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Sustainable Investment

Q1 2024 Review

Liontrust GF Sustainable Future European Corporate Bond Fund

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The Fund returned 1.0%* in euro terms over the quarter, compared with the 0.4% return from the Markit iBoxx Euro Corporates Index comparator benchmark.

Market review

The first quarter of 2024 was characterised simultaneously by a continuation and a reversal: a continuation of the volatility seen in 2023, as markets try to price the likely path of short-term interest rates in the face of incoming information; and a reversal of the sudden repricing in December which had seen UK 10-year yields sink as low as 3.5% at one stage.

As the initial impact dissipated following the Fed's December 'pivot' and weak UK inflation data, yields began the year trending higher, in what would remain the broad theme for the quarter, albeit punctuated by sudden moves in either direction. This points to the market's nervousness amid the uncertainty of outcomes and resultant paths that policymakers will choose, or be forced, to take.

Having risen around 10 basis points (bps) off their lows in the last week of 2023, 10-year gilt yields pushed higher in January and February, peaking around 4.20%, before retreating in March and ending the quarter below 4%. There were similar moves in the US and Europe, where the majority of economic upside surprises came from.

This has seen markets push back their pricing of the first rate cuts from spring to summer. Still, there has been enough flexibility in the data to allow the three major central banks to point to impending cuts in the second half of 2024, although they remain guarded over the magnitude and frequency of any easing cycle. The lingering memories of the recent inflation spike no doubt cast a doubtful shadow over any urges to move too quickly.

Most recently, the Fed elected to leave their dot-plot unchanged, continuing to signal the most likely scenario being three hikes this year. Chair Powell has seemed keener to point to the risks of overly restrictive policy on the economy, even when pushing back on cuts in March, as he did following the Fed's January meeting. Part of the reason for the moves higher in yields was the bumper upside surprise in non-farm payrolls for January, although this was largely revised downward in the March data release. Nevertheless, economic data has been firm, with inflation also surprising to the upside in both January and February. To us, the US looks like the most vulnerable to a further delay in rate cuts, at least from a fundamental perspective, however the decision of the Federal Open Market Committee (FOMC) also depends on its collective view of how restrictive the current monetary policy stance is.

The UK was confirmed as having been in technical recession in the latter half of 2023, although initial signs from Q1 appear to show this will be short-lived and shallow, with monthly GDP growth again tracking above 0.0%. The labour market continues to loosen slowly, as vacancies and wages remain on a downward trend, albeit from admittedly elevated levels. Given the lack of reliability in the ONS Labour Force Survey data, other measures have gained greater prominence and appear to confirm the easing of pressure in the labour market. Inflation data has been mixed, with December a modest upside surprise, followed by a downside miss of similar magnitude in the January numbers, and another small miss in February inflation. The ongoing bifurcation of inflation, with goods inflation weakening further to 1.1% and services stickier around 6%, is a theme seen in most advanced economies. There were methodological changes in the most recent UK print which skewed services inflation higher than it otherwise would have been, but it remains in line with Bank of England forecasts. The most recent MPC meeting saw no votes for a hike for the first time since the hiking cycle began, and an explicit acknowledgement that the Bank rate could be cut and still remain restrictive.

The European Central Bank (ECB) has done little to push back on market pricing throughout the quarter, with president Lagarde pointing to the impact of rate hikes in softening demand, and strongly hinting towards June as the likely time for a first cut, given the accumulation of data the Governing Council will have by then in order to make its judgment. Although such data has generally beaten expectations, this comes from a position of relative weakness, with growth in the euro area looking fairly anaemic over the next two years, and less labour market pressure than has been observed on the other sides of the Channel and Atlantic.

Fund performance

The Fund delivered positive performance both in absolute and relative terms, driven by credit spread compression and positive security selection. However, the move higher in yields over the quarter had a detrimental impact to performance, given the Fund's long interest rate positioning relative to the benchmark.

