Schroders

March 2024

Schroder Real Return Fund (Professional Class)

Portfolio Review

The Schroder Real Return Fund delivered a return of 4.10% (gross of fees) for the March quarter and 10.07% (gross of fees) over 12 months. Over 3 years and 5 years, the Fund has returned 4.34% p.a. and 4.97% p.a. (gross of fees) respectively.

Largest contributors

The largest contributors to performance in March was the allocation to global equity strategies and derivatives which added a total of 0.75%. Australian equities also added 0.20% and emerging markets added 0.15%. Fixed Income allocations were also positive contributors adding a total of 0.55%, mostly from Australian corporates and securitised credit.

Largest detractors

The Fund's foreign currency exposure was a small detractor.

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

The market has been continually wrong-footed on rates since the US Federal Reserve (Fed) started its hiking cycle. At the end of 2021, the market knew the Fed would have to move away from ultra-accommodative monetary policy but no one had a cash rate over 5% in their projections. Even in June 2022, after the Ukraine invasion, after the peak in oil prices, and after the peak of supply chain disruptions (as measured by the Federal Reserve Bank of New York), the market expected a peak policy rate of only 3.5%. Today with the policy effective rate at 5.3%, we're still playing the rates guessing game but now we're debating by how much the Fed will cut. After getting it so wrong on the way up, I'm not so certain the market will be any better on the way down either.

The market moved decisively more dovish after the December Federal Open Market Committee (FOMC) meeting which is now being referred to as the Powell Pivot (2023 edition). At the December meeting, Jerome Powell took further rate rises off the table and put the prospects of cuts firmly in play, with the dot plot pricing in rates at the end of 2024 at 4.6%. This was 50bps lower than their September meeting and implied 75bps worth of cuts in 2024. The market moved quickly to front run the Fed, pricing in over 150bps worth of cuts to the end of 2024, double what the Fed had just telegraphed. We were vocal in our belief the market had moved too far and that doves would be disappointed.

Since then we have seen US growth continue to hold up. Fourth quarter GDP came in above expectations at 3.3% and was then subsequently revised higher to 3.4%. Inflation has also remained far stickier than expected, with the US CPI rising 3.1% in January and then 3.2% in February year-on-year. Core PCE remains above the Fed's target at 2.8%. As discussed as a probability in our last commentary, The Go-Around, US manufacturing has now risen out of recession with the US ISM Manufacturing PMI jumping to 50.3, the highest in 17 months and well above expectations of 48.3. In the face of higher growth and stickier inflation, the market has now given up on its ultra-dovish hopes and has moved to price in 67bps worth of cuts in 2024, slightly less than what the Fed guided at the end of 2023.

We believe that this shift to pricing below 75bps is about right, but do not rule out the possibility that the market could move to price in only 50bps along the way. However, the market is pricing in a total of 170bps worth of cuts by the end of 2025, which we believe is still too much. Our economics team anticipate only 100bps in total to the end of 2025, pointing to further disappointment. Will higher growth and stickier inflation cause the remaining doves to capitulate, or has the Fed's reaction function shifted to supporting growth over fighting inflation?

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, where conventional policy becomes ineffective and policy tools only lead to asset price inflation which exacerbates income inequality. Central banks are keen to avoid a similar outcome in the 2020s. The other potential reason for this shift in emphasis is the growing level of government debt. Higher levels of growth and marginally higher inflation helps make this debt burden more manageable, especially when there appears to be no appetite for fiscal austerity.

At the March 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. We believe this is another subtle step in the shift away from strict inflation targets and instead focusing more on economic growth, employment and market liquidity, especially ahead of substantial treasury issuance over the coming quarters.

Therefore, we believe the Fed and central banks around the world will be more dovish than their mandates suggest, but likely less dovish than the market is pricing. There is still room for doves to cry. While doves cry uncle in the face of strong economic and inflation data, hawks will cry tears to mourn the relationship of inflation targeting from yesteryear. This nuance suggests investors should stay in the front end of yield curves and likely shift away from long end US duration. Equities and gold (often seen as an inflation hedge) have rallied to new highs and long end duration has sold off, with inflation-linked bonds outperforming nominals. We expect this to continue as the market digests that central banks will have a higher tolerance for growth and inflation, but the ability to cut dramatically is therefore hindered.

Asset class views

We continue to favour equities over bonds. Globally, composite PMIs are rising with positive momentum across countries. Growth in the US remains strong with both corporates and consumers looking healthy. Europe and China remain weak but even here, green shoots are appearing, with positive economic surprises. US home values continue to rise, with the spread between home equity and home loan debt reaching new wides, but not with the usual increase in home equity and lines of credit (HELOC) loans. This means that consumers are not tapping into their home equity for consumption, which is usually seen late cycle. This is likely because consumers are still enjoying positive real wage growth. Similarly, we are not seeing late cycle dynamics from corporates, such as an increase in mergers and acquisitions, and in many ways corporate activity appears early cycle. Despite rising rates, net interest expense (the interest paid on debt net the income received from cash interest) continues to fall and is now back down to levels last seen in 2005. Positioning and sentiment does remain stretched, which could lead to a short term pullback, but we would be buyers on dips.

As discussed above, we are neutral to cautious on duration. We prefer hiding out in the front end of curves and prefer German duration over the US. We have downgraded credit as spreads have tightened even further and no longer provide any valuation cushion. The market has priced in lower policy rates and improving corporate fundamentals. Valuations are expensive, but we do not believe that spreads are about to widen any time soon. Investors can continue to take carry in credit, but we believe there is minimal chance of further capital gains. We prefer the upside optionally of equities that could continue to benefit as global growth improves.

Portfolio positioning shifts

We continued to lean into the rally in risk assets, with our position in equities increasing by around 7% over the quarter, reaching a high of over 37% towards the end of March. However, we took profit in the final days of the quarter bringing the overall delta-adjusted equity positioning to 33%. We did this by selling 5% notional in futures and buying 5% notional in a 1-year call spread collar options strategy which, at maturity, will protect the portfolio on market declines of up to -20% but will allow us to capture the upside in equities from here to +15%.

We reduced our allocation to corporate credit by 6% in March and 10% over the quarter, in equal parts from investment grade and high yield corporate credit as spreads tightened significantly. We do not believe spreads will widen but prefer taking upside optionality in equities or more attractive spreads on offer in US securitised credit, where we added another 2% in March and 3% over the quarter . We continue to prefer Australian corporate credit given the relatively attractive spreads, where we hold an outsized position.

We sold 0.4yrs in duration in March after yields fell at the start of the month, bringing the overall duration at the fund level to 2.25yrs . At the end of March, our duration is 0.25yrs higher than it was at the start of the

year as yields are over 30bps higher. In options, we sold US treasury volatility at the start of the quarter, which profited from the fall in bond volatility after the January FOMC meeting. We later bought puts on US treasuries which profited from bond yields rising over the quarter. We continue to hold duration at the front end of the curve and prefer German duration to the US.

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