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GLOBAL FIXED INCOME PROCESS

Liontrust GF Absolute Return Bond Fund

Q2 2023 review

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The Liontrust GF Absolute Return Bond Fund (C5 share class) returned 0.6% in sterling terms in Q2 2023 and the IA Targeted Absolute Return, the Fund's reference sector, returned -0.5%. The Fund's primary US dollar share class (B5) returned 0.8%.

The Liontrust GF Absolute Return Bond Fund returned 0.78% during the second quarter of 2023. During the second quarter the yield carry on the Fund more than offset the drag from the rise in sovereign bond yields, the net impact on total return being just over 0.5%. The rest of the gain during the quarter was due to credit spreads, a combination of the broad credit market exhibiting a little spread tightening and some stock specific situations.

Key points:

- **Fears over a possible breach of the US debt ceiling dominated bond markets in Q2**
- **The US Federal Reserve took a hawkish approach in June with further policy tightening likely**
- **The European Central Bank raised its inflation forecast for 2023 to 5.1% due to the 'robust' labour market**
- **Headline Consumer Price Inflation (CPI) remained high in the UK at 8.7% due to stronger inflation in goods and services**
- **The true effects of monetary policy are yet to be felt due to the infamous lag – however, we now believe the UK is unlikely to avoid a recession.**

Market backdrop

As the quarter started, the contagion from the US regional banking crisis became contained; the markets could then move on to focusing on their next main worry, the US debt ceiling. A last-minute bipartisan compromise between the Democrats and Republicans led to the suspension of the debt ceiling until January 2025, as covered in more detail below. After getting past the debt ceiling worries, the bond market could then return its focus to economic fundamentals and the ongoing tightening cycle by central banks.

In June there was a small reappraisal by the bond markets of how high terminal rates will be in this cycle, there was also a larger reappraisal of the longevity of base rates staying at their peak. Starting with the US Federal Reserve, June's FOMC (Federal Open Market Committee) meeting produced what I characterise as a hawkish pause in the monetary policy tightening cycle. The Fed funds rate was held steady at the 5.00-5.25% range, but both the accompanying statement and Summary of Economic Projections (SEP) were hawkish in nature. The onus has shifted in June to be that if the data does not weaken soon then one should expect further policy tightening. The statement itself had unanimous agreement from the committee with differing opinions being exhibited in the SEP; it is clear that it is getting harder to reach a consensus as we are at or near to peak rates.

There was a nuanced somewhat hawkish change to part of the statement. The start of the sentence changed from "*extent to which*" to "*extent of*" in the outlook sentence "…*In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee* …" in June. The

statement retained the data conditional "*may be appropriate*" but the overall language hints more strongly toward further tightening.

Moving on from nuance to a more bluntly delivered message in the SEP: Real GDP forecasts for 2023 were revised up to 1.0% (prior 0.4%), with 2024 and 2025 growth rates tweaked down by 0.1% each to 1.1% and 1.8% respectively. Unemployment is forecast to finish 2023 at 4.1% (prior forecast 4.5%) then be 4.5% in 2024 and 2025 (both previously 4.6%). This year's headline PCE inflation forecast was nudged down 0.1% to 3.2%, but it is core PCE inflation that is the key variable; this was increased to 3.9% (prior 3.6%) for 2023, left unchanged at 2.6% in 2024 and projected to be 2.2% in 2025 (prior 2.1%). Accompanying the increased core PCE predictions was a revision to FOMC members' forecasts for rates in their dot plot. In the SEP in March the end 2023 rate was expected to be 5.00-5.25%, in advance of the March meeting a higher terminal rate had been anticipated but then the level was held due to the US regional banking mini crisis. The FOMC members' projections now have the end 2023 rate, and terminal rate for this cycle, of 5.50-5.75%. The bond markets are pricing a very low probability of two hikes occurring this year, so don't believe the dots' level will be achieved, but cuts from the present Fed funds rate have been completely priced out until the second quarter of 2024.

