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Sustainable Investment

Q1 2024 Review

Liontrust Sustainable Future Corporate Bond Fund

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The Liontrust SF Corporate Bond Fund returned 0.9%* over the quarter, compared with the 0.2% return from the iBoxx Sterling Corporate All Maturities Index and the average return from IA Sterling Corporate Bond sector of 0.4% (both are comparator benchmarks).

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

Our active duration management was muted over this period. We started the quarter 1 year long to the UK, with yields standing at 3.54%. However, stronger-than-expected economic data released at the beginning of the quarter pushed yields close to 4%. At this point we increased our duration positioning by 0.25 years, bringing the overall overweight position to 1.25 years. We retained this level until the quarter end. The UK 10-year ended the quarter at 3.93%, which remains above our fair value target of 2.5-3%.

Our credit positioning performed very strongly over the period, driven by both our sector and stock selection. The largest contribution came from banks and insurance sectors, 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. Positive stock selection was also noted in utilities, primarily from our holding in Orsted. Following impairments made last year, it released a turnaround plan in February with a clear direction to restoring financial security through asset farm downs. It has also refocused capital expenditure going forwards and the bonds have done well on the higher certainty outlook.

Overall sector positioning has not changed and we maintain our overweight to credit beta, which proved beneficial given the recent rally. Elsewhere, we remain underweight in utilities, consumers, and industrials, while we have generally been reducing our credit risk given recent credit spread tightening. The continued resilience in the macroeconomic environment coupled with low recession risk has led to greater than expected credit spread compression, with the sterling corporate index moving tighter by 20bps to finish the quarter at 114. As a result, we have been moving up the capital structure in financials by rotating from Tier 2 into senior paper within our favoured issuers.

Trading activity

Trading activity remained 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 trades that reflected our thoughts on valuations given strong performance and spread tightening. As mentioned previously, we sold out of tier 2 paper and bought similar maturity senior paper for both HSBC and Lloyds.

Elsewhere, with many financials issuers coming to market, we participated in a new issue from Société Générale, which was funded by disposing of BNP and BPCE bonds. On a relative value basis, we also performed switches within issuers like M&G, and from Standard Life into Santander.

Outside of financials, we diversified through adding a new holding of Vonovia, the largest listed residential landlord in Germany and Sweden, giving us exposure to large scale and diversification. Its low cyclicality and high occupancy leave it well positioned for an upcoming economic slowdown. We added a new longer dated holding from Scottish & Southern Energy, funded from our existing holding of its hybrid bonds, which looked fully valued as it approached its call date.

On disposals, we reduced idiosyncratic risk by completely exiting out of Mobico, having sold its hybrid bonds last quarter. We also made the decision to exit from Thames Water in February. Our analysis on Thames Water was part of a wider UK water sector engagement exercise and review. We met with each of our holdings and the higher leverage, poor operational performance and challenged outlook from Thames Water contributed to our decision to dispose of our holding. We reinvested the disposal proceeds into more defensive names at attractive valuations, such as Suez and topping up other favoured holdings.

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 5.5%.

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.

In terms of sector positioning, we remain underweight to consumer sectors due to the delayed impact of interest rate hikes still to have their full impact. The Fund remains overweight financials, based on attractive valuations and this is expressed through overweight positioning to both the banks and insurance sectors. We also remain overweight to telecoms due to their resilience and growth characteristics and remain underweight to the utilities sector.

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

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

	Mar-24	Mar-23	Mar-22	Mar-21	Mar-20
Liontrust Sustainable Future Corporate Bond 2 Inc	10.2%	-10.6%	-5.7%	12.9%	-1.4%
iBoxx Sterling Corporate All Maturities	7.5%	-10.6%	-5.5%	10.1%	0.0%
IA Sterling Corporate Bond	7.4%	-9.1%	-4.2%	9.0%	0.8%
Quartile	1	3	4	1	4

*Source: FE Analytics, as at 31.03.24, total return, net of fees and interest reinvested.

**Source: FE Analytics, as at 31.03.24, primary share class, total return, net of fees and interest 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.

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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