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Liontrust SF Corporate Bond Fund: Q2 2022 review

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The Fund returned -9.5% over the quarter, underperforming -7.8% from the iBoxx Sterling Corporate All Maturities Index and the IA Sterling Corporate Bond sector average of -7.4% (both of which are comparator benchmarks)*†.

Against a challenging market backdrop, this relative underperformance was driven by the Fund's credit portfolio, which detracted from returns as corporate bonds struggled. The sterling corporate bond index saw spreads widen a further 60 basis points (bps) over Q2, ending the period above 200bps.

Stock selection was the main detractor, particularly within financials, as our overweight to subordinated banks and insurance, and legacy bank debt, underperformed amid the market's risk-off tone. However, we believe this relative underperformance is overdone, with financials suffering from a combination of poor sentiment and technical detractors. Banks remain well capitalised while insurers maintain high levels of solvency, with profitability set to improve from the higher interest rate environment.

In non-financials, telecommunications also detracted from returns, primarily our holding in the high yield-rated Cellnex, which underperformed investment grade peers given its higher credit beta and concerns around potential financing for a large acquisition. Once again, however, we believe this is overdone and, after speaking with management, remain confident the company is committed to its current ratings.

While overall sector allocation was also negative, the drag from being overweight financials was partially offset by a positive contribution from prudent allocations within more defensive areas of the market, including gilts, utilities and housing associations, as well as our underweight to more cyclical, consumer-orientated sectors.

Elsewhere, our underweight interest rate risk position remains a strong performance driver, with government bond yields continuing to rise as markets price in a more aggressive path of central bank tightening. Yield moves in Europe were the most pronounced, with the European Central Bank (ECB) confirming it will soon join the Federal Reserve and Bank of England (BoE) in beginning its rate hiking cycle. German 10-year Bund yields responded by rising 79bps over the period to reach 1.34%, having peaked as high as 1.77% in June. The UK followed suit with a similarly stark sell-off and 10-year gilt yields were up 62bps to end at 2.23%, climbing as high as 2.65% as the BoE announced its fifth rate hike since December 2021. Finally, the US also saw a material sell-off in Treasuries as the Fed front-loaded its rate hikes more aggressively than the market expected, with 10-year yields rising 68bps to end Q2 just above 3%, having peaked above 3.47%.

While we benefited from being short duration versus the Index, we also saw strong relative performance from curve positioning. We have a position in place for a steepening of the UK government yield curve, which contributed to returns as the UK 3s30s yield differential increased by 32bps over the quarter, due to a combination of still-rampant inflation and a weakening economic outlook.

From a macro perspective, recent headwinds for financial markets continued through the second quarter, resulting in one of the worst starts to a year across risk assets. As outlined, this negative sentiment has resulted in wider credit spreads, while rate hikes and continued inflationary pressures have caused Government bond yields to rise further, failing to provide the protection investors seek in such uncertain times. Markets have grown increasingly concerned about the threat of recession, with a potent combination of ongoing conflict in Ukraine, still accelerating inflation, a deteriorating growth outlook, and tightening monetary policy.

Inflation remains at the forefront, as not only are we yet to see the peak but recent data appears to show it is still accelerating across developed markets. Looking around the world, levels have reached a 40-year high of 9.1% in the UK, for example, while re-accelerating to hit 8.6% in the US and the Euro area keeping pace at 8.6%.

As we head into the second half, inflation looks set to remain elevated, driven by ongoing supply chain issues and the impact of prolonged conflict in Ukraine on commodity prices; conversely, however, there are signs of other pressures easing, with Chinese lockdown restrictions beginning to lift as Covid numbers improve. Major economies are beginning to show strain under persistent inflation, particularly in consumer demand data as households struggle with a cost-of-living crisis. In the UK, consumer confidence has reached an all-time low against a backdrop of rising energy prices, negative real wage growth and higher borrowing costs, prompting the government to step in with supportive measures. There have been similar trends in Europe, which is also facing dwindling consumer confidence, and the US, where sentiment has weakened despite the economy proving more robust and less impacted by the conflict in Ukraine.