Our active duration management was muted this period. We started the quarter being +0.75 years long, which is expressed as 0.50 years long through the UK and 0.25 years through Germany. However, stronger-than-expected economic data released at the beginning of the quarter pushed yields higher, at which point we increased our duration positioning by +0.25years in Germany. This brought the overall overweight position to +1 year, which we kept in place until the end of the quarter. 10-year bund yields finished the quarter at 2.30%, which still remains above our fair value target of 1.5%.

Our credit positioning performed strongly over the period, driven by both our stock selection and sector allocation. We strongly benefitted from our overweight position to banks, although this was offset by our allocation to bunds and our overweight position in insurance. Stock selection was particularly strong in the banking sector in which we were overweight T2 subordinated bonds. Also, continuing from last quarter, legacy subordinated bank bonds were a strong contributor to performance. Call action later last year saw the market reprice the possibility of these legacy securities being called at par, benefitting our remaining position in BNP.

Overall sector positioning has not changed. We remain overweight financials, telecoms and utilities and underweight industrials. Recently, we made small moves to reduce credit beta given credit spread tightening. The continued resilience in the macroeconomic environment, coupled with low recession risk, has led to a more than expected credit spread compression with the European Corporate index moving tighter by 32 basis points (bps) to finish the quarter at 112. As a result, we have been moving up the capital structure in financials by rotating from tier 2 into senior paper within favoured issuers.

Trading Activity

Trading activity was high over the quarter, with modest moves lower in rates leading to some opportunistic borrowing. Relative value trades were also high, as we reacted to spreads compressing throughout the quarter.

In financials, we participated in relative value trades given strong performance and spread tightening. We sold down our position to Standard Chartered to purchase longer maturity Lloyds' bonds. Later in the quarter, we switched our remaining Standard Chartered position to an attractively priced new issue from the same issuer. We sold our Ing Groep position, later purchasing a new issue that was also attractively priced.

Outside of financials, we performed relative value switches to new issuance from Kononklijke Ahold Delhaize. On disposals, we reduced the Fund's exposure to ultra processed foods by completely exiting out of Kerry Group. We used the proceeds to top up positions in Verizon and Telefonica.

Outlook

Economic data releases over the quarter surprised to the upside, which led to a repricing and pushed back rate cut expectations from March to June. However, central banks have been indicating their confidence over cutting rates in the second half of the year, which is supportive for fixed income valuations, while also supporting the likelihood of a soft economic landing.

At the same time, we are yet to fully see the impact of higher rates filtering through to the real economy and expect that this will only accelerate. Inflation has broadly shown signs of softening and we expect it to fall further amid weaker consumer demand due to the ongoing transmission of higher interest rates. The latter will also result in weaker economic growth, ultimately making central banks higher for longer narrative unsustainable.

Therefore, we still see significant value in government bonds, with continued upside as we are above fair value, and we maintain a long duration position.

While corporate spreads have performed strongly in the first quarter of 2024 and many credit markets are on the tighter end of their historical ranges, we continue to believe that corporate credit offers value, with all-in yields above 3.85%.

While we expect economic growth to be challenged looking forward, we continue to believe that corporate bonds can perform well against this backdrop. Corporate fundamentals remain robust, with low levels of leverage, high interest coverage and ample liquidity. Though corporate fundamentals will inevitably weaken through a period of economic deterioration, the strong starting point significantly above long-run averages means that investment grade companies should be able to navigate this period. Defaults are expected to trend lower towards the long-term average over 2024, so current levels of return more than adequately compensate for the lower inherent risks and still provide an attractive entry point.

Overall, we remain constructive on the prospects for corporate bonds, based on attractive valuations and strong fundamentals.

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.

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

	Mar-24	Mar-23	Mar-22	Mar-21	Mar-20
Liontrust GF Sustainable Future European Corporate Bond A5 Acc EUR	10.0%	-9.3%	-5.5%	10.1%	-4.6%
Markit iBoxx Euro Corporates Index	6.8%	-7.8%	-5.7%	8.7%	-3.4%

*Source: FE Analytics, as at 31.03.24, 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.

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