

Schroder Absolute Return Income Fund

Portfolio Review

The Schroder Absolute Return Income Fund delivered a return of 0.64% (net of fees) for the month and 5.57% (net) over the 12 months to March, which is 1.42% over the RBA cash rate for the past year. Over 3 years and 5 years the fund has returned, net of fees, 1.98%pa and 2.47%pa which is 0.12%p.a. below and 0.99%p.a. over the RBA cash rate, respectively.

Largest contributors

The largest contributors for performance over the month were allocations to Australian corporates, both investment grade (+0.25%) and higher yielding issuers (+0.10%), including Australian bank sub-ordinated debt. Securitised credit was another significant contributor adding 0.12%

Largest detractors

No detractors over the month.

Market Review

Global equities gained in March, with developed markets outperforming emerging markets. Government bond yields fell in the month.

US equities made gains in March. The energy sector was boosted by rising oil prices while materials and utilities also performed well. Economic data continued to prove largely resilient with the ISM manufacturing PMI rising to 50.3, after 47.8 in February. Eurozone shares also gained in March. Financials continued their good recent run while energy and real estate were also among the top performing sectors. Japanese shares advanced in March. Gains came despite the Bank of Japan starting to normalise monetary policy by announcing the end of negative interest rates. Emerging market (EM) equities advanced in March, although the MSCI EM index lagged the MSCI World. Technology stocks in Taiwan and South Korea delivered strong returns due to optimism about the semiconductor cycle and AI enthusiasm.

In March, government bond yields in major markets (the US, the UK, and the eurozone) fell, with US 10yr yields 6bps lower, German 10yr yields 11bps lower and Australian 10yr yields outperforming declining 17bps. Japanese bond yield rose modestly and mostly for shorter maturities as the Bank of Japan raised rates, ending negative interest rates. The US Federal Reserve is still expected to cut rates, despite a buoyant economy, but rates market have reduced the total size of rate cuts to be in line with Fed projections. The European Central Bank is expected to start cutting rates in June as inflation trajectory for the Eurozone economy remains on target. Corporate bonds outperformed government bonds, driven by strong activity data and narrowing corporate margins. Credit spreads tightened due to robust investor demand, with US and European investment grade spreads reaching a two-year low.

The Bloomberg Commodity Index was higher in March. Precious metals and energy were the best-performing components of the index. Cocoa prices were significantly higher in the month due to rising demand and shortages in West Africa, where more than half of the world's cocoa beans are harvested. Gold prices continued to benefit from strong institutional demand and Chinese retail buying. The oil price continued to rally, with Brent closing \$4.00 higher at \$87.5 as supply constraints increasing and OPEC+ maintaining their reduced production quotas. The USD index was marginally stronger, mostly against the Japanese Yen and Euro, as it benefited from a reduction the markets rate cut expectations. The Australian dollar traded in a narrow range between 0.65 and 0.66 US cents and closed the month marginally higher.

Market Outlook

An interesting outcome from the March US Federal Reserve (Fed) meeting; the Fed revised up both its inflation and growth projections but strengthened the dovish tilt to its policy stance by reaffirming expectations to cut 75 basis points over the course of 2024. This, combined with the slowing down of their balance sheet reduction via quantitative tightening, signalled their willingness to accept higher inflation for longer. Markets reacted to this growth-friendly news by buying equities and gold (often seen as an inflation hedge), driving both US equity markets and the gold price to record highs. Surprisingly, long maturity bond yields fell, however bonds with coupons linked to inflation outperformed their nominal counterparts, which makes more sense.

Easier monetary policy is a win/win as long as inflation and inflation expectations remain contained; from an investment perspective the risk of higher inflation has increased along with a decline in the risk of recession.

