



Global Fixed Income

October 2023 review

Liontrust GF Strategic Bond Fund



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The Liontrust GF Strategic Bond Fund returned -1.2%* in US dollar terms in October. The average return from the EAA Fund Global Flexible Bond (Morningstar) sector, the Fund's reference sector, was -0.6%.

Market backdrop

The central banking theme of 'higher for longer' was reiterated in October, with many developed economy monetary policy setters keeping rates on hold. There was continued upward pressure on sovereign bond yields for most of the month with a rally starting towards the very end of October.

On what has been referred to by some as 'white Monday', (23rd October) bonds staged a big one-day rally. Intra-day 10-year US Treasury yields went above the psychological 5% yield level. A Tweet (X) from notorious hedge fund manager Bill Ackman stating he had closed out his Treasury short seemed to catalyse the rally. His central premise that it is too risky being short treasuries at these yield levels resonated with many people. Later in the day, former 'bond king' Bill Gross also talked about buying bonds, but he was overshadowed by Bill Ackman's pronouncements.

The timing was prescient as on 1st November, the day of the FOMC (Federal Open Markets Committee), US Treasuries rallied by 20 basis points. It is worth noting that half of this rally had occurred in advance of the FOMC press release. The initial trigger was the split of the US quarterly refunding, with less bond issuance than the market had expected or feared. The quantum of refunding had already been announced, a reduction to \$776 billion from the prior \$852 billion forecast. Markets had been estimating a figure in the \$800 billion ballpark. The trimming of what is still a huge amount of debt issuance was caused by a reduction in the predicted fiscal deficit, mainly driven by the tax receipts side of the ledger. This is likely to be the delayed tax returns from California where a moratorium was granted earlier in 2023 due to the winter storms. The second catalyst for the bond market rally was weak ISM figures, with the undershoot being

broader than just the impact of the United Auto Workers (UAW) strikes; then came the FOMC, which was a little less hawkish than before.

Federal Reserve

The Federal Reserve's FOMC unanimously agreed to hold Fed fund rates in the 5.25% to 5.50% range. There was acknowledgement of the strong economic growth in Q3 "...recent indicators suggest that economic activity expanded at a strong pace in the third quarter," but a subtle implication in the language that this strong growth was a Q3 phenomenon.

The Fed retains its tightening bias, repeating the mantra "...the extent of additional policy firming that may be appropriate" regarding returning inflation to its target level. A more dovish development is the explicit inclusion of financial conditions as an economic headwind: "...Tighter financial and credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation."

In the press conference, Fed Chair Powell caveated this with the message that the tightening in financial conditions would need to be "persistent" to have a meaningful impact on growth. Powell also reiterated that the Fed is "proceeding carefully" with monetary policy, and the dot plot from September is deemed to be a "picture in time" as opposed to a plan. Finally, it is up to the economic data to determine whether the current stance is "sufficiently restrictive" to return inflation to target. In saying this, he has kept the optionality open for the Fed to raise rates again.

I would characterise the US Treasury market as now likely to be in a holding pattern, awaiting economic data developments. If yields rally too far then it will eliminate the "persistent" tighter financial conditions. One should expect some hawkish statements from Fed officials in this scenario.

On the flip side, it is clear that the Fed will only raise rates further if it feels it absolutely has to. For US Treasuries to have a more sustained rally the economic data will need to deteriorate. In this regard, while I do not expect the weaker October US employment data to be a seminal moment in this cycle, it is a sign that restrictive monetary policy is having a meaningful impact.

European Central Bank (ECB)

In a unanimous decision, the ECB kept deposit rates at 4.0% in line with consensus, while the accompanying statement is becoming less hawkish. The ECB reiterated that "...inflation is still expected to stay too high for too long, and domestic price pressures remain strong." The latter part of the sentence referring to domestic price pressures suggests to me that wage inflation remains the key ECB concern. Meanwhile, the ECB does note that "...inflation dropped markedly in September, including due to strong base effects, and most measures of underlying inflation have continued to ease." They remain in data dependent mode, examining the same three factors as before: economic and financial data, underlying inflation, and monetary policy transmission.

At the press conference, Lagarde stated that neither the level of remuneration on reserves, nor changing the PEPP reinvestments were discussed. Markets had speculated on there being some developments here, so maintaining the status quo was taken to be a dovish sign. Regarding how long holding rates at restrictive levels is sufficient, there was firm rebuttal with Lagarde saying now is "...not the time for forward guidance, stick to data dependence knitting." Furthermore, Lagarde stated, albeit far less forcefully than on prior occasions, the "...fact that we are holding does not mean we will never hike again." Lagarde went on to say that a "...cut was not discussed at all, [that] debate would be premature."

