

Please note that the commentary is for the retail class of the fund.

The fourth quarter of 2018 proved to be a volatile one as riskier asset classes finally succumbed to concerns surrounding global growth and tightening financial conditions. Government bond yields produced strong returns as investors lowered their expectations for future rate hikes amid a flight to safety. Corporate bonds and the high-yield market in particular were hard hit, registering the weakest quarter of returns versus underlying government bonds since the third quarter of 2011 as major equity markets fell a little over 10% and oil prices slumped. Perhaps surprisingly, emerging markets held up well and outperformed developed markets, although this was after a period of weakness mid-year. On a broad trade-weighted measure, the US dollar was modestly higher. For 2018 as a whole, fewer than 10% of asset classes produced a return above three-month US Libor (cash) - amongst the lowest result on record. The fund returned -0.6% for the quarter and -0.5% over the last 12 months, against a benchmark return of 0.7% and 2.6% over the same periods.

The quarter was characterised by a significant reversal in investors' risk appetite. This was perhaps most evident in the US, where until recently the economy and equity markets had been outperforming other regions. The reversal in sentiment is difficult to attribute to any one dynamic, but rather a combination of factors, many of which incidentally have been present for some time. As widely observed, the current US economic expansion (now over nine years) is bordering on the longest in history and naturally investors have become wary of when the eventual downturn will transpire. US President Donald Trump's tax cuts gave extra life to the current expansion, but more recently his combative nature raises the prospect of bringing a premature end to the cycle.

The ratcheting up of trade tensions with China comes at a time when China is already faced with a slowing economy (reducing imports), which makes ceding to the US's desire for a smaller trade deficit challenging. China has pledged to cut tariffs, buy more US goods and services and open up its economy to foreign firms and capital. The US has suspended tariff increases on \$200 billion of Chinese imports until March; however, a full deal is yet to emerge. Apple's recent lower earnings guidance not only reflects concerns about slower growth in China but also concerns surrounding possible tariffs. It is also synonymous with events elsewhere, as globally earnings per share (EPS) downgrades rose across all sectors. Not surprisingly, earnings downgrades have weighed on equity markets. In the US, where President Trump took credit for a previously robust market, he has sought out a scapegoat in the form of the chair of the Federal Reserve (Fed), Jerome Powell. Such public criticism of the Fed's recent increases in interest rates has potentially serious consequences for its perceived independence and credibility.

It would be wrong not to acknowledge some slowing in the underlying economic data. After all, manufacturing purchasing manager indices in most regions around the world have been slowing for some time now. However, within the US, labour markets remain tight and upward pressures on wages should continue to support consumer spending (which constitutes 70% of GDP). The Fed raised official rates by a further 25 basis points (bps) in December (Fed Funds rate upper bound now 2.50%) but the median forecast for future hikes fell to two from three in 2019, and for one hike in 2020 while projections for growth, inflation and unemployment were broadly unchanged from September's projections. Subsequently, the minutes of the meeting reveal a greater sensitivity to the global environment and financial markets, with little suggestion that there is a long way to go in the tightening cycle. After a brief pause, we expect a further rise in the Fed Funds rate and remain more hawkish than current market valuations, which now price no rise for 2019 and a 50% chance of a cut for 2020. In addition to further movement in short rates, we expect longer-dated yields to move higher as safe-haven flows moderate and more adverse supply dynamics weigh on the market. The bid-to-cover ratio at US auctions has been declining and the net issuance of US Treasuries is estimated to be close to \$1.25 trillion in 2019 at a time when rising hedging costs now make US Treasuries less attractive for overseas buyers and the Federal Reserve is tapering its balance sheet. The general public will be reminded of the level of US indebtedness when the latest debt ceiling legislation expires on the 1st of March. We would expect the US 10-year bond yield (that peaked at 3.25% in the fourth quarter before falling sharply to close the year at 2.68%) to climb back above 3%. After adding slightly to duration in the prior quarter, the fund has steadily reduced duration as rate expectations have been scaled back. The fund's interest rate duration fell from 1.1 years at the end September 2018 to 0.74 years at the year-end. The recent fall in US yields was aided by a sharp fall in the oil price (down 37% during the quarter), which helped breakeven rates of inflation to fall sharply (at the 10-year point they fell from 2.15% at the end of September 2018 to 1.71% at the year-end). We would expect that a stabilisation of the oil price will see breakeven rates widen again and have switched some of our fixed-rate exposure into inflation-linked debt, where real yields (10-year closed the year at 0.97%) were little changed over the quarter.

