



# Global Fixed Income

December 2023 review

## Liontrust Strategic Bond Fund



Phil Milburn

Co-Head Global Fixed Income Team



Donald Phillips

Co-Head Global Fixed Income Team

**The Liontrust Strategic Bond Fund returned 5.0%\* in sterling terms during December. The average return from the IA Sterling Strategic Bond sector, the Fund's comparator benchmark, was 3.7%.**

### Market backdrop

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 overshoot 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.

During the press conference, Lagarde argued that there will be rich data in the first half of 2024. An obvious example is the wage rounds in spring. In my opinion, this makes it difficult for the ECB to start cutting in March due to lags in wage data availability and the ongoing stickiness of wage inflation. On how long the ECB will hold rates for, Lagarde said that for the ECB now “...*it is not time to lower their guard;*” 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.

## Fund positioning and activity

### Rates

The Fund started December with 8.0 years of duration exposure. This was reduced by 0.5 years mid-month as the rally looked to be overextended in the short term. A year-end squeeze gave the opportunity for a further 0.5-year reduction on the penultimate trading day of 2023 to take duration down to 7.0 years. For the avoidance of doubt, we deem 7.0 years of duration exposure to be a significant long duration position. Strategically, the rates cycle has turned, and we expect yields to be a lot lower later in 2024. However, the markets had priced in rate cuts happening too soon so it was prudent to take some profits and leave room to buy back a year of duration should there be a setback in the rates markets.

The geographic split of duration is US 3.2 years, Canada -0.55 years, UK 1.25 years, Europe 2.25 years, and New Zealand 0.85 years. We continue to prefer short-dated and medium-dated bonds. The net duration exposure in the 15+ year maturity bucket is zero.

### Allocation

Over the last few months as the high yield market rallied, we have taken some profits. The Fund has 23% in bonds and an 8% overlay in place to reduce risk using the iTraxx Xover credit default swap index, so net high yield exposure is 15%. This is a little below our neutral level of 20%. We are waiting for a better valuation opportunity to establish a strategic overweight position in credit. Similarly, the Fund's investment grade weighting is very close to neutral at 51%.

### Selection

State Street's investment grade rated subordinated bonds have rallied to a level just under par. We therefore took profits on the bonds as the risk/return equation was no longer favourable. Within high yield rated bonds, the Fund's holding in Altice was also sold. Altice is potentially selling its largest network in Portugal – while this could be supportive for credit metrics, there is the risk of significant cash leakage as Altice's owner (Patrick Drahi) needs funds to help refinance his separate French business. A combination of this risk, ongoing governance concerns, and a big spike in the bonds' price led to the decision to exit the position.

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

	Dec-23	Dec-22	Dec-21	Dec-20	Dec-19
Liontrust Strategic Bond B Acc	8.4%	-11.3%	-0.5%	5.9%	8.7%
IA Sterling Strategic Bond	7.8%	-11.0%	0.8%	6.6%	9.3%
Quartile	2	3	3	3	3

\*Source: Financial Express, as at 31.12.23, accumulation B share class, total return (net of fees and income reinvested).

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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