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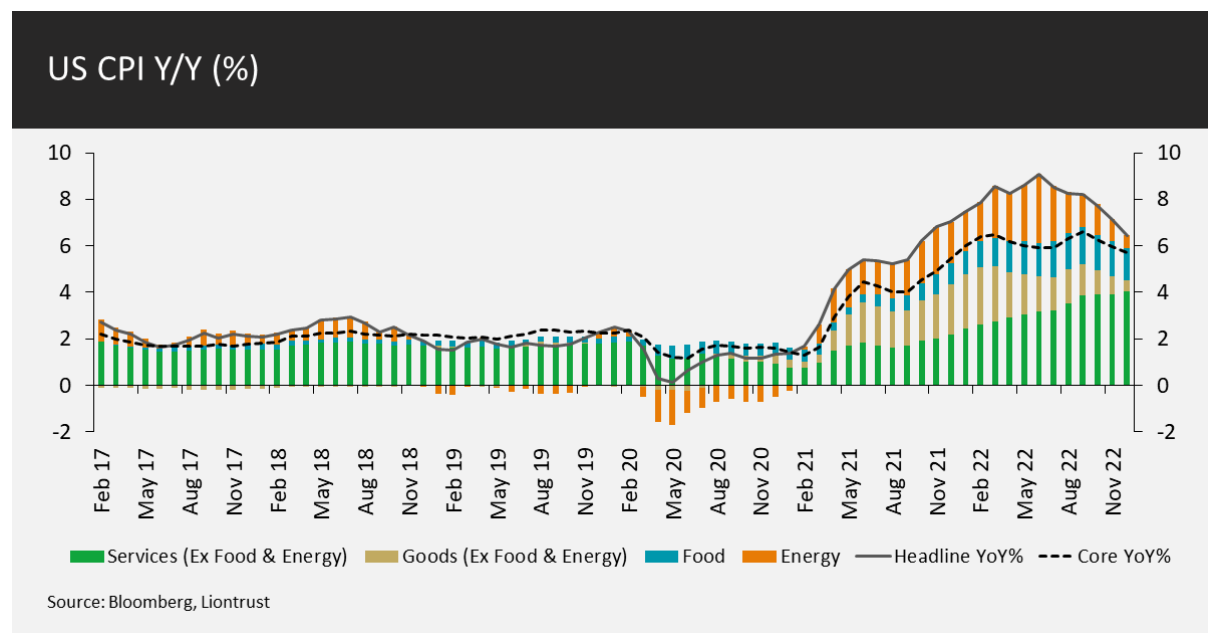
## Liontrust GF Strategic Bond Fund

### January 2023 review

Fund managers: Phil Milburn and Donald Phillips

**The Liontrust GF Strategic Bond Fund returned 3.4%\* in US dollar terms in January. The average return from the EAA Fund Global Flexible Bond (Morningstar) sector, the Fund's reference sector, was 2.7%.**

January was a very strong month for fixed income as the markets start to look forward to base interest rates peaking and inflation falling. Starting with the latter, January's US CPI data was in line with expectations. Headline inflation continued its descent from its zenith, as shown below, with the annual rate now 6.5% (consensus 6.5%, prior 7.1%). Core CPI is also decreasing: December's reading was 5.7% (consensus 5.7%, prior 6.0%).



Core goods was -0.3% month/month, affected by a fall in both used and new car prices; the one outlier in core goods on the upside was apparel prices. Food inflation (blue bars) is falling and should, hopefully, turn negative month-on-month sometime in the next few months.

Services continue to be where the Fed will focus and the average month-on-month price increases were 0.5%. Within services, both rent inflation and owners' equivalent rent remain strong, exhibiting 0.8% month-on-month gains, despite measures such as the Zillow rent index showing falls. As a reminder, the contribution to inflation from the shelter component will start to roll over late in Q2 or into Q3. Excluding shelter, core services inflation was 0.2% month-on-month; this is an encouraging sign. This core services ex-shelter inflation remains highly correlated to nominal wage inflation, which is one of the key reasons why we believe the Fed wants to do more to address the labour market imbalances.

On 1 February, in a unanimous vote, the Fed hiked by 25bps to take the fed funds rate to the 4.50% - 4.75% range. There were a few snippets from the statement that I want to highlight. Firstly, “...*Inflation has eased somewhat but remains elevated*”, where the admission of some easing of pressures is dovish at the margin. However, “...*The Committee 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 percent over time.*” My emphasis on ongoing increases is to show that the Fed’s central case is still for two more rate hikes, consistent with its dot plot.

We are approaching the peak, at least for the near term, as shown by the subtle shift in the sentence “...*In determining the **extent** 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.*” Previously, the Fed talked about the pace rather than the end level (terminal rate) that extent implies.

