

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

Government bond yields in core developed markets rose during the quarter, leading to negative returns for all but the shortest government bonds. Corporate bonds fared better outperforming government bonds, having underperformed in the previous six months. High-yield bonds continued to be among the best performing assets. The US Federal Reserve raised rates again in September against a backdrop of solid economic data. The US dollar continued to strengthen, albeit at a slower pace. The fund returned 0.5% for the quarter and 1.4% over the last 12 months, against a benchmark return of 0.7% and 2.3% over the same period.

The economic backdrop over the last three months has been dominated by trade tensions arising from the US decision to impose widespread tariffs on Chinese goods. Closer to home, the US reached a revised North American Free Trade Agreement (NAFTA) deal with Mexico and Canada. Within Europe, the new populist government of Italy has reignited debt sustainability concerns by adopting a new expansionary budget. The UK and Europe remain at a stalemate over Brexit negotiations with the odds of a hard Brexit increasing significantly. Within emerging markets, the sharp selloff in Argentina and Turkey caused investors to flee other emerging markets before some stability re-emerged in September.

The US Federal Reserve raised official rates by a further 25 bps (Fed Fund rate upper bound now 2.3%) and has signalled it intends to do the same at its December policy meeting. Despite removing the word 'accommodative' from its statement, the Federal Reserve's latest 'Dot Plot' continues to project rates rising well above those implied by the market beyond 2019, and with data continuing to be robust, the market remains vulnerable to a shift to higher rate expectations. Fed chairman Jay Powell, who has made numerous hawkish comments recently, referred to the US economy as 'remarkably positive'. The release of Fed members' "Dot Plot" projections for 2021 as unchanged over 2020 suggests the Fed doesn't see the economy rolling over in 2020 as many market participants anticipate.

The US curve bear flattened during the quarter as short yields rose faster than longer-dated issues. US five-year bond yields started the quarter at 2.7% and traded in a tight range for most of the period before moving higher in September, ending the quarter at 3.0%. Somewhat surprisingly, break-even rates of inflation remained anchored around the 2% level despite higher rates and rising oil prices. The upshot has been that real yields have risen by around 25 bps, with five-year real yields now at their highest levels since 2009 (0.9%), the fund added slightly to its break-even trades. Shorter-dated US government bonds also continued to cheapen versus swaps, with the 3-Month Libor spread falling from 40 bps at the end of June to 19 bps at the end of September. The combination of rising yields and a relative cheapening vs swaps makes US Treasury bills look relatively attractive and we see value in shorter-dated government bonds out to around 18 months in maturity. The fund has shifted its exposure to reflect this.

An increasing headwind for US Treasuries going forward is the rise in hedging costs for foreign investors. European and Japanese investors now receive 50 bps more for a German 10-year bond than a US 10-year bond after forex hedging costs. When coupled with a reduction of asset purchases by the European Central Bank, money should begin to flow out of the US and back to Europe, reversing the trend of recent years.

European markets remain dominated by politics. In Germany, Angela Merkel's coalition government faces internal strife or challenges from the far right AfD party, while in Italy, the new Eurosceptic populist coalition government is proposing a draft budget for 2019 that would increase the annual deficit threefold to 2.4% of GDP. With existing debt to GDP of 133% the proposals are likely to be deemed non-compliant with EU fiscal rules when the final proposals are submitted to the European Commission in mid-October. Not surprisingly, Italian bonds have underperformed significantly, with the 10-year spread to German bonds widening to 300 bps. There was little new news from the European Central Bank (ECB); as previously announced new asset purchases will be reduced to €15 billion a month from October before ceasing at the year-end, while reinvestments of maturing proceeds will continue for the immediate future.

In the UK, the clock is running down for Brexit negotiations, with the government's 'Chequers plan' meeting with stiff opposition from European negotiators and UK parliamentarians alike. With no other real initiatives on the table, the chances of a 'no deal' Brexit have risen significantly. Prime Minister Theresa May's bargaining position is further complicated by her coalition party, the Democratic Unionist Party's stance on the Irish border and the threat posed by the opposition party – Labour – which is focused on forcing a general election.