The European Central Bank (ECB) hiked rates by 25bps in line with expectations, taking the deposit rate to 3.50%. The most attention-grabbing part was the increase in the ECB staff's core inflation forecasts; while an upward movement was anticipated for the 2023 number, forecasts for later years were expected by the market to be revised lower. In the following sentences I have inserted the ECB's March forecasts in square brackets "…*Staff have revised up their projections for inflation excluding energy and food, especially for this year and next year, owing to past upward surprises and the implications of the robust labour market for the speed of disinflation. They now see it reaching 5.1%* [4.6%] *in 2023, before it declines to 3.0%* [2.5%] *in 2024 and 2.3%* [2.2%] *in 2025*." During the press conference Lagarde emphasised that the majority of the increase in the core CPI forecast is attributable to unit labour costs, the residual being past upward revisions to inflation data which creates a higher starting point.

The ECB is almost certain to raise rates in July, but there is debate amongst the members over whether a further rate hike is required in September. Simultaneously monetary policy will become more restrictive as the ECB undertakes quantitative tightening. The asset purchase programme (APP) reinvestments will cease in July; this will take the runoff rate up from roughly €15 billion a month to €25 billion. The ECB's balance sheet also shrank by €477 billion in June due to the scheduled expiry of the 3-year TLTROs issued during the pandemic.

In the UK, the inflation data made very unpleasant reading with the falling inflation in non-core items, food and energy, offset by stronger inflation in core goods and services. Headline UK CPI (consumer price inflation) was unchanged on the month at 8.7% against expectations of a 0.3% reduction. Core CPI continued to rise, increasing by 0.3% to 7.1%. The CPI goods annual inflationary rate actually eased from 10.0% to 9.7%, while CPI services rose from 6.9% to 7.4%. It is the services components that would have worried the Bank of England (BoE) most. These are very much seen as a domestic issue, driven by ongoing large nominal wage gains (real wages are still shrinking) and service sector corporates retaining sufficient pricing power to pass cost increases on. Food and goods inflation should significantly fall over the coming months, in line with the downward movements that have been seen in producer price inflation. Looking at energy costs, if wholesale prices remained unchanged then the contribution to CPI will fall to -1.4% late in 2023 from the +0.8% in May. The UK does have an inflation problem, but it has rotated into the services sectors of the economy; inflation here can be remedied if the central bank chooses to inflict sufficient pain on the economy.

The BoE, in response to this worrisome inflation data, surprised the market by hiking rates by 50bps to 5.0%. The market had only priced in about a 35% chance of a 50bps hike, economists had hoped for 50bps but assumed 25bps. The vote split was 7-2, with Dhingra and Tenreyro both voting for no change; note that Tenreyro's term expires in July, she will be replaced by Greene (who is estimated to be less dovish). The rationale for those voting for the hike can be summarised by its sentence: "…*the scale of the recent upside surprises in official estimates of wage growth and services CPI inflation suggested a 0.5 percentage point increase in interest rates was required at this particular meeting*." The reference to this particular meeting avoids any pre-commitment to hiking by 50bps at future meetings. Ultimately, the BoE does remain data dependent, but the employment and inflationary data has been far too strong for it; from its guidance "…*if there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required,*" it would take a big change in momentum for the persistent pressures to have demonstrably weakened before the next meeting in August.

We continue to believe that monetary policy has already overshot to the upside in the UK, but base rates will go higher still. Having had the wrong approach during the Covid crisis and been very slow to take away the proverbial punchbowl, the BoE is now having to work hard to regain credibility. With the infamous long and variable lags of monetary policy, a large overshoot is inevitable in this monetary cycle, and we see very little chance of the UK avoiding a recession.