Powell’s press conference was taken to be dovish and maybe the lack of hawkishness was what spurred on markets to rally. To be fair, I did expect Powell to push back against the market pricing more, as a loosening in financial conditions is not what the Fed currently desires. When asked explicitly about financial conditions, Powell said that the Fed’s focus is “...*not on short-term moves but on sustained changes.*” The gap between the bond market pricing for rate cuts in 2023 and the Fed’s most recent dot plots represents a “...*difference in perspective*” which Powell puts down to the market having a more optimistic view about the pace of inflation falling than the Fed; the data will determine which forecast is correct.

The ECB then hiked rates by 50bps on 2 February, in line with consensus. The deposit rate (the one of its three rates that I focus on) now stands at 2.50%. There was no ambiguity at all about its next move in March: “...*In view of the underlying inflation pressures, the Governing Council intends to raise interest rates by another 50 basis points at its next monetary policy meeting in March and it will then evaluate the subsequent path of its monetary policy.*” There was also a reiteration that not only do rates need to be restrictive, they need to stay there for a while “...*Keeping interest rates at restrictive levels will over time reduce inflation by dampening demand and will also guard against the risk of a persistent upward shift in inflation expectations.*” It also reminded readers that future meetings’ actions depend on the data – presumably they mean the meetings after March! There does seem to have been a compromise made between the hawks and doves of the ECB, the former getting an almost guaranteed further 50bps hike in March whilst the latter negotiated for an assessment of conditions at that stage.

European bond markets focused on the dovish side of the bargain, exhibiting a huge rally on the day. Watching Lagarde’s press conference, my interpretation is not so sanguine. Lagarde can talk faster than I can type so forgive any typo in the following quotes from her Q&A session: firstly, about whether post-March there will be a pause in hikes “...*What will happen next there will be more ground to cover.*” The topic was repeatedly returned to, and the answers stayed resolute “...*After March will that be the pinnacle or peak – no, no, no. We will need to assess to stay the course – raise into restrictive levels and stay there for sufficiently long to get inflation back to target.*” Furthermore, to prove she really means it “...*Underlying inflation pressure is there – alive and kicking.*” Finally, even on one of the more dovish statements that the risk assessment (on inflation and growth) is more balanced, Lagarde caveated it with “...*The risk assessment is not balanced but it is more balanced than it was in the summer.*”

The bond market’s dovish interpretation will need European core inflation to be falling by the 4 May meeting to be vindicated, and I am not convinced there will have been enough progress on either core inflation or the labour market by that stage.

In line with predictions, the Bank of England hiked rates by 50bps to 4.0%; the vote split was 7-2 with Dhingra and Tenreiro preferring to keep rates at 3.5%. Using both current 4% rates and market implied rates (at the

time of their forecasting “...a market-implied path for Bank Rate that rises to around 4½% in mid-2023 and falls back to just over 3¼% in three years’ time”), the Bank of England’s projections have inflation below 1% in two years’ time.

Its rationale behind this is “... an increasing degree of economic slack, alongside falling external pressures, leads CPI inflation to decline to below the 2% target in the medium term.” The next sentence gives the important caveat “...There are considerable uncertainties around this medium-term outlook, and the Committee continues to judge that the risks to inflation are skewed significantly to the upside.” The UK is following a similar pattern to most other developed market economies in that “...Headline CPI inflation has begun to edge back and is likely to fall sharply over the rest of the year as a result of past movements in energy and other goods prices. However, the labour market remains tight and domestic price and wage pressures have been stronger than expected, suggesting risks of greater persistence in underlying inflation.”

In my opinion, there was one key part of the statement: “...The MPC will continue to monitor closely indications of persistent inflationary pressures, including the tightness of labour market conditions and the behaviour of wage growth and services inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required.” Firstly, it is worth noting that the words “respond forcefully” that were in the December statement have now been omitted; so, if there were to be more rate hikes, they would be in 25bps increments. More importantly, the conditional “..if there were to be evidence of more persistent [inflationary] pressures” is a very strong signal that the Bank of England is either at peak rates or very close to them. With inflation risks, in its opinion, being skewed to the upside, they are not definitely finished in this tightening cycle; but they are definitely close. At the time of writing, the market has one more 25bps hike priced in.

After all the discussion above about the monetary side of the equation, there was a fiscal development during the month that will need close watching. US Treasury Secretary Yellen sent a letter to Congressional leadership on 19 January stating that the “...outstanding debt of the United States was projected to reach the statutory limit.” Firstly, it is worth a reminder that the US has some really badly concocted legislation. The debt limit was first introduced in 1917, having an absolute limit for debt in an economy that grows in both real and nominal terms makes no sense at all; ad valorem debt or deficit limits are much better structured (see Germany or even the Maastricht Stability and Growth Pact). The current limit, which has just been hit, is \$31.4 trillion. It was last raised in December 2021 by \$2.5 trillion; the limit was suspended for two years before that due to the pandemic.

Most of the time, the debt ceiling is not a problem, with new legislation just being passed to increase the limit. For example, according to the US Treasury: “...Since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit – 49 times under Republican presidents and 29 times under Democratic presidents. Congressional leaders in both parties have recognized that this is necessary.” The issue is when the politics heats up to such an extent that a deal to increase the limit cannot be struck in a timely manner. The best recent example was in 2011 (under President Obama) when the US lost its AAA rating and markets had a few very skittish days. In a similar vein to 2011, there is a Republican controlled House of Representatives with the Democrats in charge of the Senate and White House.

