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Liontrust GF SF European Corporate Bond Fund: Q2 2022 review

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The Fund returned -7.9% in euro terms over the quarter, underperforming -7.5% from the Markit iBoxx Euro Corporates Index (which is the comparator benchmark)*†.

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 euro corporate bond index saw spreads widen a further 83 basis points (bps) over Q2, ending the period above 210bps.

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, our overweight to real estate also dragged on performance, with spreads widening as investors grew increasingly concerned about the impact of tightening financial conditions on business models and property valuations. This was compounded by negative stock-specific developments, which further fuelled negative sentiment. Weak sector allocation was partially offset by stock selection, however, with our holdings concentrated in higher-quality, lower-beta issuers with robust balance sheets. Again, we believe recent underperformance is exaggerated, with property valuations yet to show signs of weakness, and remain committed to our high-quality names given their financial profiles.

Stock selection within telecommunications was also a detractor, 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, we believe this is overdone and, after speaking with management, are confident the company is committed to its current ratings. While overall sector allocation was also negative, the drag from being overweight financials and real estate was partially offset by a positive contribution from our defensive allocation to bunds.

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.

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.

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 75 bps 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.

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. We also participated in a new issue from Credit

Agricole, which again came with a healthy premium, offering an attractive entry point to add to our existing exposure. In order to fund these additions, we trimmed existing positions that had held up relatively well from a performance perspective, including Vonovia, Prologis and ING. Elsewhere, we executed a relative value switch within Aroundtown bonds, lengthening duration by less than half a year for a circa 25bps spread pick-up, taking advantage of the steep credit curve relative to peers.

We continue to be active from a duration standpoint, capitalising on volatility across government bonds. Having started the quarter at 2.25 years short relative to the benchmark, expressed via 1.5 years to Germany, one year to the US and a 0.25 year long to the front-end in the UK, we have been incrementally adding back duration as yields approached our target ranges across markets. Early in Q2, we closed our US short, as 10-year Treasury yields approached the upper end of our 3% target range, opting to close 0.5 years outright and rotate 0.25 years into both the German and UK markets, which offered more relative value against our anticipated target levels of 1.5% and 2.5% respectively. As yields pressed higher over the remainder of the period, we continued to add back duration in 0.25-0.5 year increments as 10-year bund yields approached 1.5%.

As a result, the Fund ended the quarter 0.25 years short, solely expressed through the German market. 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 3.25 years at the start of 2022 to 0.25 years. 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 implemented a curve steepener in 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.

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

	Jun-22	Jun-21	Jun-20	Jun-19
Liontrust GF Sustainable Future European Corporate Bond A5 Acc	-13.1%	4.2%	-1.0%	4.3%
Markit iBoxx Euro Corporates Index	-12.9%	3.5%	-0.5%	4.8%

*Source: FE Analytics, as at 30.06.22, 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

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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. Non-UK individuals: This document is issued by Liontrust International (Luxembourg) S.A., a Luxembourg public limited company (société anonyme) incorporated on 14 October 2019 and authorised by and regulated as an investment firm in Luxembourg by the Commission de Surveillance du Secteur Financier ("CSSF") having its registered office at 18, Val Sainte Croix, L-1370 Luxembourg, Grand Duchy of Luxembourg and registered with the Luxembourg trade and companies register under number B.238295. UK individuals: This document is 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.
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