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Liontrust GF Strategic Bond Fund

June 2023 review

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The Liontrust GF Strategic Bond Fund returned -0.6%* in US dollar terms in June. The average return from the EAA Fund Global Flexible Bond (Morningstar) sector, the Fund's reference sector, was 0.1%.

Key points:

- 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

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 their 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 the 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 downwards 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 their 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 Bank of England 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.

I continue to believe that monetary policy has already overshoot 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 I see very little chance of the UK avoiding a recession.

Fund positioning and activity

Rates

Duration was increased by 0.25 years during June, leading to 7.5 years' exposure, as a reminder we deem 4.5 years to be neutral and have a limit of 9 years. The geographic split of the duration is 2.75 years in the US, 2.4 years in the UK, 1.75 years in Europe, and 0.6 years in New Zealand.

As discussed in the market backdrop above, the change in market opinion about ongoing central bank tightening over the last two months 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 carry on this trade 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 break even 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

There was no significant change to asset allocation during June. Investment grade exposure is 50%, a weighting we view as being neutral. The Fund's high yield weighting in bonds is 24%; there is a 5% overlay in place to reduce risk using the iTraxx Xover credit default swap index, thus net high yield exposure of 19% is very close to our 20% neutral level. There is good long-term value in credit, but with the tensions between rate rises and recessionary risk, there will inevitably be further volatility in credit markets. If credit spreads widen enough to make valuation levels become very compelling again, then we will increase allocations significantly.

Selection

There was a new addition to the Fund's investment grade 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.

Two relative value switches are also worthy of mention. Firstly, in US dollars, we switched exposure from a shorter dated Barclays bond into a new 10-year Lower Tier 2 issue with a spread of 340bps; this equated to a 7.119% coupon. In the eurozone we switched Bayer 2032 maturity debt into a recently issued 2033 bond, picking up 25bps credit spread for extending maturity by just 10 months.

Finally, as the month drew to a close, credit investors had their attention drawn to rumours that Thames Water would be placed into a Special Administration Regime. We suspect that the story was a leak, coming hot on the heels of the resignation of Thames' CEO, in order to force shareholders to commit more money with a promised £1 billion extra investment currently being held back. The Fund has zero exposure to Thames Water or any other issuer in the UK water sector.

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 Strategic Bond B5 Acc	3.4%	-13.3%	5.4%	5.5%	7.6%
EAA Fund Global Flexible Bond - USD Hedged	3.6%	-10.3%	6.5%	6.1%	6.1%

*Source Financial Express, as at 30.06.23, total return, B5 share class.

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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 ¹	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 (SRRRI) ²	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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