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Liontrust GF SF European Corporate Bond Fund: Q1 2022 review

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The Fund returned -4.8% in euro terms over the quarter, outperforming -5.4% from the Markit iBoxx Euro Corporates Index (which is the comparator benchmark)*†.

Outperformance was primarily driven by the increasingly hawkish shift by central banks causing a sharp rise in government bond yields, with the Fund's underweight interest rate risk position benefiting materially.

Apart from a brief flight-to-quality by investors when the Russia-Ukraine war began, government bond yields rose markedly throughout the quarter, as central banks moved towards more restrictive monetary policy to combat higher inflation. German 10-year Bunds ended the period 73 basis points (bps) higher at 0.55%, entering positive territory for the first time since early 2019, on heightened expectations for potential rate hikes before the end of year. UK 10-year gilt yields gained 64bps to finish the quarter at 1.61%, following two 0.25% rate hikes from the Bank of England (BoE). Meanwhile, the US saw the biggest increase, as US 10-year Treasury yields rose 83bps to end at 2.34%, after a first rate increase by the Federal Reserve in more than three years.

This backdrop meant our underweight exposure to interest rate risk delivered strong performance, with the Fund, on average, around 2.75 years short duration relative to its benchmark over the quarter. Our active duration management was also key, with around 40% of the short expressed through the US market, which has materially underperformed relative to Europe and the UK.

This strong return from rate positioning more than offset the drag on performance from the Fund's credit portfolio. Being overweight credit risk was a detractor over the period, as corporate bond spreads widened in the face of geopolitical uncertainty and tightening monetary policy conditions.

Sector allocation was a modest positive, as overweight allocations to more defensive, less cyclical parts of the market, including telecoms and Bunds, contributed against a risk-off backdrop. The Fund also benefited from being underweight the oil & gas sector, with Europe heavily reliant on Russian oil & gas, largely through not owning Gazprom bonds, which drastically underperformed following the invasion of Ukraine and subsequent sanctions before dropping out of the investment grade index altogether. These contributions more than made up for negative sector allocation from being overweight higher-beta areas such as banks and real estate.

Positive sector allocation was offset by negative stock selection from some of our higher-beta holdings, however. This was primarily due to broad spread weakness in the banks sector, as our overweight subordinated and underweight senior positioning detracted over Q1, reflecting general weakness in risk markets resulting from growing concerns around global growth. Furthermore, stock selection, particularly in legacy bank bonds, undermined performance, with previous gains eroded as the probability of an early call reduced. This was partially counterbalanced by strong stock selection within the insurance sector.

Our exposure to telecommunications proved the main negative in the non-financials space. This was principally attributable to our holding in Telecom Italia, with the bonds suffering from being a higher-beta high yield name in the broader sell-off, which was subsequently compounded by a particularly weak set of results that led to ratings downgrades and likely further negative ratings pressure. Meanwhile, our holdings in other higher-beta crossover high yield tower companies Cellnex and Inwit also underperformed broader market weakness.

From a macro perspective, the start of the year has obviously been overshadowed by Russia's invasion of Ukraine, sending shockwaves throughout financial markets. The conflict and resulting fallout have resulted in surging commodity prices, given Russia's position as a major exporter, exacerbating already significant inflation

pressures. Risk assets suffered as a result, with equities and bonds both posting negative returns against a backdrop of heightened uncertainty and volatility.

Russia's actions have drawn widespread condemnation, with severe sanctions imposed by Western allies including the UK, US and Europe. These have predominantly been financial in nature, seeking to cripple the Russian economy, including freezing the assets of the Russian Central bank, excluding banks from the global financial system SWIFT, and direct sanctions targeting oligarchs and other wealthy individuals. This was combined with multinational companies terminating or withdrawing Russian operations under considerable pressure from governments and investors.

In the UK, inflation reached a 30-year high of 7.0% in March and is forecast to rise above 8% before the end of the year, with risks skewed further to the upside. It is a similar picture in the US, where the level hit a 40-year high of 8.5%, as well as in the Euro area, which saw an all-time high of 7.5%. The ongoing conflict in Ukraine, combined with renewed Covid-19 outbreaks and strict lockdowns in China, are intensifying commodity price rises and supply chain disruption, further adding to mounting inflationary pressures.

