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Schroder ISF* Strategic Bond

Fund Manager: Julien Houdain, James Ringer, Martin Coucke & Global Unconstrained Fixed Income Team | Fund update: December 2024

Performance overview

– Government bond markets reversed most of the gains achieved in November, with yields rising across the major sovereign markets. In the US, the Federal Reserve (Fed) cut interest rates for a third consecutive time, bringing the target rate to a range of 4.25% to 4.5%. However, the Fed Chair Jerome Powell cautioned fewer cuts were likely next year due to stubbornly high inflation. The US 10-year yield closed the year at 4.57%, which was 36bps higher than end of November and its highest level since April. Markets began pricing in the decreasing likelihood of another cut in January, as well as the anticipation of inflationary policies from the incoming Republican administration threatening to increase the US fiscal deficit.

– As expected, European Central Bank (ECB) cut interest rates in December to 3% from 3.25%. This was the fourth time this year the ECB made the decision to lower its deposit rate, but the market was disappointed as the tone was less dovish than expected. Concerned with the potential for new US tariffs, among other factors, hampering economic growth, some policymakers had been pushing for 50bp rate cut. The ECB lowered its growth forecast for the Eurozone economy to 1.1% in 2025. Government bond yields rose across European markets in December, with the 10-year German bund yield rising by 28bps to close the year at 2.35%.

– The Bank of England (BoE) kept interest rates unchanged in December, and the decision was heavily influenced by sticky inflation, which saw a rise for the second consecutive month to 2.6%. 10-year gilt yields rose 33bps over the month, as market expectations for four 25bp interest rate cuts in 2025 were scaled back to two. The BoE cautioned there was considerable uncertainty as to how the UK economy might respond to higher employment costs, which take effect in April.

– Credit spreads on investment grade debt, as measured over government bonds, tightened marginally during December. US investment grade credit was a notable underperformer in December as inflationary pressures and the incoming economic policies of the Trump administration are leading investors to consider more defensive strategies. A combination of low issuance volumes and strong inflows into European investment grade credit saw the market hold up relatively well. In Europe, corporate hybrids and higher yielding issues outperformed, while spreads tightened further on real estate and insurance sector issues. US high yield bonds also underperformed, in contrast to Europe where high yield bonds returned positive performance in December.

– In currency markets, the US dollar trade weighted index recorded a two-year high in December, after the Fed signalled a more cautious approach to easing monetary policy in 2025.

Drivers of fund performance

– The total fund return was negative during December as positive contributions from credit allocations were offset by the negative impact from rates exposure.

– In major government bond markets, a long position in UK gilts versus the US was additive although this was offset by a long position in gilts versus German bunds.

– In emerging bond markets, exposure to local currency Brazilian government bonds detracted.

– Within the US Treasury market, a curve steepening trade was additive following the release of stronger than expected inflation and labour market data

– Asset allocation, in the form of an overweight position in European investment grade credit, had a positive impact as well as exposure to US agency MBS (mortgage-backed securities).

– In currency markets, the negative impact from a long position in the Brazilian real was largely offset by a long US dollar positions vs the euro.

Portfolio activity

– As December's sell-off in major bond markets became more substantial, we took opportunities to increase the headline duration of the portfolio from 4.22 years at the start of the month to 4.60 years by the turn of the year.

– Mid-month we increased outright European duration, as we gained conviction that the combination of weak growth and potential falls in inflation would lead the ECB to cut interest rates more significantly than the market currently expects. We also increased the long US duration position, despite the strength of the

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

economy. Expectations for Fed interest rate cuts are reined in, and as the 'no landing' scenario (where inflation remains sticky and the Fed has little headroom for further rate cuts) becomes more of a consensus view, the potential for a single - more negative - data point to shift the market's view becomes higher.

- Additionally, in the US Treasury market we introduced a tactical curve steepening trade based on attractive valuations.
- On cross-market trades, we began the month with long positions in the UK, versus US Treasuries and German bunds. Our broad conviction in major government markets has been that gilts are most attractive, given how the UK budget has elevated downside risks to the corporate employment outlook. On the other hand US Treasuries, given the continued strength of the US economy, are much less attractive, with Europe somewhere in between. As the gilts versus bunds trade was less successful, we closed this position out mid-month.
- In previous months, exposure to Brazilian local currency government bonds had performed well against a backdrop of attractive yields and controlled inflation. However, in recent weeks the government has failed to meet market expectations in terms of spending cuts, exacerbating concerns over the country's fiscal deficit. After investor confidence declined rapidly in early December, we halved the existing position in Brazil and hedged the remainder using CDS indices.
- Given a rapid decline in the Brazilian real into December we considered there was scope for a tactical rebound in the currency and established a long position through an options strategy. However, this detracted as investors became more concerned about fiscal developments. We maintained a long US dollar versus euro position, through the options market reflecting the contrasting macro environments between the two economies.

Outlook/positioning

- While bond markets have had a challenging 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, in contrast to deteriorating 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 as corporations 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 indicates a much shallower cutting cycle from the Fed is likely as we progress through 2025.
- Additionally, the new 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. 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 deteriorating on the other side of the Atlantic, as the Eurozone contends with a combination of cyclical and structural challenges. We have less confidence in prospects for 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 over the coming months. The service sector also appears to be losing momentum, and this will be pivotal for the ECB in considering how the path of interest rates should develop, following the most recent 25bp cut in December.
- Nevertheless, given the depressed current state of global manufacturing, it is difficult to envisage European manufacturing sentiment deteriorating much more, aside from the onset of a recession. 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.
- UK economic indicators continue to be slightly weaker, particularly with reference to the labour market. The October Budget has weighed on UK sentiment with the likely impact of depressing private sector hiring in the near term. But private sector earnings growth 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 stickiness of inflation. 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 imminent policy-driven inflation risks all help justify this scenario.

– 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 in global 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)
2024	5.0	6.3
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

Source: Schroders, Bloomberg, as at 31/12/2024. 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.

Important information