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Liontrust GF SF European Corporate Bond Fund: Q3 2023 review

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The Fund returned 0.1%*† in euro terms over the quarter, compared with the 0.3% return from the Markit iBoxx Euro Corporates Index comparator benchmark.

The third quarter posed challenges for global bond markets as conflicting macroeconomic data continues to paint a mixed picture, resulting in significant volatility in government bond yields. However, despite this volatility 10 year Gilt yields were broadly unchanged over the quarter.

In the UK the Bank of England delivered a widely expected 25 basis points (bp) interest rate hike, before surprising markets by electing to leave interest rates unchanged at its September meeting. This came against a backdrop of falling inflation, softening growth, and a loosening in the labour market. However the Bank of England acknowledged that there remains a long way to go to reach the 2% inflation target, emphasising a higher for longer path for interest rates, particularly given ongoing strength in wage growth and demand for services. This has led markets push out expectations for interest rate cuts.

However we continue to believe that inflation will fall faster than the Bank of England and broader market forecast, driven by the continued decline in consumer demand with the full impact of interest rate hikes yet to be felt. This is combined with disinflationary pressures from deflationary producer prices and still significant base effects to fall out of inflation calculations. Services inflation has been a key focus for the BoE, however we expect the recent softness seen in the August figures to continue, with leading indicators such as PMIs suggesting that deterioration in the services sector is starting to catch up with the broader economy. The resulting weakness in both inflation and growth outlooks is likely to challenge the BoEs higher for longer narrative.

In the US, the Federal Reserve similarly raised rates by 25bps at its the first meeting of the quarter before also maintaining interest rates at the second, marking the second pause this year. US 10-year treasury yields climbed 74bps, driven by expectations of an extended period of higher rates, amidst several Fed officials all reiterating the higher for longer narrative. Whilst still correlated with wider government bond yields, the US materially underperformed over the period, as the ongoing resilience of the underlying economy continues to diverge from the weaker outlooks for both Europe and the UK, particularly the strength in the US labour market. US underperformance was further compounded by fiscal concerns, with a growing budget deficit, threat of government shutdown, and Sovereign rating downgrade by Fitch

In Europe, the European Central Bank raised rates twice during the quarter, each time by 25bps, bringing deposit rates to an all-time high of 4%. While the central bank hinted that the most recent hike might be its last, hawkish rhetoric from the US and rising oil prices pushed yields in Europe higher. Although expectations for the first interest rate cut were pushed further into the future, another hike appears unlikely in the context of growing concerns about economic growth stagnating at best across Europe.

During the third quarter, despite high levels of volatility form a yield perspective, sterling corporate bond credit spreads tightened around 15bps over the period as demand for corporate credit remained robust. Credit curves steepened as greater clarity over the near term path of interest rates led shorter dated spreads to perform well, whilst higher uncertainty over the longer term outlook saw a more muted tightening for longer dated bond spreads.

Performance

The Fund marginally underperformed its benchmark over the quarter with underperformance predominantly driven by the Fund's credit positioning although partially offset by its long duration positioning.

During the quarter, we retained our overweight interest rate positioning, which currently stands at 0.5 years long relative to the benchmark. This overweight interest rate positioning is expressed solely through the UK, where we have the highest conviction following the significant underperformance of gilts year-to-date relative to both bunds and treasuries. However, over the last quarter 10-year gilt yields remained relatively flat, and after the better than expected inflation data and subsequent pause in rate hikes by the Bank of England, 2-year gilts rallied and caused a steepening of the UK gilt curve.

While UK 10-year yields saw only modest increases due to weaker economic data and subdued inflation prints, 30-year yields sold off in late September, driven by stickier inflation expectations and the narrative of enduring higher rates.

On the credit side, the Fund had positive sector performance from banks, real estate and utilities, but this was offset by negative stock selection within those sectors.