US debt ceiling

The debt limit was formally raised under the Fiscal Responsibility Act (FRA) 2023. There was a huge range in outcomes of spending cuts between zero and $4.5 trillion over the next decade, the non-partisan Congressional Budget Office (CBO) puts it at $1.5 trillion. Obviously, it is subject to changes during budgeting processes and the forecasts after the first couple of years are very much trajectory based anyway.

The reduced spending is across four main categories:

1. Two years of spending caps (this is by far the largest contributor)
2. Rescinding unspent Covid funding
3. Some modifications in work requirements for programs such as SNAP and TANF (Supplemental Nutrition Assistance Program, Temporary Assistance for Needy Families)
4. Reforms to energy permits

The cuts to federal spending in fiscal year 2023 are negligible, with about $65 billion expected in 2024 according to the CBO (note fiscal 2024 starts in Q4 2023), or roughly 0.25% of GDP. To put this in context, after the debt ceiling debacle in 2011 the fiscal contraction was 0.7% of GDP. Additionally, the moratorium on student loan payments will end in August, this was in the FRA but expected to happen anyway, a small headwind for consumption later this year.

The debt limit will be suspended until 1st January 2025. In my opinion this is a poor choice of date as it will be in the period between the next US election and inauguration. Unless one party achieves a clean sweep of the presidency, House and Senate in the elections, we will be back in the same situation with all the post campaigning animosity simmering along too. Once the debt limit is reinstated it will be at the current level plus the cumulative increase in obligations between now and 1st January 2025. It will not be instantly binding as the Treasury can start using extraordinary measures again to delay the new X-date.

Post the suspension of the debt limit, there has been a flood of US Treasury Bill issuance as the US Treasury looks to rebuild their liquidity. From a low of $23 billion in early June, the US Treasury's general account has been replenished by approximately $400 billion of net supply. It appears that the largest buyer has been money market funds who have been attracting large inflows due to higher rates and the US regional banking crisis, total assets standing over $5.8 trillion. A good chunk of their inflows had effectively been parked with the Federal Reserve using their Reverse Repo Facility (RRP), although they are not the only market participants with access to the RRP, they will make up a decent percentage of the $2.2 trillion usage at the start of June. By the end of the month the RRP usage had shrunk by approximately $300 billion. Note that any T Bills bought by domestic investors other than the money market funds creates a drain on US financial system reserves. This will bring forward the date at which the Fed stops its quantitative tightening (QT) program as reserves reduce towards the level which the Fed deems to be ample (probably somewhere in the $2-2.5 trillion range).

Performance commentary

Carry Component

We split the Fund into the Carry Component and three Alpha Sources for clarity in reporting, but it is worth emphasising we manage the Fund's positioning and risk in its entirety. As a reminder, the Carry Component invests in investment grade bonds with <5 years to maturity, within this there is a strong preference for investing in the more defensive sectors of the economy.

During the second quarter the yield carry on the Fund more than offset the drag from the rise in sovereign bond yields, the net impact on total return being just over 0.5%. The rest of the gain during the quarter was due to credit spreads, a combination of the broad credit market exhibiting a little spread tightening and some stock specific situations discussed below.

Alpha Sources

Rates

The Fund spent most of the quarter with a duration of 2.0 years, above the neutral level of 1.5 years (as a reminder the permitted range is 0-3 years). During April 0.25 years of duration exposure was switched out of the US into Europe, with the former having significantly outperformed the latter. The yield differential between 5-year US Treasuries and the German equivalent had reached 108bps, the switch was then reversed when the differential moved out to 140bps. At the end of the quarter the Fund had duration exposure of 2.0 years split between 1.05 years in the US, 0.70 years in Europe and 0.25 years in the UK.

