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Liontrust GF SF European Corporate Bond Fund: Q4 2022 review

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The Fund returned 1.3%*† in euro terms over the quarter, compared with the 1.2% return from the Markit iBoxx Euro Corporates Index comparator benchmark.

Market backdrop

Despite improved performance over the final quarter of the year, 2022 proved to be one of the worst years for asset returns in the last 20 years. Central banks struggled to control persistently high inflation, with significant interest rate increases dominating markets in 2022.

In the final quarter, investor optimism focused on the belief that peak inflation had been achieved, following weaker inflation data. This led to a reduction in expectations for where interest rates would finally peak. This saw all of the US federal Reserve, Bank of England and European Central Bank deliver reduced rate increases of 50bps in December. However, the accompanying hawkish commentary from the US Federal Reserve and European Central Bank resulted in yields moving higher towards the end of the quarter.

Inflationary pressures have started to alleviate in Europe, with euro area inflation falling from a peak of 10.6% to 10.1% in November. This was despite heavy reliance on Russian gas, as a milder than expected winter saw falling gas prices help to alleviate inflation pressures.

This was positive for risk assets, as investors grew more hopeful that we are approaching the end of monetary tightening. The ECB now expects average inflation of 8.4% in 2022, 6.3% in 2023, 3.4% in 2024 and 2.3% in 2025. It sees recession in the region being relatively short lived and shallow.

Similarly, Q4 finally showed some encouraging signs that inflation might have peaked in the US which saw relief rallies in bonds, as Federal Reserve Chair Jerome Powell hinted that future interest rate hikes would be dialled down. Headline inflation fell to just over 7%, having peaked above 9% in June, following consecutive downside surprises, leading markets to start pricing in interest rate cuts as soon as late 2023.

Whilst there has been some softening in the economic data the labour market continues to be resilient with unemployment remaining at 3.6%. This Fed remains focussed on this and is watching for signs that the labour market is easing.

In the UK, the political landscape stabilised following the inevitable regime change amidst the turmoil following September's disastrous mini-budget announcement.

In October, Rishi Sunak was appointed as the new Prime Minister, with Jeremy Hunt the new Chancellor, who swiftly reversed almost all of the fiscal stimulus measures announced in the mini budget, while also promising further fiscal tightening to come. This reassured market concerns about the scale of unfunded government spending plans, with equities and bonds staging large rallies in mid and late October, recovering much of the previous month's underperformance, as 10-year gilt yields fell sharply from a decade high of 4.5%. The pound also recovered against the US dollar.

This positive sentiment was somewhat tempered by the latest inflation print, which, despite falling from 11.1% in October to 10.7% in November, remains more persistent than in the US and Europe. This saw the Bank of England maintain a more hawkish approach despite the drop in headline inflation.

The Bank of England now expects UK GDP to decline by 0.1% in 2022 Q4, 0.2% better than expected in the November Report. Inflation, however, is expected to fall sharply from mid-2023 to below the 2% target in years two and three of the projection.

On a similar trend, labour demand has begun to ease, with the unemployment rate rising slightly to 3.7%, but it still remains tight. Despite a somewhat resilient labour market, we have seen a clear deterioration in the real economy, with household consumption weak and most housing market indicators continuing to soften.

Fund review

The Fund's relative outperformance was primarily driven by our overweight credit position, as corporate bonds rallied strongly amidst a risk-on tone as investors grew increasingly optimistic that we are approaching the end of the monetary policy tightening cycle. This was driven by a combination of strong sector allocation and stock selection across our core sectors.

Financials were the biggest outperformers as our allocation to the Banks and Insurance sectors benefitted from a strong recovery on improved macro-economic sentiment, particularly given our overweight allocation to higher beta subordinated bonds.

Meanwhile, our overweight to the Telecommunications sector also delivered strong positive contribution over the period, particularly stock selection as our higher beta and longer spread duration holdings outperformed.

This outweighed the drag on performance from our exposure to the Real Estate sector as the combination of high inflation, tightening financial conditions, rising yields and the growing threat of recession have weighed on the property market, particularly amongst higher beta names, such as Aroundtown and Canary Wharf. There was also negative contribution from our more defensive allocation to Bunds.

Rates attribution was broadly neutral after we lengthened the Fund's duration position to neutral versus its benchmark.

Rates positioning was proactive as we continued to actively manage the Fund's duration over the quarter.

Following central bank willingness to hike by more, we closed our underweight duration position to Europe. We are now neutral duration, supported by the high all-in levels of yields, better than expected levels of gas storage over the winter, and recent comments by some European central bank members to stop hiking after the next meeting.

Fund trading activity was muted over the period. While issuance picked up, demand was high and certain deals that appeared attractive came at expensive valuations. Even challenged names had order books multiple times oversubscribed.

Outlook

As we enter 2023, the market is approaching a potentially important transition period that could see the 2022 headwinds ease in the months ahead.

Inflation has shown definitive signs of peaking, and while still too high in an absolute sense, it could prove a positive surprise if price pressures ease faster than expected.

On a monetary policy level, the hiking campaign is likely near complete. In December, the Fed signalled that it expected the peak interest to rate be 75bps higher than current rate, which could easily be reached in the first few months of 2023.

Economic growth and corporate earnings are indeed expected to decline in 2023, but these expectations now seem to have been fully priced into equities and bonds at current levels. We believe the focus of the market should turn to single name issuers and fundamentals and move away from monetary policy tracking.

From an investment perspective, corporate spreads also appear to be making steady progress in tightening, after spiking to 2020 levels this summer. This should help corporates improve their financing conditions on new debt issuance in 2023.

Declines of the magnitude we saw in 2022 are usually followed by strong recoveries. Bonds, as represented by the Bloomberg US Aggregate bond Index, have never experienced two consecutive years of negative returns. Therefore, we think market declines seen in 2022 have ultimately yielded substantial long term opportunities in the fixed income markets. Slower growth should be constructive for fixed income securities, which, coupled with current attractive valuations and well positioned corporate balance sheets, presents an opportunity for the sector and offers investors attractive compensation.

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

	Dec-22	Dec-21	Dec-20	Dec-19
Liontrust GF Sustainable Future European Corporate Bond A5 Acc EUR	-14.8%	-0.3%	1.0%	7.3%
Markit iBoxx Euro Corporates Index	-14.2%	-1.1%	2.7%	6.3%

*Source: FE Analytics, as at 31.12.22, A5 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

Key Risks and Disclaimer

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