There are also indications of the slowdown being felt more broadly, with leading indicators including PMIs falling across developed economies and approaching contraction territory. This leaves central bankers in an unenviable position of trying to tame inflation without stifling growth, leading to divergence among policymakers.

Given the US economy continues to be more resilient than developed market peers, the Fed reiterated its primary focus is getting inflation back under control. As a result, the FOMC increased the Fed Funds rate by 125 basis points (bps) in total over the period, including a 75bps hike at its June meeting, the largest rise in 30 years. Comments from Fed Chair Jerome Powell suggest they will continue to be hawkish until there is evidence inflation is responding, and he did not rule out another 75bps hike in July.

In the UK, meanwhile, the BoE elected to raise rates 50bps in total during the quarter to reach 1.25%, with consecutive 25bps hikes at May and June meetings. Similar to the Fed, they warned inflation risks remain skewed to the upside, forecasting a peak above 11% before year end, and signalling their capacity to act more forcefully if required. Unlike the Fed, however, the BoE has continued to opt for a more modest hiking path, reflecting the deteriorating growth outlook, with the Bank having further revised down growth forecasts and acknowledging the deterioration in consumer confidence; it also remains the BoE's belief that high inflation will itself impact demand and lead to lower levels of future inflation.

Arguably, the ECB finds itself in the most precarious position as it is most exposed to the threat of policy error from doing too much too soon, given potential negative shocks from the conflict in Ukraine. This could have a detrimental impact on the economy and temper inflation without the need for raising rates but with levels broadly in line with the US and the UK, the ECB is under pressure to take action to stop higher prices becoming entrenched. While the Bank opted to keep rates on hold over Q2, it has signalled its intention to raise by 25bps in July and hike again in September, with the magnitude dependent on inflation figures at that point.

Meanwhile, inflation outlook and expectations for higher rates has led to spread widening among European peripheral government bonds, with levels between German and Italian borrowing costs at highest level since the European Sovereign Debt Crisis. This prompted the ECB to call an emergency meeting in June to calm markets, as borrowing costs for the eurozone's most-indebted members threatened to enter 'unsustainable' territory. President Christine Lagarde said they are looking to accelerate plans for a new anti-fragmentation tool to maintain stability among members, with more details to be announced at the July meeting.

Over the quarter, trading activity in the Fund remained modest given turbulent conditions, which has seen new bond issuance slow dramatically. Despite this, we were able to add some names at attractive valuations, with healthy new issue premiums on offer given prevailing volatility.

We added Blackstone Property Partners Europe, an open-ended private equity fund focused on real estate investments with a diversified portfolio of high-quality, well-located assets, predominantly within the more resilient logistics and residential segments. The company is well positioned to withstand a period of economic weakness, with its defensive nature helping it fare better than peers following a marked increase in e-commerce penetration rates across Europe in the wake of the pandemic.

Another name added was Rentokil, which brought a new deal to help finance its acquisition of Terminix. It is a global leader in commercial pest control and hygiene services, whose products help ensure safe working and home environments. The company has solid credit fundamentals, combined with a commitment to deleveraging

and a strong track record through previous economic downturns, which should see it benefit from spread tightening relative to peers.

Given the significant underperformance within banks, which, to reiterate, we see as unjustified given robust sector fundamentals, we have also been adding to favoured names within the sector, narrowing our underweight relative to the benchmark. This included a new issue from Yorkshire Building Society, as well as top ups in Rabobank, Lloyds and Santander. We will continue to look for opportunities to close our underweight as credit markets stabilise. Similarly, we have added to favoured names within the insurance sector following recent underperformance, including a new RT1 issue from Aviva and top ups in Legal & General and Phoenix.

In order to fund these additions, we exited positions in short-dated bonds from Student Finance and Stagecoach, as well as trimming some holdings within the housing associations sector, all of which had performed relatively well from a total return perspective year to date. Further to this, we also exited some of our smaller, undersized holdings within the portfolio such as Eversholt.

