Schroders

April 2023

Schroder Fixed Income Fund

Portfolio Review

Over April, the portfolio returned 0.28% (before fees), outperforming the benchmark by 0.08%. Modest spread compression in Australian investment grade credit was the main contributor.

We made two key changes to positioning during the March quarter - to increase interest rate duration, and to reduce exposure to riskier credit asset classes. In April, we held positions broadly unchanged.

The Schroder Fixed Income Fund aims to deliver low-risk income and diversification by accessing opportunities and managing risks across the spectrum of fixed income opportunities. The current environment is offering both attractive yields over medium-term investment horizons and good diversifying potential as the cycle turns, while volatility is creating opportunities for active managers. We are positioned with an up-in-quality stance, favouring investment grade credit to generate income, and with overweight interest rate exposure to help provide diversification.

Market outlook

Coming into this year we firmly believed high-quality fixed income offered attractive relative and absolute value. We also expected the economic cycle to turn in favour of bonds – as headline inflation softens with supply chains normalising, as growth weakens with rate hikes and cost pressures biting, and as central banks complete their aggressive tightening and potentially shift to easing.

Four months into the year, our conviction is now even greater, albeit a few things are surprising us.

The US banking system is under considerable strain with regional banks sequentially facing asset devaluation, deposit flight, loss of investor confidence (plummeting share prices) and an FDIC-brokered fire sale. The asset devaluations have varied in nature but all have a common cause – higher interest rates. Silicon Valley Bank suffered from very poor hedging of its interest rate risk, incurring significant losses on its treasury holdings. More commonly, the assets suffering revaluation are commercial property loans, which being illiquid, escalate the solvency issue to an immediate liquidity crisis as deposits are withdrawn. Commercial property and other asset revaluations are a simmering issue in other regions too – notably in Europe, but also here in Australia.

Public fixed income markets took their medicine last year, the worst for bonds since the 1970s. Bonds were first to be hit as the rates revaluation mechanism is more direct in liquid, public assets. The rippling out of the rates shock is now being felt elsewhere.

We expected higher rates to take their toll on the economy, but have been a little surprised at the resilience of consumers. Buffers built up during Covid have proved effective (to date) in offsetting some of the ongoing real income squeeze, and some relief for wage earners is now in sight, with wage rises on the horizon in Australia amid an ongoing tight labour market. The housing market here is also stabilising earlier, in part driven by a firm rebound in migration. Strong competition may actually see a relaxation of home lending conditions in Australia, in contrast to the ongoing tightening of credit supply expected in the US and Europe.

Albeit that the consumer and business spending slowdown is taking longer to materialise, the balance of risks continues to move towards slowing growth and away from accelerating inflation. High-quality fixed income is poised to do well relative to other assets, particularly should downside risks gather speed. Higher than comfortable core inflation likely increases downside growth risk as central banks keep inflation-fighting

their number one priority. This means that rate cuts are unlikely this year and leaves riskier assets vulnerable. Bonds should again fulfil their role as cyclical diversifiers.

Positioning

Drawing together our key research inputs, our key views remain little changed and we believe that now is the time to be:

– **Owning interest rate risk** in the countries where central banks have tightened most aggressively/where inflation is showing best evidence of softening (e.g. the US) and in markets which have greater sensitivity to interest rates (e.g. Australia). Within these markets, short-dated bonds should do relatively better than longer as the cycle turns down

– **Holding up-in-quality allocations.** The high quality of Australia's investment grade credit market, its short tenor, and relatively wide spread make it particularly appealing to us versus other corporate bond markets. We are able to access good yield in this way, while minimising exposure to riskier credit

– **Rotating issuers to improve overall credit quality.** With our Australian credit allocations, we have been buying banks from an underweight position, and de-risking by reducing lower-rated corporate issuers. We believe that Australian banks are well positioned, with simpler business models than global peers, high liquidity and robust capital levels

– **Staying liquid,** providing greater flexibility to position actively. We expect market volatility to remain high as we come to the turn in the cycle. We expect to use this volatility to continue to accumulate interest rate duration and high quality assets at attractive levels.

High-quality fixed income offers enhanced income levels and improved diversification benefits as the cycle turns. We believe asset allocators should rebalance back in favour of fixed income.

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