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Liontrust GF SF European Corporate Bond Fund: Q2 2023 review

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The Fund returned 1.6%*† in euro terms over the quarter, compared with the 0.4% return from the Markit iBoxx Euro Corporates Index comparator benchmark.

The second quarter proved to be a difficult period for global bond markets, as central banks continued their focus on tackling persistent levels of inflation, with core inflation in particular proving more stubborn than expected. Central banks reacted by raising interest rates in order to rein in inflation towards target levels. This, coupled with accompanying hawkish statements, resulted in markets pricing in higher terminal interest rates.

The ECB increased interest rates by 50bps over the quarter with successive hikes in May and June, taking the deposit rate to 3.5% whilst also signalling that they still have further to go. This was in response to the ongoing persistence in inflation, as despite headline inflation falling to 5.5% in June, core inflation showed little sign of easing at 5.4%. In contrast, there continues to be clear evidence pointing to a slowdown in the economy, with the Eurozone entering a mild technical recession following two consecutive quarters w a -0.1% contraction in GDP. Meanwhile forward-looking indicators also continue to deteriorate pointing to a further slowdown in UK government bonds underperformed as yields rose to levels not seen since the mini-budget turmoil last September. The Bank of England increased rates by 25 basis points (bps) in May and then surprised the market by following this with a further 50bps increase to 5.0% in June. The step up to a 50bps increase followed strong wage growth of 7.2% reported in June, with UK headline and core inflation also surprising to the upside.

The Bank signalled that further rate hikes would be increasingly data driven going forward, with Governor Bailey acknowledging that inflation was taking longer than expected to come down. The market reacted by pricing in further rates increases, with the terminal rate forecast to be above 6%, driving yields sharply higher over the quarter. Economic data continued to be resilient, although the effect of recent rate increases has not been fully felt by households, due to them being on fixed rate mortgages. This is expected to feed through over the next 18 months as these cheap fixed rate deals expire.

In the US, the Federal Reserve raised interest rates by 25bps in May, and left rates unchanged in June. This was the first time in over 12 months that the Fed has not increased rates, although the accompanying dot plot of rate predictions showed two further rate rises in 2023. US inflation continued to decline due to base effects and is now 4.0%. Economic data has proven to be resilient as evidenced by on-going employment growth, with monthly non-farm payroll data above 200,000, demonstrating that the US labour market remains tight. The US debt ceiling negotiations did cause volatility at the beginning of the quarter on fears of a technical default. However, an agreement was reached in the Senate to suspend the debt ceiling and legislation was signed off by President Biden in early June.

Feared contagion from Q1’s banking sector issues failed to materialise, despite the collapse of First Republic Bank in the US in May. There had been concerns that a wider impact on the banking sector from these failures would lead to tightening in credit conditions, but the failed banks’ problems were specific to each bank and not a wider sector issue.

Over the second quarter, sterling corporate bond credit spreads were broadly flat, which was a resilient performance given the volatility in government bond markets. Corporate bonds were supported by a strong new issue market and fund flows into the asset class, given the attractive all-in yield levels.

Performance

The Fund delivered strong outperformance of its comparator benchmark over the second quarter, driven by particularly strong performance from credit selection which more than offset the drag on performance from the Fund's long duration positioning.

Our overweight position to financials proved to be a strong contributor, as both our banks and insurance holdings performed well, benefitting from improved sentiment as fears of weakness in the banking sector subsided as contagion risks did not materialise. Our holdings across high quality European names continue to benefit from improving net interest margins in a higher rate environment, alongside well-capitalised balance sheets and robust asset quality, resulting in credit ratings remaining stable to improving across the names held. We believe these companies are well positioned against potential further weakness in sentiment and to capture a potential recovery.