We continue to be active from a duration standpoint, capitalising on volatility across government bonds. Having started the quarter at two years short relative to the benchmark, expressed via 1.5 years to the UK and 0.5 to the US, we have added back duration as yields approached our targets in both markets. Early in Q2, we closed our US short, as 10-year Treasury yields approached the upper end of our 3% target range, closing 0.25 years outright and rotating 0.25 years back into the UK, which, at 2%, offered more relative value against our target of 2.5%. As yields pressed higher over the remainder of the period, we continued to add back duration in 0.25-year increments as 10-year gilt yields approached 2.5%.

As a result, the Fund ended the quarter just 0.25 years short, solely expressed through the UK. We continue to believe government bonds remain overvalued given the inflationary environment, and therefore maintain an underweight to interest rate risk, but have pulled the short back from two years to 0.25. We now view government bonds as around fair value, given that we are close to central bank target terminal rates and yields are broadly consistent with long-term inflation mandates. As such, we have lower conviction over the path for yields in the near term and prefer to have flexibility to be tactical on duration management rather than maintaining a structural short.

Meanwhile, we also retained our curve steepener on the UK, continuing to believe the BoE is becoming increasingly wary of the growth outlook. As such, we expect the Bank to underdeliver on the level of hikes priced into the front end of the curve, with expectations for the rate to reach 3% in 2023 before falling towards 2%.

Looking to the future, the outlook for financial markets remains challenging, with investors firmly focused on central bank policy as they try to engineer a soft landing. But despite inflation running at its highest level in 40 years, we continue to believe tightening will be less aggressive than markets are pricing in, with policymakers reluctant to hike in the face of deteriorating economic growth outlook.

We believe we are entering a period of little to no real GDP growth over the next few years, with the UK and Europe likely to experience a shallow or technical recession and the US to follow suit if the Fed continues with its aggressively hawkish inflation-first rhetoric. That said, we remain positive on credit and with current valuations pricing in a deeper, more protracted, recession, corporate bonds present a rare value opportunity. Outside of periods of extreme stress, including the Global Financial Crisis, early part of the pandemic and European Sovereign Debt Crisis, current credit spreads are close to 25-year wides and trading at levels approximately double the pre-GFC average. Moreover, current spread levels are implying a five-year default rate forecast of around 10% in European investment grade, around ten times the long-run average rate and more than two-and-a-half times the worst ever rate.

This is despite corporate fundamentals remaining healthy: interest coverage is at record highs and net leverage well below long-run averages among European investment grade issuers, while liquidity remains robust given low funding requirements after the majority of companies termed out debt at attractive rates in recent years. Overall, investment grade balance sheets are in a strong position and more than capable of withstanding a period of low to no growth, which is not reflected in current valuations.

We remain committed to our high-quality names within our favoured sectors, which should be relatively well positioned for current conditions owing to strong fundamentals and robust operating performance. 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 as they were not eligible for programs. Meanwhile, our largest non-financial exposures within the telecommunications and utilities sectors demonstrate resilience and strong fundamentals and remain insulated from inflation pressures given their essential services offering and significant pricing power.

We are also overweight service sectors, which are less susceptible to inflation-eroding profitability margins, and underweight more cyclical manufacturing and consumer focused areas, which are particularly vulnerable to rising input prices and falling demand.

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

	Jun-22	Jun-21	Jun-20	Jun-19	Jun-18
Liontrust Sustainable Future Corporate Bond 2 Inc	-16.4%	5.2%	5.5%	5.6%	0.4%
iBoxx Sterling Corporate All Maturities	-14.5%	2.9%	6.5%	6.8%	0.4%
IA Sterling Corporate Bond	-12.9%	3.3%	5.8%	5.6%	0.6%
Quartile	4	1	3	3	3

*Source: FE Analytics, as at 30.06.22, primary share class, total return, net of fees and interest reinvested.

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 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. 22/518