Our insurance holdings and overweight position to the sector have fared well over the quarter with positive returns driven by strong stock selection. The sector is also benefiting from current interest rate levels, but also from rigorous balance sheet management and high levels of solvency ratios, hence the decision to maintain our overweight position. The USD denominated holding to subordinated AXA paper specifically contributed strongly to the fund's performance.

Banks have been a resilient sector, supported by the strong reporting period and increased profits given the prevailing high interest rate environment. Although we maintain a similar overall allocation position to the benchmark, we are overweight subordinated securities, which have resulted in negative contribution from the performance of perpetual securities with lower reset spreads. These securities have widened in spread terms as current yield levels suggest that the bonds will not be called at the next call date. However, 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 either remaining stable or improving across the names held. We believe these companies are well positioned to benefit from a high interest rate economy and capture a potential recovery.

In utilities, our overweight position performed well due to strong year-to-date earnings, fuelled by favourable energy price trends and asset growth. We currently maintain a 5.4% overweight position relative to the benchmark, positively affecting sector selection. However, this was offset by negative stock selection. Orsted faced potential impairments tied to higher rates, supply chain disruptions, and US tax credits, and was a detractor. Going forward, we believe Orsted and the wider utilities sector stands to gain from high wholesale margins and investments in renewable energy

We also maintain a small overweight position to the REITS sector, which has showed recent signs of stabilisation and reversal of previous underperformance. However, we have had negative contribution from our holding in Canary Wharf Group, which we disposed of on grounds of credit quality and concerns over medium term performance.

Trades

As mentioned, we disposed of Canary Wharf Group on the basis of avoiding idiosyncratic risk. Whilst we believe the name had strong ESG credentials, demand for office space has been deteriorating and pressure on commercial real estate values weighed on the company's ability to manage leverage and covenant metrics. As such, we decided not to bear such idiosyncratic risk and disposed of the holding. We reinvested proceeds from the disposal into favoured names with stable cash generation and resilient operations to an economic slowdown, like Compass group and Deutsche Telekom.

Outlook

We continue to believe that corporate credit offers significant value at these levels of all-in yields.

Despite market volatility, recent developments re-enforce our belief that we are at or very close to the end of the interest rate tightening cycle. We are starting to see signs of the impact of higher rates filtering through into the real economy, and expect that this will only accelerate with the majority of the impact still yet to be felt. We expect inflation to continue to fall amidst weaker consumer demand due to ongoing transmission of higher interest rates, which will also result in weaker economic growth, ultimately making central banks higher for longer narrative sustainable.

Therefore we continue to see significant value in government bond yields, with a still significant upside to reach fair value, and maintain our long duration position.

This is coupled with credit spreads that continue to misprice the underlying strength of corporate balance sheets. Whilst we expect growth to be challenged, we expect this to primarily be driven by the consumer. Corporate fundamentals remain very robust, with low levels of leverage, high interest coverage and ample liquidity. Whilst corporate fundamentals will inevitably weaken through a period of economic deterioration, the incredibly strong starting point significantly above long-run averages, means investment grade companies will be able to navigate this period. Defaults are only expected to return to long-run averages, whilst current spread levels imply a far higher deterioration in the default cycle, leading us to believe that corporate spreads remain at an attractive entry point for investors.

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

	Sep-23	Sep-22	Sep-21	Sep-20	Sep-19
Liontrust GF Sustainable Future European Corporate Bond A5 Acc EUR	4.5%	-16.9%	2.8%	-0.5%	4.9%
Markit iBoxx Euro Corporates Index	3.6%	-15.7%	1.6%	0.2%	6.1%

*Source: FE Analytics, as at 30.09.23, 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 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
SRI[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 PRIIP KID of the fund; [2]SRI = Summary Risk Indicator. Please refer to the PRIIP KID for further detail on how this is calculated.

Key Risks

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

We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments.

- All investments will be expected to conform to our social and environmental criteria.

- 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 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.

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.

Disclaimer