Schroders

Schroder ISF* Global Bond

Fund Manager: Julien Houdain, James Ringer and Global Unconstrained Fixed Income Team | Fund update: First Quarter 2024

Market overview

- Central banks were in the spotlight during Q1. Uncertainty around inflation saw the European Central Bank (ECB), the Bank of England (BoE) and the Federal Reserve (Fed) all proceed with caution, needing greater confidence that inflation was moving sustainably down towards their targets.
- Meanwhile, the Swiss National Bank (SNB) surprised with a 25 basis point interest rate cut to 1.5%, and several emerging market economies continued their rate cutting cycles.
- The Bank of Japan bucked the trend, raising interest rates (from -0.1% to +0.1%) for the first time in 17 years in an anticipated move to end negative rates.
- Government bond yields rose in most major markets as expectations of immediate interest rate cuts were pared back, but bond market volatility was relatively subdued.
- Despite heavy supply, corporate bonds outpaced government bonds amid stronger activity data and robust corporate margins. Across US and European issuers, spreads tightened more in high yield credit than in investment grade.

Drivers of fund performance

- While the fund outperformed the benchmark, the total return was negative as yields rose during the quarter. Asset allocation, with a focus on high quality credit, was a key driver of relative performance, while the fund's rates strategy also added to returns over the benchmark.
- Performance benefited from the continued spread compression of European investment grade credit as an overweight was maintained. US investment grade credit, where we held a corresponding underweight, underperformed European issues. Sector-wise, the fund's concentration in financial issuers provided an additional boost for relative performance, with this sector having outperformed on the prospect of interest rates staying higher for longer.
- In broader spread markets, an overweight to European covered bonds proved to be a further positive. As well as earning additional yield for the fund, spread compression delivered positive excess returns over government bonds. However, it was a slightly different picture for US Mortgage-Backed Securities (MBS), where spreads widened as expectations for interest rate cuts were pushed back, and our overweight position detracted.
- In rates, both cross-market and outright duration (interest rate risk) generated positive relative performance. An underweight to Canada held against Australia mid-quarter was a notable contributor. More recently, the introduction of a long UK position versus first the US, and then Germany, added performance.
- Turning to directional rates performance, the fund's exposure to local currency emerging market debt (across a selection of markets) contributed positively. Although yields rose, the additional income provided from these higher-yielding markets meant that overall returns were still positive.
- In developed markets, the introduction of a modest directional overweight in the US later in the quarter benefited as markets pulled back from a peak in yields in mid-March. Elsewhere, even though the market reaction to the rise in interest rates was relatively muted, a structural underweight to Japan benefited performance too.
- High conviction in a steepening of yield curves was reflected in the fund's strategy. However, after a promising start, the US yield curve bear flattened (i.e. yields at the shorter end moved comparatively higher versus longer-dated Treasuries) as a series of stronger than expected inflation prints dampened the market's anticipation for immediate interest rate cuts. It was a similar story for the UK curve, and a steepening position here, held for a period intra-quarter, also produced relative losses.
- Despite relatively low foreign exchange (FX) risk, the fund generated positive performance. An underweight to the Swiss franc, held against the euro, was a notable contributor as the SNB's policy of FX appreciation ended and interest rates were cut in response to easing inflation pressures.

