Schroders

April 2023

Schroder Real Return Managed Fund

Portfolio Review

The Schroder Real Return (Managed Fund) returned 0.67% (post-fees) for the month, taking the one-year return to 2.85% (post-fees).

Largest contributors

The drivers of returns were widespread in April, with equities (predominantly driven by Australian equities), credit, foreign currency and insurance linked securities all adding approximately 0.1% each to portfolio returns. The portfolio's duration exposure (including its overlays) was a secondary contributor.

Largest detractors

There were no major detractors to portfolio returns in April. While the portfolio's aggregate currency exposure was a positive contributor, the long Japanese yen (JPY) position was a moderate detractor during April.

Market Review

Equities

Despite ongoing concerns around the banking sector, equity markets rallied through April on the back of resilient macroeconomic data and better than expected earnings in US and Europe. We are 70% of the way through the first quarter earnings season, and despite absolute levels of earnings falling compared to last year in both US and Europe, they have surprised to the upside against relatively benign expectations. Global equities increased by 1.6% over the month in local currency terms, while Australian equities rallied by 1.8%. Emerging market equities underperformed, delivering -1.1% in US dollar terms for the month. Equity market volatility also continued to fall, with the VIX Index dropping to 15.8, the lowest month end level in almost 2 years. During April, we sold the remaining S&P call options that were held in the portfolio, which resulted in the fund's option adjusted equity weight falling to 15%.

Duration and Credit

Bond yields moved higher in the first half of the month, before rallying in the latter stages to end the month broadly unchanged. On the inflation front, data was mixed, with US headline CPI falling to 5% on a headline basis, while core inflation continues to remain resilient, actually moving moderately higher to 5.6%, though leading indicators for the shelter component (which has a relatively large weighting within US core CPI) continue to suggest a moderation in core inflation going forward. In Australia, both the headline and trimmed mean measures of inflation moderated over the first quarter, coming in at 7.0% and 6.6% respectively on an annual basis, with the latter measure being below market expectations. Towards the latter stages of the month, the ongoing issues surrounding the US debt ceiling began to make news headlines once again, though so far market reaction has been relatively benign. Australian 10 year bond yields moved 0.04% higher over the month to finish at 3.34%, while in the US 10 year bond yields rallied by 0.05% to finish the month at 3.42%. German and Japanese bond yields also moved higher by 0.02% and 0.04% respectively during April. Credit spreads tightened marginally across investment grade and high yield in developed markets, while emerging market debt spreads were flat over the month. Within the portfolio, we continued to add marginally to portfolio duration, bringing the total level to over 2.5 years at the end of April. The portfolio's credit position remains defensive, with the high yield allocation fully hedged out through CDX.

Currencies

The US dollar (USD) was mildly weaker through April, as result of strength in the Euro and British pound. The DXY Index fell -0.8%, but actually rallied by 1.1% against the Australian dollar and 2.6% against the JPY. The weakness in the JPY was a result of the new Bank of Japan (BoJ) governor maintaining the BoJ's existing yield curve control policy (at least for now) . The Australian dollar weakened against most major currencies as a result of the market mostly pricing out further RBA rate hikes (which later proved to be incorrect in May), as well as weakness in industrial commodity prices, notably iron ore, which dropped by over 12% during April. The portfolio's currency exposure remains unchanged over the month, retaining its defensive tilt towards the USD and JPY, while maintaining some emerging market currency exposure.

