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Global Fixed Income

Q4 2023 review

Liontrust GF Absolute Return Fund

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The Liontrust GF Absolute Return Bond Fund (C5 share class) returned 3.0%* in sterling terms in Q4 2023 and the IA Targeted Absolute Return, the Fund's reference sector, returned 2.9%. The Fund's primary US dollar share class (B5) returned 3.2%.

There were two main drivers of the total return during the fourth quarter: the rally in government bonds and the yield 'carry' in the Fund, the former contributing about 10 basis points more. A tightening in credit spreads added a further small tailwind to Fund returns, with alpha also incrementally generating performance.

Market backdrop

The bond market themes of the fourth quarter can be neatly broken out by month. 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.

Inflation data in November then acted as the main catalyst for a significant bond market rally. For example, US Consumer Price Inflation (CPI) came in a tenth better than expectations on most measures, including ex food and energy. The one area where inflation remains sticky is in "*supercore*" services, the part of the economy that is most correlated to nominal wage inflation.

In Europe, Eurozone headline CPI was below expectations at 2.9% compared to consensus forecasts of 3.1% and a prior month 4.3% level. Services inflation is decelerating, albeit gradually, decreasing by 0.1% to 4.6%. I characterise this inflation data as showing continued progress in bringing CPI back to target, but with services inflation being sticky there is still more work to do. Eurozone interest rates are restrictive and core inflation won't hit the 2% target for a few quarters yet, but the longer rates are held at these restrictive levels the greater the chance is that a deeper recession than necessary will be caused.

After November's fall in inflation data and associated bond rally, markets' attention in December focussed on how central bankers would react to lower bond yields. The dovish Federal Reserve dominated perceptions in bond markets, with more hawkish pronouncements from the European Central Bank and Bank of England failing to curb markets' enthusiasm.

The Federal Reserve's FOMC (Federal Open Market Committee) held rates steady. It was the combination of the statement, Summary of Economic Projections (SEP) and press conference that was a lot more dovish than markets had anticipated. There were, in my opinion, four key dovish elements. Firstly, the inclusion of the word "*any*" in the FOMC statement is a very strong hint that the Fed no longer has a tightening bias: "…*In determining the extent of **any** additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments*."

Secondly, in the SEP, inflation forecasts were revised down, with some last-minute adjustments made to this year's estimates to incorporate the latest data. The key is the set of downward revisions to the core PCE inflation forecast, showing an improved trajectory towards the 2.0% target over the coming years. 2024 core PCE inflation is now forecast to be 2.4% (previously 2.6%), with 2025 at 2.2% (previously 2.3%), and inflation hitting the 2.0% target in 2026.

These revisions to inflation forecasts helped to justify alterations to the dot plot, FOMC members' best estimates of where interest rates will be. The important change was to the end 2024 forecasts. The market had hoped that 50bps of cuts would be forecast; it ended up being 75bps. The clustering of dots around the 75bps cuts was also dovish, with only two officials now expecting to keep rates on hold in 2024. While this dot plot has not fully vindicated market pricing, the downward direction of the next change in interest rates is now very clear.

Finally, in the press conference Fed Chair Powell had the chance to push back against the cuts' narrative - instead he embraced it. The crucial sentence was "…*the question of when will it become appropriate to begin dialling back the amount of policy restraint in place, that begins to come into view and is clearly a topic of discussion out in the world and also a discussion for us at our meeting today.*" So, while they are not yet in rate cutting mode, it is just a question of when not if. I continue to believe that rate cuts will start a little later than the market forecasts due to sticky core services inflation, but when they do start, they will be much larger than consensus is currently pricing in.

The European Central Bank (ECB) kept deposit rates on hold at 4.0%, as was expected. There is an increasing body of evidence, such as weak economic activity, showing that the ECB has already overshot in this rates cycle. However, the ECB is still trying to regain inflation fighting credibility, so wants more time and economic data to persuade them to rectify the latest mistake.