Where things get interesting, in my opinion, is on the timing of any dovish shift. Lagarde put emphasis on wanting to see the wage settlement round of 2024 before thinking about cuts. This suggests that the ECB will not be in a position to cut rates until their June meeting (the schedule

does not have a May meeting). However, Lagarde also mentioned weaker growth on numerous occasions, the quarterly ECB economic forecasts are bound to be revised down in December. Maintaining the higher for longer restrictive stance while revising down economic forecasts will involve some very nuanced messaging!

Bank of England

The Bank of England's Monetary Policy Committee (MPC) held rates at 5.25%, in line with expectations. The vote split was 6-3 with Green, Haskel, and Mann all preferring to hike rates by 25bps. The message that "...further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures" has been retained. The MPC sees the labour market as being softer than suggested by the Labour Force Survey (they highlight the "increasing uncertainties" surrounding the survey); they state "...falling vacancies and surveys indicating an easing of recruitment difficulties also point to a loosening in the labour market."

The timing of the return of CPI (consumer price inflation) to the 2% target has been pushed out a little to the end of 2025 "...compared with the August Report modal projection, CPI inflation is expected to return to close to the 2% target slightly less rapidly in the middle of the forecast period, reflecting higher energy and other import price inflation, with the latest profile relatively flat around 2% over the four quarters from 2025 Q2." The MPC notes that risks to its modal inflation forecast are skewed to the upside; this can be seen in the Bank of England's forecasts with the mean for 2025 staying 0.3% above the mode (2.2% versus 1.9%).

In the Bank of England's CPI fan charts, there is a significant difference between projections using the market path at their time of modelling (rates at 5.25% until 2024 Q3 then declining gradually to 4.25% by the end of 2026) and those assuming constant rates of 5.25%. The former conditions see inflation only reaching the 2% in 2025, the latter creates a significant undershoot in inflation during the forecast period. Hence the tension will remain about how long the Bank of England continues with restrictive monetary policy, following the Table Mountain shape as the Bank's Huw Pill infamously said over the summer.

Fund positioning and activity

Rates

The Fund started October with 8.0 years of duration exposure. This was taken up to 8.25 years as US 10-year yields flirted with the 5% milestone. At the end of the month, the Fund remained strategically long duration with 8.15 years' exposure – as a reminder neutral is 4.5 years with a range of 0-9 years. The geographic split is US 3.75 years, Canada -0.5 years, UK 1.6 years, Europe 2.55 years, and New Zealand 0.75 years. We continue to prefer short-dated and medium-dated bonds and the net duration exposure in the 15+ year maturity bucket is zero.

A new cross market position was established; using bond futures we have gone 0.5 years short duration Canadian 10-year bonds and 0.5 years long duration US 10-year bonds. The Canadian economy is slowing more rapidly than that of its neighbour. Canadian bond yields should be below those in the US, but how much below is the key question; valuations have reached extreme levels. At a yield differential of 85bps on the generics (or 80bps on the cheapest-to-deliver into the futures contracts) the disparity is at multi-decade wide levels.

Allocation

Asset allocation was unchanged during October as we continue to wait for a better opportunity to add to credit. Investment grade exposure is around 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 just below our 20% neutral level.

Selection

The Fund sold out of its Southern Company hybrid bonds; the market convention is for the bonds to trade on a cash price as opposed to credit spread. That cash price was almost unmoved over the last 6 months despite sovereign bond yields being much higher, i.e. the credit spread is much tighter.

Also, within the investment grade ratings arena, we undertook a relative value switch in Standard Chartered. We sold the holding company lower tier 2 bonds and bought into the operating company lower tier 2 bonds. The latter have a lower spread – it is still 250bps, but benefit from a bullet maturity; note that lower tier 2 bonds are frequently double dated for regulatory reasons. The bonds are obsolete capital subject to grandfathering arrangements, so we may see a liability management exercise by the company which would benefit bondholders.

Discrete years' performance (%) to previous quarter-end*:

	Sep-23	Sep-22	Sep-21	Sep-20	Sep-19
Liontrust GF Strategic Bond B5 Acc	5.3%	-15.7%	3.2%	6.4%	7.4%
EAA Fund Global Flexible Bond - USD Hedged	5.8%	-12.1%	4.2%	3.4%	6.7%

*Source Financial Express, as at 30.09.23, total return, B5 share class. Discrete data is not available for ten full 12-month periods due to the launch date of the portfolio (13.04.18).

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>

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.

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.

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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