Market Outlook

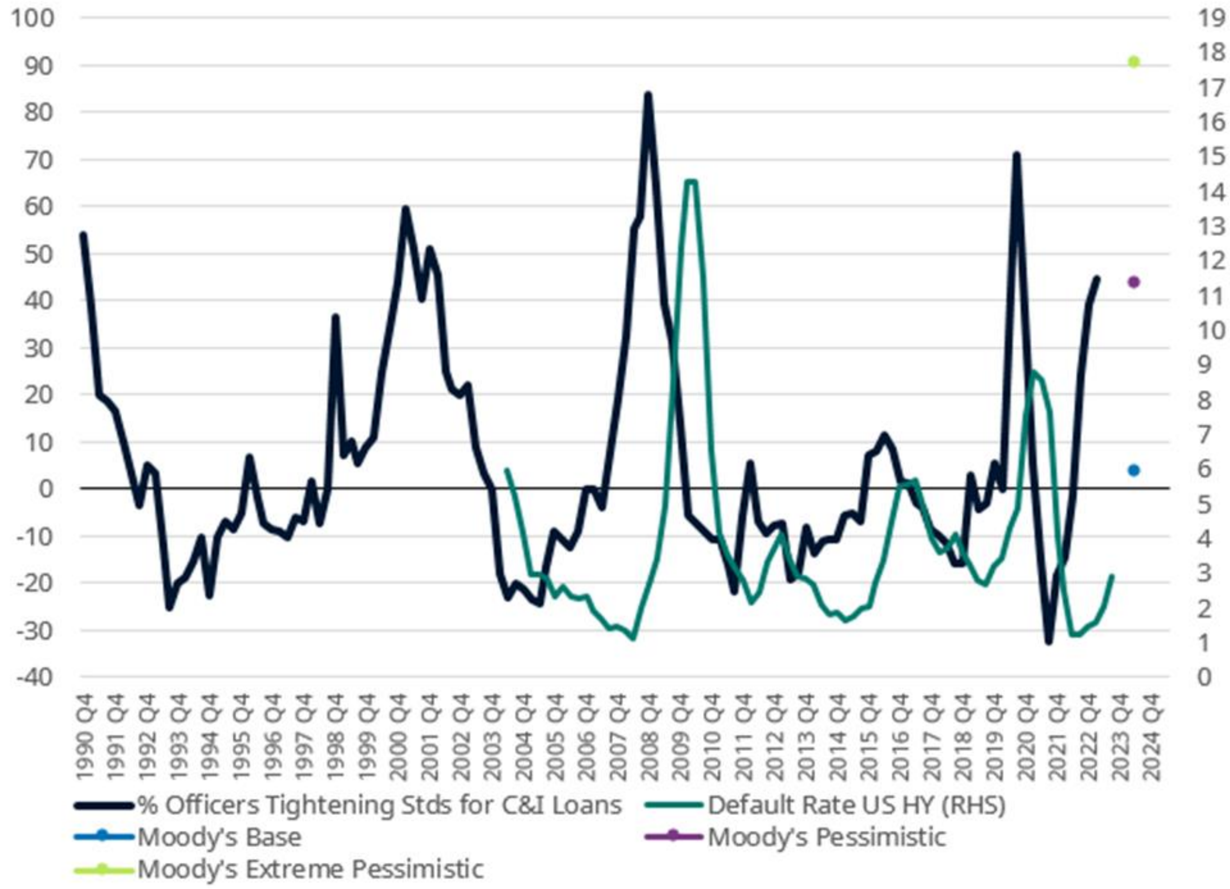
April drew to a close with recession still an expectation, not the reality. Economic data generally continues to moderate, but is not yet dire, while inflation, the key focus of policy maker attention, is also starting to soften but remains uncomfortably and stubbornly high. While bond markets are reflecting the ongoing tussle between these factors, equities in April (at a headline level at least) seemed to reflect a more positive interpretation of events.

We remain of the view that recession is the most likely outcome for key economies, given the accumulated policy tightening and the eventual outworking of Covid stimulus, and remain very defensively positioned. Unfortunately, the confluence of current economic outcomes is uncomfortable for central banks and rates are more likely to rise than fall in the near term. Any potential for rates cuts seems remote and in our opinion is not a 2023 scenario.

Our conviction in looming recession (both in Australia and in key global economies), is reflected in our recession indicator which has been flashing red for 12 months now, with 65% of the indicators signalling recession. US employment, a lagging indicator, is starting to show some cracks. Although the headline unemployment rate remains at historical lows at 3.5%, initial jobless claims are now starting to rise. This means that they are finally correlating with other negative labour market signals and we expect the unemployment rate to increase over the remainder of the year. We are also cognisant that monetary policy acts with a lag and while rates have been rising steadily for 12 months now, starting rates were low and the pass-through to household and business cash-flows more muted.

