Schroders

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Schroder ISF* EURO Corporate Bond

Fund Manager: Patrick Vogel | Fund update: November 2024

Market overview

- Credit spreads in the European investment grade market, as measured over government bonds, remained broadly unchanged overall during November, with the market posting a positive total return over the month. Corporate hybrids and higher yielding issues underperformed, while autos weakened following the November US elections as investors priced in the prospect of trade tariffs on European exports with the incoming Trump administration buoyed by the Republicans now holding an outright majority in both chambers of Congress.
- European economic indicators released during November highlighted continuing weakness. Significantly, the closely watched composite purchasing managers index (PMI) for the Eurozone came in well below expecting, declining to a 10-month low highlighting a contraction in the services sector as well as manufacturing. Third quarter GDP (gross domestic product) in Germany was revised down, with declining exports a major drag on growth. Although consumer price inflation (CPI) for the Eurozone climbed to 2.3% year-on-year, up from 2.0% in October, there are signs that underlying inflation pressures are easing with service prices slightly declining. As anticipated, the ECB implemented a 25bps rate cut at its latest monetary policy meeting. Markets are anticipating the European Central Bank (ECB) will lower interest rates further over the coming months.
- However, this is against a backdrop of considerable uncertainty due to ongoing political tensions over France's proposed 2025 budget. Notably, yields of French government bonds rose briefly above Greek government bonds for the first time in history. This was caused by the threat of a no-confidence vote leading to a government shutdown, which heralded a dramatic shift in market sentiment. Spreads over German bunds rose to their highest levels in 12 years and are at risk of increasing further.
- Meanwhile, the rest of Europe saw 10-year government bond yields fall, broadly influenced by the weakness of European economic indicators and rapidly decreasing demand in the automotive sector with further redundancies announced by major manufacturers and suppliers.

Drivers of fund performance

- The fund underperformed its benchmark after fees during November.
- Exposure to corporate hybrid holdings, particularly in real estate and energy, detracted from active returns.
- In contrast, holdings in shorter-dated issues, particularly paper with good carry, performed well over the month.
- Holdings in Romanian sovereign debt lost ground on market volatility ahead of the presidential elections.

Portfolio activity

- With credit spreads for the broad market at tight levels historically, we were highly selective in the new issue market during November, as generally available yields were not enticing.
- Our main addition through the primary market was a longer-dated issue from a leading global booking portal, a commission orientated business focused on the travel and leisure sector. The issue is covered with the bonds supported by significant free cash flows.
- We also participated in a higher yielding new issue from a German pharmaceutical company. Aside from the available yield, the bonds are underpinned by low leverage, healthy profit margins and strong cash flows.
- In the technology sector, we added a short-dated holding in a retail orientated payment processing business, as the issue was priced on an attractive yield.
- Given the ongoing political uncertainty in France, we reduced exposure to French credit further during November selling down holdings in banks, insurers and energy companies.
- Likewise, we also reduced the risk profile of the portfolio through lowering exposure to the autos

*Schroder International Selection Fund is referred to as Schroder ISF throughout this document sector, where competition from China and the risk of tariffs on exports to the US are significant headwinds.

- In the retail sector, our holding in bonds issued by an owner of leading fashion brands was paid back early as the regulator blocked a proposed acquisition on antitrust grounds.
- From a diversification perspective, we retained exposure to emerging markets with low correlation to European credit markets. Holdings in Mexico and Chile provide an alternative source at income, while in Central Europe Romanian bonds are trading at attractive credit spreads in comparison with the European investment grade market.

Outlook/Positioning

- The economic recovery in Europe is struggling to gain any momentum with recent indicators highlighting that the weakness in manufacturing has now spread to the services sector. In addition, concerns about job security with the announcement of further redundancies in the autos sector have significantly weakened consumer confidence in Germany.

- 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 the prospect of elections in Germany in early 2025 following the collapse of the coalition government.

- Against this background, pressure on the ECB to sanction further monetary easing has intensified. A further 25bps interest rate cut has been priced in for December, while in total investors are discounting six 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.

- Heading into 2025, new issuance volumes are set to pick up 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, 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 senior banks has largely played out, while cyclical sectors such as autos face considerable headwinds. In addition, ongoing political risk warrant a cautious approach to duration risk in the Frech 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, 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**
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
2014	8.8	9.9	8.3

Source: Schroders, as at 31/12/2022. 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.

Important information