Schroders

Schroder ISF[1] Global Bond Q2 2024

Market summary

The quarter started on a disappointing note for the global bond market, spurred by renewed concerns about US inflation and prompting investors to reassess the timing of rate cuts. Later, a more conducive market environment was driven by the emergence of softer labour market conditions and encouraging news on inflation.

Investment grade (IG) corporate bond markets in the US and Europe delivered both positive absolute and relative returns over government bonds. This was mainly a function of the relatively higher income earned as credit spreads actually widened during the quarter. There was some divergence in global government bond markets. Following an initial sharp sell-off in US Treasuries, yields peaked towards the end of April and subsequently trended lower (albeit not in a straight line). The European Central Bank (ECB) kicked off its rate cutting cycle, but it was political risk that dominated towards the end of the period when French spreads widened sharply versus Germany on the announcement of a snap Parliamentary election. The more fiscally challenged members of the eurozone, such as Italy, also suffered contagion.

Performance

The fund outperformed the benchmark over Q2, although the overall return was negative. On a relative basis, asset allocation – where we continue to focus on high quality credit – was the main source of outperformance. Rates and currency strategies detracted slightly.

An overweight to European investment grade credit worked well, while on a sector basis, a preference for financials further boosted returns. Financials outperformed on a supportive growth outlook and on signs that interest rates would fall more slowly than previously envisaged. Conversely, a corresponding underweight to US investment grade detracted, although again sector allocation was positive, with the most significant underweight focused in the underperforming industrial sector.

Across broader spread markets, performance benefited from an allocation to US agency mortgage-backed securities (MBS) and EUR covered bonds. While spreads were broadly unchanged, these asset classes continued to benefit from a relatively benign macro backdrop and the additional income earned over government bonds with similar risk and maturity profiles.

The contribution from rates was slightly negative, principally from a cross-market underweight to Canada versus the US as unexpectedly softer inflation allowed the Bank of Canada to cut rates earlier than expected. Other cross-market strategies fared better, with a UK versus Germany performing well on a dovish sounding Bank of England.

While duration (interest rate risk) was kept relatively modest – a reflection of our macro views - a directional overweight to the US, opened following the peak in yields for the quarter, contributed positively. Yield curve steepening strategies, which were generally focused in the US, also contributed overall. However, an exposure to local currency emerging market debt (EMD) was a detractor as markets in Mexico, Brazil and Indonesia cheapened.

The performance from currencies was slightly negative. The two notable detractors came from an overweight to the Japanese yen, versus the Swiss franc, which suffered from the Bank of Japan's unexpected pivot to a more dovish stance and also an overweight to the Brazilian real versus the euro. A resurgence of fiscal concerns was negative for the real.

Strategy

The fund's strategy reflects our macroeconomic views, where the probability we've assigned to a 'soft landing' (our base case) has increased and risks of a 'no landing' (a scenario where bond returns are most adversely affected) have receded. This was reflected in a modest increase in the portfolio's headline interest rate risk (duration) over the period. However, we still see it as difficult for global bond markets to structurally rally from here, with many segments of the market well priced for a 'soft landing' outcome and therefore keep risk relatively low.

[1] Schroder International Selection Fund is referred to as Schroder ISF

Using April's peak in Treasury yields, we added US duration. Conviction was supported by signs of softer inflation data and weaker labour market indicators. We also added exposure to local currency emerging market debt (EMD), where we looked through the political noise, focusing on Brazil and Mexico which offer attractive yields. The Brazilian central bank continued to ease monetary policy conditions during the quarter, and while the Banxico have held rates steady since March, a favourable inflation trend gives it leeway to cut further.

We continued to exploit cross-market rates opportunities during the quarter. We were initially biased to underweight Germany, holding the position versus both the US and the UK. Our view being that following June's rate cut - which had been well-telegraphed by the ECB - the market was being overly optimistic over the pace of further easing. We later took profits, closing both positions. Elsewhere, less favourable circumstances motivated us to close an underweight to Canada versus the US. Canadian inflation printed below consensus and the Bank of Canada cut rates and was more dovish than expected both by the market and by ourselves.

We tempered our enthusiasm for curve steepeners, closing steepening risk in the UK and reducing exposure in the US. Nevertheless, we believe there remains some merit in positioning for steeper curves on a more tactical basis as central banks are gradually turning to easing cycles and in the case of the US, fiscal indiscipline remains. Conversely, we have become increasingly positive on inflation strategies, with some degree of easing by central banks providing tailwinds to higher breakeven inflation rates. We position overweight to US breakevens – where too little inflation risk premia is priced - versus Europe and the UK.

We made no major changes to our asset allocation views, favouring European over US investment grade (IG) credit given comparatively favourable valuations. With respect to high yield (HY), our view is that valuations do not provide much compensation for the additional risk further down the credit spectrum, and for this reason hold no exposure. Meanwhile, attractive yields and an expected gradual decline in rate volatility going forward keeps us positive on US agency mortgage-backed securities (MBS) although we've reduced exposure a little in European covered bonds. Our view is that the political instability in France could limit the extent of spread compression here. Just to note, we have held limited French risk in the portfolio for some time due to our concerns on the fiscal front.

Currency risk in the portfolio was kept low as we exploited a number of tactical opportunities. An overweight to the Brazilian real versus the euro, a carry positive trade, was closed following the emergence of increased fiscal concerns. Similarly we cut an overweight to the Japanese yen, held versus the Swiss franc after the Bank of Japan unexpectedly pivoted to a more dovish stance. By the end of the period we held an overweight to the Mexican peso versus the euro, an overweight to the Norwegian krone versus the Swedish krona and keept an overweight to the US dollar versus the euro via options.

Outlook

The commencement of the rate cutting cycle has been considerably delayed, contrasting sharply 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 flow perspective.

This comes at a time when the global economic outlook is gradually improving. The US has undoubtedly led the recovery, but there are now signs of this growth broadening out to other regions as well, like the Eurozone. This means that a 'soft landing' remains our base case, and while we are of course watching for recessionary warning signs, so far, these have been very few and far between.

However, it's inflation that remains in the driving seat and we expect the disinflationary progress to be continually challenged. With goods prices having normalised, the easy wins on getting inflation back to target are now firmly behind us. Nevertheless, countries are at differing stages of this disinflationary process – and we think there are relative value opportunities to be exploited there.

In addition to the prevailing macro environment, the heavy election cycle and ongoing geopolitical tensions further underline possible risks. At the time of writing, the likelihood of a hung parliament in France has increased once more, becoming the most likely outcome. With it comes fiscal paralysis, which given budgetary concerns, is the most market friendly scenario for now, at least until the budget negotiations in Autumn 2024. The US Presidential elections will also inject increased uncertainty into the outlook as the rhetoric between President Biden and former President Trump ramps up. All these factors highlight the benefits of an agile and nimble approach to fixed income investing as advantageous.

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