Schroders

Marketing material for professional clients only

Schroder ISF* EURO Bond

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

Performance overview

- Against a relatively benign economic and market backdrop, yields fell across European government bond markets in anticipation of interest rate cuts commencing in June. Along with the Federal Reserve (Fed) and the Bank of England, the European Central Bank (ECB) left interest rates unchanged. The Fed's Summary of Economic Projections (SEP) showed no change to its forecast for three rate cuts this year, despite forecasting lower unemployment and higher core inflation compared to December's release. The accompanying statement also set a dovish tone.
- At its meeting in early March, the ECB lowered forecasts for inflation, and is now expecting the consumer price index to decline to its 2% target next year. Accordingly, bond markets are anticipating that the ECB will cut interest rates in June. Economic indicators for the Eurozone released last month highlighted that business activity, as measured by the Purchasing Managers index (PMI), is being lifted by a rebound in the services sector. Notably, southern European economies have been outperforming, benefiting from a recovery in tourism, while they have less exposure to the manufacturing cycle.
- The US 10-year Treasury yield fell from 4.24% to 4.2%, and with the curve still heavily inverted, the yield on the benchmark 2-year remained unchanged at 4.6% on the month. While the 10-year German bund yield fell from 2.41%. to 2.3%, equivalent yields in both the Italian and Spanish markets fell further.
- European investment grade corporate bonds outperformed government bonds over the month as spreads continued to tighten. High beta areas of the market continued to outperform the broader index, with subordinated and senior financials, as well as BBB- rated credit, particularly strong. The technical backdrop remained supportive with new issues over four times oversubscribed, and continuing inflows into European investment grade credit funds.

Drivers of fund performance

- The fund produced a positive total return although performance was ahead of the benchmark in March. Credit and rates strategies were both additive.
- In credit markets, an overweight position in covered bonds and agency Mortgage-Backed Securities (MBS) worked well.
- An overweight allocation to European investment grade corporate bonds made a positive impact as spreads compressed further.
- In rates, an overweight position in the UK versus the US and Germany made a positive contribution.
- Tactical trading of the yield curve steepening position in the US was also additive.

Portfolio activity

- Overall fund duration remains close to the benchmark, as we do not see valuations as being particularly attractive at these levels.
- The main change was a shift to an off-benchmark long US duration position. Based on our outlook for the US economy, particularly the labour market, Treasury bond valuations look attractive. In terms of cross-market positioning, we introduced overweight positions in the US versus Canada, where in our view the bond market is discounting too many cuts relative to the Fed, and Germany. Our concern around the risk of US labour market conditions re-tightening, which would prompt concerns of secondary round inflation effects, diminished somewhat last month. While February's US non-farm payroll report showed the labour market remaining healthy, large downward revisions to previous months have reduced the likelihood of any inflationary impact.
- We continue to favour a curve steepening strategy in the US, and during March we tactically traded this position, partially reducing and subsequently reinstating the 5 to 30 year Treasury curve steepener.
- While we still favoured an off-benchmark exposure to the UK gilt market based on an improved disinflationary outlook, although we reduced the size of this allocation, taking profit versus the US and reducing the position against Germany. Aiming to capitalise on a similar rationale, we introduced a short position in the UK inflation-linked gilt market.
- We made no major changes in terms of asset allocation over the month. Our highest conviction positions remain in covered bonds and agency MBS,

*Schroder International Selection Fund is referred to as Schroder ISF throughout this document which offer attractive yields with relatively low credit risk.

– In corporate bond markets, we retained a preference for high quality European issues. Despite ongoing spread compression, we believe the European market still offers value, particularly relative to the US.

Outlook/positioning

– Consistent with our central thesis of a 'soft landing', firming goods demand has driven an upturn in the global manufacturing cycle. The US has led the way, but the Eurozone has been a more recent beneficiary of this cyclical uplift, with a more accommodative interest rate outlook offering additional support. Not only does it appear that the region's manufacturing cycle has turned, but the services sector also seems to be recovering, feeding through to the labour market. Leading indicators are signalling a clear improvement and, given the weakness of growth expectations for the region, the hurdle for positive surprises is easy to beat.

– One note of caution, however, is the stickiness of inflation. The disinflation progress we saw in the services sector at the tail-end of 2023 has come to an abrupt halt, with three consecutive rising monthly prints since. Though favourable base effects mean year-over-year core inflation should continue to decline in the immediate future, this stickiness of underlying prices could pose challenges further out, without marked improvement.

– It is unlikely that this worsening in services inflation dynamics will prevent a start of the easing cycle, with the ECB signalling an interest rate cut in June come what may, but we believe the market is pricing in too many rate cuts, too quickly, after June.

Calendar year performance (%)*

Year	Fund (A Acc)	Fund (I Acc)	Target
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
2014	10.8	11.8	11.1

Source: Schroders, net of fees (where applicable), bid-bid, with net income reinvested as at 31/12/2023. 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.

Past performance is not a reliable indicator of future results. The value of investments and the income from them may fall as well as rise and investors may not get the amount originally invested. Some performance differences between the fund and the benchmark may arise because the fund performance is calculated at a different valuation point from the benchmark. Please see the respective fund factsheets for the performance of other share classes.

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