



# Global Fixed Income

## August 2023 Report

### Liontrust Strategic Bond Fund



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The Liontrust Strategic Bond Fund returned -0.2% during August; the IA Sterling Strategic Bond sector median returned -0.1%.

#### Market backdrop

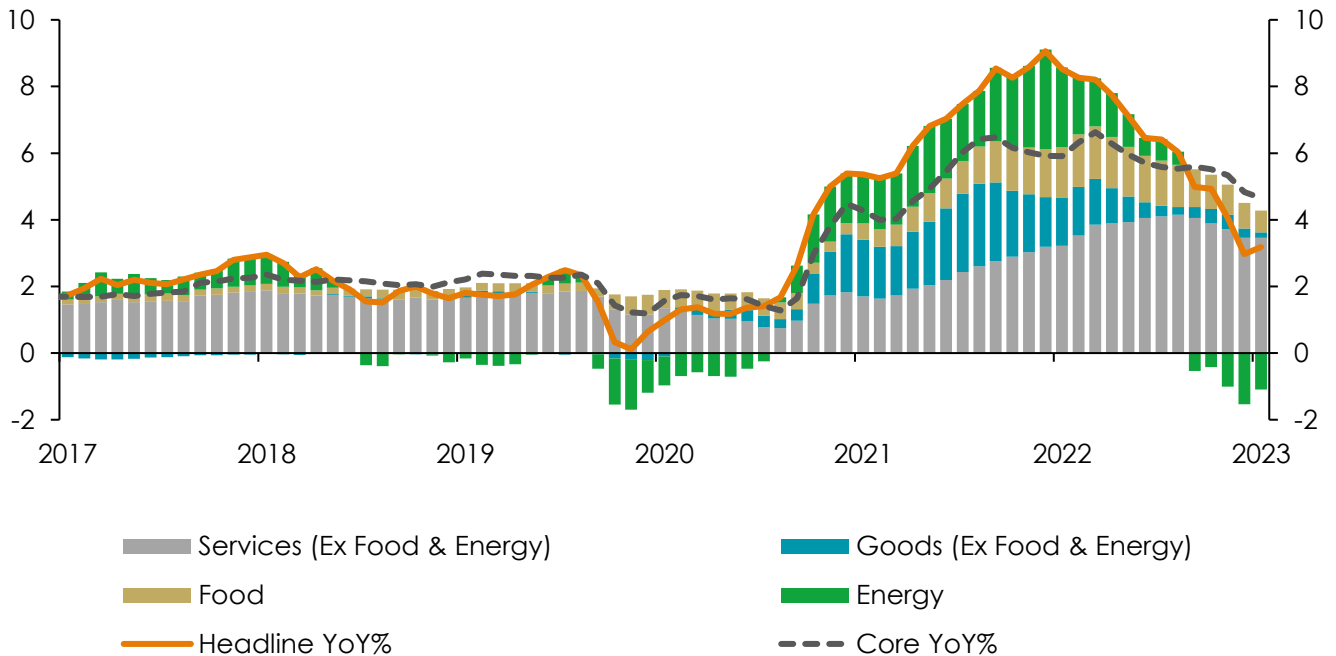
The news that Fitch had cut its sovereign rating on the US from AAA to AA+ caused a bit of a stir at the start of August. The last prolonged debt ceiling debacle was in 2011 when S&P's cut made much more of a splash. Fitch is less followed, and most investors had already adjusted mandates for the US losing the purity of its AAA. The US Treasury has been revising upwards its bond issuance forecast to meet its funding needs, so the rating cut did help to remind markets about the current fiscal largesse.

