Please note that the commentary is for the US dollar retail class of the fund. The feeder fund is 100% invested in the underlying US dollar fund. However, given small valuation, trading and translation differences for the two funds, investors should expect differences in returns in the short term. Over the long term, we aim to achieve the same outcome in US dollar terms for both funds.

The US-China trade negotiations remained a dominate factor in markets during the fourth quarter. Optimism that a preliminary deal could be struck led bond yields to rise modestly and trade within a relatively narrow range. Risk-based assets performed strongly as the downdraft in economic data appeared to be abating, a 'no deal' Brexit was averted, and central banks once again demonstrated their willingness to maintain accommodative polices. Corporate bonds enjoyed another strong quarter of outperformance. In stark contrast to 2018, when most asset classes lost value, the calendar year of 2019 saw all major asset classes produce positive returns when measured in their respective currencies. The fund returned 1.0% during the fourth quarter and 4.7% during 2019, against a benchmark return of 0.5 % and 2.6% respectively.

The US Federal Reserve (Fed) delivered a third consecutive 0.25% cut in its policy rate (Fed Fund's rate upper bound is now 1.75%) at its policy meeting in late October. Aside from recessions, the Fed has never cut more than three times. The current moves have been portrayed as a mid-cycle adjustment and the Fed is now seen as likely to hold rates for some time, replacing the pledge in its statement to "act as appropriate" with more neutral guidance. Chairman Powell noted policy was now in a good place barring a "material reassessment" of the outlook. While the bar to further rate reductions is now high and would require a deterioration in consumer activity, the bar to raising rates appears equally high. The link between the unemployment rate and inflation would appear to have become substantially weaker, and the suggestion that the inflation target should be seen as a policy midpoint rather than a ceiling means the Fed will be less inclined in the short term to react to inflation marginally above its target. Against this backdrop, it's not surprising that the US ten-year bond yield traded in a tight range (and even more so when looking at the real rates of US inflation-linked bonds) during the quarter, ending the year at 1.92%. The unwind of early October's lows (1.53%), coupled with lower short rates, saw the slope of the yield curve once again in positive territory, (suggesting a lower recessionary probability) although it remains extremely flat out to five-year maturities. Within US inflation-linked markets, wider break-even rates of inflation (10-year breakeven widened from a low in early October of 1.53% to 1.92% at the year-end) accounted for most of the move higher in nominal yields another indicator consistent with diminishing expectations of a recession.

The Fed's Dot Plot for 2020 and 2021 (which was shifted lower with every update during 2019), now projects unchanged rates in 2020 and one increase in 2021. At the year end, market pricing was still consistent, with a 70% chance of one further cut in 2020, with markets having priced out around half a cut for 2020 and 2021 during the final quarter. With rate expectations now largely on hold, the Treasury Bill curve was essentially flat out to one year (yields of around 1.5%) and appeared relatively expensive versus alternative assets.

The real drama during the quarter has been taking place in the US repo market, where liquidity dried up as the large US banks pulled back (mostly due to regulatory capital considerations in the run-up to the year-end, but also due to an outflow of cash for tax payments), prompting overnight rates to briefly touch 10%. The Fed was caught on the back foot and had to respond by offering term repo facilities ($255 billion at the year-end), as well as buy US Treasury Bills (announced in mid Oct, $169 billion held at the year-end) to create liquidity. The Fed rejects the notion that this amounts to another round of quantitative easing, citing financial "plumbing issues" within the market, but it is another instance in which central bank activities are now a swing factor within markets. The first days of 2020 have seen renewed demand for liquidity, and the Fed expects this to drop off during January. If not, rates pressure will again emerge. From the fund's perspective, the biggest impact of the repo market disruption was via cross currency swaps. The demand for US dollars in the banking system allowed the fund to purchase non-US denominated assets (principally in yen, sterling and euros), and hedge them back into US dollars in the future, thus getting paid for lending dollars in the near term.

With quantitative easing of €20 billion a month currently back in operation and unlikely to end until just before rates rise, policy also looks set to remain unchanged for the foreseeable future within Europe. However, Christine Lagarde, the recently appointed European Central Bank (ECB) president, has announced a strategic review of the ECB's mandate. While other central banks are also in the middle of such exercises (US and Canada, with the UK set to follow), the ECB's last introspection was 16 years ago. The current inflation target of "below but close to 2%" is likely to become more definitive, but other issues including climate change and inequality are also likely to be addressed. With interest rates already in negative territory and the Eurozone stuck in a low growth, low inflation predicament any policy change is arguably more significant. Despite reservations from some Eurozone members, we believe a more expansive fiscal policy is necessary from core members such as Germany. Should this transpire, bond yields and the euro would likely rise. The ECB renewed quantitative easing (QE) programme and low government rates mean many corporate spreads have once again tightened to levels that look relatively unattractive.

