

# Schroder ISF\* Strategic Bond

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## Performance overview

- June was generally a positive month for global bond markets. With only a few exceptions, government bond yields fell over the month as concerns about inflation lessened slightly. US Treasury yields fell across the curve on anticipation that the Federal Reserve (Fed) would still cut rates this year, following a series of generally weaker economic data.
- The latest US Consumer Price Index (CPI) release showed a marked improvement, with the monthly core figure highlighting the slowest increase in seven months. However, the Fed struck a more hawkish tone while keeping interest rates on hold. The accompanying revised forecasts suggested just one cut over the rest of 2024, scaled back from three cuts that were anticipated back in March.
- As anticipated, the European Central Bank (ECB) announced a 25bp cut in the deposit rate - the first since 2019. The accompanying statement and upgrade to inflation forecasts were construed by the market as relatively hawkish. However, the major market-moving event was around political developments in France where government bond yields rose over the month after President Macron's call for a snap election. The first round of voting was dominated by the hard right National Rally (RN). The formation of a left-wing alliance generated greater uncertainty, not only about the outcome of the parliamentary elections, but also concerns about France's already unstable fiscal position.
- A change of government was widely expected when the UK went to the polls on the 4 July and had little impact on markets. On the macro front, May's inflation release showed an encouraging decline in the year-on-year headline figure to 2%. However, some of the details were less favourable, including services inflation, a key metric monitored by the Bank of England (BoE), which came in at a higher-than-expected 5.7%. Despite only two members voting to lower interest rates, the BoE's decision to keep rates unchanged was viewed as relatively dovish, the statement pointing to the decision to remain on hold as being 'finely balanced'.
- While still generating positive returns, the performance of corporates lagged government bonds, with spreads widening on weaker sentiment

due to French political uncertainties. Globally, high yield corporate bonds outperformed investment grade issues, led by the US market.

- In foreign exchange markets, the US dollar outperformed most other major currencies. The Japanese yen was again the notable laggard, with weakness attributable to the wide divergence of interest rates.

## Drivers of fund performance

- The total fund return was positive during June as rates strategies contributed.
- On duration (interest rate risk), long positions in the US and the UK contributed positively.
- Curve steepening strategies, managed on a tactical basis, were additive.
- In inflation-linked markets, a long position in the US versus Europe also contributed.
- Credit positioning detracted, as the fund was exposed to a widening of spreads in the US, and amongst European investment grade corporate bonds.

## Portfolio activity

- From a macroeconomic perspective, we continue to assign a high probability to a 'soft landing'; a gradual weakening of the economy where recession is avoided and inflation pressures ease.
- We continue to hold a long duration position at the headline level, mostly in the US and Europe, where we maintain long credit positions. We also favour local currency emerging market debt (EMD) as a means of enhancing the portfolio's yield.
- Within our rates strategy, on a cross-market basis, we closed an overweight to the US against Canada given a shift in the inflation outlook for the latter. Inflation in Canada has been softer than expected, which allowed the Bank of Canada to cut interest rates last month.
- Elsewhere, we used the dovish market reaction from the BoE's monetary policy committee meeting to close an overweight to the UK versus Germany, while also exiting a curve steepening trade we held in the

UK. The BoE's accompanying statement provided the market with optimism that interest rates could be cut as early as August.

- Asset allocation remained largely unchanged. We retained a preference for European investment grade corporate bonds, while also retaining a substantial exposure to US MBS (mortgage-backed securities) which continue to offer exposure to high quality assets on an attractive yield.
- In the inflation-linked markets, we increased cross-market long positions in the US (Treasury Inflation Protected Securities) versus the UK and the eurozone. 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.
- In currencies, we initiated a long position in the Norwegian krone against the Swedish krona on expectations of a comparatively hawkish Norges Bank.

though the pace of easing is slower than widely anticipated at the beginning of the year.

- There is currently an unusual mix of events threatening to upset the status quo, including the uncertainty around the outcome of the French parliamentary elections. At the time of writing, the likelihood of a hung parliament has increased once more, becoming the most likely outcome. With it comes fiscal paralysis, which given budgetary concerns is the most market friendly scenario for now, at least until the budget negotiations in Autumn 2024. The US Presidential elections will also inject increased uncertainty into the outlook as the rhetoric between President Biden and former President Trump ramps up.

*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.*

## Outlook/positioning

- Our core view is for global growth to remain steady, with recent data showing ongoing resilience in the US and a cyclical pickup across Europe. We are encouraged by the latest signs of disinflation but we expect the path back to central banks' inflation targets will be slow and uneven, with service sector prices in particular remaining sticky.
- Nevertheless, this 'soft landing' outlook is already well-priced across many sectors of the bond market, so we are mindful that valuations are already stretched. This is the case particularly in some segments of the corporate credit market, where credit spreads remain close to historically tight levels.
- The market continues to be driven by evolving expectations over the possible timing of rate cuts. Nevertheless, the start of an easing cycle is an important juncture, both for sentiment and market direction and there are a growing number of central banks that are now cutting interest rates, even

## Calendar year performance (%)\*

Year	Fund (A Acc)	Fund (I Acc)
2023	6.9	8.2
2022	-5.3	-4.2
2021	-0.7	0.6
2020	-1.3	-0.1
2019	7.7	9.0
2018	-3.0	-1.7
2017	1.2	2.5
2016	2.9	4.2
2015	-3.5	-2.3
2014	2.0	3.3

Source: Schroders, Bloomberg, as at 31/12/2023. Performance net of fees (where applicable), NAV to NAV (bid to bid), USD. Fund performance should be assessed against its objective of providing a positive return over a 12-month period in all market conditions.

## 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.
- **Bond Connect risk:** The fund may be investing in the China Interbank Bond Market via the Bond Connect which may involve clearing and settlement, regulatory, operational and counterparty risks.
- **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.
- **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.
- **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.
- **Issuer risk:** The fund is permitted to invest more than 35% of its scheme property in transferable securities and money market instruments issued or guaranteed by an EEA State / governments of the following country: United States of America.
- **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.
- **No capital guarantee risk:** Positive returns are not guaranteed and no form of capital protection applies
- **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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