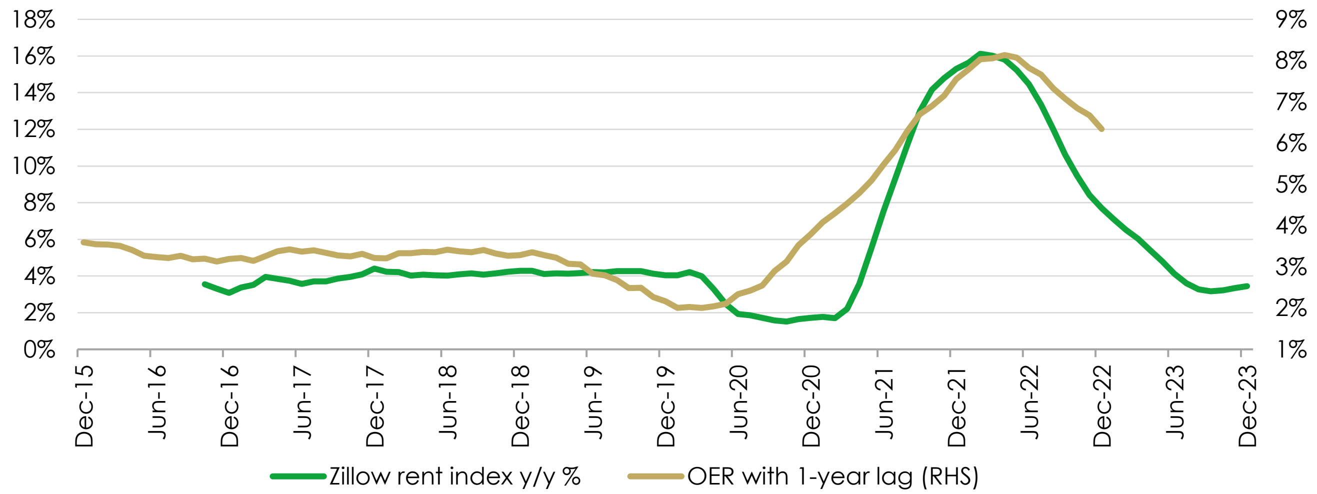
US CPI Y/Y (%)



Source: BLS, Bloomberg, Liontrust 31.12.17 to 31.12.23

It is informative to split the services segment into shelter-related inflation and other core services. The main constituents within shelter are rents and owners' equivalents rents (OER). These data series started 2023 at a run rate of 0.7% to 0.8% inflation per month and finished the year at a monthly pace of around 0.4% to 0.5%. They should trend down further during 2024 given the measurement methodology undertaken by the Bureau of Labor Statistics (BLS) causes these data series to lag current developments. The chart below shows the progression of inflation in rents observed in the market using Zillow's data (green line). The gold line is OERs lagged by a year, which closely follows the pattern of market rents.

