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THE SUSTAINABLE FUTURE PROCESS

Liontrust SF Corporate Bond Fund: Q3 2023 review

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The Fund returned 2.4%* over the quarter, compared with the 2.5% return from the iBoxx Sterling Corporate All Maturities Index comparator benchmark and the average return from IA Sterling Corporate Bond sector, also a comparator benchmark, of 2.1%.

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 (BoE) 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 to 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. While 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 ratings agency 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, while higher uncertainty over the longer term outlook saw a more muted tightening for longer dated bond spreads.

Performance

The Fund delivered a positive return despite the volatility in bond yields, driven by spread compression combined with the high level of carry amidst the current higher yield environment. Whilst Fund performance was broadly in line with that of its comparator benchmark, it outperformed the peer group average.

The Fund's broadly neutral performance relative to its benchmark, was driven by outperformance from interest rate positioning, which was offset by underperformance from credit positioning.

Whilst the fund's overweight credit position benefitted from spread tightening, it also resulted in our overweight allocation to more defensive sectors including Gilts and Housing Associations proving to be a drag over the period. This was combined with negative stock selection within the banks sector, as market expectations for calls in some of our legacy subordinated bonds fell as higher yields make shorter call options less economical. We remain comfortable with these positions and expect this to reverse as yields trend lower in the months ahead.

This was partially offset by strong performance from positive stock selection within the Insurance sector, particularly within long held, favoured names such as Axa and Aviva.

The negative contribution from credit was offset by positive contribution from interest rate positioning. The fund retained its 1.5 year long duration position over the quarter, which is solely expressed through the UK market. The position is made up of a 1.25 year long through the UK 10-year, where yields were broadly unchanged, and 0.25 long through the UK 3 year, where yields rallied as the outlook for near term interest rates became clearer seeing the Fund benefit from the yield curve steepening over the quarter.

Trades

Trading activity was relatively limited over the quarter. We primarily participated in new issues in financials, while activity in other sectors was low.

We participated in a newly issued short-dated bond from Yorkshire Building Society. The bank is defensively managed with low leverage, strong asset quality and strong liquidity. We also favour the name from a sustainability standpoint, with 87% of the loan book relating to owner occupied mortgages but also providing commercial loans to housing associations. The new issue came cheap to existing bonds, and we rotated out of existing position, resulting in a pickup in yield and spread whilst shortening duration.

We also participated in a new issue from BNP Paribas, which issued senior bonds at an attractive valuation, rotating out of existing bonds, moving up the capital structure for a limited drop in spread. We also focused on performing relative value switches in the insurance sector, including Zurich, and Legal & General.

Outside of financials, we largely reduced our holding in Mobico's (previously National Express) hybrid notes, following uncertainty over new management and recent issues with contract renewals and US bus drivers' wage negotiations.

We also disposed of Canary Wharf Group regarding credit quality concerns. While 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.

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 amid 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 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. While 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.

While 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, while 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 Sustainable Future Corporate Bond 2 Inc	11.3%	-26.1%	2.4%	4.0%	8.7%
iBoxx Sterling Corporate All Maturities	8.7%	-23.6%	0.3%	4.3%	11.0%
IA Sterling Corporate Bond	7.3%	-20.5%	1.3%	4.2%	9.0%

*Source: FE Analytics, as at 30.09.23, total return, net of fees and interest reinvested.

**Source: FE Analytics, as at 30.09.23, primary share class, total return, net of fees and interest reinvested.

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.

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