Schroders

April 2025

Schroder Real Return Active ETF (ASX: GROW)

Portfolio Review

The Schroder Real Return Active ETF (ASX: GROW) returned -0.39% (post-fees) for the month, taking the quarterly return to -1.59% and the one-year return to 7.34% (post-fees).

Largest contributors

The largest contributor to performance over the month was the Fund's active approach to interest rate positioning which contributed over 0.30% to performance. Allocations to investment grade credit, inflation-linked bonds and emerging markets debt contributed 0.12% collectively. The Fund's currency position also provided an additional tailwind to performance.

Largest detractors

The Fund's equities exposure was the largest detractor to performance as equity markets remain volatile amidst a backdrop of tariff uncertainty.

Market Review

Financial markets saw heightened volatility across asset classes following the announcement of President Trump's 'Liberation Day' tariffs. The announced tariffs, which were calculated based on US trade deficits, rather than actual tariffs imposed upon US goods, were higher and more widespread than most people had expected. The trade war further escalated as China and the US went back and forth, announcing a series of reciprocal tariffs against each other, while the US Federal Reserve (Fed) seemingly pushed back against immediate interest rate cuts, citing the inflation risks that stemmed from tariffs. Volatility spiked, with the VIX index moving above 60 on an intra-day basis at the height of the tariff uncertainty, while the US equity market was at one point down over 20% from its peak in February. The announcement of a 90 day pause to the reciprocal tariffs, resulting in most countries other than China, having their tariff rate be scaled back to 10% until July, resulted in a sharp rebound in risk assets. The announcement of further exemptions on electronics and smartphones and the announcement of ongoing trade negotiations with various countries further eased tensions. Reassurances that President Trump was not looking to fire the Fed chair Powell after initially floating the possibility, along with resilient economic data in the US and a solid start to the US earnings, resulted in equity markets continuing to rebound towards month end.

As we continue to navigate the earnings season in the US, the outlook for corporate profits seems increasingly uncertain, with a number of companies in the US withdrawing their profit guidance. While a lot of the economic data seems to be resilient at this stage, soft data such as confidence and sentiment remains very weak, and questions are being asked as to if, and when, this data converges again. Meanwhile in Australia, the Q1 inflation print was moderately above market expectations, with headline inflation remaining at 2.4% year on year, while the trimmed mean measure moved lower to 2.9% and now within the Reserve Bank of Australia's (RBA) target range. This will most likely result in an RBA rate cut in May, with the market pricing in a number of additional rate cuts for the remainder of the year, in anticipation of the negative growth impact from tariffs.

Global developed equity markets fell 0.4% in local currency terms, led by continued underperformance from the US. Elsewhere, other equity markets were more positive, with Australian equities performing strongly with a return of 3.6%, being driven by a strong rebound in the share price of CBA. Emerging market equities also did well with a return of 1.3% for April in US dollar terms, while European and Japanese equities also delivered marginal positive returns for the month. While monthly returns in equities were generally quite reasonable, they do not reflect the large intra-month drawdown and volatility experienced following the announcement of the 'Liberation Day' tariffs.

We also saw large intra-month swings in the bond market, notably in the US long end. The US 10-year treasury yield initially rallied following the tariff announcement, falling to below 3.9%, before a sharp selloff over the next week towards 4.5%. Other developed markets followed suit to some extent, with their 10-year bond yields also experiencing elevated volatility and intra-month swings. Ultimately, US 10-year bond yields fell by 0.04%, to finish April at 4.16%. The US front end rallied, as the market moved to price in more interest rate cuts from the Fed, with the US 2-year bond yield falling almost 0.3% to finish the month at 3.6%. Elsewhere, Australian 10-year bond yields fell by 0.22% to finish April at 4.16%, while 10-year bonds also rallied in Germany and Japan, falling by 0.29% and 0.17% in those respective markets. Credit spreads underperformed, moving wider across sectors, with investment grade and high yield markets widening by 10 and 40 basis points, respectively.

Within FX, the US dollar continued to underperform, failing to act as a risk-off hedge, as it has done during prior bouts of market volatility. During the month, US equities, bonds and the dollar were highly correlated, a relatively rare occurrence for a developed market like the US, which signalled capital flight out of all US-based assets, regardless of the asset class. The US dollar index fell 4.6% over the month, with outperformance from the Euro and Yen, both appreciating by over 4.5% against the US dollar in April. The Australian dollar, initially fell below 60 US cents in the early stages of the month, before rallying to finish approximately 2.5% higher against the US dollar by the end of April. Within commodities, there was strong divergence in performance, with the broader index down almost 5% in the month, driven by oil prices falling by more than 17% in April. Industrial metals also had negative returns, while gold was a standout, continuing its recent strong performance, with a return of over 5% in April. At one point, gold reached a high of $3,500, before reducing some of its gains toward the end of the month.

