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Schroder ISF* Global Inflation-Linked Bond

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

Market overview

- Fixed income markets, including both real yields (inflation adjusted) and fixed coupon bonds, experienced considerable volatility in the last quarter of 2024, primarily driven by geopolitical tensions, central bank decisions, and fluctuating inflation rates. Notably, the period was marked by sell-offs in major government bond markets, particularly in the US & UK, but with inflation-linked bonds outperforming vs. fixed coupon government bonds on higher inflation expectations. The negative outlook for the European economy, and perceived lack of inflation pressure, ensured European inflation-linked bonds performed broadly in line with fixed coupon bonds, both of which sold off as European bond yields were dragged higher by the moves in the US and UK.
- At the start of the quarter the sell-off in US Treasuries and US Treasury Inflation Protected Securities (TIPS) was driven by concerns over potential inflationary policies arising from a possible Republican victory. Inflation figures saw an unexpected uptick, leading to a rise in bond yields as market priced in fewer rate cuts for 2025. By the end of December, the Federal Reserve (Fed) had cut rates for the third consecutive time, bringing the target range to 4.25%–4.5%, but Fed Chair Jerome Powell indicated fewer cuts might follow due to persistent inflation concerns. Despite a slight pull back in fears of inflationary policy mid-quarter, US 10yr Treasury yields experienced a notable rise, finishing the year at 4.57%. Similarly, US 10yr TIPS yields increased sharply over the quarter reaching 2.23%, with inflation breakevens (market based expectations of inflation), which had started rising from a year low of 2.03% in September, continuing to increase to 2.34% (US Fed inflation target is 2%) at year-end indicating market uncertainty regarding the Fed's future actions amidst rising expectations for inflation, if Trump were to implement his economic policies.
- In the UK, the Labour government's first budget at the end of October saw significant reactions in the gilt market. Chancellor of the Exchequer, Rachel Reeves, announced a £40 billion tax increase and concerns over projected borrowing were also rising. Consequently, UK 10yr gilt yields rose, as did UK 10yr inflation-linked bond yields while sterling depreciated against the dollar, reflecting investor anxiety. Meanwhile, the Bank of England (BoE) cut interest rates to 4.75%, although concerns over elevated inflation and wage growth dampened possibilities for further reductions in the near term.
- UK business confidence slipped to a two-year low as companies grappled with a bleak outlook for sales alongside rising costs, particularly an increase in employers' National Insurance contributions announced in the budget, while new staffing regulations have led firms to adopt a cautious approach to hiring. As a result, employment fell in December at the fastest rate since the global financial crisis in 2009, excluding the pandemic period. The flash Purchasing Managers' Index (PMI) survey's price indices signal an uptick in inflation, indicating further pressures on businesses as they navigate these challenging economic conditions.
- At the end of December as eurozone inflation stood at 2.3%, the European Central Bank (ECB) - having already cut rates over the quarter leaving the base rate at 3% at the end of the period - signalled their commitment to gradual rate cuts, amid ongoing uncertainties surrounding economic growth. The service driven rise in Eurozone PMI offset some of the continuing contraction in manufacturing, which is expected to continue given potential US trade tariffs. Eurozone PMI remains below the 50 mark (currently 49.5), suggesting the economy is still contracting, hence German 10-year fixed coupon bonds and European real yields underperformed by a similar magnitude.

Drivers of fund performance

- The fund posted a negative total return and underperformed the benchmark over the quarter.
- In nominal rates, long positions detracted as investors reduced duration risk ahead of the US elections. Subsequently, a long UK gilts vs German bunds position was a drag on returns.
- An overweight in in emerging market nominal duration, focused on Brazil, also detracted.
- Inflation strategies, focused on an overweight in US vs Europe breakevens detracted early in the quarter.
- Credit allocations were additive, notably US agency MBS (mortgage-backed securities) post the elections

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

and exposure to European and sterling investment grade credit.
- In currency markets, a long US dollar positive vs the euro was additive.