One of the key outcomes of our 2024 Strategic Investment Conference was an expectation that central banks would tolerate inflation above the strict 2% target, at least in the short term. The post-GFC period was dominated by disinflation and low growth. With inflation stubbornly below the targets, central banks adopted unconventional policies (negative rates, yield curve control, quantitative easing and forward guidance) in an unsuccessful program designed to reignite inflation and growth. Central banks will be very keen to avoid inflation overshooting to the downside again, where conventional policy becomes ineffective. The other potential reason for this shift in emphasis is the growing level of US government debt. With fiscal discipline not on the horizon from either presidential candidate, and increased spending requirements for energy transition, defence, infrastructure and social security, the level of US federal debt is expected to continue to rise from 120% of GDP currently. The need to have a higher level of sustainable debt is becoming more necessary. Higher levels of growth and marginally higher inflation enables the US economy to run higher levels of debt. Following the outcome and messaging of the latest Fed meeting, we may consign March 2024 FOMC meeting as the day when the “doves” downed the “hawks” and the start of the shift away from strict inflation targeting.

In Australia, the Reserve Bank left interest rates unchanged at their March meeting, as broadly expected. Australian bond yields continue to range trade between pricing in a 25 basis point cut and a 50 basis point cut by the end of 2024. With domestic household spending in the doldrums, we think the next RBA move will be to cut rates but with inflation well above the recently affirmed target of 2.5%, we expect the RBA will remain cautious. With the recent outperformance of US bonds and between 40 to 50 basis points of cuts factored into current yields, we have reduced Australian duration risk. In US yields, we also cut duration early in March and mostly avoided the negative impact of the rise in yields ahead of the higher than expected February inflation data. As part of the duration reduction, we switched from nominal bonds and increased inflation protection by adding 2.5% exposure to US inflation-linked bonds, which is now at 7.5% of the portfolio. Most of our duration exposure remains in Europe, where more progress is being made on inflation and growth remains weak. We expect the European Central Bank (ECB) to start cutting rates in June and expect more cuts than in Australia and the US over the course of 2024. As at month end, the duration of the portfolio was at 1 year, down from 1.8 years a month ago. Rather than take significant duration risk in Australian rates, which we view as fully priced, we have increased the portfolio's exposure to foreign currency to 4%, by selling the Australian dollar against the US dollar and Japanese yen. We believe the AUD can depreciate further if the RBA cuts by what is currently factored into rates markets.

In credit markets, we have started to reduce risk and continue to rotate exposures away from expensive US corporate exposures. Having captured the high yield (HY) spread compression from over 500 basis points, we hedged the portfolio's exposure to global high yield bonds with US high yield (HY) spreads now being priced at the most expensive quintile (below 320 basis points). Whilst we do not see a catalyst for US HY spreads to re-widen, with BB-rated US corporates offering only 200 basis points extra yield, we prefer to own higher quality Australian subordinated bank debt at 175 basis points extra yield. At current pricing, we don't believe the additional yield on offer in HY is adequate compensation for the additional credit risk. We also continued to reduce exposure to the global investment grade corporate strategy, mostly due to valuation concerns on US corporates (which dominate the global IG strategy) where spreads are also in the most expensive quintile. We reduced global investment grade corporates by 4%, and rotated 2% to a more focused strategy in European investment grade corporates, where valuations are far more attractive. We also added 2% to Australian mortgage-backed securities, where pre-pandemic vintages with attractive loan-to-valuation metrics and weighted-average life below two years are still yielding 100bps over swap. After a frantic February, the new issue market was quieter in March and we were mostly inactive in the primary market.

The Schroder Absolute Return Income Fund remains close to fully invested with cash levels below 10% and the yield to maturity close to 5.20%. We have reduced interest rate risk considerably over the past two months, particularly in Australian and US rates, where pricing is broadly aligned to our expectations for central bank rate cuts. We are also concerned about the recent stalling in progress on US core inflation, with goods inflation no longer declining and services inflation remaining stubbornly high. This is making us more cautious on interest rate exposure overall particularly if, as we suspect, the US central bank has made a subtle tilt to a more pro-growth stance and will tolerate higher inflation for longer. Credit should continue to perform, particularly if growth remains robust, but we are rotating out of expensive US corporate exposures and being more focused into Australian and European investment grade and US securitised assets where there is more value for the credit risk. In addition, we have increased the inflation protection in the portfolio by adding more US inflation-linked bonds.

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