

Schroder ISF* EURO Bond

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Performance overview

- In a well-telegraphed move, the European Central Bank (ECB) announced a 25bp cut in the deposit rate in early June, the first since 2019. The accompanying statement and upgrade to inflation forecasts were construed by the market as relatively hawkish. However, the major market-moving event was around political developments in France where government bond yields rose over the month after President Macron unexpectedly called parliamentary elections. The first round of voting was dominated by the hard right National Rally (RN). The formation of a left-wing alliance generated greater uncertainty, not only about the outcome of the parliamentary elections, but also concerns about France's already unstable fiscal position.
- Aside from events in France, concerns about inflation lessened slightly as the latest release of the US Consumer Price Index (CPI) showed a marked improvement with the monthly core figure highlighting the slowest increase in seven months. However, the Federal Reserve struck a more hawkish tone while keeping rates on hold. The accompanying revised forecasts suggested just one cut over the rest of 2024, scaled back from three cuts that were anticipated back in March.
- European government bond markets diverged, with German yields falling, while fiscal and political risk drove yields higher in France and Italy. Spreads on European investment grade corporate bonds widened over the month, with French issuers underperforming.

Drivers of fund performance

- Fund performance was positive and ahead of the benchmark in June.
- On duration (interest rate risk), an off-benchmark overweight to the US contributed positively as Treasury yields fell.
- Curve steepening strategies, managed on a tactical basis, were also additive.
- In Inflation-linked markets, a long position in the US versus Europe also contributed.

- In credit, an overweight allocation to European investment grade (IG) bonds detracted.

Portfolio activity

- From a macroeconomic perspective, we continue to assign a high probability to a 'soft landing'; a gradual weakening of the economy where recession is avoided and inflation pressures ease. Accordingly, we maintain only a modest overweight to overall portfolio duration, particularly as bond markets are already well-priced for this outcome.
- The duration overweight is concentrated in local currency emerging market debt as a means of enhancing the portfolio's yield while, despite some reductions over the month, we also still maintain an overweight to US duration.
- On a cross-market basis, we closed an overweight to the US vs Canada given an unexpectedly softer shift in the inflation outlook for the latter.
- We also took the opportunity to reduce exposure to US curve steepening strategies, where we continue to manage risk more tactically.
- Elsewhere, we used the dovish market reaction from the Bank of England's (BoE) monetary policy committee meeting to close an overweight to the UK versus Germany and also to exit a curve steepening trade we held in the UK. The BoE's accompanying statement provided the market with optimism that interest rates could be cut as early as August.
- Asset allocation remains largely unchanged. We continue to hold an overweight to EUR investment grade corporates. We trimmed exposure to European covered bond issuers to manage the political risk in France, although we maintained an overweight position and switched into European agencies.
- In the inflation-linked markets, we increased cross-market long positions in the US (Treasury Inflation Protected Securities) versus the UK and Europe. Our view is that US inflation risks are underpriced in TIPS as we expect US growth to continue holding up relatively well in comparison to other developed economies, while inflation is likely to ease only gradually.

Outlook/positioning

- The commencement of the interest rate cutting cycle has been considerably delayed, contrasting markedly with many investors' predictions. Moreover, the pace of rate cuts is likely to be slower and shallower than originally expected. Nonetheless, the process has now started and after a difficult couple of years for bond markets it signifies a crucial juncture. Although structural challenges – such as high debt and deficits – remain, the start of a rate cutting cycle is supportive from a valuation, sentiment, and capital flow perspective.
- The French political scene clouds the near-term outlook. Ongoing uncertainty around the formation of a new government means that there remain many unanswered questions, which may take several weeks to clarify. As it stands, the likelihood of a hung parliament has increased once more, becoming the most likely scenario. With it comes fiscal paralysis, which given budgetary concerns is the most market friendly scenario for now, at least until budget negotiations in Autumn 2024. In the meantime, we anticipate news flow to keep volatility relatively high across Eurozone fixed income asset classes, but with this comes idiosyncratic opportunities where markets may have become dislocated.
- Looking beyond the political uncertainty, our sense is that the outcome of the elections will not significantly affect monetary policy conditions. While the fiscal indiscipline of member states will be of concern, it is unlikely to derail the easing cycle the ECB has already embarked upon as disinflationary progress is made. This should offer some support to European fixed income assets over the medium term.

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.

- From a corporate credit perspective, the encouraging news is that European economic growth is recovering and investor demand for the asset class continues to be strong. While it remains a carry-positive environment for now as a 'soft landing' is still likely, the potential for further gains from spread compression alone appears limited. Instead, we are placing great emphasis on careful bond selection to find idiosyncratic opportunities to deliver attractive returns.

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
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.

- **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.

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