As discussed in the market backdrop above, the change in market opinion about ongoing central bank tightening over the quarter has led to further yield curve inversion across most developed economy bond markets. Yield curve inversion refers to when shorter dated bonds yield more than longer dated ones, in this case significantly more. Valuations have reached extreme levels, so we have implemented a 2s10s curve steepener in the Fund. The sizing of this is to be 0.25 years of duration exposure long the 2-year US bond future and 0.25 years short the 10-year Treasury future – i.e. the position is duration neutral. The notional exposure in the 2-year (about 13% long) is much higher than that in the 10-year (about 3% short), combined with the yield differential of 97bps at the time of entering the trade this means the position adds about 50bps to the Fund's yield. The curve could invert further but each month the yield carries on this is just over 4bps (50/12) so we can afford for the curve to invert 16bps each month (0.25 years times 16bps = 4bps capital loss, thereby offsetting the income gain) and still breakeven on the trade. Except for just before SVB failed in March, the last time the curve was this inverted was in the late 1970s/early 1980s.

Allocation

The weighting in the Carry Component has been in the mid to high 80's percentage area throughout the quarter, due to the compelling yield on short-dated defensive investment grade. Within the constituent mix of Carry there was an asset allocation shift in June. For the first time in the Fund's 5-year history a reasonable exposure to short-dated sterling credit has been purchased. We switched out of euro-denominated credit into sterling and now have 7.2% in the latter. Both the underlying gilt yield and credit spreads on offer are attractive. Part of the reason for the higher credit spreads is an illiquidity premium, so we would not want to go above 15-20% in the Fund's sterling exposure. If further gilt underperformance happens, we would add another 0.25 years by switching out of dollar-denominated credit.

Selection

There was a new addition to the Fund's investment grade Selection exposure in June - bonds issued by a stock market stalwart, 3i. Although one of its portfolio holdings (Action) has become an outsized position for it, this is only due to its success. 3i's gearing is very low, and its long-term investment approach and diversity appeal to us. A spread of 278bps for a 6-year BBB+ rated bond is very attractive. This was funded by the proceeds from selling Vonovia's 2029 maturity bonds.

Examining stock level performance, Selection was mixed during the quarter. Profits were taken in Grifols bonds, and Zurich Insurance bonds performed reasonably well. A profits warning from Catalent caused us to reassess the fundamentals of the company, the position was sold at a loss during the quarter. Overall, the net contribution in Selection was a very small positive impact. Credit spreads tightening within Carry provided the majority of the gains emanating from the spread category during the second quarter.

Discrete 12 month performance to last quarter end (%):**
Past Performance does not predict future returns

	Jun-23	Jun-22	Jun-21	Jun-20	Jun-19
Liontrust GF Absolute Return Bond C5 Acc GBP	2.5%	-5.6%	1.5%	2.1%	1.9%
IA Targeted Absolute Return	1.5%	-0.7%	7.2%	-0.4%	0.4%

*Source: Financial Express, as at 30.06.23, total return (net of fees and interest reinvested), C5 class.
**Source Financial Express, as at 30.06.23, total return, C5 class. Discrete data is not available for ten full 12-month periods due to the launch date of the portfolio

Key Features of the Liontrust GF Absolute Return Bond Fund

Investment objective & policy[1]	The investment objective of the Fund is to generate positive absolute returns over a rolling 12 month period, irrespective of market conditions. There is no guarantee the investment objective will be achieved over this or any other time period. The Fund aims to achieve its investment objective through investment in corporate and government fixed income markets worldwide, including developed and emerging markets. In achieving its objective, the Fund also aims to minimise volatility and reduce the possibility of a significant drawdown (i.e. a period where the Fund is worth less than the initial investment at the start of a 12 month period). The Fund invests in a wide range of bonds issued by companies and governments, from investment grade through to high yield. The Fund invests in developed and emerging markets, with a maximum of 20% of its net assets invested in emerging markets. Investments are made in US Dollar denominated assets or non-US Dollar denominated assets that are predominately hedged back into 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). 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 (SRRI)[2]	2
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.

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.

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 Absolute Return 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 Fund may invest in derivatives. 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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