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## Liontrust GF Strategic Bond Fund

October 2022 review

Fund managers: Phil Milburn and Donald Phillips

**The Liontrust GF Strategic Bond Fund returned 1.3%\* in US dollar terms in October. The average return from the EAA Fund Global Flexible Bond (Morningstar) sector, the Fund's reference sector, was 0.4%.**

### Market backdrop

For the last few months, the bond market has been caught between two opposing forces. On one side the continued elevated sticky inflation has led to higher yields as further rate rises are deemed necessary. However, the bond market keeps trying to oppose this and discount a "dovish pivot" by central banks.

The words dovish pivot are anathema to me. In reality, the focus is simply on the pace of rate hikes; whilst monetary policy is still being tightened, the debate should be about how hawkish central bankers are and the word dovish left out of the lexicon. More importantly, there is no pivot as that would mean a change in direction,

I will give a couple of examples: in late October, the Bank of Canada surprised markets by only increasing rates by 50bps to 3.75% when expectations were for a 75bps hike; this is a deceleration in the pace of tightening. Given that the Bank of Canada (along with the Reserve Bank of New Zealand) was one of the first and fastest rates hikers in developed markets, it is viewed as a potential route map for other central banks.

During the month, the European Central Bank raised rates by 75bps, in line with expectations, taking the deposit facility rate to 1.5%. This is not the end of the hiking cycle as "...inflation remains far too high and will stay above the target for an extended period." Therefore, the ECB "...expects to raise interest rates further," the big change in this sentence compared to September's meeting was the removal of the preface "...over the next several meetings." This removal was taken to be dovish by the market, during the press conference Lagarde emphasised the ECB's data-dependent approach with inflation and monetary policy changes (and lags thereof) being its key focus. In my opinion, the removal of the word several does not mean that there will be one more hike and then a pause, but does increase the probability of that happening.

The Federal Open Market Committee (FOMC) members voted unanimously to raise US interest rates by 75 basis points to a 3.75% to 4.0% range, in line with expectations. Further rate hikes are to be expected, as the Fed "...anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 per cent over time." The next sentence in its statement was new and gives a hint towards a reduction in the pace of tightening to come: "In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

Whilst the sentence is new, it does not change the conclusion. The Fed will slow the pace of hiking if economic data weakens, otherwise we will receive another 75bps increase at its 13-14 December meeting. Between now and then there are two more employment reports and consumer price inflation data points for the Fed to digest.

Ultimately, even if and when central banks do slow down their pace of rate hikes, it is the destination that is more important. Firstly, one needs to look at where peak rates are going to be in this monetary cycle, and this will continue to depend on economic data. Then, secondly, the cumulative tightening undertaken to reach the zenith will cause a recession. The question is, how deep this recession will be?.

I mentioned above the high and sticky inflationary environment; this is a current economic indicator caused by a combination of supply chain stresses (which are now easing), and excess demand due to monetary policy being kept too loose for far too long. The other very strong current economic indicator is the labour market, here demand outstrips supply by so much that central bankers view inflicting economic damage as a necessary condition to conquer wage inflation. Some other activity indicators are starting to weaken, for example US consumption which only grew by 1.4% in the quarter thereby lifting GDP by 1.0%. This slowing in the pace of consumption growth is supported by consumer confidence surveys and illustrative of the impact that the squeeze on real incomes is having.

Forward looking indicators, such as sentiment surveys and the shape of the yield curve, point towards an impending recession in 2023. This should be expected given the natural lags in transmission of monetary policy.

One part of the US economy that epitomises the impact of higher interest rates is the housing market. Data released in October showed that house prices fell by about 1% in August (FHFA -0.7%, S&P CoreLogic -1.3%). Although the annual rate is still above 10%, this will rapidly roll over. And that's before the lagged effect of the recent surge in mortgage rates to 7% really starts to bite. Shelter based inflation (rents and owner-equivalent rents) will start to fall significantly in 2023. My best estimate is that it will be in Q2 given the way that the BLS (Bureau of Labor Statistics) calculates its numbers. As a reminder, shelter makes up almost 40% of the Consumer Price Inflation (CPI) basket.

