

Schroder ISF* EURO Bond

Fund Manager: Julien Houdain, James Ringer, Martin Coucke & Global Unconstrained Fixed Income Team | Fund update: December 2024

Performance overview

- There were some tentative signs of stabilisation in European economic indicators released during December. The closely watched composite purchasing managers index (PMI) for the Eurozone picked up driven by the services sector activity, which managed to offset some of the continuing contraction in manufacturing. However, it remains below the 50 mark, suggesting the eurozone economy is contracting as activity in both Germany and France remains sluggish. As expected, the European Central Bank (ECB) cut interest rates in December to 3% from 3.25%. This was the fourth time this year the ECB made the decision to lower its deposit rate, but the market was disappointed as the tone was less dovish than expected. Concerned with the potential for new US tariffs, among other factors, hampering economic growth, some policymakers had been pushing for 50bp rate cut. The ECB lowered its growth forecast for the Eurozone economy to 1.1% in 2025 and cautioned this did not as yet reflect the impact of proposed US tariffs on exports.
- Government bond yields rose across European markets in December, with the 10-year German bund yield rising by 28bps to close the year at 2.35%. Ratings agency Moody's downgraded France's credit rating, citing political instability and cautioning it will be difficult for the incoming government to tackle the country's fiscal deficit. Unease over deteriorating public finances have pushed the yield spread for French bonds over benchmark German debt to its highest level since the Eurozone debt crisis.
- In the US, the Federal Reserve (Fed) cut interest rates for a third consecutive time, bringing the target rate to a range of 4.25% to 4.5%. However, the Fed Chair Jerome Powell cautioned fewer cuts were likely next year due to stubbornly high inflation. The US 10-year yield closed the year at 4.57%, which was 36bps higher than end of November and its highest level since April. Markets began pricing in the decreasing likelihood of another cut in January, as well as the anticipation of inflationary policies from the incoming Republican administration threatening to increase the US fiscal deficit.
- Credit spreads in the European investment grade market, as measured over government bonds, tightened overall during December. A combination of

low issuance volumes and strong inflows into European investment grade credit saw the market hold up relatively well in comparison with government bonds. Corporate hybrids and higher yielding issues outperformed, while spreads tightened further on real estate and insurance sector issues.

Drivers of fund performance

- The Fund posted a negative total return but outperformed the benchmark in December. Credit allocations made a positive contribution while rates positioning detracted.
- Within credit, an overweight position in the European investment grade market was additive, as was exposure to US agency MBS (mortgage-backed securities).
- In government bond markets, a long position in gilts versus German bunds detracted, as did exposure to European government related agencies.
- A long position in UK gilts versus US Treasuries was additive over the month.

Portfolio activity

- As December's sell-off in major bond markets became more substantial, we increased the headline duration of the portfolio from a neutral position versus the index at the start of the month to nearer 0.3 yrs overweight by the end of the year.
- Mid-month we added outright European duration, as we gained conviction that the combination of weak growth and potential falls in inflation would lead the ECB to cut interest rates more significantly than the market currently expects. We also added some tactical overweight exposure to the US, despite the strength of the economy. Expectations for Fed interest rate cuts are reined in, and as the 'no landing' scenario (where inflation remains sticky and the Fed has little headroom for further rate cuts) becomes more of a consensus view, the potential for a single - more negative - data point to shift the market's view becomes higher.
- On cross-market trades, we began the month with long positions in the UK, versus US Treasuries and German bunds. Our broad conviction in major government markets has been that gilts are most

attractive, given how the UK budget has elevated downside risks to the corporate employment outlook. On the other hand, US Treasuries - given the continued strength of the US economy - are much less attractive, with Europe somewhere in between. As the gilts versus bunds trade was less successful, we closed this position out mid-month.

- Credit allocations remained broadly unchanged as we continue to favour the European investment grade market. Within broader spread markets, we have become more constructive on European covered bonds due to improved valuations and an encouraging supply outlook for 2025.
- US agency MBS remain one of our highest conviction views in asset allocation, and we prefer more recent issues, which bear higher coupons and have relatively lower interest rate risk compared to older issues, of similar maturity, with lower coupons.

