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Liontrust Strategic Bond Fund

March 2022 review

Fund managers: Phil Milburn and Donald Phillips

The Liontrust Strategic Bond Fund returned -0.5%* in sterling terms in March. The average return from the IA Sterling Strategic Bond sector, the Fund's comparator benchmark, was -0.5%.

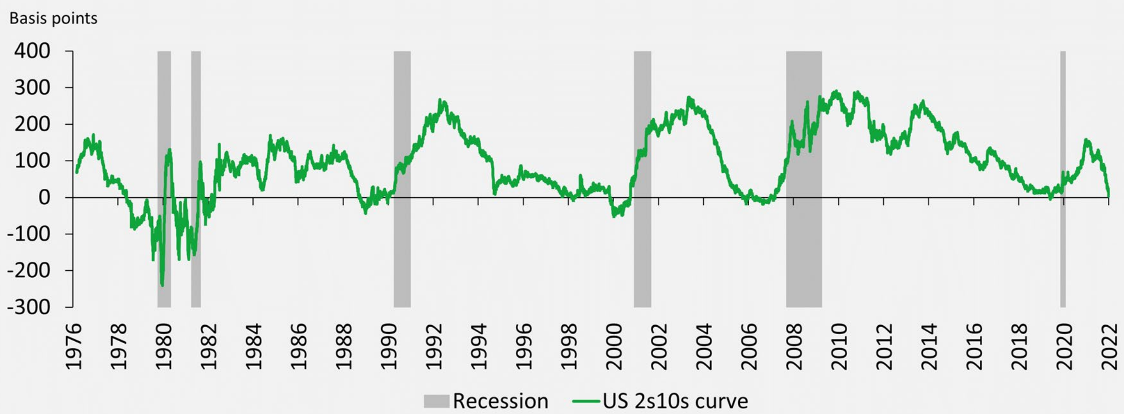
US yield curve flashing a warning signal

Every US recession in the last 50 years has been preceded by an inversion of the US yield curve. This much-followed market indicator has infamously predicted nine of the last six recessions, but even with the false positives it is a phenomenon that cannot be ignored. In March, the Federal Reserve raised interest rates for the first time since 2018; by the end of the month, the curve had briefly inverted intra-day.

Firstly, for those not familiar with bond market jargon, the yield curve merely represents the difference in yields between bonds of varying maturities. Normally, yield curves are upward sloping; it is riskier to lend to the government for longer periods as the chance of inflation eroding the value of your bond investment goes up, as does the risk of a deterioration in the credit quality, or even of a default. The specific part of the yield curve studied as a recessionary indicator is the US 2s10s: the difference in yields between the US 10-year government bond and 2-year Treasuries. An inversion is when the latter yields more than the former.

I should note that others prefer to look at 3-month yields compared to the 10-year. The two generate similar results but the 2s10s is more forward looking. On average, it takes about 18 months after the 2s10s yield curve inverts before a recession starts, but there is a large variation around the timing. There is less of a lag between any inversion of the 3-month versus 10-year yield differential and a recession occurring – this just shows that policy had become too tight (interest rates are too high and have choked off growth and investment). Presently, the curve between 3 months and 2 years in the US is very steep; effectively telling you that the Federal Reserve is hugely behind in this cycle and will be increasing interest rates rapidly to try to catch up.

US '2s10s' curve and US recessions



Source: Bloomberg, NBER, Liontrust. '2s10s' series: US 10 year treasury yield minus the US 2 year treasury yield, 01.06.76 to 31.03.22

During March, various Federal Reserve speakers voiced opinion that the pace of tightening must accelerate, with the consensus now saying that interest rate policy has to get beyond neutral or even to tight levels in order to bring inflation under control. Explicitly, the Fed's median dot plot policy rates predictor is now 2.8% versus its estimate of a 2.4% neutral level (we discussed the hawkish rate rise during March). The problem is that inflation has become embedded in expectations, with wage inflation being the most important self-fulfilling inflationary feedback loop.

The Fed has its own preferred measure (the 18-months forward 3-month rate minus the current 3-month rate), but all it currently shows is that the Fed should not have left policy so loose for so long – we have been vocal in that regard since early 2020. More interestingly, officials were keen to talk about the prospect for an economic soft landing, such as that achieved in 1994. The bond market clearly disagrees, as you can see from the narrowing of the spread between 10-year and 2-year yields in the chart above (a flattening of the yield curve), before the yield curve's brief intra-day inversion). So, is it "different this time?"

There is an argument that quantitative easing (QE) has depressed the term premium, the extra yield one should be paid for owning longer maturity government bonds. I have some sympathy with this but would counter that QE has also kept short rates too low. Whilst the yield curve would probably be steeper without QE, the flattening of the last 3 months cannot be ignored. This is particularly the case as we rapidly approach the period when quantitative tightening (QT) will start.

Although interest rates were much higher half a century ago, there is strong similarity with the experience in the 1970s in that the curve currently is inverting as we witness a supply shock. Firstly, the pandemic constrained supply and, post the great economic reopening, there are still bottlenecks throughout the supply chain including, for example, for semiconductors. Now Putin's war has caused further spikes in commodity prices. These will continue to feed into headline inflation over the months to come. But will they feed into core inflation in the longer term? For this we need to look at the demand side of the equation.