From an economic perspective, the slowdown in the eurozone has been more abrupt, with Germany slowing particularly acutely (albeit from very strong levels). This slowdown is testament to the uncertainty surrounding global trade and the slowing of the Chinese economy. A disorderly Brexit will also be very disruptive for Europe, despite politicians' insistence otherwise. Politics too are in a period of flux, with both Angela Merkel and Emmanuel Macron's influence on the wane as their popularity falls. Populist politics are now increasingly mainstream and this year's European Parliamentary elections in May raises the prospect that anti-EU factions could muster sufficient votes to disrupt legislative business. Italy's recently elected populist government is already siding with the 'Yellow Vest' protestors in France and only recently averted EU sanctions after a compromise to its budget deal. There was little change in the European Central Bank's (ECB) policies during the quarter and that means the cessation of net monthly asset purchases. The ECB will however continue to reinvest redeeming bonds, which average around €18 billion a month during 2019. The ECB may also opt to redeploy these proceeds into longer-dated securities to maximise the duration impact (similar to Operation Twist). In the event of weakness in the banking market, we expect a reappearance of the LTRO (Long-Term Refinancing Operation) programme that proved its worth in the 2011 eurozone crisis. The likelihood of no movement in policy rates seems higher now in the eurozone than in the US. The fund bought some Italian government bonds during the quarter, but has since sold them after the yield spread over German government bonds tightened.

In the United Kingdom (UK), the countdown to Brexit is somewhat reminiscent of the Doomsday Clock. After negotiating a deal with the European Union (EU), Prime Minister Theresa May now has to get the proposed deal through the UK parliament. As it currently stands, this looks unlikely to happen, which gives rise to many potential political permutations. In essence, it boils down to a no deal exit from the EU as early as March, or the prospect of a second referendum as politicians go back to the electorate. The pretence of ingrained positions ahead of key parliamentary actions makes the situation more difficult to read. Some corporate valuations appear very attractive, should the economic climate be anything other than apocalyptic.

Corporate bonds suffered one of their worst quarters in recent years as spreads widened substantially in the face of rising concerns around global growth, earnings downgrades and less support from central banks asset purchases. The flattening of yield curves has also led to the underperformance of financial equities, with the poor sentiment pressuring spreads, particularly subordinate deals. Credit curves widened and also steepened over the quarter, with lower-rated debt suffering the most. Overall, US investment-grade credit was flat over the quarter but this masked a 3% underperformance versus US government bonds of the same maturity. For 2018 as a whole, US investment-grade credit underperformed by 2.8% and only outperformed in the third quarter. US high-yield debt fared worse, falling 4.6% in price during the quarter - a 7% underperformance relative to government bonds.

The fund continued to take advantage of movements in the euro cross-currency basis to purchase a number of short-dated euro-denominated holdings, which when hedged offered an attractive pickup versus US equivalent positions. As the sell-off in the market continued, the fund looked to lengthen its credit positions as the term premium improved markedly. With US rate expectations collapsing and intermediate swap spreads narrowing, the fund has been able to secure floating-rate debt at similar spreads to fixed-rate instruments. We consider this to be very attractive and have been adding to high-quality names in the three to five-year portion of the curve. The fund added to its holding in Nepi on market weakness; sadly a little too early as a short seller's report subsequently emerged, although this has received significant rebuttal from the company and other investors. The fund reduced some of its exposure in Intu convertibles after they rallied on a prospective bid from Brookfield. Unfortunately this offer did not materialise and our remaining bonds retraced their gains. At the end of 2018, the fund bought small positions in SEB, Swedbank and Credit Suisse Tier 1 deals after significant weakness in the sector.

The setback in credit means valuations are more attractive, but only in the context of the last few years. The unwinding of central bank asset purchase programmes is significant and the effects may have further to run. The return of high volatility is likely to persist and valuations needs to reflect this. While fears of a global slowdown may prove overdone, corporate profitability may prove more susceptible to a downturn as financial conditions tighten, and wage pressures rise. The rise in populism also represents a challenge to big business as does increased regulation.

The FTSE EPRA NAREIT developed market property index fell 5.5% in US dollars during the quarter. The UK, Europe and the US were the weakest regions, with retail-orientated holdings under continued pressure. Sears and HMV are but two established operators who have fallen victim to the pressures brought about by the challenges of e-commerce, or too much debt. While the best mall operators should be able to repurpose the void space, the challenge for second tier malls is more challenging. The fund sold out of its US holdings (Simon Property Group, Macerich and Taubman) during the quarter and increased exposure to European names (Unibail and Klepierre). The fund also increased its exposure to Hammerson and sold its holding of Capital & Counties in the UK. The fund's exposure to property shares fell from 3.2% at the end of September to 2.4% at the year-end. The fund also has exposure to property via its holdings of Intu, Redefine and Cromwell convertibles.

The US dollar (as measured by the Fed's broad trade-weighted index) strengthened by a further 2% over the quarter, but this index has a lower weighting to the Japanese yen and a higher allocation to the Chinese renminbi and Mexican peso than some other indices. When compared to the euro, the US dollar strength has been more muted and positioning and sentiment has begun to diminish as US rate expectations have been scaled back. While the US dollar's strength may feel stretched, its growth remains more robust than in other regions. A resolution of the trade dispute with China should also boost sentiment and, with it, the US dollar.

The interest rate duration of the fund is now relatively short at 0.74 years, with around 0.3 years attributable to inflation-linked securities, reflecting our view that future US rate expectations are too dovish and breakeven rates will rise. Asset classes such as corporate credit are more attractive but longer-dated instruments are not at levels one could consider to be obviously cheap, and the fund's focus remains on those of 5 years or less to maturity. We expect volatility to remain elevated as central bank asset purchases worldwide turn negative in early 2019 and resulting risk premiums should be higher than the market demanded in early 2018.

Portfolio managers
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