

# Schroder ISF\* EURO Corporate Bond

Fund Manager: Patrick Vogel | Fund update: January 2025

## Market overview

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- Credit spreads in the European investment grade market, as measured over government bonds, tightened further during January. A combination of low issuance volumes and strong inflows into European investment grade credit, with institutional investors particularly active around the 10-year part of the curve, pulled yields lower. So far, the quarterly results season in Europe has been broadly encouraging, particularly amongst banks with interest margins peaking combined with an upturn in fee income boosted by M&A activity.
- The fourth quarter GDP figures, published at the end of the month, highlighted the Eurozone economy stagnated last quarter. Germany faces the headwind of a severe manufacturing slowdown as well as political uncertainty with federal elections scheduled for February. The French economy unexpectedly contracted, while output was flat in Italy. The exception was Spain, where growth exceeded expectations driven by the services sector.
- 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, with persistent inflationary pressures in the services sector. 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 bund yield ended the month 11bps 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.

## Drivers of fund performance

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- The fund marginally underperformed its benchmark after fees during January.
- An underweight in the banking sector was the main factor that detracted from performance over the month.
- Exposure to emerging markets was also marginally negative.
- Security selection in the services, insurance, healthcare, and transportation sectors was additive.

## Portfolio activity

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- During January, we selectively increased exposure to emerging market bonds. In contrast to the G7 economies, debt/GDP levels in emerging markets are at more sustainable levels as overall governments have been more fiscally disciplined. In addition, from an income perspective the available coupon on emerging market bonds is attractive.
- Amongst financials, we added holdings in several euro denominated issues from major US banks. These provide exposure to the US economy, which is growing at a significantly faster rate than Europe, on a more attractive credit spread than dollar denominated securities of an equivalent maturity.
- We added to corporate hybrid exposure, acquiring a holding in an Italian utility group priced on an attractive yield premium.
- We established a position in a US REIT operating in the healthcare sector. This was a senior issue, trading well below par, where the company's finances are now stabilising after a period where revenues were impacted by tenancy-related issues.
- On the disposals side, we reduced exposure to higher beta segments of the credit market, a notable example being Tier 2 credit issued by European and US banks.

- Given the prospect of US tariffs on European exports, we continued to reduce exposure to the autos sector.
- We also sold down our holding in hybrid securities issued by a European oil and gas exploration group, as well as taking profits on a holding in the travel and leisure sector.
- 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 meaningful recovery in economic activity.
- After a quiet start 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 over the course of 2025, supporting tighter spreads at broad market level.

## 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 imminent elections in Germany.
- Against this background, pressure on the ECB to sanction further monetary easing has intensified. In total, investors are discounting further interest rate cuts over the coming months with the ECB's key deposit rate reduced to 2% by the summer. 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 gradually decline, driven by a weaker labour market.
- 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 selectively 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.*

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.

## 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

## 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.

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**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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