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

Portfolio activity

- The fund's strategy reflects our view of the likelihood of a global 'soft landing'. Despite some recent upside inflation surprises, disinflationary progress remains on track, with favourable year-on-year base effects set to permit an easing of monetary policy conditions. Meanwhile, leading indicators are showing clearer evidence that the global manufacturing cycle, which had a tough 2023, has started 2024 on a surer footing. Regionally, portfolio strategy reflects a more optimistic view for the eurozone economy than previously.
- Overall portfolio duration was kept close to the benchmark. However, we made several changes to underlying positions, the most notable being the extension of the US duration overweight towards the end of the period. The market sell-off left Treasury valuations looking cheap relative to our outlook for the economy, and we opened cross-market positions versus Canada and Germany. This was in line with the reduction in our probability of a 'no landing' outcome, having witnessed some easing in US labour market conditions. While February's US non-farm payroll report showed growth remaining healthy, large downward revisions to previous months have reduced the likelihood of a significant inflationary impact.
- Elsewhere, we established an overweight to the UK against the US and Germany. The rationale was partly valuation-based, given the UK market's recent underperformance and partly fundamental, due to the economy's relatively stronger disinflationary impulse and the idea that inflation in the UK would 'catch down' to other economies. We later scaled back positioning to take profit, although a similar rationale led us to open a short UK inflation position.
- The net changes over the quarter left the portfolio most defensively positioned in eurozone duration as leading indicators exhibited clear signs of improvement in the labour market at a time when the progress of service sector disinflation appears to have stalled. While it is unlikely that this worsening in services inflation dynamics will prevent a start of the easing cycle in June, we believe the market is pricing in too many rate cuts, too quickly, after that. We also extended an underweight to Japan identifying ongoing value in the position in view of the Bank of Japan's gradual shift away from negative rates.
- Our conviction for selected emerging markets was retained. As well as the potential for yields to fall further as inflation pressures allow central banks to extend their rate-cutting cycles, the high level of income provided by emerging bond markets is compelling. However, given increasing concern over Brazil's fiscal outlook, we closed our position here and opened a position in Mexico, where March saw the Bank of Mexico make the first rate cut of the cycle.
- In terms of asset allocation, we shifted to an underweight to corporate bonds early in the quarter by selling US investment grade issues. In our view an underweight to the US is warranted given expensive valuations, with the market apparently having already perfectly priced a 'soft landing' scenario. We switched exposure instead into US MBS, which offer attractive yields with comparatively lower credit risk. European investment grade credit, in contrast to the US, continues to offer value, particularly as we see signs of stabilisation in the manufacturing outlook. Accordingly, we took the opportunity to extend the relative overweight position here. Similarly, in line with our conviction in high-quality credit, we also extended an overweight to European covered bonds during the quarter. We maintained a negative view on corporate high yield bonds, as we consider valuations particularly unattractive.
- FX risk was kept relatively low over the period, but we continued to trade on an opportunistic basis. We introduced an underweight to the Swiss franc against the euro in anticipation of the SNB ending its FX intervention, but later closed the position to take profit. At the end of the quarter, we held an overweight to the Brazilian real (against the euro), which earns attractive carry, and an overweight to the Australian dollar against the New Zealand dollar. This position aims to exploit the divergence between the two central banks, with the Reserve Bank of New Zealand likely to cut interest rates sooner and more aggressively than the Reserve Bank of Australia.

Outlook/positioning

- Markets are coalescing around a June interest rate cut for the US Fed, ECB and BoE, but what happens subsequently will depend on several factors, principally inflation. Here, the final push towards central banks' targets is proving to be the most difficult one. Although favourable base effects mean year-on-year core inflation should continue to decline in the immediate future, a stickiness of underlying prices - particularly across services sectors - could pose challenges further out. So far, market inflation expectations have remained relatively well anchored, but this requires close monitoring.
- On growth, firming goods demand has driven an upturn in the global manufacturing cycle which is consistent with our central thesis of a 'soft landing'. With ongoing US resilience, an improvement in growth prospects across the eurozone, and China stabilising we are currently far less concerned about a 'hard landing' or recessionary outcome.
- However, we believe the resilience of labour markets is a potential headwind for a deep interest rate-cutting cycle, and we are alert for any indications of a re-tightening in conditions. Nevertheless, despite the current strength in labour markets, for now we are reassured by the recent speed of declines in both US quit rates and hiring plans which means conditions so

far are not challenging the assumption of interest rate cuts as we move into the summer.

- With lower bond volatility and the possibility that we are entering a more rangebound environment, we continue to favour those fixed income asset classes which offer additional yield. While some markets appear expensive, we consider there remains value in high quality sectors, particularly European investment grade corporates, and securitised assets.

Calendar year performance (%)*

Year	Fund (A Acc)	Fund (I Acc)	Target
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
2014	0.9	1.9	0.6

Source: Schroders, net of fees (where applicable), bid-bid, with net income reinvested as at 31 December 2023. Target is BBgBarc Global Aggregate TR.

- 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

- **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.

Important information