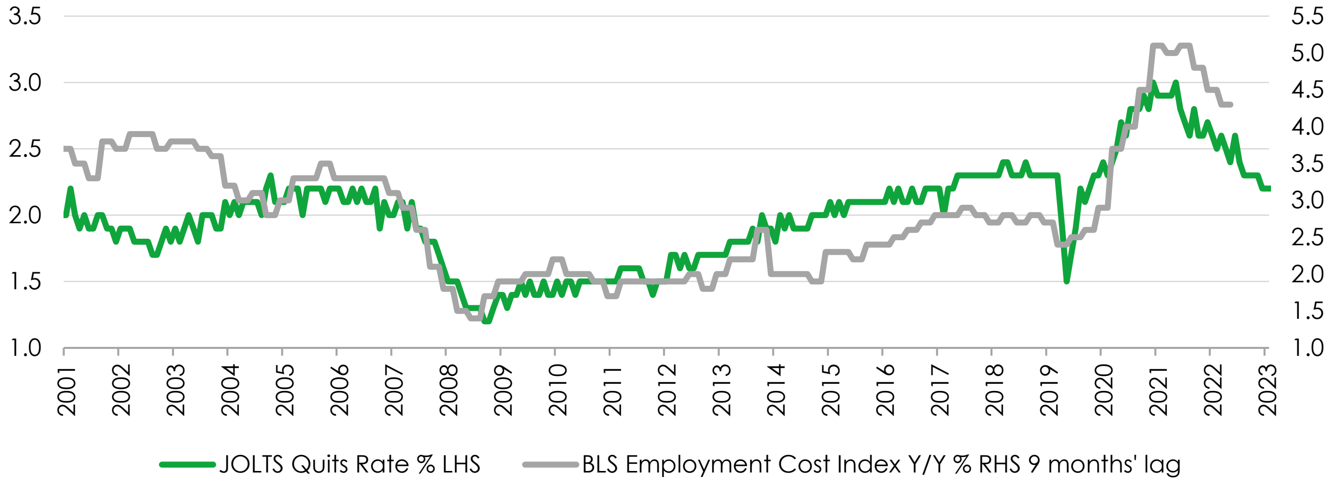
Zillow rents and lagged OER



Source: Zillow, BLS, Bloomberg, Liontrust 31.12.15 to 31.12.23

With shelter inflation due to trend downwards, the last leg of the inflation problem to conquer is other core services. Price movements in services are highly correlated to nominal wage inflation and have proven to be sticky in nature. While progress has been made, the Federal Reserve will want to see more rebalancing in the labour market before it feels comfortable declaring victory. Some services line items will still see pricing pressure, for example, healthcare costs will continue to have a meaningful upward contribution to inflation as the impact of workers' salary increases has not fully fed through yet. However, as previously discussed, the labour market is softening and wage inflation should follow. The chart below shows the jobs quits rate (green line); this is a good indicator of confidence in the labour market as most people only tend to quit their job if they have a better opportunity elsewhere. The quits rate is now at a level commensurate with the one prevailing before the Covid labour market distortions. The grey line shows the Employment Cost Index (ECI) lagged by nine months; the ECI has tended to follow the direction of quits which suggests that nominal wage inflation will keep slowing over the coming months.

Quits versus ECI



Source: Bloomberg, Liontrust 31.12.2001 to 31.12.2023, ECI shown with a 9-month lag

Fixed income positioning

There is a trade-off between the amount of time that it will take to reach the economic environment in which the Federal Reserve will feel comfortable cutting rates, and the speed of cuts towards a neutral 2% to 3% vicinity once they do start. Our central thesis remains that there will be a mild recession, the consumer preventing anything more alarming. This will lead to rate cuts occurring in the US, as well as most other developed economies, later on in 2024. Markets keep trying to price in an earlier easing cycle. We believe that although cuts will start later, they will be larger than the market is currently assuming. As a reminder, most tightening cycles last roughly 50% longer than loosening cycles, following a shape sometimes referred to as going up the stairs and down the lift shaft.

We continue to have a strategic long duration position in our strategic bond range. We have tempered the size of the long, now having 7.0 years of exposure compared to 8.0 years for most of the fourth quarter of 2023. Due to the upcoming rate cutting cycle we believe that yield curves will steepen, so net duration exposure in the 15+ years maturity bucket is zero.

Examining credit fundamentals, leverage in the investment grade universe is high compared to historic cycles. However, this is partly due to the ratings mix over time of the index evolving to contain a higher proportion of BBB rated bonds; leverage remains very manageable. The ratings downgrade cycle is picking up and, except for European BB-rated credits, the ratings drift is negative. Higher financing costs have led to a marked reduction in mergers and acquisitions activity, so the risk of companies being subject to a leveraged buyout has greatly reduced.

