

Schroder ISF* Global Credit Income

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

Market overview

- Credit markets generated positive returns, with spreads tightening in the European investment grade market over the month. In contrast, spreads on US investment grade issues were unchanged. Globally, high yield corporate bonds extended their positive performance year to date, underpinned by the prospect of lower interest rates.
- July was a positive month for government bond markets, propelled by expected interest rate cuts as inflation pressures eased. The potential start of a rate-cutting cycle, being crucial for bond markets, meant that central banks took centre stage once again.
- In the US, a second consecutive month highlighting weaker than expected core inflation and signs of slowing growth proved sufficient for the US Federal Reserve (Fed) to signal interest rate cuts at its September meeting. The Federal Open Market Committee (FOMC) met on the last day of the month and as widely expected, interest rates were kept unchanged. Nevertheless, Fed Chair Jerome Powell steered the market towards a September rate cut, fuelling a rally in Treasuries.
- Similarly, barring any major surprises in data, the European Central Bank (ECB) appeared to be signalling a September rate cut. The July flash release of Eurozone core inflation was slightly more robust than anticipated, due to elevated goods prices. However, this did not alter the market's expectations for rate cuts. European government bond markets performed well across the board. French government bonds recovered much of their previous losses following the second round of elections which unexpectedly resulted in a hung parliament. The ensuing political deadlock reassured investors that more extreme budgetary measures might be blocked.
- UK gilts participated in the month's rally as investors awaited the Bank of England's (BoE) announcement at the start of August. The market was split on whether a rate cut would occur at this meeting or the subsequent one in September.

Drivers of fund performance

- The Fund produced a positive total return but underperformed its reference index during July.
- The main detractor was the short duration of the portfolio, limiting sensitivity to changes in interest rates, as bond yields fell over the month.
- Security selection in subordinated financials, real estate and corporate hybrids made a positive contribution.
- A focus on shorter-dated credit with between 1-5 years to maturity was additive.

Portfolio activity

- We maintained a cautious approach to interest rate risk, limiting duration in the US following the recent rally in Treasury bonds.
- In the euro-denominated investment grade market, we continue to favour holdings with between 1 to 5 years to maturity which offer a similar yield to the broader market while limiting exposure to interest rate risk.
- We continue to focus on the real estate sector, particularly in Europe, as a combination of attractive credit spreads and the start of the monetary easing cycle should underpin total returns.
- Amongst banks, during July we added AT1 bond issues from leading European banks which offer attractive yields, particularly as they had sold off recently.
- In the primary market, we participated in a new issue from a mining group focused on the glass and ceramics markets which are linked to the product development cycle in the technology sector, particularly semiconductors.
- We continue to favour Agency MBS (mortgage-backed bonds) as they provide exposure to high quality assets on an attractive yield, particularly in comparison to US investment grade corporate issues, with less associated idiosyncratic risk.
- We remain underweight in the 10-20 year segment of the credit market, on relative valuation criteria. Likewise, we continue to favour euro-denominated

investment grade issues over US-dollar denominated credit.

Outlook/Positioning

- While our core view of a ‘soft landing’; a gradual weakening of the economy where recession is avoided and inflation pressures ease, remains intact the probability of a recession or ‘hard landing’ scenario has increased.
- This reflects two primary drivers. One is the weakening we have seen in leading manufacturing indicators recently, which has been global. The US ISM manufacturing, and the Eurozone, Chinese and Global manufacturing PMI (purchasing managers indices) have all softened. As a highly cyclical sector, we put considerable emphasis on the signal from manufacturing, and such broad-based softening merits an increase in hard-landing probabilities.
- The second reason were further signs of softening in the US labour market. Weaker than expected non-farm payroll gains were the most obvious indicator here, but we have also seen an increase in initial jobless claims, and a reduction in consumer confidence measures around the labour market. Given the crucial importance of the labour market for both the growth outlook and for Fed decision making, it is appropriate that greater signs of slowing in the economy are reflected in higher probability of a hard landing.
- Finally, we have seen signs of market dislocation in recent days in some assets, such as major spikes in volatility indices. In our view, the impact on the growth outlook at this stage due to financial conditions and credit conditions tightening is very limited, hence we maintain our base case of a ‘soft landing’. Moreover, now that inflation has moderated the Fed has greater ability to offset a tightening of financial conditions by easing policy rates more quickly if necessary.
- The US Treasury market has repriced extremely rapidly, with a significant fall in 2-year bond yields. Although we do not disagree that the Fed is now likely to ease monetary policy more than was previously expected, we believe the repricing of yields lower has overshot, and expect some reversal of this recent decline.

- Consequently, we are not inclined to increase interest rate risk in the portfolio given the extent of the recent repricing.
- Looking back at previous recessions, they almost never happen in a vacuum. Usually either a large external or internal shock would be critical in tipping the balance, such as a surge in oil prices or a banking crisis.
- With the November US elections looming, both candidates are pro-growth without much concern about the fiscal deficit, which also slightly reduces the chance of a recession in the medium term. Overall, we are closely monitoring the market and will add interest rate risk if we consider pricing becomes more reasonable.
- In addition, we have also seen a significant repricing of credit spreads. 1 to 5-year investment grade bonds now look particularly attractive, and we have been adding to this part of the market. All in all, we believe the fund is fairly balanced with flexibility to capitalise on opportunities if we were to see more dislocations.

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 (%)*

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.

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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