Liontrust Monthly Income Bond Fund: Q1 2022 review

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The Fund returned -4.3% over the quarter, outperforming the -5.6% return from the IA Sterling Corporate Bond sector (the comparator benchmark) and -6.4% from the iBoxx Sterling Corporates 5-15 Years Index (the target 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. UK 10-year gilt yields gained 64 basis points (bps) to finish the quarter at 1.61%, following two 0.25% rate hikes from the Bank of England (BoE). German 10-year Bunds ended the period 73bps higher at 0.55%, entering positive territory for the first time since early 2019, while the US saw the biggest increase as 10-year Treasury yields rose 83bps to end Q1 at 2.34%, after a first rate hike 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 four 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, which has materially underperformed relative to the UK.

This strong return from rate positioning more than offset underperformance 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.

Sector allocation was positive, as our overweight allocations to more defensive areas of the market, including gilts, utilities and housing associations, contributed against a risk-off backdrop. This was offset by negative stock selection from higher-beta holdings, however.

Our overweight subordinated and underweight senior positioning within the bank sector detracted over Q1, reflecting general weakness in risk markets resulting from growing concerns over the impact of the war in Ukraine on 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. Our allocation to US dollar bonds within telecoms also detracted, as US credit underperformed sterling equivalents.

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.

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, 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.

Elsewhere, the US also saw a 25bps rate rise in March but unlike the BoE, however, 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 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.

Despite opting to keep rates on hold, there was also more hawkish rhetoric 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.

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 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.

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 a 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 chance 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. With banks, this was largely limited to the re-investment of the proceeds from a Lloyds bond that was called in February into the company's longer-dated bonds, as well as a relative value switch moving lower in the capital structure within Standard Chartered. We also reduced our position in longer-dated Legal & General notes for longer-dated Prudential notes. While the underlying credit has slightly weaker fundamentals, we believe the pickup in spread more than offsets this. We exited our position in Assicurazioni Generali on relative value grounds, rotating proceeds into favoured names such as Zurich.

As outlined, we were relatively active in terms of the Fund's duration positioning over Q1. After starting the year with an overall short of 4.5 years, expressed via a 2.5 year short to the UK and two years to the US, we elected to lengthen overall duration in early February given the speed and scale of the rise in government bond yields. This was done by adding back one year of duration, equally split to the UK and US, after 10-year gilt yields and 10-year Treasury yields had risen around 50bps to 1.5% and 2% 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 shorten duration by 0.5 years through the UK, given exacerbated inflation pressures, particularly for energy prices. We also rotated 0.5 years of the short out of the US into the UK given the relative underperformance, with 10-year Treasury yields approaching our estimated target range for the year. The Fund ended the quarter four years short duration relative to its benchmark, expressed via three years to the UK and one to the US. 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 on 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.

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

	Mar-22	Mar-21	Mar-20	Mar-19	Mar-18
Liontrust Monthly Income Bond B Gr Inc	-4.0%	14.9%	-3.0%	1.1%	4.2%
iBoxx Sterling Corporates 5-15 years	-5.6%	10.6%	-0.3%	4.5%	1.6%
IA Sterling Corporate Bond	-4.2%	9.0%	0.8%	3.0%	1.7%
Quartile	2	1	4	4	2

*Source: FE Analytics, as at 31.03.22, primary share class, total return, net of fees and interest reinvested.

For a comprehensive list of common financial words and terms, see our glossary at: liontrust.co.uk/benefits-of-investing/guide-financial-words-terms