

Schroder ISF* Global Inflation-Linked Bond

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Market overview

- Global real yields (inflation adjusted) were little changed over the course of the quarter, with the overall inflation-linked government bond market returning only a modest negative return overall (local currency terms) This occurred despite a rise in nominal yields across most major markets, as investors focused on the timing and subsequent pace of interest rate cuts.
- Despite the moderation of headline inflation globally, core inflation remained elevated. Core goods inflation has now normalised back to pre-pandemic levels, with investors and policymakers alike focusing on the easing of service price inflation, which is proving sticky.
- US breakevens (market-based inflation expectations) initially rose following March's consensus beating consumer price index (CPI) print, but later fell back on weaker labour market data and subsequent signs of broad-based disinflation. The US Federal Reserve (Fed) remained sensitive to inflation and the latest Federal Open Market Committee (FOMC) meeting in June struck a relatively hawkish tone. While keeping rates on hold as expected, the accompanying revised forecasts signalled just one rate cut over the rest of 2024, a decrease from three cuts that were anticipated back in March.
- UK inflation breakevens ended the quarter slightly lower. In the latest release (for May), headline inflation showed a fall to 2% on an annual basis, which was the first time since mid-2021. However, beneath the surface some of the details were less favourable, including service sector inflation, a key metric monitored by the Bank of England (BoE), which came in at a higher-than-expected 5.7% year-on-year. Despite only two members voting to lower interest rates, the decision to keep policy unchanged in June was viewed as relatively dovish, the statement pointing to the decision to remain on hold as being 'finely balanced'.
- In a similar move to the UK, German breakevens fell on broad disinflationary progress. However, this progress remains slow, a point highlighted by the latest European Central Bank (ECB) policy meeting. In a well-telegraphed move, the ECB announced a 25bp cut in the deposit rate - the first cut of this kind since

2019. However, the accompanying statement and upgrade to inflation forecasts were interpreted by the market as relatively hawkish.

Drivers of fund performance

- The fund posted a negative total return but outperformed the benchmark over the quarter.
- Inflation strategies, which concentrated in an overweight to US breakevens on a cross-market basis, contributed.
- In nominal rates, a cross-market underweight to Canada versus the US detracted as unexpectedly softer inflation allowed the Bank of Canada to cut rates earlier than expected. Other cross-market strategies fared better, with a UK versus Germany performing well on a dovish sounding Bank of England.
- Outright nominal US duration made a positive contribution.
- In currency markets, an overweight position in the Brazilian real versus the euro detracted.

Portfolio activity

- Overall portfolio strategy remains skewed towards the probability of a 'soft landing' as such, interest rate and inflation risk is kept low on a relative basis.
- We retain exposure to local currency emerging market debt as a means of enhancing the portfolio's yield while, despite some reductions over the quarter, we also still maintain an overweight to US nominal duration.
- We continued to exploit cross-market opportunities in both nominal and in inflation breakevens. We initially held a nominal overweight in the US versus Germany, our view being that the bond market was overly optimistic over the pace of further easing from the ECB, following June's strongly signalled rate cut. We later took profits on this position. Less favourable circumstances prompted us to close an overweight to the US versus Canada, as unexpectedly softer inflation allowed the Bank of Canada to cut rates earlier than expected.
- Dovish policy guidance from the Bank of England (BoE) initially led us to increase the nominal overweight in

the UK versus Germany. Subsequently, we scaled back and then closed this position after the BoE signalled a possible rate cut in August.

- In inflation-linked markets, duration remained close to the benchmark over the quarter. We increased cross-market long positions in the US (Treasury Inflation Protected Securities) versus the UK and Europe. Our view is that US inflation risks are underpriced in TIPS as we expect US growth to continue holding up relatively well in comparison to other developed economies, while inflation is likely to ease only gradually.
- We traded more tactically around US nominal yield curve strategies, given the relatively rangebound nature of the market, reducing exposure to a steepening position in order to manage risk towards the end of the quarter.
- FX risk was kept relatively low over the quarter. At the end of the quarter, the main active currency exposure was an overweight to the Norwegian krone versus the Swedish krona on expectations of a comparatively hawkish Norges Bank.

Outlook/positioning

- The commencement of the rate cutting cycle has been considerably delayed, contrasting sharply with many investors' predictions. Moreover, the pace of rate cuts is likely to be slower and shallower than originally expected. But still, the process has now started and after a difficult couple of years for bond markets it signifies a crucial juncture. Although structural challenges – such as high debt and deficits- remain, the start of a rate cutting cycle is supportive from a real yield perspective.
- Meanwhile, inflation remains in the driving seat and we expect the disinflationary progress to be continually challenged. With goods prices having normalised, the easy wins on bringing inflation back to target are now firmly behind us and present the potential for market-based inflation expectations to adjust. Furthermore, with countries at differing stages of this disinflationary process, there are also relative value opportunities to be exploited.
- This is occurring at a time when the global economic outlook is gradually improving. The US undoubtedly

has led the recovery, but there are now signs of this growth broadening out to other regions, like the Eurozone. It means that a 'soft landing' remains our base case and while we are of course watching for recessionary warning signs - so far, these have been very few and far between.

- In addition to the prevailing macro environment, the heavy election cycle and ongoing geopolitical tensions further underline possible risks. At the time of writing, the likelihood of a hung parliament in France has increased once more, becoming the most probable outcome. With it comes fiscal paralysis, which given budgetary concerns is the most market friendly scenario for now, at least until the budget negotiations commence in Autumn 2024. The US Presidential elections will also add to the increased uncertainty on the investment outlook as the rhetoric between President Biden and former President Trump ramps up. All these factors highlight the benefits of diversifying into global inflation-linked markets.

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	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..

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 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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