If you were looking at the key sovereign ratios for the US in isolation and put your hand over the top of the page to hide the bit that says US, you would be very concerned. There's a huge current account deficit, a high fiscal deficit that even next year is likely to be still in the 6% of GDP ballpark range, and a government debt-to-GDP ratio of about 98% (CBO end 2023 forecast, using federal debt held by the public). However, the US retains its privileged position of having the world's largest reserve currency; furthermore, the asset side of the balance sheet is strong. The US dollar will eventually be knocked off its perch, as happened to sterling in the 20th century, but this is unlikely to happen for many decades yet. The Fitch downgrade effect has already faded, but the ongoing fiscal deficit and associated glut of supply will remain at the forefront of bond investors' minds.

A combination of the factors above and economic data releases being above expectations caused US Treasury bond yields to rise in the first half of August. The two most important data sets released were those for inflation and employment – I will cover those in turn.

Annual consumer price inflation (CPI) in July at 3.2% was less than forecast (consensus 3.3%, prior 3.0%) while core CPI was in line with expectations at 4.7% (consensus 4.7%, prior 4.8%). Energy (contribution to annual CPI rate shown below in green bars) is still a large negative contributor with a -12.5% price move over the last 12 months, but energy prices were up 0.1% in July. It is worth noting that recent commodity price increases, including US gasoline prices, will add about 0.6% to August's headline CPI.

Fig 1: US CPI year-over-year (%)



Source: BLS, Bloomberg, Liontrust.

Core goods prices (blue bars) were down in July, even excluding autos where prices fell 1.3% the reduction was still 0.2%. I see this as a sign of the continued improvement in supply chains, some destocking, and some margin pressure on producers and wholesalers. The key inflationary component that the Fed is focussed on remains services (grey bars). As the Bureau for Labor Statistics (BLS) points out "...the index for shelter was by far the largest contributor to the monthly all items increase, accounting for over 90 percent of the increase." Due to the quirks of the measurement of shelter inflation there is a long lag between housing activity cooling and rents (and owners' equivalent rents OER) reducing. The trend in shelter is still favourable; from a monthly CPI run rate of 0.7-0.8% earlier in 2023 we are now in the 0.4-0.5% area. By the end of 2023 the monthly increases are set to fade to about 0.3%, before hitting a 0.2% run rate in spring 2024. This leaves the rest of services to focus on, which were up by 0.2% in July after being flat in June; this is despite the 8.1% fall in airfares. Note here that one other inflationary blip in August is a likely rebound in airfares due to jet fuel costs. Looking past erratic items like airfares there was a little more inflation in July in recreation, education and communication services. Core services inflation remains highly correlated to nominal wage inflation and my thesis remains that the Fed will not declare a victory over inflation until there has been significant further loosening in the labour market.

Before turning to the labour market, it is worth noting that the US PMI surveys coming in below expectations helped to turn the direction of bond yields around, with the Treasury market rallying in the latter half of August. The US composite PMI remained in expansionary territory at 50.4, but both manufacturing (47.0) and services (51.0) undershot expectations.

The JOLTS job openings in July were way below expectations at 8,827k (consensus 9,500k, prior 9,165k revised down from 9,582k). Combined with August's unemployment figure we can update one of our favourite ratios:

Fig 1: Job openings/unemployed



Source: BLS, Bloomberg, Liontrust.

*Note: due to lags in the release of the JOLTS data, the most recent ratio uses July openings and August unemployment figures.*

Vacancies per unemployed person is now down to 1.39x. This is still indicative of a tight labour market but is a huge improvement from the peak of just above 2. Having reached a zenith at 3% in 2022, the quits rate continued to ease downwards to 2.3%; this is a level commensurate with pre-Covid times. As a reminder, the quits rate is (inversely) correlated to wage inflation as one only tends to voluntarily quit if there is a better job elsewhere.

Nonfarm payrolls in August were 187k (consensus 170k, prior 157k) and private payrolls were 179k (consensus 148k, prior 155k). Although the headline payrolls figure was just above expectations, the two-month revision was -110k. The unemployment rate was the biggest surprise coming in at 3.8% (consensus 3.5%, prior 3.5%). In numbers of people this is a shift from 5,841k to 6,355k or over 0.5m people increase in unemployment. Some of this was caused by layoffs and some from an increase in the participation rate to 62.8% (consensus 62.6%, prior 62.6%).

