

# Schroder Fixed Income Fund

## Portfolio Review

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In May, the portfolio returned -0.2% (before fees), behind the benchmark by 0.3%. This takes our one year performance returns to 7.5% (before fees), ahead of benchmark by 0.6%. At May end, the portfolio is yielding 4.5% with an interest rate duration of 5.2 years.

## Market Outlook

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The global economy started 2025 in a strong position, and whilst the threat of US tariffs, trade policy and general uncertainty will weigh notably on growth, it is probably not enough to tip the global economy into recession. Trump euphoria has well and truly disappeared, with whiplash tariff policy and an unsustainable US fiscal deficit, where debt to GDP is expected to spiral to all-time-highs in coming decades.

An increased US tariff regime is here to stay, and the economic damage is in train. Our baseline assumes that the US effective tariff rate on average settles around 8-12%. This is still a substantial increase compared to pre-Liberation Day, where the effective US tariff rate was 3%. The trade shock will hit economies simultaneously, generally pushing economies below potential growth. While global inflation will moderate, the US differs versus the rest of the world because of tariffs. In the US, the fall in inflation towards target is interrupted by the passthrough from tariffs and a level shift up in prices. US growth will slow towards trend, but inflation is likely to reaccelerate putting the US Federal Reserve in a difficult position, unable to ease policy to support growth as inflation rises.

Monetary policy is now a balancing act. Central banks will need to respond to slower growth and softer inflation, with the exception of the US Fed. Disinflation will continue globally with weaker demand, currency appreciation and lower oil prices driving inflation lower. This will see most central banks continue to ease policy back to more neutral levels to support growth rates.

In Australia, the Reserve Bank of Australia (RBA) is set to deliver a soft landing as inflation has continued to moderate and the labour market remains resilient. The RBA lowered the cash rate in May to 3.85% and have lowered their estimate of the neutral cash rate to 3%. Their revised forecasts acknowledged the balance of risks are tilted to the downside, due to weaker consumption and uncertainty around global trade. Given the cash rate remains in restrictive territory, there's plenty of ammunition to respond to weaker growth. Furthermore, while Australia's fiscal position has deteriorated over recent years, it remains relatively healthy, which provides policy flexibility to support growth in a deeper growth slowdown. This means we view the likelihood of an Australian recession as low.

Looking ahead, global bond markets will be driven by trade and fiscal policy, with markets, of late, focusing more on the rising deficits in both the US and Eurozone. The key driver of rising deficits in the US are a combination of slower growth and rising interest costs given debt levels. Germany is projected to run its largest deficit outside of a recession since unification, with the main drivers being infrastructure and defence. Sustained high deficits are seeing government bond yields continuing to climb, following a month of weak government bond auctions with bond investors requiring higher risk

premiums or higher yields to be lending governments money. At these high levels of yields, we are now getting compensated for taking on additional interest rate and credit risk that sets up attractive incomes and supporting positive overall fixed income returns on a forward-looking basis. The environment will continue to be volatile and uncertain with a lot of opportunities to add value, we continue to see a large dispersion in expected returns across global fixed income asset classes that allows for active rotation to ensure we are in the right assets at the right time of the economic cycle.

## Positioning

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With the outlook more uncertain, and the risk of a global slowdown being priced into markets, we have started to increase credit quality and move shorter down the maturity curve. This will ensure we can preserve capital and deliver strong fixed income returns in an uncertain and volatile environment. We have reduced our exposure to higher yielding credit and increased our allocation to defensive high quality assets by 10%, with a preference for semi-government bonds.

Regionally, we are preferring to hold exposure in those countries and sectors where valuations are attractive and the central bank can ease monetary policy to support growth, i.e. Australian and European investment grade bonds. Australian semi-government valuations remain attractive across the mid-to-long end of the curve. Supply going forward will become less of a drag to the sector; while the aggregate funding task remains relatively high vs. the longer-term trend, the forward projections are expected to stabilise around current levels. In addition, with the RBA finally able to reduce the cash rate, this is a positive and supportive factor for semi-governments and other high quality corporate bonds in the Australian market. We have reduced all holdings to US asset classes, both credit and mortgage-backed securities and increased our allocation to Australian mortgages as the RBA commences its easing cycle. We remain positive on asset classes like emerging market debt as high real yields and a lower US dollar is supportive of returns in the asset class.

In rates, we prefer interest rate risk in those markets where policy rates are being lowered – Australia, Europe and the UK. We continue to hold a very negative view of US rates, particularly in the long end of the curve as the large (potentially unfunded) fiscal deficit and higher inflationary environment keeps yields elevated and under pressure to move higher. Our interest rate risk is held in shorter maturities, where we are positioned for growth to weaken and curves to steepen (yields falling in short maturities and rising in longer maturities).

Overall, we are raising quality by rotating the portfolio into higher quality investment grade sectors and reducing higher yielding credit as the outlook remains uncertain and valuations are back to expensive levels. Our preference is to be owning Australian bonds over global bonds with more attractive valuations and a central bank that is reducing the cash rate. Fixed income is now a better diversifier of equity risk. If global growth starts to materially weaken with recession risk increasing, we will continue to reshape the portfolio, raising cash and credit quality, reducing credit risk, and increasing our interest rate risk to position for central banks to come back to ease policy and support growth rates.

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