Liontrust SF Monthly Income Bond Fund: Q2 2023 review

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The Fund returned -4.9% over the quarter, compared with the -2.8% average return from the IA Sterling Corporate Bond sector (the comparator benchmark) and -4.1% return from the iBoxx Sterling Corporates 5-15 Years Index (the target benchmark)*.

Market backdrop

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.

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.

In Europe, the ECB increased interest rates by 50bps over the quarter, taking the deposit rate to 3.5% and signalled that they still have further to go. There are signs from economic survey data that the eurozone economy is slowing, but similar to the other economies, core inflation remains stubbornly high at over 5.0%.

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.

In the UK, the Bank of England corporate bond disposal programme, which had been viewed as a potential negative overhang on the corporate bond market, has now concluded, which should further support corporate bond spreads.

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 underperformed its benchmark over the quarter, with performance having been predominantly driven by the Fund's long duration position, which proved to be a significant detractor as government bond yields rose sharply amidst stronger economic data, resilient inflation prints, central banks' interest rate hikes and hawkish rhetoric.

We started the quarter being 0.5 years overweight duration relative to the benchmark, which was expressed solely through the UK, with 10 year yields close to 3.5%. However, releases of stronger than expected inflation and labour market data, followed by an unexpected 50 basis point (bps) hike by the BoE has resulted in markets anticipating a far more aggressive tightening cycle from the BoE with terminal rate expectations peaking above 6.5%. This led to a sharp increase in UK gilt yields, with 10 year yields rising by 96bps to end the quarter at 4.38%.

As UK 10 year yields rose, moving further away from our fair value target of 2.5-3% over the quarter, we incrementally added 0.75 years of duration. This included 0.5 years through the UK 10 year, but also 0.25 years of duration through the 3-year point at the front end of the curve, as market terminal rate expectations, which we believe are overdone, resulted in the highest level of yield curve inversion seen since the year 2000.

We also added a cross market position in the UK-US 10 year, as the underperformance in gilts saw 10-year gilt yields rise above 10-year US treasury yields for the first time since 2014 and the most since 2009.

The Fund ended the period +1.25 years long duration relative to its benchmark, expressed via a 1.75 year long through the UK and 0.5yr short through the US.

Our overweight credit positioning performed well over the quarter and generated strong outperformance, predominantly driven by stock selection, which partially offset the underperformance from our duration positioning.

Our overweight position to financials proved to be the strongest contributor, as both our banks and insurance holdings performed well during the quarter, 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.

This more than offset the drag on performance from our overweight allocation to gilts, as well as underperformance from our utilities exposure.

In the utilities sector, the Fund's holding in Thames Water had a small negative impact on performance, following the surprise resignation of its Chief Executive and press speculation over the possibility of it being placed in a special administration scheme. The Fund's exposure is to the senior bonds within the operating company, and these have explicit creditor protections. We do not think the government will place Thames Water under a special administration regime, as it has not met the specific criteria that could invoke this. Subsequent news following the quarter end was supportive for the bonds, providing reassurance that shareholders would provide additional equity support.

The news around the name had a negative impact across the broader water utility industry, which affected the other water companies in our Fund. However, we think the recent underperformance is temporary and our holdings should perform well as their underlying credit metrics are resilient.

Within the banking sector, the biggest contribution to the Fund's credit performance was the early call announcement of the HSBC legacy disco bonds. The company announced that they would call the bonds at par, which were trading at around 75 cents, adding around 25bps of performance from the circa 1% position held in the Fund. 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 the 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 holdings in AXA and Swiss Re that contributed positively.

Trading activity

Trading activity was muted over the quarter. We participated in new issues in Financials, while activity in other sectors was low. New issues in general remain relatively limited, but given strong investor demand, these resulted in aggressive valuations and hence we decided not to participate.

We participated in new issues from favoured names including BPCE, Royal London and Rothesay. They all came at attractive valuations offering high coupons at a discount to existing bonds, in high quality companies, with robust underlying credit fundamentals.

These new issues were partially funded by the proceeds from the call announcement in our HSBC legacy discounted 'disco' bonds, whilst we also switched out of our existing holding in Rothesay, rotating the proceeds into the new issue, lengthening spread duration as we believe the name should perform well in a higher interest rate environment. We disposed of our dollar holding from Telefonica, as the dollar bonds had outperformed during the quarter. Similarly, we exited our position to Santander, where we held a relatively short-dated Senior bond to capture the relative value on offer in the new issues.

Outlook

so far this year, are still for muted growth over the next few years. Recent stronger-than-expected inflation data has resulted in markets pricing in four to five further hikes, taking the market-derived peak in base rates beyond 6%, over 100bps higher than current levels. However, with the economic growth outlook anaemic and inflation likely to belatedly fall back towards the Bank of England's 2% target next year, 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.

Discrete years' performance, to previous quarter-end:**
Past performance does not predict future returns

	Jun-23	Jun-22	Jun-21	Jun-20	Jun-19
Liontrust Sustainable Future Monthly Income Bond B Gr Inc	-6.0%	-12.3%	7.1%	3.6%	4.0%
iBoxx Sterling Corporates 5-15 years	-7.5%	-14.6%	3.6%	5.8%	7.1%
IA Sterling Corporate Bond	-4.6%	-12.9%	3.3%	5.8%	5.6%

*Source: FE Analytics, as at 30.06.23, B share class, total return, net of fees and interest reinvested.
**Source: FE Analytics, as at 30.06.23, primary share class, total return, net of fees and interest reinvested.

For a comprehensive list of common financial words and terms, see our glossary at: liontrust.co.uk/benefits-of-investing/guide-financial-words-terms