

Schroder ISF* Global Inflation-Linked Bond

Fund Manager: Julien Houdain, James Ringer and Global Unconstrained Fixed Income Team | Fund update: First Quarter 2024

Market overview

- Global real yields (inflation adjusted) rose over the quarter driven by the nominal market, delivering negative returns for the inflation linked (linker) bond market. The drawdown was consistent across countries, Australia being the notable exception which registered a modest positive return. Nevertheless, breakeven inflation rates rose, marking an outperformance over nominal government bonds as concerns over persistent inflation re-emerged.
- The market's exuberance for imminent rate cuts were tempered somewhat following several stronger than expected inflation prints – particularly in the US. This led markets to push back expectations for interest rate cuts from March to June. The US Federal Reserve (Fed) kept interest rates on hold, awaiting more conclusive evidence that inflation was moving sustainably towards target.
- Inflation remained a focal point for bond markets throughout the quarter. Despite indications of diminishing inflationary pressures, unexpectedly high inflation readings tempered enthusiasm for imminent rate cuts but supported linker valuations. Both the US and eurozone reported inflation rates exceeding forecasts, raising concerns about the enduring nature of service sector inflation in particular. In the UK, service prices also remain sticky, although overall inflation measures surprised to the downside in February's print, encouraging a more dovish stance by the Bank of England.

Drivers of fund performance

- The fund slightly underperformed the benchmark over the quarter, with negative total returns as real yields rose during the period.
- High conviction in a steepening of yield curves was reflected in the fund's strategy. But – after a promising start – the US yield curve bear flattened (i.e. yields at the shorter end moved comparatively higher versus longer-dated Treasuries) as a series of upside inflation misses dampened the market's anticipation for immediate rate cuts. It was a similar picture for the UK curve, and a steepening position here, held for a period intra-quarter, also produced relative losses.
- Cross-market strategies generated positive performance. In inflation linked markets, an

overweight in the US versus Europe made a positive contribution as breakeven rates reflected the continuing divergence between the US and eurozone economies. In nominal markets, a long duration (interest rate risk) position in the UK versus first the US, and then Germany, added performance later in the quarter as gilt yields declined sharply in March. An underweight to Canada held against Australia mid-quarter was also notable contributor.

- In terms of off-benchmark asset allocation, performance benefited from the continued spread compression of European investment grade credit and government-related debt.

Portfolio activity

- Overall fund duration remained close to the benchmark throughout the quarter, given we did not consider bond market valuations as being particularly attractive at prevailing levels.
- However, we made several changes to our underlying positions, the most notable being the extension of the nominal US duration overweight towards the end of the period. The market sell-off left Treasury valuations looking cheap relative to our outlook for the economy, and we opened cross-market positions versus Canada and Germany. This was in line with the reduction in our probability of a 'no landing' outcome, having witnessed some easing in US labour market conditions. While February's US non-farm payroll report showed growth remaining healthy, large downward revisions to previous months have reduced the likelihood of a significant inflationary impact.
- Elsewhere, we established an overweight to the UK against the US and Germany. The rationale was partly valuation-based, given the UK market's recent underperformance and partly fundamental, due to the economy's relatively stronger disinflationary impulse and the idea that inflation in the UK would 'catch down' to other economies. We later scaled back positioning to take profit.
- In inflation linked markets, a similar rationale led us to open a short UK position. We also increased the long US versus European inflation swaps position, to reflect the continuing divergence between the two economies.
- With a view of enhancing the fund's yield, we continue to allocate a modest position in off-benchmark markets, including government-related and high quality corporate

bonds. We took profit on the fund's supranational exposure as spreads tightened relative to government bonds but retained a position in European agencies.

- FX risk was kept relatively low over the period, but we continued to trade on an opportunistic basis. We introduced an underweight to the Swiss franc against the euro in anticipation of the SNB ending its FX intervention, but later closed the position to take profit. At the end of the quarter, we held an overweight to the Australian dollar against the New Zealand dollar. The position here aims to exploit the divergence between the two central banks, with the Reserve Bank of New Zealand likely to cut interest rates sooner and more aggressively than the Reserve Bank of Australia.

Outlook/positioning

- Markets are coalescing around a June interest rate cut for the US Fed, European Central Bank (ECB) and BoE, but what happens subsequently will depend on several factors – principally inflation. Although favourable base effects mean year-over-year core inflation should continue to decline in the immediate future, a stickiness of underlying prices - particularly across the services sectors - could present challenges further out. So far, market inflation expectations have remained relatively well anchored.
- On growth, firming goods demand has driven an upturn in the global manufacturing cycle which is consistent with our central thesis of a 'soft landing'. With ongoing US resilience, an improvement in growth prospects across the eurozone and with China stabilising we are currently far less concerned about a 'hard landing' outcome or recession.
- We believe the resilience of labour markets is a potential headwind to the depth of the interest rate cutting cycle. For now, we are reassured by the recent speed of declines in both US quit rates and hiring plans as this means, while the labour market outlook remains strong, conditions do not appear to be re-tightening, an eventuality which might preclude further rate cuts.

Risk considerations

- **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.
- **Capital risk / negative yields:** The fund may lose value when interest rates are very low or negative.
- **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:** 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.
- **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

- An environment where central banks are becoming increasingly dovish at a time when inflation remains elevated is a positive one for linkers. Oil prices were driven sharply higher over the quarter by resilient growth and the prospect of Chinese stimulus supporting demand and have the potential to rise further against a background of geopolitical tensions. This could drive up costs more generally, adding to inflationary pressures. Against this backdrop, linkers should provide investors with a useful diversifier over the coming months.

Calendar year performance (%)*

Year	Fund (A Acc)	Fund (I Acc)	Target
2023	1.0	1.9	1.8
2022	-20.6	-19.9	-19
2021	3.6	4.5	4.6
2020	7.0	7.9	8.3
2019	5.7	6.6	5.4
2018	-4.0	-3.2	-2.6
2017	0.4	1.3	1.3
2016	8.2	9.2	8.6
2015	-1.3	-0.4	-0.9
2014	8.3	9.3	9.5

Source: Schroders, net of fees (where applicable), bid-bid, with net income reinvested as at 31 December 2023. Target is ICE BofA Global Inflation-linked Govt TR EUR..

- 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

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 chosen by the investment manager. The fund may invest in companies that do not reflect the beliefs and values of any particular investor.

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