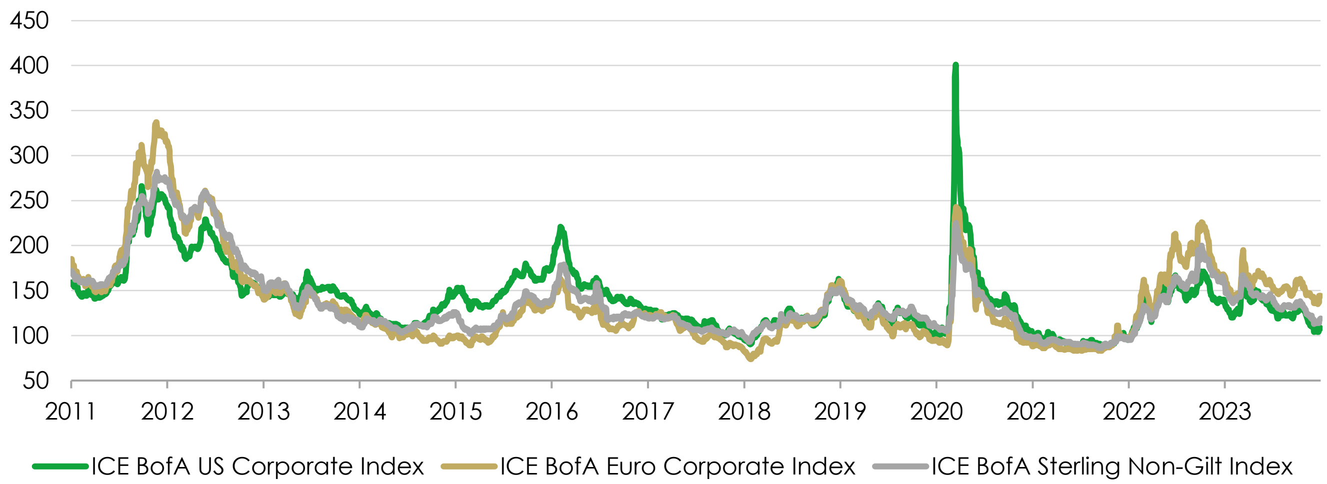
Within high yield, contrary to some popular perceptions defaults have been happening; the default rate is currently in the 4% to 5% range which is about average. We note though that is rare to see the average, one tends to see very few defaults and then a sudden thematic spike. It is conceivable that the market has absorbed a mini default hump caused by the interest rate cycle. If this proves to be the case, one should expect the default rate to stay near an elevated average rate as debt refinancing forces more companies to restructure their debt burden. Some debt restructuring has been pre-emptive, with distressed exchanges, and some coercive in nature. The lead indicator for further defaults/quasi-defaults is the distressed ratio, which has fallen over the last few months.

Overall, the coming year is likely to prove that fundamentals really do matter in leveraged finance. Interest coverage ratios are manageable for nearly all apart from the lower echelon of the high yield universe. We expect a high degree of market bifurcation between the majority of companies that will be survivors and can easily manage paying investors a higher coupon, and the minority, whose business model or balance sheet cannot cope with a higher cost of capital.

The balance between strong demand and a benign supply outlook provides a strong technical support for credit. Flows into the asset class have increased as new investors are enticed by the higher yields or coupons on offer. Gross supply of new corporate bonds in 2024 is expected to be at similar levels to 2023, but net supply will be down year-on-year.

The problem with corporate bonds is that credit spreads are now priced for perfection. The chart below shows the progression of credit spreads over time. The rally, spread tightening, since November 2023 has taken spreads near to their historic tight levels. Euro spreads are wider than those in the US, hence we have a preference for the former; this applies across the ratings spectrum.

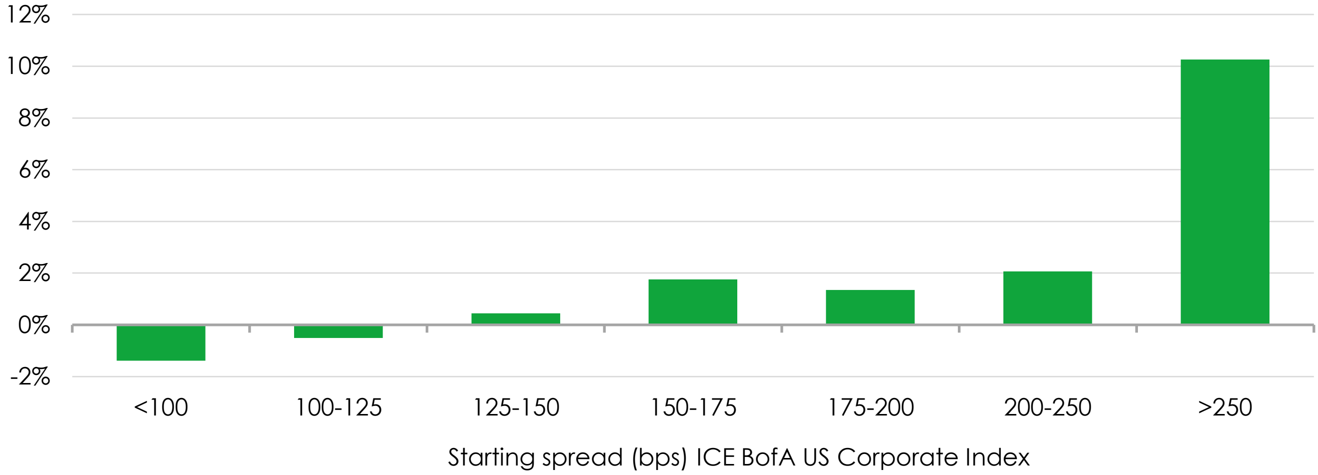
Investment Grade Index credit spreads (bps)



