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Schroder ISF* Global Bond

Fund Manager: Julien Houdain, James Ringer, Martin Coucke and the Global Unconstrained Fixed Income Team | Fund update: January 2025

Market overview

- January was a month of contrasting trends for government bond markets. After a weak start, the latter part saw a strong rebound, largely due to positive news on inflation. One of the key market themes focused on President Trump's inauguration and its potential implications for policy, particularly regarding anticipated changes to tariffs and their impact on both the US and global markets. In terms of macro news, while December's US labour market report was strong, the Treasury bond market was placated by further signs of disinflation. The US Federal Reserve (Fed) kept interest rates unchanged following 100bps worth of rate cuts made in the prior three meetings. However, the market reaction to the news was limited.
- As expected, the European Central Bank (ECB) cut interest rates by a further 25bps to 2.75% in January. ECB president Lagarde issued a cautious assessment of the economic outlook, highlighting the risk of global trade tariffs and uncertainty as to whether the impact would be inflationary or deflationary. The latest consumer price indices for December revealed that inflation remains above the ECB's 2% target. Nevertheless, the ECB expects inflation to return to its target over the course of this year. With investors already discounting the most recent ECB interest rate cut, government bond yields in most European markets were broadly unchanged. However, the benchmark 10-year German bund yield ended the month higher at 2.46%, having retreated from a six-month high in mid-January as weaker economic indicators strengthened the case for further interest rate cuts.
- The UK faced its own challenges as concerns over the fiscal deficit became more pronounced. Signs of slower economic growth heightened worries about the public finances, resulting in a sharp rise in gilt yields by mid-month. However, as the market shifted its focus back on inflation, with December's core CPI (Consumer Price Index) survey below expectations, yields fell back at the month end.
- In the US, despite a high volume of new issuance, credit spreads in the investment grade market, as measured over government bonds, remained broadly unchanged in January. In contrast, European investment grade credit outperformed with spreads tightening further. A combination of low issuance volumes and strong inflows into the European investment grade market, with institutional investors particularly active around the 10-year part of the curve, pulled yields lower. High yield markets gained ground, particularly in the US, where robust investor demand was driven by strong corporate earnings and attractive yields.
- The US dollar trade weighted index fell back slightly in January, as reassuring inflation data rekindled hopes for interest rate cuts in 2025. President Trump's stance on trade tariffs, while firm, was not as aggressive as had been feared, easing market concerns about inflationary pressures.

Drivers for fund performance

- The Fund posted a positive total return but marginally underperformed its benchmark over the month. Positive contributions from credit allocations were offset by rates strategy, which detracted from performance.
- In rates, the cross-market long position in the UK versus the US detracted as gilt yields rose sharply early in the month, as did an outright US duration stance.
- Asset allocation, in the form of an overweight position in European investment grade credit in preference to US investment grade bonds had a positive impact.
- Exposure to European covered bonds and a preference for US agency MBS (Mortgage-Backed Securities) was additive.

Portfolio activity

- The headline duration of the portfolio was reduced in line with our view that ongoing robust US economic indicators keep the risk of a 'no landing' scenario

*Schroder International Selection Fund is referred to as Schroder ISF throughout this document

(where inflation remains sticky, and the Fed has little headroom for further rate cuts) relatively elevated.