Market Outlook

On April 2nd, Donald Trump unveiled sweeping tariffs across all trading partners, far in excess of what anyone was expecting. No country was spared, not even Australia, which has a trade deficit with the US, nor even an uninhabited island, whose penguin population seemingly didn't buy enough US fish to appease Trump. This sent assets into free-fall. At one point, US equities were down 15% intra-month or down over 20% from the 2024 peak. US high yield credit spreads blew out over 100 basis points (bp) or over 200bps from the 2024 low. However, despite rallying at the start of the sell-off, US government bonds and the US dollar also collapsed. The US dollar index fell over 5.5% intra-month and US 10-year bond yields rose by 50 basis points in a couple of days. It was clear the market had taken Trump's 'America First' tariff talk as a signal to Sell American assets.

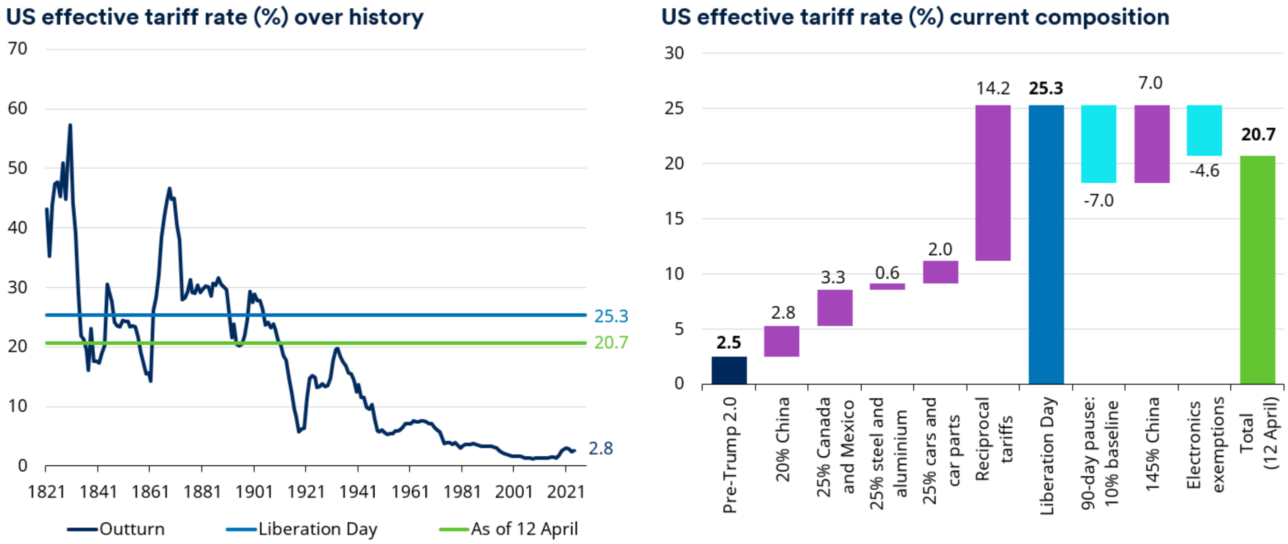
However, Trump eventually found his pain point. The rise in US bond yields meant it would be more expensive for the US to refinance its debt, which is the exact opposite of what he has been trying to achieve. He announced an extension to the tariff timeline, allowed certain goods to be exempt, discussed a plethora of potential trade deals and essentially sidelined Peter Navarro and pushed Scott Bessent out in front of the cameras to soothe markets. This about-face by Trump gave confidence to the markets, which was further relieved when US corporate earnings and economic data was better than expected. Assets recovered, with global equities, investment grade and high yield credit, along with US 10-year treasury yields, all essentially flat for the month.

However, these figures are all still looking in the rear-view mirror. The true pain of the tariffs is yet to be seen.

Tariff Fallout

Initially, many viewed Trumps tariff threats as mere bluster aimed at negotiating better trade deals. However, Liberation Day revealed a much harsher reality. Economists were expecting overall tariffs could reach an effective US rate of 8-12%, with concerns that rates above 10% could tip the economy into recession. But Trump's unconventional method of calculating reciprocal tariffs, based on the trade deficit rather than equivalent tariffs, drove the effective rate to over 25%, and exacerbated by retaliatory measures from China that pushed it closer to 30%. While recent efforts have eased tensions, with the effective tariff rate now dropping to around 20%, the concern of 'peak tariff fear' might be behind us. However, there is still the risk that if trade deals are not reached by the end of the 90-day pause, tariff rates could rise again.