To summarise, we are not fixated on trying to call a dovish pivot. We are looking at economic fundamentals and the forward-looking indicators are deteriorating. We do not know the exact peak in base interest rates, but we are confident that the conditions will be in place later on in 2023 for monetary policy to be eased. Combine this fundamental backdrop with attractive real yields available on sovereign debt, and we believe there is a strong case for being long duration. At 5.5 years, the Fund's duration is above its 4.5-year neutral level and almost double where it started the year; should US Treasury yields rise further, we will continue strategically adding to duration exposure

## **Fund positioning and activity**

### **Rates**

During October 10-year US Treasury yields briefly went above 4.25% so we took the chance to incrementally add to the Fund's duration taking it to 5.5 years. This is split between 2.75 years in the US, just above 0.25 years in New Zealand, a contribution from the Eurozone slightly over 1.5 years and the UK just under 1 year. We effectively had zero UK duration exposure until August, then during the gilt market turmoil caused by September's mini budget, we added further to the Fund's duration exposure in the UK. The U-turn on the budget and change in leadership happened very rapidly, leading gilts to outperform other rates markets during the month; we are glad we had added and in hindsight should have added more. However, the Fund invests in global developed economy bond markets and the UK is only a small part of that universe.

### **Allocation**

There was minimal change to the Fund's asset allocation during October. Investment grade corporate bonds represent just under 60% of the Fund's assets. The high yield weighting finished the month slightly above 30% but has been trimmed towards 30% on the first day of November. As a reminder, we have a quality bias within credit, limited exposure to the most cyclical parts of the credit market, and the Fund owns no CCC rated bonds.

### **Selection**

There were no significant sales or new additions in credit during October. Dispersion at the stock level has increased across the market, the Fund had more positives than negatives. Outperformers during October included Zurich Insurance, Catalent, Iqvia, Vodafone, Netflix, and HCA. Laggards were mainly in the real estate sector (Castellum, Heimstaden Bostad and CPI property), with Standard Chartered and Fresenius' bonds also experiencing credit spread widening.

**Discrete 12 month performance to last quarter end (%)\*\*:**

***Past Performance does not predict future returns***

	Sep-22	Sep-21	Sep-20	Sep-19
Liontrust GF Strategic Bond B5 Acc	-15.7	3.2	6.4	7.4
EAA Fund Global Flexible Bond - USD Hedged	-12.1	4.3	3.4	6.7

\*Source Financial Express, as at 30.09.22, total return, B5 share class.

\*\*Source Financial Express, as at 30.09.22, total return, B5 share class. Discrete data is not available for ten full 12-month periods due to the launch date of the portfolio (13.04.18).

*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.*

**Key Features of the Liontrust GF Strategic Bond Fund**

Investment objective & policy <sup>1</sup>	The investment objective of the Fund is to maximise total returns over the long term through a combination of income and capital. The Fund will seek to achieve its objective by investing in bond and credit markets worldwide. The Fund invests in a wide range of bonds issued by corporates and governments, from investment grade through to high yield. The Fund invests in developed and emerging markets, with a maximum of 40% of its net assets invested in emerging markets. Investments may be made in "hard" currencies, such as US Dollar, Euro and Sterling, and up to 25% of the net assets of the Fund may be invested in soft currencies, such as those of emerging markets. Where the Fund invests in non-US Dollar assets, the currency exposure of these investments will generally be hedged back to US Dollar. 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). In addition, the Fund may invest in cash or cash equivalents, such as deposits and Money Market Instruments, for cash management purposes. Within the limits stated above, there are no geographical or economic sector restrictions on the Fund's investments. 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. The fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.
Recommended investment horizon	5 years or more
Risk profile (SRR1) <sup>2</sup>	4
Active/passive investment style	Active
Benchmark	The Fund is actively managed without reference to any benchmark meaning that the Investment Adviser has full discretion over the

	composition of the Fund's portfolio, subject to the stated investment objectives and policies.
Sustainability profile	The Fund is a financial product subject to Article 8 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.

For a comprehensive list of common financial words and terms, see our glossary at:

<https://www.liontrust.co.uk/glossary>

#### Key Risks:

**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 GF Strategic Bond 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. Bond markets may be subject to reduced liquidity. The Fund may invest in emerging markets/soft currencies and in financial derivative instruments, both of which may have the effect of increasing volatility. The use of derivatives may create leverage or gearing. A relatively small movement in the value of a derivative's underlying investment may have a larger impact, positive or negative, on the value of a fund than if the underlying investment was held instead.

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