If proof that higher rates are having a negative impact is required, then we need to look no further than the unfolding crisis in US small/regional banks, where the Federal Reserve's policy actions have exposed the accumulated risks of the free money era on bank balance sheets, as well as a flawed regulatory framework and poor management in some of these banks themselves. The pressures here will likely lead to a further tightening in lending standards by US banks, which will restrict access to credit to the riskiest borrowers, both household and corporate. Bank lending standards have already increased and are consistent with levels prior to past recessions. The chart below shows a Federal Reserve survey of the percentage of senior loan officers tightening lending standards and the US high yield default rate. The latest survey was conducted prior to Silicon Valley Bank being closed by US regulators, but shows a significant tightening in lending standards was well underway and consistent with a significant increase in the default rates of the most risky corporate borrowers. The next senior loan officers survey is due out in early May and we expect confirmation of a further tightening of lending standards.

Chart 1: US Federal Reserve Senior Loan Office Survey vs Moody's High Yield Defaults



Source: US Federal Reserve, Moody's Investors Service.

The Reserve Bank of Australia is well aware of the long and variable lags of the impact of previous monetary policy decisions and while political pressure on the RBA has been intense, a pause in April after a cumulative 3.5% lift in official rates since May last year was justifiable. However, slowing down the pace of tightening is sensible. Inflation, while moderating, remains way too high for policy maker comfort. This unease was reflected in the RBA's decision to lift rates in early May to 3.85%, despite market expectation for an extended pause. The Fed also raised rates again in early May, with a clear message that while there are positives in the global inflation fight, the fight isn't over and inflation remains uncomfortably high.

Over the past few months, our strategy has been shifting to increasing duration risk and reducing credit risk as the balance of probabilities shifts towards a recession in the US and Australia. We have been reducing exposure to credit, particularly higher risk credit, as we believe the riskiest borrowers will struggle to refinance their debt as lending standards tighten. This is an intentional consequence of tighter monetary policy. Credit availability (at any price) will be restricted for both households and corporates that have high debt loads and reduced capacity to pay. The credit binge honeymoon is over! Current credit spreads for non-investment grade issuers are insufficient to compensate investors for the level of defaults that typically occur in a recession, so we have cut all exposure to high yield credit and have implemented hedges via credit derivatives in high yield to reduce overall portfolio credit risk.

We have been increasing duration exposure whenever yields backup. Duration has increased to 2.5 years, from 1.75 years at the end of last year and we expect to increase further as opportunities present. We have favoured longer dated maturities to gain duration exposure in both the US and Australia, as shorter maturities are still exposed to further policy tightening. Again patience is required, but we expect yields to eventually decline as central banks succeed in further moderating inflation and growth starts to contract.

Our foreign currency exposures remains skewed to defensive currencies, mainly the USD and the Japanese yen (JPY). Historically the yen has performed well during cyclical declines, particularly against the Australian dollar, and together with our US dollar (USD) exposure, provides a downside risk hedge (alongside our duration exposure) against further weakness in credit spreads. In addition, the yen remains very cheap historically and we patiently wait for the new Governor of the Bank of Japan to begin the process of dismantling their yield curve control policy, which should lift bond yields and the yen.

Our equity position is key in terms of downside portfolio protection. At 15%, it is close to historic lows and skewed to Australia, Japan and emerging markets, which we see as being both the lowest risk and best value. Our US exposure is close to 0%. Interestingly, returns form US stocks this year have been driven almost exclusively by a handful of large tech stocks on the back of optimistic rate expectations, which we don't think will be sustained.

The flip side of this is that our cash weight remains high, with around 1/3 of the portfolio currently in cash (which now pays us a decent nominal return as well as being a good short-term store of value). It's important to note here, though, that we have increased activity in the portfolio over the last 18 months, as both economic and market volatility have increased. We see this as being more consistent with the broader environment where liquidity is less abundant and assets need to compete for capital. This means fundamentals matter again, as opposed to abundant liquidity driving prices, and we expect this heightened level of portfolio activity to continue and to be reflected in both asset allocation and implementation decisions.

Important Information