Outlook/positioning

While bond markets have had a challenging final quarter of 2024, the global macro-economic environment has not fundamentally altered its course in the last few weeks. The key trends as we move into 2025 are towards stronger data in the US, but rather worse business sentiment in Europe and the UK.

- Business sentiment has been deteriorating on the European side of the Atlantic, as the Eurozone contends with a combination of cyclical and structural challenges. We have little confidence in prospects for a rebound here, given that the ominous threat of the US imposing tariffs on imports will weigh on major capital expenditure decisions and could therefore limit any improvements in the European manufacturing sector over the coming months. The service sector also appears to be losing momentum, and this will be pivotal for the ECB in considering how the path of interest rates should develop, following the most recent 25bp cut in December.
- Nevertheless, given the depressed current state of global manufacturing, it is difficult to envisage European manufacturing sentiment deteriorating much more, aside from the onset of a recession. With this backdrop any global rebound in manufacturing is likely to remain limited, keeping a lid on commodity price gains, and helping inflationary pressures stay contained.
- UK economic indicators continue to be slightly weaker, particularly with reference to the labour market. The October Budget has weighed on UK sentiment with the likely impact of depressing private sector hiring in the near term. But private sector earnings growth came in higher than expected, and price pressures remain robust, giving the UK a lingering inflation challenge and leading the Bank of England (BoE) to hold interest rates in December,

having cut in November. The BoE is anticipating cuts to progress on a quarterly basis from here. The market, however, has been revising down expectations given the stickiness of inflation. At the start of December, the market expected two full 25bp cuts by next June (i.e. in line with the Bank's "quarterly" expectations) but by the year end pricing had moved to imply one cut and only a 50% chance of a second.

- We made no changes to the probabilities in our scenario framework during December, with our base case remaining a global 'soft landing' of steady growth and controlled inflation. The risks, however, remain skewed in the direction of a more hawkish, higher interest rate, 'no landing' environment. The stalling of the disinflation process in the US, the release of pent-up demand in the form of business spending now that the US election is out of the way, and the potential policy-driven inflationary risks all help justify this probability.
- The imminent arrival of the new US administration is grounds for much uncertainty as we move into 2025. But, as ever, the resulting shifts in economic dynamics impact different areas of the bond markets in different ways, providing us with the opportunities that allow our investment process to generate performance in fixed income.

Past performance does not predict future returns. The value of investments and the income from them may go down as well as up and investors may not get back the amount originally invested.

Calendar year performance (%)*

Year	Fund (A Acc)	Fund (I Acc)	Target
2024	2.4	3.3	2.6
2023	6.7	7.6	7.2
2022	-20.3	-19.6	-17.2
2021	-3.3	-2.5	-2.9
2020	4.5	5.5	4.0
2019	6.6	7.5	6.0
2018	-1.1	-0.2	0.4
2017	1.1	2.0	0.7
2016	2.9	3.9	3.3
2015	0.2	1.1	1.0

Source: Schroders, net of fees (where applicable), bid-bid, with net income reinvested as at 31/12/2024. Target benchmark: Bloomberg Barclays EURO Aggregate. The fund aims to provide capital growth and income in excess of the target benchmark. The fund's investment universe is expected to overlap to a limited extent with the components of the target benchmark.