Central banks find themselves in a difficult position, with risk of policy error elevated as they try to find the balance between curtailing inflation without compromising growth. As a result, monetary policy came under increased scrutiny over the quarter. At the beginning of the year, central bank messaging had already started to pivot, becoming more hawkish after dropping the word 'transitory' from inflation commentary and citing more broad-based and persistent inflation than anticipated. The BoE followed a first 0.15% hike in December with 25bps rises at its February and March meetings to reach 0.75%. This was driven by inflationary pressures combined with a tight labour market, given continued rises in job vacancies, wage growth and falling unemployment.

The extent of the hawkish shift at the February meeting took markets by surprise, with four of nine Monetary Policy Committee (MPC) members voting for a 50bps hike and the Bank announcing it would begin quantitative tightening by stopping reinvestment of proceeds from maturing government bonds and looking to sell down its corporate bond portfolio. Despite raising rates again in March, however, subsequent commentary struck a more dovish tone, tempering expectations over the number of further hikes this year, predominantly due to concerns over the growth outlook.

Despite opting to keep rates on hold, there was more hawkish narrative from the European Central Bank (ECB) to start the year. It announced an accelerated timescale for the reduction of its asset purchase programmes, which are now due to be concluded by September. Meanwhile, President Christine Lagarde also dropped from messaging that a rate hike was off the table for 2022, opening the door for a potential raise before the end of the year following the end of asset purchases. In spite of macro uncertainty, European economic data has proved resilient and continues to be supported by high levels of consumer savings, healthy labour markets and fiscal support packages. Europe remains more vulnerable to the ongoing conflict in Ukraine than either the US or the UK, however, given its reliance on Russian oil and gas coupled with historically high inflation. In response, the European Commission announced plans to reduce dependence on Russian gas by two-thirds by the end of the year and accelerate the transition to renewables but this is unlikely to be achievable over the short term given the lack of alternatives.

Elsewhere, the US also saw a 25bps rate rise in March and the Fed reiterated its hawkish stance, prioritising taming inflation through a more aggressive hiking cycle. The FOMC dot plot chart is currently indicating another six hikes this year, averaging 25bps per meeting, followed by a four more in 2023. The subsequent Fed minutes highlighted that only uncertainty stemming from the situation in Ukraine prevented a 50bps hike in March, with several officials, including Chair Jay Powell, saying such rises might be appropriate at upcoming meetings to get inflation under control. The outlook for higher rates is supported by ongoing tightening in the labour market, resulting in further wage growth and low levels of unemployment alongside resilient economic data.

Expectations for considerably more aggressive Fed hiking saw a flattening of the US yield curve over Q1. Front-end yields rose dramatically, with two-year yields up 160bps to end the period at 2.34% in line with 10-year Treasuries, as markets priced in more hikes than even the FOMC forecasts. This has increased concerns around the prospect of an inverted yield curve, which is often cited as a potential leading indicator of a recessionary environment. Historically, however, it has proved unreliable, wrongly predicting recessions roughly three times

more often than being correct. While risks have increased, we do not believe we are heading towards recession given the resilience of underlying economic data, ample consumer savings and healthy corporate balance sheets.

Given the backdrop of heightened uncertainty and volatility, trade activity was relatively modest to start the year.

We participated in a new issue from Haleon, a consumer healthcare business formed by the combination of GlaxoSmithKline and Pfizer's consumer healthcare units, which is due to be spun out in Q2. We believe the company demonstrates strong sustainability credentials, aiming to help individuals take responsibility for their health before reaching the healthcare system, with over-the-counter products such as vitamins, toothpaste and painkillers. We also feel the entity has a robust credit profile given its large scale and strong diversification by both geography and product line, with a dominant position across several markets. It is highly cash generative, with resilient cash flows, which should be supportive of its deleveraging ambitions over the coming years. Against this, we exited our position in Unilever on relative value grounds.

Elsewhere, we participated in new issuance from Segro, a pan-European logistics real estate company, and Snam, which has the largest European natural gas transportation network and storage capacity. Given weak market conditions, both came with attractive new issue premiums compared to existing bonds as well as comparable peers.

