

# Schroder ISF\* Strategic Credit

Fund Manager: Peter Harvey | Fund update: November 2024

## Market overview

- Within credit markets, spreads as measured over government bonds tightened generally across the board during November, but significant rallies were seen in US high yield where spreads ground even tighter to historical lows. The US high yield sector has been influenced by the incoming Trump administration's expected pro-business policies and tax cuts aimed at stimulating growth. In contrast, spreads on European high yield widened as market sentiment was impacted by the political turmoil in France and structural economic challenges in Germany.
- In the US, market participants anticipated an additional 25bps reduction at the Federal Reserve's (Fed) monetary policy meeting. The Fed chair Jerome Powell noted that supporting the labour market is vital, reducing its key federal funds rate down to 4.50–4.75%. However, Donald Trump's victory in the Presidential elections raised expectations that the Fed might be forced to keep interest rates higher for longer, as the incoming administration's proposed policies are likely to herald inflationary pressures. Nevertheless, the initial effect on Treasury yields was short-lived, with markets reassessing the timeline and feasibility of implementing these policies. The 10-year Treasury yield declined over the month.
- 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 expectations, declining to a 10-month low highlighting a contraction in the services sector as well as manufacturing. 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 expected, 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

sovereign debt 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 generated a positive total return during November.
- Exposure to the UK banking sector made the largest positive contribution in the Investment Grade space.
- Amongst automotives, our holding in US car manufacturer Ford gained ground.
- Insurance and the financial services sectors were also additive.
- In the real estate sector, the holding in US hospital landlord MPT detracted on missed rental payments amongst hospital tenants.
- Healthcare detracted from returns, in particular two names we hold as the bonds fell towards the end of November.

## Portfolio activity

- The portfolio remains well diversified with our main sector exposures as healthcare, banking and financial services.
- During November, we participated in a high yielding new issue from German pharmaceutical company Gruenthal. Aside from the available yield, the bonds are underpinned by low leverage, healthy profit margins and strong cash flows.
- In the real estate sector, we added to Canary Wharf Group, which we already held, as an equity commitment letter was confirmed to support refinancing.
- We sold out our position and were able to re-purchase bonds at par in UK specialised asset

management business, Arrow Global, as they refinanced and were able to extend us into a new instrument with an attractive coupon.

- We maintained a significant allocation to investment grade corporate bonds, focused on BBB-rated issues. The narrowing differential in credit spreads between BB and BBB-rated securities shifts the risk/return profile in favour of the latter, while also acting as a buffer against market volatility.

## Outlook/Positioning

- In the run up to the US election, growth was strong, inflation was falling, and the labour market was close to balanced. The much discussed ‘soft landing’, a scenario where economic growth slows but does not contract and inflation pressures ease, was being delivered.
- However, there is a high degree of uncertainty on the outlook for 2025. The key policies of the incoming Trump administration, including stricter immigration controls, tax cuts, fewer regulations on business, and trade tariffs, suggest a growing inflationary risk. Combined these factors may cause the Fed to cease easing monetary policy earlier than expected. We see growing risk of a ‘no-landing’ scenario in the US, in which inflation remains sticky and interest rates may be required to be kept higher for longer, although it is not our base case.
- 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.
- There is a continuing disparity in credit valuations within high yield markets. Spreads in some parts of the market, notably BB and B-rated issues in both the

euro and dollar denominated markets, measured over government bonds, are at historically tight levels. In contrast, amongst issuers lower down the credit spectrum there is greater disparity with European markets offering more value than in the US.

- The technical backdrop for high yield markets remains favourable, demand should be boosted by the reflationary bias of the incoming Trump administration’s policy agenda and the rally in equity markets as well as the CDX High Yield and iTraxx Crossover indices.
- However, we remain mindful of duration risk particularly in view of tighter spreads and generally more demanding valuations, preferring to focus on shorter-dated credit. Nevertheless, the dispersion in valuations should continue to present investment opportunities in areas of the high yield markets that have been overlooked.

**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 back the amount originally invested.**

## Calendar year performance (%)

	C Acc	Target
2023	11.3	2.8
2022	-7.7	1.3
2021	3.7	0.0
2020	3.8	0.3
2019	8.8	0.8
2018	-1.8	0.7
2017	4.3	0.4
2016	5.9	0.5
2015	3.4	0.6
2014	3.0	0.6
2013	4.7	0.5

Source: Schroders, as at 31/12/2023. All performance net of fees (where applicable), NAV to NAV (bid to bid), GBP returns. Target : ICE BofA Sterling 3-Month Government Bill Index.

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

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**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.

**Derivatives risk – efficient portfolio management and investment purposes:** Derivatives may be used to manage the portfolio efficiently. 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. The fund may also materially invest in derivatives including using short selling and leverage techniques with the aim of making a return. When the value of an asset changes, the value of a derivative based on that asset may change to a much greater extent. This may result in greater losses than investing in the underlying asset.

**Event risk:** The fund will take significant positions on companies involved in mergers, acquisitions, reorganisations and other corporate events. These may not turn out as expected and may result in losses to the fund.

**High yield bond risk:** High yield bonds (normally lower rated or unrated) generally carry greater market, credit and liquidity risk.

**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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