The consumer is in a fortunate position of having a strong balance sheet, with excess savings having accrued during the pandemic lockdown periods. These savings are not distributed equally, with socio-economic groupings A to C owning the vast majority. Thus, it is the lower socio-economic groups that not only lack savings but also have a higher exposure to headline inflation through the necessity of heating and eating; such basics are frequently excluded from core inflation calculations. The wallet substitution impact of higher energy prices can be mitigated in two ways, government intervention (with huge variance country by country) or by wage inflation. Labour markets are tight and elevated wage inflation remains our central case for the next couple of years – hence why central bankers are having to act.

For some time, we have believed that economies are comfortably strong enough to live with interest rates being higher for longer, especially if they curb inflation and actually improve living standards. This is on the basis that, for example, the Federal Reserve raises rates to the 2% area and keeps them there, rather than raise more aggressively only to cut in short order. With some Fed voting members now wanting rates above 3%, the goalposts have shifted and there is a real danger rates are now raised to recession-inducing levels.

So, to answer whether it will be different this time: if the Fed rapidly raises interest rates to be above 3%, then we think a recession is likely to follow in 12-24 months' time (so, no, it is not different this time); if, however the Fed is partly just talking a hawkish game to discourage inflation expectations and pauses at 2%, then we will expect a soft landing and the yield curve to start steepening again.

Rates

March started with a rates rally, so we trimmed the duration of the Fund down to 3.5 years[†]; the rally rapidly reversed, and we used the weakness to increase duration back up to 3.75 years where the Fund remained at the end of the month. The duration remains below our neutral level of 4.5 years; we believe that pockets of the sovereign bond market now offer value, but the broad market is still overvalued.

Towards the end of March, the 5s30s curve inverted, a much rarer occurrence than a 2s10s inversion. At a differential of minus 4 basis points, we switched half a year's duration exposure out of the 30-year into the 5 to

7-year area; this leaves the Fund with zero net duration exposure in the 15+ years maturity bucket in the US. The Fund has 2.25 years' duration contribution in the US; the majority of this is at the 5-year tenor.

The Fund took profits on its "butterfly" yield curve position in European duration, out of the wings (5-year and 30-year) and into the body (10-year), during March. This leaves the Fund positioned with a small positive exposure in 0 to 5-year maturities and the majority of the 1.5 years' worth of European duration at the 10-year tenor.

On the cross-market front, the Fund retains its strategic position to be long New Zealand relative to Australia. The spread between the two narrowed over the month and we anticipate it can go much further.

Allocation

Due to attractive valuations, we added to the Fund's investment grade exposure during the month, increasing it to just above our 50% neutral level - physical holdings represent 56% of the Fund's assets and there is a 6% risk-reducing overlay. The high yield weighting is just below 30% (neutral is 20%), with a strong preference for the quality end of the spectrum.

Having started the year underweight credit risk, we have used the valuation opportunity that arose during the crisis to add 15% to the total weighting, thereby taking the Fund overweight. With Putin's war on Ukraine not escalating, credit spreads staged a rally during the latter part of March, so our decision to add is starting to be vindicated. Once valuations are no longer attractive, we will reduce weightings toward neutrality again.

Selection

As a quick reminder which will not come as a surprise, the Fund has zero exposure to any Russian or Ukrainian sovereign or corporate debt. We have no intention of buying.

Stock level activity continued along the same theme as February: we have been trimming or selling relative outperformers and increasing weightings in any laggards. New purchases included debt issued by Rabobank, Bank of New York Mellon and Telefonica, the latter being funded by trimming the Fund's exposure to Eircom.

Finally, we switched part of our holding in Ardagh Packaging into the metal-can subsidiary from the part of the group more exposed to glass packaging. Glass packaging is a higher energy intensity, although we believe Ardagh Group has more than enough resilience and pricing power in order to weather the energy price storm.

Discrete 12 month performance to last quarter end (%):**
Past Performance does not predict future returns

	Mar-22	Mar-21	Mar-20
Liontrust Strategic Bond B Acc	-3.8%	12.5%	-3.0%
IA Sterling Strategic Bond	-2.2%	12.4%	-1.3%
Quartile	4	2	3

*Source: Financial Express, as at 31.03.2022, accumulation B share class, total return (net of fees and income reinvested.
**Source: Financial Express, as at 31.03.2022, accumulation B share class, total return (net of fees and income reinvested. Discrete data is not available for five full 12-month periods due to the launch date of the portfolio (08.02.18).

Fund positioning data sources: UBS Delta, Liontrust.
†Adjusted underlying duration is based on the correlation of the instruments as opposed to just the mathematical weighted average of cash flows. High yield companies' bonds exhibit less duration sensitivity as the credit risk has a bigger proportion of the total yield; the lower the credit quality the less rate-sensitive the bond. Additionally, some subordinated financials also have low duration correlations and the bonds trade on a cash price rather than spread.

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/glossary