- The most significant adjustment came from the closure of an overweight position in Indonesia. The Indonesian bond market is highly correlated with US Treasuries, but with less market sensitivity (a lower beta). Since we see no immediate catalyst for it to outperform on a relative basis, we decided to switch the exposure to US Treasuries at the two-year part of the curve.
- With the UK facing the threat of stagflation, we saw it prudent to close our cross-market long position in gilts against the US early in the month. Given the rise in global bond yields, the gilt market is increasingly focused on the challenges the UK government might face in funding its spending programme within the parameters of its fiscal rules.
- We maintained an overweight position in the eurozone. From a growth perspective, we consider the economic outlook appears much more challenging here than elsewhere and US trade tariffs present an additional threat, which policymakers at the ECB will be monitoring closely.
- We retain a preference for European covered bonds. Our strategy in January was to utilise the increased supply of new issues, harvest the available yield premium and subsequently take profits.
- While our directional rates views are relatively modest, yield curve positioning continues to be an additional source of potential return. We introduced a modest curve steepening position in the US, where ongoing fiscal uncertainty could lead longer yields to move comparatively higher than the short end.
- More tactically, we identified an opportunity in European inflation-linked securities, where the curve appears too flat, with very little inflation premium currently priced into longer dated maturities. As such, we implemented a curve steepening trade via inflation (HICP) swaps.
- Elsewhere, we aimed to exploit the relative steepness of the Japanese government bond (JGB) yield curve compared to that of the US, positioning for the JGB curve to flatten on a relative basis. The relationship between interest rates and curve shape suggests that further interest rate hikes will lead the yield curve to flatten. With core inflation still above 2% and signs of continued wage growth, we expect the Bank of Japan to steadily raise interest rates after hiking in January.
- In terms of credit, our preference for US agency MBS remains in place as a relatively defensive means of adding yield given attractive valuations.
- We maintained an underweight to US investment grade corporates, where we view valuations as being particularly unattractive while credit spreads are historically tight. Instead, we favour the European market – particularly shorter dated corporates, which we consider provide an optimal point between risk and yield.
- Currency risk remains low. Tactically, we implemented a small, long position in the Mexican peso versus the euro, based on an anticipated de-escalation of US tariff threats against Mexico.

Outlook/positioning

- The economic outlook presents a divergent picture across global economies. Strong growth in the US reflects a case of exceptionalism, with much softer activity evidenced across the eurozone and the UK.
- Despite more conciliatory actions in recent weeks, US trade policy has the potential to lead to further market volatility. While the details of these policies and their impact are currently unclear, they are likely to raise stagflationary risks to the US economy in an environment where any negative effects on growth may be balanced by higher consumer prices. Three factors are important in assessing the risk of stagflation. Firstly, the extent to which companies will pass higher import prices to consumers or absorb reduced margins, Secondly, the impact of rising consumer prices on inflation expectations and potential second-round effects. Lastly, whether the Fed views these price increases as temporary or as a persistent inflation risk.
- Meanwhile, we have stronger conviction in our eurozone outlook. Here growth is already weak and will likely deteriorate further due to external shocks. Although inflation remains persistent, there are emerging signs of disinflation that we expect to strengthen in the first half of the year, which should lead the ECB to focus more on growth concerns rather than inflation fears.
- This environment warrants a more conservative positioning in outright duration risk, while we prefer to seek opportunities through yield curve strategies. Our view on asset allocation has not changed in recent months and we retain a preference for US agency MBS over corporate credit, given better valuations and the available yield.

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	-2.1	-1.2	-1.7
2023	4.5	5.4	5.7
2022	-19.1	-18.4	-16.2
2021	-5.7	-4.8	-4.7
2020	8.4	9.2	9.3
2019	8.8	9.7	6.8
2018	-3.5	-2.6	-1.2
2017	7.1	8.0	7.4
2016	2.1	3.1	2.1
2015	-5.1	-4.2	-3.2

Source: Schroders, net of fees (where applicable), bid-bid, with net income reinvested as at 31 December 2024. Target is BBgBarc Global Aggregate TR.

Risk considerations

- **ABS and MBS risk:** The fund may invest in mortgage or asset-backed securities. The underlying borrowers of these securities may not be able to pay back the full amount that they owe, which may result in losses to the fund.
- **Bond Connect risk**: The fund may be investing in the China Interbank Bond Market via the Bond Connect which may involve clearing and settlement, regulatory, operational and counterparty risks.
- **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.
- **Currency risk / hedged shareclass**: The hedging of the share class may not be fully effective and residual currency exposure may remain. The cost associated with hedging may impact performance and potential gains may be more limited than for unhedged share classes.
- **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 country: United States of America.
- **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.

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