US corporate bonds outperformed government bonds during the quarter (by 1.7%), resulting in an excess return from corporate bonds which, year to date, are now broadly

flat. European investment grade spreads remained soft with corporates broadly matching the returns from government bonds but still underperforming (by 0.8%) year to date. After several years of trading tighter, European and US spreads are now more closely aligned as European spreads begin to factor in reduced support from the European Central Bank's asset purchase programme. High-yield markets continued to outperform investment grade securities, with US markets particularly strong - up 2.4% in the third quarter versus 1.7% for the European high-yield markets.

Having pulled back from the high-yield market in the first quarter, the fund rebuilt positions in shorter-dated US denominated bonds (particularly financials) in the second quarter. These positions subsequently rallied strongly, particularly those maturing within the next two years. The fund has exited many of these positions, choosing to switch slightly longer given a steepening credit curve and rebuild its exposure to cheaper government bonds. For most of the last 18 months, European denominated corporate bonds have been expensive to comparative US bonds, though this has begun to change recently as European spreads have widened as the ECB scales back its asset purchase programme. Towards the end of September, the cross-currency basis also moved significantly (mostly for technical year-end reasons), allowing investors to buy European assets (and a few other currencies too) and swap them back into US dollars at attractive levels. The fund has therefore begun to buy more non-US denominated assets and lock in more attractive returns.

The FTSE EPRA/NAREIT Developed Total Return Index weakened in September as bond yields rose for the quarter; the index fell 0.2% in US dollars. The weakest region over the quarter was the UK - down around 5.2% in local currency and 6.4% in US dollars. The fund increased its exposure to European shopping centres via Unibail and Klépierre and reduced its exposure to US malls by reducing the exposure to Simon Property Group, while our holding in GGP was acquired by Brookfield. The fund sold its German residential exposure (Vonovia, LEG and Deutsche Wohnen) after a strong run; we believe rising bond yields may present a better buying opportunity. The fund remains active in property convertibles, switching its INTU 2018 exposure longer into 2022 and adding to our position in Redefine convertibles. Brexit concerns continue to overhang the UK market and while a 'no deal' outcome would prove very disruptive initially, valuations arguably now price in bad news. The fund's current exposure to property is around 3%.

Within foreign exchange markets, the US dollar continued to strengthen, and the Fed's broad trade-weighted index was up 1.3% during the quarter. The Mexican peso and Canadian dollar were two of the better performing currencies after the conclusion of NAFTA talks. Emerging market forex continued to struggle as negative sentiment spilled over from Argentina (down over 30%) and Turkey (down over 20%). Several emerging markets (such as India and Indonesia) have resorted to higher interest rates and import reduction measures to try to arrest the weakness in their currencies. China, whose economy continues to cool, faces a dilemma; a weaker currency helps exports at the margin but also raises the prospect of further capital flight and being labelled a currency manipulator by the US. For now, it appears China is once again selling dollars to stem the currency weakness (which may push up US Treasury yields) and is resorting to cutting bank reserve ratios to alleviate liquidity conditions domestically. While US growth appears to be outpacing other regions, the US dollar will remain well supported. But after a strong run from US assets, increasing hedging costs and heavy positioning, US external funding needs should begin to weigh on the US dollar and provide emerging markets with some relief.

The interest rate duration of the fund is around 1.1 years, marginally longer than at the end of June, as short rates have increased. We continue to view longer-dated government bonds as vulnerable to hawkish Fed rhetoric and reduced support from overseas buyers. Within credit markets, we see the best risk reward in intermediate maturities but remain cautious with non-US credit now an alternative source of value. The credit duration of the fund is around 1.6 years currently, similar to the level at the end of June. The redemption yield on the fund at the end of September was around 0.4% higher than in June at 3.8% versus 3 Month US Libor of 2.4%. Investors should be cognisant that central banks are still in the early stages of removing unparalleled financial support; we believe this necessitates a continued cautious stance.

Portfolio managers
Mark le Roux, Stephen Peirce, Nishan Maharaj and Seamus Vasey
as at 30 September 2018