We exited our position in Telecom Italia during the period. Following a prospective private equity bid in November 2021, the company's results have deteriorated, leading to ratings downgrades and further negative ratings pressure. While we remain unconvinced a takeover bid will be successful, uncertainty regarding the company's alternative proposal to separate its networks into standalone business, combined with ongoing weak results, leave risks skewed to the downside.

There were also negative headlines around Annington, one of the UK's largest residential landlords. The company owns the former Ministry of Defence (MoD) estate and now largely rents properties back to the MoD as family accommodation. The MoD stated its intention to force a repurchase of these properties, which could potentially strip Annington of its assets. We believe the MoD's chances of succeeding in the buy-back process is limited, and even if they do, downside risk is low due to the bonds' protective covenants. As such, we made a relative value switch from shorter-dated/lower-cash price bonds into longer-dated/higher-cash price; the latter fell significantly to trade closer to par, which we believe should reverse once the legal challenge is resolved.

In financials, activity was low over the quarter, generally limited to several trades in January where we moved up the capital structure within favoured names including Santander, Credit Agricole and Societe Generale. We switched from subordinated into senior bonds on relative value grounds, reflecting the fact Tier 2 bonds were trading too tight to senior spreads.

As outlined, we were relatively active in terms of the Fund's duration positioning over Q1. After starting the year with an overall duration short of 3.25 years, expressed via 1.75 years to the German market, two years to the US and a 0.5 year long position to the UK, we elected to rotate one year of the short out of the US and into Germany in January following significant underperformance of Treasuries relative to Bunds at the beginning of the year. Given the speed and scale of the rise in government bond yields, we then decided to lengthen overall duration in mid-February. This was done by adding back 0.5 years of duration via the US, as well as 0.25 years through the German market, after 10-year Treasury and Bund yields had both risen around 50bps to 2% and 0.3% respectively.

Following Russia's invasion of Ukraine, government bond yields fell, retracing much of their previous rise before resuming the sell-off in March as central banks began to tighten monetary policy. Once markets had settled somewhat, we elected to lengthen duration again slightly given the magnitude of the sell-off, which we achieved by adding 0.5 years through the German market.

Further to this, we rotated 0.5 years of the short out of Germany and back into the US after Treasuries had outperformed, with 10-year yields approaching lows relative to Bunds, despite the decidedly hawkish tone from the Fed. We also chose to reduce our long position to the UK by 0.25 years. The Fund ended the period 2.25 years short duration relative to its benchmark, expressed via a 1.5-year short to the German market, one-year short to the US and 0.25 years long via the UK. We will continue to actively manage the position in future.

Looking to the rest of the year, risks for financial markets remain elevated: inflationary pressures are set to continue and there is scope for further geopolitical uncertainty from the situation in Europe. We believe the global economy will continue to rebound but have moderated our expectations for growth. While we do not expect growth to slow as much as consensus, we think there will be a moderation as interest rates rise at pace. Inflation pressures continue to be broad-based across a range of segments, with the Ukraine conflict and reintroduction of strict lockdowns in China having a pronounced effect on energy and commodity prices as well as wider supply chain disruption. Given the tightness in labour markets, we expect wage growth to start coming through more strongly to add to the inflation mix.

In the UK, we believe the market is pricing in more rate hikes than the BoE will deliver over the remainder of the year, given concerns over moderating growth and the impact of the rising cost of living on consumer confidence and spending. However, with inflation continuing to overshoot expectations and risks remaining skewed towards the upside, gilt yields will stay under pressure. As for the US, our view is that rising rates and inflation could have similar impacts on growth and there is potential for the Fed to look towards quantitative tightening to combat inflation, putting further upward pressure on Treasury yields.

The hawkish pivot from central banks has seen nominal government bond yields rise materially but this has been outstripped by the pace of inflation, with real yields remaining deeply negative. We therefore continue to favour a short duration position in the Fund given the growth and inflation outlook.

A strong technical environment and healthy corporate balance sheets leave us positive on credit, with valuations less stretched after spread widening so far this year. Credit metrics are broadly strong, with leverage near record lows and interest coverage at record highs, while liquidity continues to be robust with high levels of cash still available, leading to a benign default environment. Higher yields should continue to see demand for the asset class, particularly at the medium and longer end of the market.