Political horse-trading in the UK saw the minority Conservative government accept a delay to the UK exit from the EU, which boosted sentiment in international markets and saw Sterling rise nearly 8% against the US dollar - the best return of any G10 currency during the quarter. Subsequent to a negotiated delay, an election took place in which Boris Johnson secured a surprisingly large majority. This effectively sealed the UK decision to leave the EU, which is now expected to happen on the 31 January. While both the UK government and the EU discuss a more constructive period of negotiations, it remains to be seen if Johnson will stick to his decision to rule out any extension to the transition period, in effect imposing an end-of-year deadline for a free trade deal, something that looks overly ambitious and will again raise the spectre of a 'No Deal Brexit'. Another contentious issue will be the UK's insistence on its ability to diverge from EU rules and standards while still seeking preferential access to the single market. Despite the uncertain economic backdrop and pledge to balance the current (day-to-day) budget, March's budget is likely to see tens of billions of pounds allocated to infrastructure (capital) spending. Despite the Brexit issues, the rejection of the Labour Party's anti-business policies in the recent election is a position for several sectors of the UK economy and greatly reduces the credit risk associated with many issuers.

Better news on trade, low volatility and easing from numerous central banks boosted the appeal of emerging market debt. Emerging markets (EM) posted another quarter of solid returns, both in local currency terms and a reversal of the weakness in foreign exchange markets during the third quarter helped local EM bonds post much stronger returns when measured in US dollars. In the dollar market, the spread on hard currency EM debt index fell from 337 basis points (bps) to 277 bps.

Corporate bonds produced robust returns during the quarter, outperforming government bonds for the fourth consecutive quarter and by the largest annual margin (6.5% in US investment grade) since 2012. In the last 20 years, total returns on corporate bonds were only higher in 2009. The outperformance was broad-based, with longer-dated and lower-rated sectors of the market producing the best returns, with the only exception being the very weakest sector (CCC-rated) of the sub-investment grade universe, a sign perhaps that exuberance does know some bounds. Total issuance within US investment-grade was $1.17 trillion during 2019, 1.4% lower than in 2018, but within sub-investment grade, it was 57% higher, at $315 billion. The fund's overall exposure to credit reduced during the quarter as new investments were concentrated within shorter maturities, the credit quality of our holdings has also become more concentrated within much higher more liquid instruments as the yield sacrifice associated with these positions has narrowed. The fund continues to hold credit protection via options linked to the spread on the US investment-grade index to limit downside in the event of spread widening.

Property stocks returned 2% for the quarter, bringing the annual return to a very healthy 23%. European and UK REITs were notable outperformers, with US dollar returns boosted by euro and pound strength in the quarter. For Europe, a 6% local currency return translated to 9% in US dollars. For UK REITs, a 12% Sterling return translated to over 20% in US dollars as the pound rallied following Boris Johnson's comprehensive election victory. The US, Japan and Hong Kong were marginal underperformers. The fund's exposure to listed property was relatively stable, at around 2.4% of fund. The fund's holding in Land Securities was sold and our holding of Klepierre was reduced after a strong recovery in recent months. A small holding in Redefine properties was initiated. Our exposure to property was also reduced via the sale of Cromwell convertibles and a reduction in our exposure to Intu convertibles. Our holding of Unite debt was also bought back. Elsewhere, German residential stocks recovered slightly, benefiting our holding of Deutsche Wohnen, but our mall operators continue to face a tough retail backdrop.

The US dollar strength finally began to wane and, barring the yen (which tends to weaken when risk subsides), was weaker across all major currencies during the quarter. The Fed's broad trade-weighted dollar index was lower by 2.6%. US growth, both real and nominal, remains higher than other developed regions and the outperformance of US stocks has also underpinned the US dollar. The slowdown in global trade and manufacturing activity has been more acute outside of the more insular US, which is why an improvement in sentiment saw the US dollar underperform. While volatility has fallen across asset classes as investors anticipate the persistence of current conditions, we believe tail risks are higher than expected. The recent events in the Middle East are a good example of surprises that are not on investors' usual radar. Two other scenarios include a setback in asset prices after a strong run, which would likely benefit funding currencies such as the yen as well as a pivot towards a more expansive fiscal policy in Europe, which would likely boost the euro. The fund took advantage of the historically low levels of implied volatility to purchase currency options on the yen and euro that will benefit from strength in the currencies or higher volatility.

The fund's exposure to any one particular risk remains low, interest rate sensitivity is particularly low and credit duration has shortened. The fund's exposure to property is modest and it holds a small amount of inflation-linked assets too. Our bias towards shorter, highly liquid instruments means the fund can respond quickly to opportunities that may arise. Overall, the low level of volatility feels at odds with the current level of uncertainty surrounding trade, geopolitics and asset prices, and this makes option-based strategies worthy of consideration. It also leads us to be cautious on risk-based assets, despite the lack of defensive alternatives. After strong returns across all asset classes in 2019, 2020 promises to be more challenging.

Portfolio managers
Stephen Peirce, Nishan Maharaj and Seamus Vasey
as at 31 December 2019