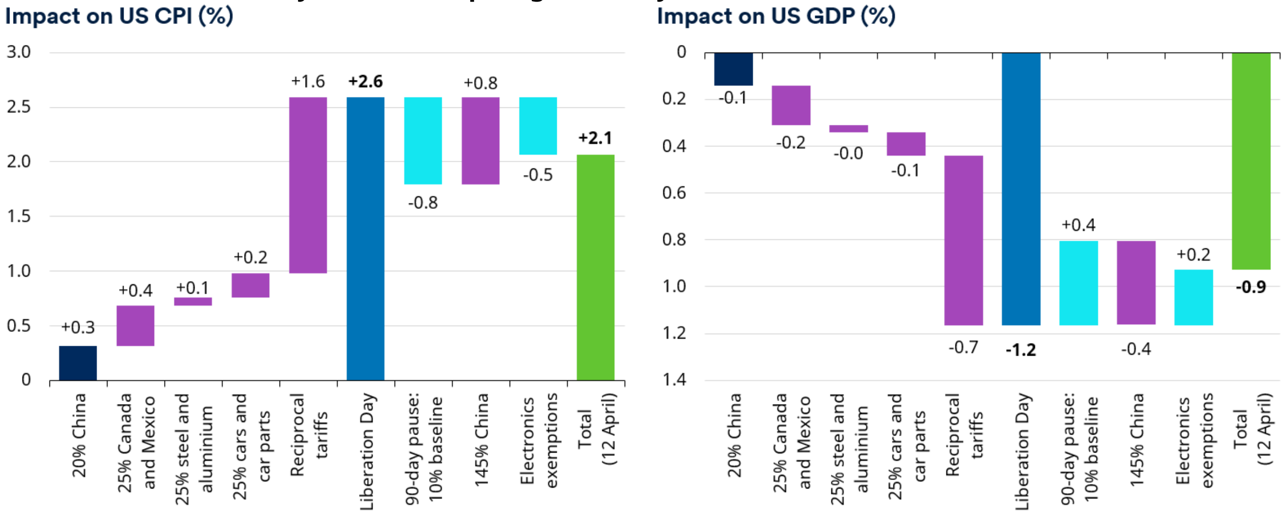
Chart 1: Effective tariff rate set to climb to a 115-year high of 20.7%



145% on China represents the additional 91% imposed since Liberation Day on 2 April.
Source: Schroders Economics Group. 13 April 2025

At time of writing, US trade agreements are advancing, with even China starting to thaw tensions. However, the damage may already be done. Prolonged uncertainty increases the risk of an unnecessary US recession. Inflation and the depreciation of the US dollar are eroding consumer purchasing power, while fear that tariffs will weigh on real wage growth could be prompting consumers to reduce spending. Our economics team suggests that tariffs at 20% will increase US inflation by 2% and hit growth by 1%. This could be worse if tariffs rise again or from other second-order effects, such as retaliation from other countries or the killing of animal spirits. The combination of rising inflation and stagnating growth could see the US slipping into stagflation, a scenario where economic growth is negative but inflation is too high for the Federal Reserve to implement cuts effectively.

Chart 2: The US economy faces a sharp stagflationary shock



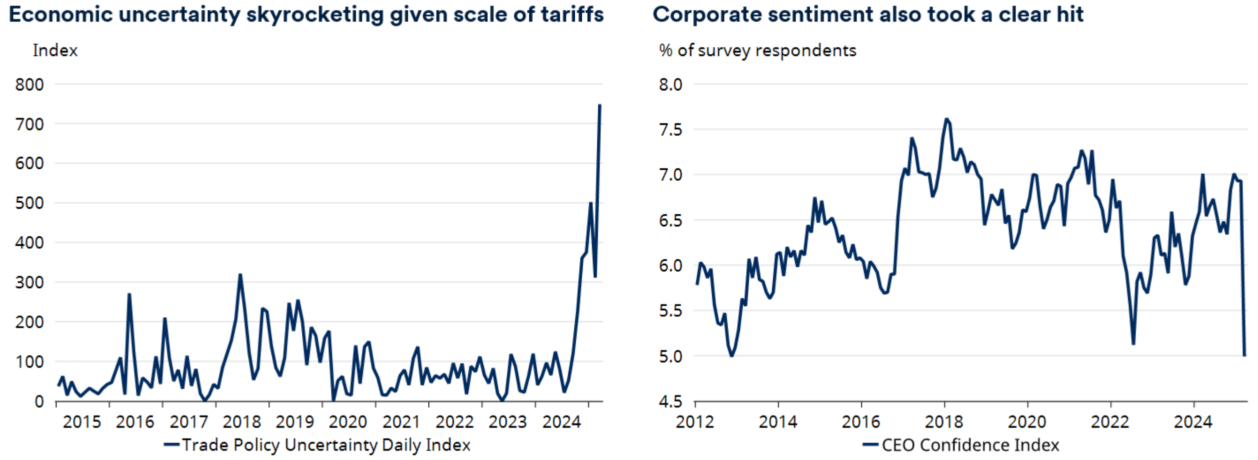
145% on China represents the additional 91% imposed since Liberation Day on 2 April.
Source: Schroders Economics Group. 13 April 2025