Compared to the prior ECB staff inflation forecasts from September there was "…*a downward revision for 2023 and especially for 2024*." Updated forecasts are for headline inflation in 2024 to be 2.7% (previously 3.2%), with it returning to be very close to the 2% target during 2025. Note that these staff forecasts are based on data up to 23 November 2023 (there was weaker inflation data after this date). The ECB states that although underlying inflation has eased, "…*domestic price pressures remain elevated, primarily owing to strong growth in unit labour costs*." The focus remains on conquering this last leg of inflation. The statement maintained the wording that "…*the Governing Council considers that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution*" to reaching the inflation target. ECB president Lagarde emphasised that the ECB is data dependent not time dependent, it appears to me that the ECB is choosing to err on the side of keeping monetary policy restrictive for too long.

The Bank of England's Monetary Policy Committee (MPC) left rates on hold at 5.25%. The vote split of 6-3 points towards a current preference for further monetary policy tightening, with Greene, Haskel, and Mann all preferring a 25bps rate hike. The hawkish bias was retained with the unchanged sentence: "…*Further tightening in monetary policy would be required if there were evidence of more persistent inflationary pressures*." While nobody actually expects another rate rise, there is continued emphasis on keeping monetary policy restrictive for a long time. In my opinion, the Bank of England has a similar philosophy here to the ECB, erring on the side of cutting rates too late.

The MPC still see risks to their modal inflation forecast "…*skewed to the upside*." Services inflation remains the biggest issue for the MPC, there is therefore a lot of focus on the UK labour market. The statement does note "…*there has been further evidence of some loosening in the labour market*," but (and I wonder if this sentence was inserted last minute after the FOMC meeting) "…*relative to developments in the United States and the euro area, measures of wage inflation were considerably higher in the United Kingdom and services price inflation had fallen back by less so far*." The MPC's outlook for wage inflation is for some cooling, with their agents' survey pointing towards a "…*fall in average annual pay settlements in 2024*." Once again the risks here are viewed by the MPC as skewed to the upside.

Overall, it will take a while for the "*higher for longer*" mantra to change, particularly due to central bankers having to regain credibility after the transitory farce. However, monetary policy is restrictive, and this is starting to show through in a wider array of economic data. I believe that the natural consequence for interest rates of "*higher for longer*" will be later but larger rate cuts. Once economic data, including inflation and labour market indicators, has weakened enough for central banks to start cutting then I think they will want to rapidly move towards a more neutral policy stance. This is presently somewhere in the region of 2-3% on base rates in the US and UK. Markets may be pricing in the first cuts happening too soon, but the eventual extent of cuts is still underestimated.

Fund performance

We split the Fund into the Carry Component and three alpha sources for clarity in reporting, but it is worth emphasising we manage the Fund's positioning and risk in its entirety. As a reminder, the Carry Component invests in investment grade bonds with <5 years to maturity; within this there is a strong preference for investing in the more defensive sectors of the economy.

Yield carry and the rally in government bonds drove Fund returns. A tightening in credit spreads added a further small tailwind, with alpha contributing incrementally.

Alpha sources

Rates

The Fund spent most of the quarter with a duration of 2.0 years, above the neutral level of 1.5 years (as a reminder, the permitted range is 0-3 years). As the rally in bonds progressed during December, the Fund's duration was marginally shortened down to 1.9 years. This is split between 1.4 years in the US, minus 0.5 years in Canada, 0.8 years in Europe, and 0.2 years in the UK.

A new cross market position was established during the quarter: 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. However, the bond markets are priced with a much larger differential; US 10-year Treasuries yielded over 80 basis points more than their Canadian cousins, close to the widest spread between the two we have seen for the last three decades. By the close of the quarter this position had generated 3 basis points of alpha.

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Allocation

The weighting in the Carry Component has been in the high 80s to low 90s percentage area throughout the quarter, due to the compelling yield on short dated defensive investment grade. With the weighting in the Carry Component being so high we have maintained a lower than usual exposure to other credit in Selection.