Portfolio activity

- Headline nominal duration started the month at +0.49 years versus the benchmark predominantly through Europe, given its weaker growth outlook, and Australia, where we have felt the central bank have consistently been too hawkish given the potential for the labour market to soften. These were held against US Treasuries and were closed ahead of November, reducing active duration, to shield the fund from heighted market uncertainty heading into the US election.
- Nominal duration remained in line with benchmark during November, before we took the opportunity to increase this to nearly 0.4 years overweight by the end of the year after bond markets had sold off earlier in December.
- We added outright European duration as we gained conviction that the deteriorating economic outlook in Europe would drive the ECB to cut rates faster than the market expects. We also introduced an overweight to the US, on the view that the 'no landing' scenario has been overdone and negative economic data could shift the market view. Additionally, we introduced a tactical US Treasury curve steepening trade based on attractive valuations.
- With a clear result from the US elections, we were able to reengage with country trades driven by the relative outlook for global economies, as opposed to pre-election conjecture. The UK remains one of our preferred markets to express nominal duration views. Following the US elections we implemented a long UK vs US nominal duration position as the US is expected to underperform given the inflationary nature of Trump's policies. We had retained conviction in our long UK 10-year gilts vs. Europe position. However, the declining outlook for the Eurozone economy and increasing political uncertainty, notably in France but also in Germany, meant that bunds outperformed gilts. We subsequently closed this position out in December.
- In inflation-linked markets, duration remained in line with the benchmark. We closed a long US TIPS vs Europe position to lock in long-term profits.
- Credit allocation remained broadly unchanged as we continue to prefer European investment grade bonds on relative valuation criteria. We added to our exposure in US agency MBS, with a preference for newer issues.
- In currency markets, we began the quarter with a long position in the Japanese yen against the Swiss franc, a play on diverging central bank policy between a more hawkish Bank of Japan and a relatively dovish Swiss National Bank. This position moved against us in October and was closed out. In November, we introduced a long US dollar positions vs the euro and Chinese renminbi, given the prospect of US trade tariffs weighing on the outlook for trade partners. Subsequently, US dollar strength against the euro reflected the contrasting macro environments between the two economies. In December, given the sharp decline in the Brazilian real, we considered there was scope for a tactical rebound and established a long position versus the dollar through an options strategy.

Outlook/positioning

- While bond markets have had a tough final quarter of 2024, the global macro-economic environment has not fundamentally altered its course in the last few weeks. The key trends as we move into 2025 are towards stronger data in the US, but rather worse business sentiment in Europe and the UK.
- We have noted the recent meaningful signs of improvement in the US manufacturing cycle, and we expect to see further positive survey data points as businesses continue to adjust to a new pro-business and de-regulatory agenda.
- At the same time, disinflation momentum in the US has largely stalled, which argues for a much shallower cutting cycle from the Fed as we move through the new year.
- In addition, the Trump administration's largely pro-inflationary agenda is likely to remain a significant factor. Market movements in December reflected the potential for tariff-related price rises in the global economy, as well as the possible tightening of the US labour market due to immigration restrictions and deportations.
- In practice there have already been some tentative signs that the labour market is tightening again: we observe that US corporate profit growth continues to be positive, historically a constructive signal for jobs. Essentially, the downside risks to the US economy from a weaker labour market appear to be diminishing, which will ease any remaining recession concerns at the Fed.
- Business sentiment has been souring on the other side of the Atlantic, as the Eurozone contends with a combination of cyclical and structural challenges. We have less confidence in seeing much of a rebound here, given that the ominous threat of the US imposing tariffs on imports will weigh on major capital expenditure decisions and could therefore limit any improvements in the European manufacturing sector in coming months. The service sector appears to be losing momentum too: this will help focus the ECB as they consider how the path of interest rates should develop, following their 25bp cut in December.

- Nonetheless, given the depressed current state of global manufacturing, it hard to envisage European manufacturing sentiment becoming much worse, in the absence of a recession. At least with this backdrop any global rebound in manufacturing is likely to remain limited, keeping a lid on commodity price gains, and helping inflationary pressures stay contained.
- Firms in the UK have been demonstrating only limited ability to grow, and survey data continues to be slightly weaker, particularly with reference to the labour market. The October Budget has been a factor here, weighing on UK sentiment with the likely impact of depressing private sector hiring in the near term. But private sector pay growth data came in higher than expected, and price pressures remain robust, giving the UK a lingering inflation challenge and leading the BoE to hold interest rates in December, having cut in November. The BOE is anticipating cuts to progress on a quarterly basis from here. The market, however, has been revising down expectations given the slightly better data. At the start of December, the market expected two full 25bp cuts by next June (i.e. in line with the Bank's "quarterly" expectations) but by the year-end pricing had moved to imply one cut and only a 50% chance of a second.
- We made no changes to the probabilities in our scenario framework during December, with our base case remaining a global 'soft landing' of steady growth and controlled inflation. The risks, however, remain skewed in the direction of a more hawkish, higher interest rate, 'no landing' environment. The stalling of the disinflation process in the US, the release of pent-up demand in the form of business spending now that the US election is out of the way, and the potential policy-driven inflation risks all help justify this probability.
- The imminent arrival of the new US administration is grounds for much uncertainty as we move into 2025. But, as ever, the resulting shifts in economic dynamics impact different areas of the bond markets in different ways, providing us with the opportunities that allow our investment process to generate performance for our clients in fixed income.

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
2024	-3.3	-2.4	-2.0
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

Source: Schroders, net of fees (where applicable), bid-bid, with net income reinvested as at 31 December 2024. 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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