Risk considerations

- **Capital risk / distribution policy:** As the fund intends to pay dividends regardless of its performance, a dividend may represent a return of part of the amount you invested.
- **Contingent convertible bonds:** The fund may invest in contingent convertible bonds. If the financial strength of the issuer of a contingent convertible bond falls in a prescribed way, the value of the bond may fall significantly and, in the worst case, may result in losses to the fund.
- **Counterparty risk:** The fund may have contractual agreements with counterparties. If a counterparty is unable to fulfil their obligations, the sum that they owe to the fund may be lost in part or in whole.
- **Credit risk:** A decline in the financial health of an issuer could cause the value of its bonds to fall or become worthless.
- **Currency risk:** The fund may lose value as a result of movements in foreign exchange rates.
- **Derivatives risk:** Derivatives may be used to manage the portfolio efficiently. The fund may also materially invest in derivatives including using short selling and leverage techniques with the aim of making a return. A derivative may not perform as expected, may create losses greater than the cost of the derivative and may result in losses to the fund.
- **High yield bond risk:** High yield bonds (normally lower rated or unrated) generally carry greater market, credit and liquidity risk.
- **IBOR risk:** The transition of the financial markets away from the use of interbank offered rates (IBORs) to alternative reference rates may impact the valuation of certain holdings and disrupt liquidity in certain instruments. This may impact the investment performance of the fund.
- **Interest rate risk:** The fund may lose value as a direct result of interest rate changes.
- **Issuer risk:** The fund is permitted to invest more than 35% of its scheme property in transferable securities and money market instruments issued or guaranteed by an EEA State / governments of the following countries: France and Germany.
- **Liquidity risk:** In difficult market conditions, the fund may not be able to sell a security for full value or at all. This could affect performance and could cause the fund to defer or suspend redemptions of its shares.
- **Market risk:** The value of investments can go up and down and an investor may not get back the amount initially invested.
- **Operational risk:** Operational processes, including those related to the safekeeping of assets, may fail. This may result in losses to the fund.
- **Performance risk:** Investment objectives express an intended result but there is no guarantee that such a result will be achieved. Depending on market conditions and the macro economic environment, investment objectives may become more difficult to achieve.
- **Sustainability Risk:** The fund has environmental and/or social characteristics. This means it may have limited exposure to some companies, industries or sectors and may forego certain investment opportunities, or dispose of certain holdings, that do not align with its sustainability criteria. Therefore, the fund may underperform other funds that do not apply similar criteria. The fund may invest in companies that do not reflect the beliefs and values of any particular investor.

Important information

Marketing material for professional clients only. This document does not constitute an offer to anyone, or a solicitation by anyone, to subscribe for shares of Schroder International Selection Fund (the "Company"). Nothing in this document should be construed as advice and is therefore not a recommendation to buy or sell shares. An investment in the Company entails risks, which are fully described in the prospectus. Subscriptions for shares of the Company can only be made on the basis of its latest Key Investor Information Document and prospectus, together with the latest audited annual report (and subsequent unaudited semi-annual report, if published), copies of which can be obtained, free of charge, from Schroder Investment Management (Europe) S.A. These documents may be obtained in English, free of charge, from the following link: www.eifs.lu/schroders. Schroders may decide to cease the distribution of any fund(s) in any EEA country at any time but we will publish our intention to do so on our website, in line with applicable regulatory requirements. The fund has environmental and/or social characteristics within the meaning

of Article 8 of Regulation (EU) 2019/2088 on Sustainability-related Disclosures in the Financial Services Sector (the "SFDR"). For the UK only: This product is based overseas and is not subject to UK sustainable investment labelling and disclosure requirements. The fund maintains a higher overall sustainability score than its sustainability benchmark based on the investment manager's rating system. Any reference to sectors/countries/stocks/securities are for illustrative purposes only and not a recommendation to buy or sell any financial instrument/securities or adopt any investment strategy. Past Performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. Exchange rate changes may cause the value of investments to fall as well as rise. Schroders has expressed its own views and opinions in this document and these may change. Schroders will be a data controller in respect of your personal data. For information on how Schroders might process your personal data, please view our Privacy Policy available at www.schroders.com/en/privacy-policy/ or on request should you not have access to this

webpage. A summary of investor rights may be obtained from <https://www.schroders.com/en/lu/professional-investor/footer/complaints-handling/>. For your security, communications may be recorded or monitored. Issued by Schroder Investment Management (Europe) S.A., 5, rue Höhenhof, L-1736 Senningerberg, Luxembourg. Registration No B 37.799. Distributed in the UK by Schroder Investment Management Ltd, 1 London Wall Place, London EC2Y 5AU. Registration No 1893220 England. Authorised and regulated by the Financial Conduct Authority. Information for Switzerland: Schroder Investment Management (Switzerland) AG is the Swiss representative («Swiss Representative») and Schroder & Co Bank AG is the paying agent in Switzerland of the Luxembourg domiciled Schroder International Selection Fund. The prospectus for Switzerland, the key information documents, the articles of association and the annual and semi-annual reports may be obtained free of charge from the Swiss Representative.