Overall, the labour market and inflationary data was not sufficiently surprising to be likely to sway FOMC voters' minds either way. This now leaves just one key data point, US CPI on 13th September, before the next FOMC meeting on 20th September. Unless there is a major shock to the upside in the CPI data, the Fed is likely to pause at its September meeting. It might not yet take out the extra hike pencilled in for 2023 from the dot plot in the updated summary of economic projections -- it will be very interesting to see.

## Fund positioning and activity

### Rates

Duration was increased halfway through August by 0.5 years to 8.0 years. 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, 2.5 years in the UK, 2.0 years in Europe, and 0.75 years in New Zealand.

In early August we took some profits in the US 2s10s yield curve steepener, taking the position size back down to 0.25 years. Strategically, we like the position for the long-term but the curve has moved rapidly so it was prudent to trim. The mechanics of the bond/futures basis and the steep roll-up on the 2-year means we have only made a good handful of basis points so far, but it still all counts.

### Allocation

Asset allocation was unchanged during August as we await a better opportunity to add to credit. Investment grade exposure of 49% is as close to our 50% neutral weighting as makes no difference. The Fund's high yield weighting in bonds is 23%; there is a 7% overlay in place to reduce risk using the iTraxx Xover credit default swap index, thus net high yield exposure of 16% is a little below our 20% neutral level.

## Selection

Stock level activity was subdued during August, a traditionally quiet month on the micro rather than macro front. One new investment grade purchase was made in BBVA lower tier 2 debt in sterling. The bond has just over a 10-year maturity and is callable after 5 years. A credit spread of 360bps, to give a coupon of 8.25%, is very attractive. On the sales side of the ledger we exited from the small residual Pershing Square holding. The fundamentals of the company remain solid but the bond had not attracted the liquidity we had hoped for so we thought the capital would be better deployed elsewhere.

### 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 Strategic Bond B Acc	1.2%	-12.5%	5.1%	2.8%	5.5%
IA Sterling Strategic Bond	-0.2%	-10.2%	6.1%	3.8%	5.3%

\*Source: Financial Express, as at 31.08.2023, accumulation B share class, total return (net of fees and income reinvested).

\*\*Source: Financial Express, as at 30.06.2023, accumulation B share class, total return (net of fees and income reinvested).

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/benefits-of-investing/guide-financial-words-terms>

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## Key Risks

### **Past performance does not predict future returns. You may get back less than you originally invested.**

Any performance shown represents model portfolios which are periodically restructured and/or rebalanced. Actual returns may vary from the model returns. There is no certainty the investment objectives of the portfolio will actually be achieved and no warranty or representation is given to this effect, whether express or implied. The portfolios therefore should be considered as long-term investments.

- The fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.
- Bonds are affected by changes in interest rates and their value and the income they generate can rise or fall as a result;
- The creditworthiness of a bond issuer may also affect that bond's value. Bonds that produce a higher level of income usually also carry greater risk as such bond issuers may have difficulty in paying their debts. The value of a bond would be significantly affected if the issuer either refused to pay or was unable to pay.
- Overseas investments may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of the Fund.
- The Fund can invest in derivatives. Derivatives are used to protect against currency, credit or interest rate moves or for investment purposes. There is a risk that losses could be made on derivative positions or that the counterparties could fail to complete on transactions.
- The Fund uses derivative instruments that may result in higher cash levels. Cash may be deposited with several credit counterparties (e.g. international banks) or in short-dated bonds. A credit risk arises should one or more of these counterparties be unable to return the deposited cash.
- The Fund invests in emerging markets which carries a higher risk than investment in more developed countries. This may result in higher volatility and larger drops in the value of the fund over the short term.
- The Fund may encounter liquidity constraints from time to time. Participation rates on advertised volumes could fall reflecting the less liquid nature of the current market conditions.
- Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

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