Source: ICE BofA Indices, Liontrust 10.01.2011 to 08.01.2024

The best predictor of future returns in fixed income is current valuations. Within credit we look at excess returns, whether a corporate bond returns more or less than the same maturity government bond. When credit spreads are tight it does not take a lot of spread widening to erode the extra yield one had garnered from investing in the corporate bond. The bar chart below shows the average excess return over the next 12 months when the current credit spread is at various levels. When index credit spreads are tight, less than 100 basis points, or 100-125 basis points, the excess return has on average been negative. At higher index credit spreads the future excess return gets progressively more positive – one is rewarded for buying credit during stressed times.

Excess return next 12 months

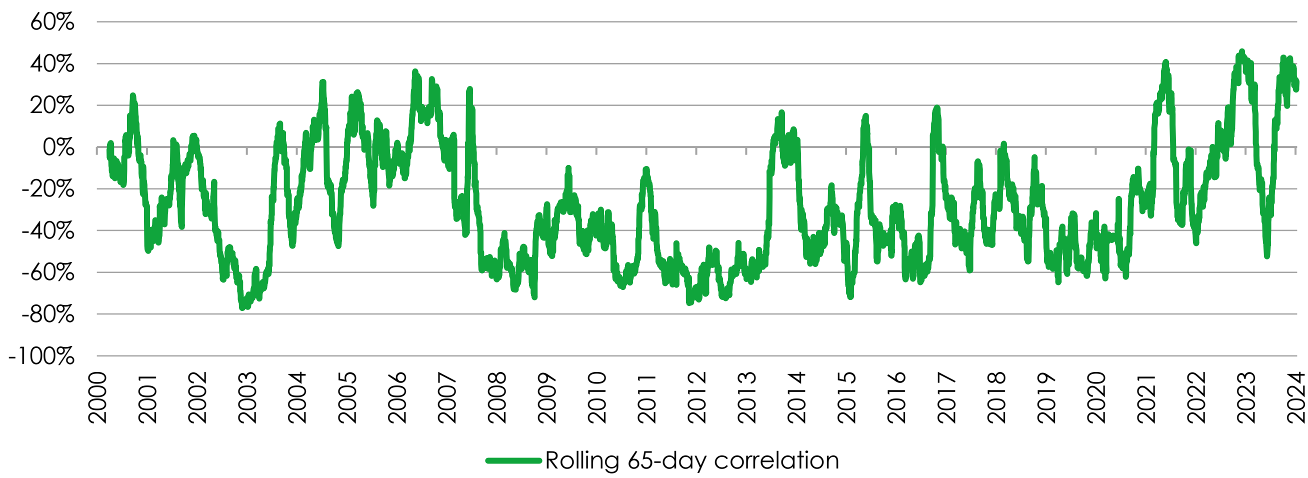


Source: Liontrust, ICE BofA US Corporate Index (C0A0), monthly data 31.12.1996 to 31.12.2023, buckets calibrated to have at least 20 data points

Our strategic bond range is underweight investment grade exposure with a 40% weighting compared to neutral at 50%. Being underweight credit means missing out on some yield carry, so not only do you need to be correct in your view, but you also need to be right relatively quickly. Combined with benign fundamentals, this leads us to temper the size of our underweight. We are targeting adding to credit during a period of volatility as opposed to anticipating a lurch higher in defaults and the permanent destruction of capital. The one area where we are concerned about capital loss remains CCC-rated credit; our strategic bond range has no exposure, and the high yield strategy only has a 5% weighting in strong stock selection opportunities.

From a portfolio construction perspective, we remain highly cognisant of the high correlation between sovereign bond markets and riskier markets. In the middle of 2023 a typical negative correlation had arisen, but as focus shifted back to the monetary cycle the positive correlation between risk and the proverbial risk free reasserted itself.

Rolling 3 months (daily returns) correlation of S&P 500 and US Treasury returns.



Source: Bloomberg, Liontrust 31.12.23

We believe that the positive correlation will remain in place until the market starts focusing more on economic growth. The conditions that will bring about the start of the rate cutting cycle could well provide the catalyst for this. The other possibility would be an unforeseen market shock, or an earlier liquidity crunch event than presently anticipated.

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.

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.

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