For the immediate future, there is no cause for alarm. The US enters a “debt issuance suspension period” (DISP) and utilises “extraordinary measures” to bide themselves over for a few months. Most of the extraordinary measures involve extracting US debt from various trusts – for example, by not rolling over maturities – and replacing it with different obligations that do not count towards the debt limit (with a promise for a future make whole once the debt limit is raised). The cumulative impact of these extraordinary measures is estimated by Oxford Economics to be \$428 billion; JP Morgan economists estimate \$448 billion capacity so a very similar ballpark. Note that the US can also run down its Treasury General Account cash balance if it chooses to do so; it is currently about \$400 billion.

Exactly how long the US federal government can keep servicing its obligations for is a moveable feast. One of the bigger variables is the size of the April tax receipts (which are likely to be lower than in 2022 due to less capital gains tax being realised). August is normally a big budget deficit month, so that makes a good central case with June being the earliest and November the latest.

The politics around this will be more testing than usual as Speaker of the House McCarthy was only elected by promising right-wing Republicans that he would use the debt limit to force through spending cuts. On the flip side, the Democrats want to just raise the limit with no strings attached. There is a reasonable probability that this will be taken to the wire. Hopefully common sense will prevail, but the polarisation of politics has increased the risks.

If all the cash balance and extraordinary measures are used up, the federal government will go into shutdown. Even then, the US will not necessarily default on its debt obligations as the Treasury could attempt to prioritise debt payment to avoid a technical default. Transcripts from FOMC meetings during past debt ceiling episodes suggest that this option has been given serious consideration.

There is another option: invoking Section 4 of the 14th Amendment. The key sentence is: “...*The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned*”. This could allow for the Treasury to breach the ceiling given that the debt limit itself is creating an unconstitutional situation. This would be viewed as using the least illegal option. Obama rejected this idea in the past, but there is no guarantee that Biden will either remember or even care about that.

## **Rates**

There was a small 0.25-year reduction in core duration in the Fund during the month, with the exposure at the end of January being 5.0 years (reminder: range 0-9 years, neutral 4.5 years). There were some adjustments by geography with a reduction in duration in the US and Eurozone, and increases in the UK and New Zealand. Exposure is 2.0 years in the US, 1.25 years each in the Eurozone and the UK, and 0.5 years in New Zealand.

My use of the term core duration above is because we also now have a 0.5-year short duration position in Japan. The Bank of Japan, for now, maintained its yield curve control (YCC) targeting 10-year JGB yields of around 0% with a range of 0.5% permitted above or below the target level. However, the Japanese Government Bond (JGB) market remains dysfunctional. In my opinion YCC is no longer fit for purpose but it appears that the exit from it is being handled in a gradual manner. This year's shunto wage round over the next two months will be very revealing about whether the pick-up in inflation in Japan (obviously still low by international standards) passes through into wage inflation, and following that services inflation. With Kuroda leaving the BoJ in April, after 10 years at the helm, this could give the new BoJ Governor the chance to get rid of YCC; it's possible Kuroda does it as a parting gift in March but not likely. Given the nature of the JGB market it is better to think of this as a special standalone alpha position rather than knocking half a year off the effective duration contribution; JGB's have a low beta and little correlation, most of the time, to other bond markets.

## **Allocation**

There was a small reduction in credit risk during the rally in January. Strategically we believe credit offers long-term value both examining spreads and, particularly, the all-in yield. However, the upcoming recession in 2023, and reduction of central bank liquidity, mean that we need to see more of a premium to justify a large overweight position. Investment grade exposure at 49% is just below our neutral level of 50%, the high yield weighting is 25% compared to a neutral level of 20%. 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

The Fund sold long-dated HCA in the US dollar market and, also, took profits in Eli Lilly in Euros. We also trimmed Fresenius' bonds during the rally. On the reinvestment side a new issue gave a good opportunity to top up Ashtead exposure at a cheap level. Within high yield we trimmed both Ziggo and SFR after a very strong start to the year for its bonds. There was one new addition to the Fund this month, Sealed Air 5-year bonds in US dollars. For this high quality (high BB rating) defensive packaging name a yield of 6.125% for 5-year bonds was both cheap outright and relative to their existing bonds.

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

*Past Performance does not predict future returns*

	Dec-22	Dec-21	Dec-20	Dec-19
Liontrust GF Strategic Bond B5 Acc	-11.0	-0.3	7.7	10.2
EAA Fund Global Flexible Bond - USD Hedged	-8.6	0.1	5.6	9.6

\*Source Financial Express, as at 31.01.23, total return, B5 share class.

\*\*Source Financial Express, as at 31.12.22, 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.*

<sup>†</sup>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
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	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 (SRRRI) <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. SRRRI = 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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