Within the banks sector, the biggest contribution to the Fund's credit performance was the early call announcement of the HSBC legacy discounted 'disco' bonds. The company announced that they would call the bonds at par, which were trading at around 75 cents, adding around 90 basis points (bps) of performance over the period. The regulator has been pushing for action from banks in this space, with the bonds due to lose capital treatment in 2025 as well as the cessation of Libor in June 2023. This had a positive impact for Fund's other disco holding from BNP, given HSBC represented around 45% of the market it has set a precedent that other issuers are expected to follow, which saw both Barclays and Standard Chartered also calling their discos during the quarter.

Our overweight to the insurance sector also performed well, with strong stock selection from our USD denominated subordinated holdings in AXA and Swiss Re that contributed positively.

There was also positive contribution from the REITs sector, reversing most of the underperformance in Q1. The fear of US commercial real estate concerns spreading to Europe subsided gradually while recent results demonstrated companies' ability to pass through rental increases that somewhat offset valuation declines. Our exposure to more resilient sectors such as logistics fared well over the quarter, whereas offices continue to be under pressure, with a clear bifurcation between higher and lower quality space.

This more than offset the underperformance from the Fund's duration positioning. We started the quarter being neutral duration to the benchmark, however as yields continued to rise in response to continued interest rate hikes from central banks amidst more persistent than expected inflation data, we elected to initiate a 0.5 year long position. This is expressed solely through the UK market, where we have the highest conviction following the significant underperformance of gilts over the period relative to both bunds and treasuries. The long duration position proved to be a detractor over the remainder of the quarter as yields continued to rise, with 10 year gilt yields peaking at more than 200bps above 10 year bund yields, the highest level since the early 1990s.

Fund activity

Fund activity was muted over the quarter.

We participated in a new issue from National Westminster Bank, which came with an attractive yield and spread pick up relative to existing bonds. The company rates highly from a sustainability perspective, given it is predominantly a retail bank with a focus on mortgage and SME lending with limited exposure to investment banking. The company also has robust underlying credit fundamentals, given it is well-capitalised, retains high asset quality and improving profitability in a higher interest rate environment. The new issue was funded by the proceeds from the call announcement in our HSBC disco bonds.

Outlook

There is a real risk that major European economies fall into recession in the coming months and consensus forecasts, while upgraded so far this year, are still for muted growth over the next few years. While recent stronger-than-expected inflation data, has resulted in markets pricing in further hikes. However, with the economic growth outlook anaemic and inflation likely to belatedly fall back towards the 2% target, we think the case for further rate hikes is limited.

The further rise in policy rates by central banks will take time to fully feed through and will have a material impact on financing, particularly for consumers as a larger proportion of fixed rate mortgages expire adding further pressure to already existing signs of strain. As the effects of cumulative hikes feeds through, we expect base rates will peak soon as economic activity begins to slow.

However, we anticipate further volatility throughout this year as the bond market is currently particularly focused on short-term patterns in macroeconomic data, such as inflation prints, as it tries to predict the peak in base rates.

Despite the building economic headwinds, corporate fundamentals remain incredibly healthy. Borrowing remains well below long-run averages, while interest coverage is significantly higher than historical levels and still high cash-to-debt levels also emphasize balance sheet strength.

While these metrics have already started to deteriorate – and will continue to do so – the average corporate is well placed to withstand the anticipated period of economic weakness given the historically strong starting point for company balance sheets.

The increase in yields, alongside widening of corporate bond spreads, has made the total yield on corporate bonds very attractive. Investment grade sterling bonds are now yielding levels not seen since the global financial crisis.

We continue to argue that corporate bonds remain very attractive from a total return perspective, with short-term mispricing providing an opportunity, with yields close to peaking coupled with strong fundamentals and attractive valuations.

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-23	Jun-22	Jun-21	Jun-20
Liontrust GF Sustainable Future European Corporate Bond A5 Acc EUR	0.2%	-13.0%	4.3%	-0.8%
Markit iBoxx Euro Corporates Index	0.1%	-12.9%	3.5%	-0.5%

*Source: FE Analytics, as at 30.06.23, 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