Corporates hate uncertainty

Economic uncertainty is skyrocketing, as business are unsure where the dust will settle. Uncertainty over the actual tariff rate, uncertainty over what goods are exempt, uncertainty over which countries will be targeted or reach trade deals, all leads to corporates pairing back their spending and hiring plans. CEO confidence is collapsing back to levels only seen in 2022 and 2013. Looking at the weighted average of various regional surveys shows that capital expenditure plans have also collapsed to levels not seen since 2020. If import prices squeeze margins, corporates may be forced to slow hiring or even consider firing staff. There is no sign that corporates are considering layoffs, but household surveys show a fall in perceived job security, which would be another reason for consumers to curtail spending.

There are already anecdotal tales of US importers not being able to afford the tariff for their goods and being forced to go into debt to cover the bill. Cargo-carrying container ships departing China for the US have already fallen more than 30% since Liberation Day, and the Port of Los Angeles is expecting volume to plummet 35%. Apple CEO Tim Cook estimates tariffs will cost close to $1bn this quarter and delivery company UPS is planning to lay off 20,000 staff. While Trump's trade war could be resolved tomorrow by a change of heart or a flurry of superficial trade deals, the longer it takes, the greater the damage to the economy.

Chart 3: Economic uncertainty will sap spending from consumers and corporates



Source: Schroders, Macrobond, 11 April 2025.

Unfortunately, all of the 'hard data' and earnings results we have seen so far have all been looking in the rear-view mirror. It will take time for the real cost of Liberation Day to come through. In the meantime, stickier US inflation from tariffs makes the Federal Reserve's (Fed) job more challenging. University of Michigan surveys show 1-year inflation expectations jumping to 6.7% and the 5-year inflation jumping to 4.4% (which is the highest since 1990). While we believe the Fed will cut to defend growth, they may be dragged kicking and screaming. Other countries will be able to cut rates more quickly and aggressively to defend growth, as they will not suffer from similar inflationary impacts. Fiscally, the US will be in a worse position than other countries who came into this more fiscally sound. Germany has already flagged a potential boost to fiscal stimulus of 3.5% of GDP. The irony of Trump's America First policies may make the US the last to be able to stimulate its way out of the global recession we didn't have to have.

Portfolio changes

We have been de-risking the portfolio since early December 2024, when we were warning clients that markets were pricing in all the positives of a Trump presidency, but had failed to account for all the protectionist policies that were still on their way. We therefore reduced equities from a high of above 45% in early December down to 35% by the end of March. Under the surface, we were selling equities and buying calls to keep our delta-adjusted equity weight unchanged, but reducing our downside risk. We continued to cut equities in early April, down to below 30% delta-adjusted and added 0.5 years to duration, reaching a high of 3 years duration at the portfolio level. We also reduced credit by around 2% by buying credit default swap protection, added to our Japanese yen (JPY) position and sold a good portion of our inflation-breakeven trades before the real carnage began.

Our delta-adjusted equity position fell to around 28% before we started buying back. We also rolled down the strike on our calls, which saw our equity weight rise to 35% intra-month post the Liberation Day sell-off. Within credit, we took profit on some of our protection, adding back split evenly between investment grade and high yield. The rally in bonds provided the opportunity for us to reduce our allocation from 3 to 2.65 years. We also took profit on the front end of curves in Australia and Germany and moved towards the belly and back end. In the US, we went shorter in the back end of US curves which helped when yields spiked. We used the collapse in gold to below 3,000 as an opportunity to add 2%, given our view that the US dollar would suffer and central banks will look for alternatives to US treasuries. This included topping up our exposure to gold miners in equities.

After bond yields spiked and risk assets rallied, we increased our duration back to 3 years, particularly in the front end of the US and Australia. Bond yields started to rally towards the end of the month, which saw us trim once again to end the month at 2.65 years at the fund level. We also added back to Australian inflation-linked bonds after the real yield hit 2%. We hold 1 year duration in Australia, 0.75 in US, 0.60 years in Germany and 0.2 in the UK, with the remainder in emerging market local currency bonds.

Given our more negative view in the medium-term, we have been selling rallies in equities. We sold into the end of the month, reducing our delta-adjusted equity weight to 28%. However, this is comprised of 25% in equities and the extra 3% is the delta exposure from our call options. We hold a 5% notional June 5650 call (now 1% out of the money at April end) and a 4% notional December 6200 call in case we're wrong and markets reach new highs by the end of the year. We continue to take carry in credit markets that show relative value, such as Australia and European credit. We're moving more cautious and looking to protect the downside for our clients. We currently hold around 20% in cash which we will look to deploy if and when opportunities arise.

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