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Schroder ISF* EURO Corporate Bond

Fund Manager: Patrick Vogel | Fund update: December 2024

Market overview

- Credit spreads in the European investment grade market, as measured over government bonds, tightened overall during December. A combination of low issuance volumes and strong inflows into European investment grade credit saw the market hold up relatively well in comparison with government bonds. Corporate hybrids and higher yielding issues outperformed, while spreads tightened further on real estate and insurance sector issues.
- There were some tentative signs of stabilisation in European economic indicators released during December. The closely watched composite purchasing managers index (PMI) for the Eurozone picked up driven by the services sector activity, which managed to offset some of the continuing contraction in manufacturing. However, it remains below the 50 mark, suggesting the eurozone economy is contracting as activity in both Germany and France remains sluggish.
- As expected, European Central Bank (ECB) cut interest rates in December to 3% from 3.25%. This was the fourth time this year the ECB made the decision to lower its deposit rate, but the market was disappointed as the tone was less dovish than expected. Concerned with the potential for new US tariffs, among other factors, hampering economic growth, some policymakers had been pushing for 50bp rate cut. The ECB lowered its growth forecast for the Eurozone economy to 1.1% in 2025 and cautioned that as yet this did not reflect the impact of proposed US tariffs on exports.
- Government bond yields rose across European markets in December, with the 10-year German bund yield rising by 28bps to close the year at 2.35%. Ratings agency Moody's downgraded France's credit rating, citing political instability and cautioning it will be difficult for the incoming government to tackle the country's fiscal deficit. Unease over deteriorating public finances have pushed the yield spread for French bonds over benchmark German debt to its highest level since the Eurozone debt crisis.

Drivers of fund performance

- The fund outperformed its benchmark after fees during December.
- Exposure to higher beta segments of the European credit market, notably corporate hybrid holdings in the real estate sector and subordinated financials, contributed to performance.
- Portfolio spread duration was additive as credit spreads tightened over the month.
- Security selection in the healthcare sector was also additive.
- Underweight positioning in the consumer goods and telecommunication sectors detracted.

Portfolio activity

- With credit spreads for the European investment grade market at tight levels on index level historically, we were highly selective in the new issue market during December, as generally available yields were not enticing.
- Our main additions through the primary market included senior secured short-dated debt from a Spanish pharmaceutical group that was priced on an attractive yield. This was a private placement structured as a refinancing of existing short-dated maturities.
- We participated in an issue of short-dated bond from a REIT focused on the Dubai financial services sector. The issue carries a low loan to value (LTV), and Dubai is growing rapidly as a financial services hub, particularly for wealth management businesses.
- Amongst longer dated securities, we added a holding in a US healthcare group on an attractive yield, as well as bonds issued by a European diagnostics and testing group.

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

- In the banking sector, we further reduced exposure to Tier 2 subordinated issues, where spreads have tightened markedly.
- We reduced exposure to higher yielding issues in consumer cyclical sectors such as leisure and autos, as well as holdings in a Scandinavian telecommunications group and a leading European real estate developer.
- We also marginally reduced the spread duration of the portfolio.

Outlook/Positioning

- The economic recovery in Europe is struggling to gain any momentum with recent indicators highlighting further weakness in manufacturing as the continuing decline in new orders is driving businesses to reduce output. In addition, concerns about job security with the announcement of further redundancies in the autos sector have significantly weakened consumer confidence in Germany, as well as in France.

- The outlook is clouded further by the risk of trade tariffs on exports to the US, as well as ongoing political uncertainty in France and forthcoming elections in Germany following the collapse of the coalition government.

- Against this background, pressure on the ECB to sanction further monetary easing has intensified. In total, investors are discounting five additional rate cuts over the next 12 months. Furthermore, pressure on the EU to implement proposed structural reforms aimed at boosting the region's competitiveness is likely to grow.

- While the Eurozone CPI is running above its 2% target, inflation is likely to moderate as service sector inflation should decline further driven by a weaker labour market.

- We continue to believe growth in Europe will remain subdued and that further significant monetary easing from the central bank is required to support any sustainable recovery in economic activity.

- After a traditionally quiet end to the year, we would expect to see a sustained upturn in new issuance volumes over the coming months and while credit spreads are at tight levels historically, we anticipate the primary market should offer opportunities to deploy cash currently parked in short-dated government bonds. Moreover, with further interest rate cuts in the pipeline we expect the demand for credit to remain high in 2025, supporting tighter spreads at broad market level.

- We have reduced the risk profile of the portfolio as the rally in banks has largely played out, while cyclical sectors such as autos face considerable headwinds. In addition, ongoing political uncertainty warrants a cautious approach to duration risk particularly in the French credit market.

- From this perspective, we are looking for opportunities in the single A rating segment, as it is historically cheap to go up in quality. Non-cyclical sectors, notably healthcare and business services, also provide attractive real income.

- Going forward, a combination of positive carry and idiosyncratic opportunities should underpin total returns from the European investment grade market.

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 (%)

	A Acc	I Acc	Target**
2024	6.0	7.0	4.7
2023	9.7	10.8	8.0
2022	-16.4	-15.6	-13.9
2021	-1.2	-0.2	-1.0
2020	4.6	5.6	2.6
2019	8.8	9.9	6.3
2018	-2.9	-1.9	-1.1
2017	4.6	5.6	2.4
2016	5.8	6.9	4.8
2015	0.7	1.8	-0.4

Source: Schroders, as at 31/12/2024. All performance net of fees (where applicable), NAV to NAV (bid to bid), EUR. ** ICE BofA Euro Corporate Index.

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.

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.

Emerging and less developed markets: The fund may invest in emerging and less developed markets. Investing in emerging and less developed markets is subject to greater risks than investing in securities of developed countries such as ownership and custody risks, political and economic risks, market and settlement risks, liquidity and volatility risk, legal and regulatory risks, execution and counterparty risk, and currency risk, which may adversely affect the net asset value per share of the fund and investors may as a result suffer losses.

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.

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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