We remain committed to our high-quality names within our favoured sectors, which should be relatively well positioned for current conditions. Financials should benefit from rising rates and improving profitability, and are not exposed to potential supply pressures from the unwind of central bank corporate bond holdings, having not been eligible for the programs. Meanwhile, our largest non-financial exposures within the telecommunications and utilities sectors demonstrate resilience and strong credit fundamentals and remain insulated from inflation pressures given their essential services offering and significant pricing power. We are overweight service sectors, which are less susceptible to inflation eroding profitability margins, and underweight manufacturing sectors, which are particularly vulnerable to rising input prices and reduced consumer demand.

Key Features of the Liontrust GF SF European Corporate Bond Fund

INVESTMENT OBJECTIVE & POLICY[1]:	The Fund aims to maximise total returns (a combination of income and capital growth) over the long term (five years or more) through investment in sustainable securities, primarily consisting of European investment grade fixed income securities. The Fund invests at least 80% of its assets in bonds issued by companies which are denominated in Euro or non-Euro corporate bonds that are hedged back into Euros. The focus is on investment grade corporate bonds (i.e. those which meet a specified level of creditworthiness). The Fund invests in companies that provide or produce more sustainable products and services as well as having a more progressive approach to the management of environmental, social and governance (ESG) issues. Although the focus is on investment grade corporate bonds, the Fund may also invest in government bonds, high yield bonds, cash or assets that can be turned into cash quickly. Where the Fund invests in non-Euro assets, the currency exposure of these investments will generally be hedged back to Euro. 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.
RECOMMENDED INVESTMENT HORIZON:	5 years or more
SRRI[2]:	4
ACTIVE / PASSIVE INVESTMENT STYLE:	Active
BENCHMARK:	The Fund is considered to be actively managed in reference to IBOXX Euro Corporate All Maturities (the "Benchmark") by virtue of the fact that it uses the benchmark(s) for performance comparison purposes. The benchmark(s) are not used to define the portfolio composition of the Fund and the Fund may be wholly invested in securities which are not constituents of the benchmark.
SUSTAINABILITY PROFILE	The Fund is a financial product subject to Article 9 of the Sustainable Finance Disclosure Regulation (SFDR).

Notes: [1]As specified in the KIID of the fund; [2] SRRI = Synthetic Risk and Reward Indicator. Please refer to the KIID for further detail on how this is calculated.

Discrete years' performance*, to previous quarter-end:
Past performance does not predict future returns

	Mar-22	Mar-21	Mar-20
Liontrust GF Sustainable Future European Corporate Bond A5 Acc	-5.5%	10.1%	-4.6%
Markit iBoxx Euro Corporates Index	-5.7%	8.7%	-3.4%

*Source: FE Analytics, as at 31.03.22, primary share class, in euros, total return (net of fees and income reinvested). Discrete data is not available for 10 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:
liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks and Disclaimer
†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 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. The Distribution Yield is also the Underlying Yield for this fund. Issued by Liontrust Fund Partners LLP (2 Savoy Court, London WC2R 0EZ), authorised and regulated in the UK by the Financial Conduct Authority (FRN 518165) to undertake regulated investment business. **This is a marketing communication.** This document should not be construed as advice for investment in any product or security mentioned, an offer to buy or sell units/shares of Funds mentioned, or a solicitation to purchase securities in any company or investment product. Examples of stocks are provided for general information only to demonstrate our investment philosophy. It contains information and analysis that is believed to be accurate at the time of publication, but is subject to change without notice. While care has been taken in compiling the content of this document, no representation or warranty, express or implied, is made by Liontrust as to its accuracy or completeness, including for external sources (which may have been used) which have not been verified. It should not be copied, forwarded, reproduced, divulged or otherwise distributed in any form whether by way of fax, email, oral or otherwise, in whole or in part without the express and prior written consent of Liontrust. Always research your own investments and if you are not a professional investor, please consult a regulated financial adviser regarding the suitability of such an investment for you and your personal circumstances. 22/275