Selection

Stock selection was additive to performance during the quarter. Within Selection, the best two issuers' bonds were AIA and 3i, each adding approximately 3 basis points to performance. Most other credit holdings performed in line with the broader market, benefitting from the credit spread tightening seen during the period. The two exceptions in the Carry Component were T-Mobile US, which added 3 basis points, and Heimstaden Bostad which detracted 5 basis points. The position size in the latter was reduced to 0.6% to reflect the ongoing volatility of bonds in the real estate sector.

A new position in Selection was established in Standard Chartered operating company lower tier 2 bonds. The bonds have a credit spread of 250bps and benefit from a 'bullet' maturity. Lower tier 2 bonds are frequently double dated for regulatory reasons, with principal repaid over a range of dates, but this issue has a 'bullet' repayment of loan principal at final maturity. The bonds are obsolete capital subject to grandfathering arrangements, so we may see a liability management exercise by the company at some stage; the holding in the issuer in the Carry Component was sold to fund this purchase.

Also in Selection, a small holding was purchased in IQVIA secured debt; it is just over 5 years maturity so counts as Selection until February. At the riskier end of the Fund's low risk spectrum, US dollar denominated Intesa lower tier 2 bonds that mature in June 2024 were purchased, yielding over 7% at the time. Similarly, the small holding bought in the May 2024 maturity bonds in Saga yielded above 10% despite being covered by cash and shareholder commitments. Virgin Media bonds were sold for both valuation reasons and to manage the overall risk within Selection.

Activity within the Carry Component was higher than usual during the quarter, driven by a combination of numerous bonds maturing and inflows into the Fund. Due to the inverted shape of the yield curve in the 0–5-year maturity bucket, 2024 maturity bonds offer attractive yields relative to other tenors. Purchases of 2024 maturity debt included American Express, AbbVie, Bristol Myers Squibb, Bank of New York Mellon, Becton Dickinson, Deutsche Bank, Equinix, eBay, and Mercedes. Furthermore, some of the cash has been reinvested in a January 2024 maturity US Treasury to then be redeployed when that matures. Additions to the Carry Component that have a maturity other than 2024 included Brambles, Nationwide Building Society, Netflix, and Roche.

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Key Features of the Liontrust GF Absolute Return Bond Fund

Investment objective & policy[1]	The investment objective of the Fund is to generate positive absolute returns over a rolling 12 month period, irrespective of market conditions. There is no guarantee the investment objective will be achieved over this or any other time period. The Fund aims to achieve its investment objective through investment in corporate and government fixed income markets worldwide, including developed and emerging markets. In achieving its objective, the Fund also aims to minimise volatility and reduce the possibility of a significant drawdown (i.e. a period where the Fund is worth less than the initial investment at the start of a 12 month period). The Fund invests in a wide range of bonds issued by companies and governments, from investment grade through to high yield. The Fund invests in developed and emerging markets, with a maximum of 20% of its net assets invested in emerging markets. Investments are made in US Dollar denominated assets or non-US Dollar denominated assets that are predominately hedged back into US Dollar. 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. The fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.
Recommended investment horizon	5 years or more
Risk profile (SRI)[2]	2
Active/passive investment style	Active
Benchmark	The Fund is actively managed without reference to any benchmark meaning that the Investment Adviser has full discretion over the composition of the Fund's portfolio, subject to the stated investment objectives and policies.
Sustainability profile	The Fund is a financial product subject to Article 8 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.

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

	Dec-23	Dec-22	Dec-21	Dec-20	Dec-19
Liontrust GF Absolute Return Bond C5 Acc GBP	6.5%	-4.6%	-0.4%	2.9%	2.5%
IA Targeted Absolute Return	4.3%	-0.4%	3.5%	2.6%	4.4%

*Source: Financial Express, as at 31.12.23, total return (net of fees and interest reinvested), C5 class. Discrete data is not available for ten 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:
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.

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.

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.

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.

There is no guarantee that an absolute return will be generated over a rolling 12 month period or any other time period

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

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