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Schroder ISF* Global Credit Income

Fund Managers: Julien Houdain & Martin Coucke | Fund update: March 2024

Market overview

- Against a relatively benign economic and market backdrop, yields fell across the major government bond markets in anticipation of interest rate cuts commencing in June. The Federal Reserve (Fed), European Central Bank and the Bank of England left interest rates unchanged. The Fed's Summary of Economic Projections (SEP) showed no change to its forecast for three rate cuts this year, despite forecasting lower unemployment and higher core inflation compared to December's release. The accompanying statement also set a dovish tone.
- The Swiss National Bank, surprised with a 25 basis point rate cut to 1.5%. With inflation back to target, the move was aimed at easing pressure on the currency and supporting growth. Against the trend, the Bank of Japan (BOJ) raised interest rates (from -0.1% to 0.1%) for the first time in 17 years in an anticipated move to end negative rates. Nevertheless, the BOJ's forward guidance remains dovish, with the statement noting a likely accommodative stance being maintained given the current outlook for economic activity and prices.
- Corporate bonds continued to outperform government bonds amid stronger economic data and robust corporate earnings. Despite heavy supply, credit spreads tightened further in March on the back of strong investor demand for new issues, and spreads in both US and European investment grade markets declined to the tightest level for two years. Globally, spreads compressed across the investment grade market, led by real estate sector. High yield markets also generated positive total returns, although the European market lagged with spreads widening on the month.
- The US 10-year Treasury yield fell from 4.24% to 4.2%, and with the curve still heavily inverted, the yield on the benchmark 2-year remained unchanged at 4.6% on the month. The 10-year German bund yield fell from 2.41%. to 2.3%, while yields in the Italian and Spanish markets fell further. UK gilts outperformed on the month, with the 10-year yield declining from 4.12% to 3.93% as February's inflation data highlighted a larger than expected decline in both the core and headline consumer price index measures.

Drivers of fund performance

- The Fund produced a positive total return and performance was ahead of its reference benchmark during March.
- Exposure to banking sector issues was a key contributor over the month, particularly in the eurozone and the UK.
- An overweight allocation to Mortgage-Backed Securities (MBS) also had a positive impact.
- Over a month when credit spreads tightened, the Fund's underweight in spread duration, particularly in the US investment grade market, detracted.
- Contributions from overall portfolio duration and yield curve positioning were broadly neutral.

Portfolio activity

- Given continued spread compression across the investment grade bond market, activity during March was focused on reducing the risk profile of the portfolio. We added to our holdings in the dollar-denominated Agency MBS market, while reducing exposure to European investment grade corporate bonds.
- Purchases were focused on shorter-dated bonds, with between 1 and 5 years to maturity, to reduce the sensitivity of the portfolio to changes in credit spreads.
- On cross-market positioning, we added to US exposure versus Canada, where in our view the bond market is discounting too many interest rate cuts relative to the US. Based on our outlook for the US economy, particularly the labour market, Treasury bond valuations look attractive. Our concern around the risk of labour market conditions re-tightening, which would prompt concerns of secondary round inflation effects, diminished somewhat last month. While February's US non-farm payroll report showed the labour market remaining healthy, large downward revisions to previous months have reduced the likelihood of any inflationary impact.

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

- In the Eurozone, we now hold a more negative view on duration as leading indicators highlight clear signs of improvement in the labour market at a time when the progress of service sector disinflation looks to have stalled. While it is unlikely that this worsening in services inflation dynamics will prevent the start of the European easing cycle in June, we believe the market has become over optimistic and is pricing in too many interest rate cuts after that.
- Amongst financials, we selectively added holdings in Tier One bonds from European insurance companies. We believe there is still scope for further spread compression amongst financials, where valuations are attractive relative to the broader investment grade market.

Outlook/Positioning

- Consistent with our central thesis of a 'soft landing', firming goods demand has driven an upturn in the global manufacturing cycle. The US has led the way, but the Eurozone has been a more recent beneficiary of this cyclical uplift, with a more accommodative interest rate outlook offering additional support. Not only does it appear that the region's manufacturing cycle has turned, but the services sector also seems to be recovering, feeding through to the labour market. Leading indicators are signalling a clear improvement and given the weakness of growth expectations for the region, the hurdle for positive surprises is easy to beat.
- However, an improving global growth backdrop presents an upside risk to inflation and there has already been a flurry of surprises in recent data releases. Although favourable base effects mean year-over-year core inflation should continue to decline in the immediate future, continued stickiness in underlying prices could pose challenges further out, without marked improvement.
- The resilience of labour markets is also a potential headwind to the depth of the forthcoming interest rate cutting cycle. This continues to warrant close scrutiny, particularly in the US.
- Looking at the outlook for credit markets, we have become more cautious on the near-term prospects given both the speed and the extent of spread compression in recent months. Accordingly, we favour both Agency MBS and securitised bonds with a low spread duration and an attractive yield, particularly given the buffer this provides from capital losses.
- We remain underweight in the US corporate bond market, restricting our exposure given the extent to which credit spreads have already tightened and valuations now appearing increasingly stretched. Likewise, while we expect the supportive technical backdrop of demand for new issues and inflows into investment grade credit funds to underpin European corporate bonds, we have become more cautious on the immediate outlook, particularly for longer-dated securities.

Calendar year performance (%)*

Year	A DisMF	I DisMF	BM1	BM2	BM3	BM4
2023	9.5	11.0	9.7	9.6	14.0	10.5
2022	-12.7	-11.5	-14.1	-14.1	-12.7	-16.5
2021	0.9	2.3	-0.2	-2.9	1.0	-1.5
2020	6.6	8.0	7.9	10.4	7.0	5.9
2019	11.3	12.9	13.2	11.5	12.6	14.4
2018	-1.6	-0.3	-1.4	-3.6	-4.1	-4.6
2017	7.8	9.3	6.7	9.1	10.4	9.3
2016	-	-	-	-	-	-
2015	-	-	-	-	-	-
2014	-	-	-	-	-	-

Source: Schroders, NAV to NAV (bid to bid), net of fees (where applicable), USD, as at 30/12/2023. Comparator benchmarks: 1. Bloomberg (Bbg) Multiverse ex Treasury A+ to B- USD Hedged, 2. Bbg Global Aggregate Corp TR, 3. Bbg Global **High Yield TR USD), 4. JP Morgan EMBI Global TR. Comparator** benchmarks included for performance comparison purposes and do not have any bearing on how the manager invests the fund's assets.

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.
- **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. A reduction in the financial strength of the issuer of such bonds 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 markets & frontier risk**: Emerging markets, and especially frontier markets, generally carry greater political, legal, counterparty, operational and liquidity risk than developed markets.
- **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.
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