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

Developed market interest rates remain low and look set to remain so for an extended period, with most developed economies likely to inject further fiscal stimulus into their economies. Low absolute rates and negative real rates continue to push investors into high beta asset classes, resulting in another quarter of good returns. Most gains were front-loaded as economic activity recovered, but a growing wave of second-round Covid-19 infections weighed on sentiment during September. Corporate bonds outperformed government bonds, with high yield outperforming investment grade. Within emerging markets, performance were mixed and the performance of local currency assets lagged other riskier asset classes. Within foreign exchange markets, the US dollar weakened as economic activity globally improved. The retail class of the Fund returned 0.61% during the third quarter and 0.9% over the previous 12 months against a benchmark return of 0.1% and 1.2% respectively.

US treasuries continued to trade within a tight range during the quarter, as the Federal Open Market Committee (FOMC) update their forward guidance that the Fed Funds lower bound would likely remain at zero until 2023. The size and composition of the quantitative easing programme remains unchanged ($120bn a month, of which $80bn is UST and $40bn MBS), with Fed Chairman Jerome Powell noting that the committee has a lot more ammunition, if needed. The Fed's current balance sheet is broadly unchanged versus the end of June at just over $7tn, with a $300bn rise in asset purchases offset by an unwinding of central bank liquidity swaps. While GDP forecasts for 2020 were revised up from -6.5% in June to -3.7% in September, future expectation were revised lower (2021 to 4% from 5%, 2022 to 3% from 2.5% and 2023 expected to be 2.5%). Unsurprisingly, updated unemployment forecast reflected a similar pattern, with fourth-quarter unemployment of 7.6% expected vs 9.3% previously. The Fed's expectations for inflation only converges with their target at the end of 2023, given the recent messaging that inflation will be allowed to 'run hot' as they pursue an average inflation target of 2%. This implies that the Fed Funds rate may well be on hold beyond 2023, and the market has currently only priced in 10 basis points (bps) of hikes by the end of 2024. When asked about the possible impact of unchanged rates on financial market stability, Powell indicated that regulation and supervision were the first line of defense, and noted that a long period of zero rates and balance sheet expansion in the wake of the Global Financial Crisis did not trigger stability risks.

The US national debt is now above $27tn (up $7tn during Trump's presidency), equal to 138% of GDP, while the official Federal debt (which excludes Federal trust funds), is forecast by the Congressional Budget Office (CBO) to be a mere 98% of GDP by the end of 2020 - a figure only exceeded in the two years shortly after WWII. With the CBO expecting a deficit of 16% of GDP in 2020, which equates to around $3tn, the funding of the US government is becoming an increasingly hot topic. This has prompted talk of whether the Fed may need to adopt a yield curve control policy at some point in the future to prevent an aggressive steepening in the yield curve.

In the near-term, another stimulus package is seen as necessary to cushion the blow from previous initiatives, such as the payroll relief programme, which have begun to roll off. With a looming US election, negotiations surrounding the scale ($1.5-$2tn in magnitude) and make up of such a programme appear to have reached a stalemate, with Fed representatives becoming increasingly vocal on the need for action. A piecemeal deal now seems more likely, with further action potentially delayed until a new administration is inaugurated in January.

In recent weeks, the perception has been that Biden's stronger polling makes a Democratic victory increasingly likely and a contested election less likely, with the chances of a 'blue wave' (Democratic control of the house and senate) rising. However, the 2016 election, where Clinton won the popular vote but not the electoral college, as well as the Gore/Bush recount of Florida in 2000, make investors understandably cautious of backing perceptions with actions and helps explain why option premiums within riskier asset classes over the election period are so high. The common narrative is that a Biden presidency would see an expansionary budget (although a more redistributive package could emerge, as was the case post Clinton's election in 1992), which would likely push up bond yields. US ten-year bond yields traded within a tight band of 0.6% to 0.7% for the majority for the quarter, with bond volatility declining to historic lows at the end of September. The Fund's exposure to US rates remains relatively low from a duration perspective and the Fund took advantage of cheap levels of volatility to add options on US Treasury yields that benefit from rising yields.

The Fed's move to target average inflation alongside its extended guidance and expectations of more fiscal stimulus boosted breakeven rates of inflation by around 30bps (10-year up from 1.3% to 1.6%, down from a high of 1.8% at the end of August) during the quarter. With nominal yields relatively stable, the rise in break-evens translated into more negative real yields, with US 5-year real yields falling from -0.9% to -1.2%. The Fund continues to hold around 6% of its assets in US inflation-protected securities, with the bulk of this in the 3-7-year area.

Within Europe, the decision in July of European Union (EU) member states to run a federal deficit (via the €750bn recovery fund) in response to an economic crisis represented a step forward in European integration. It was also supportive of the euro and peripheral bonds, where the Italian ten-year fell below a 1% yield. The fallout from Covid-19 has also brought about a more flexible attitude to state aid within the banking sector and the European Central Bank (ECB) endorsing bank consolidation. A second wave of Covid-19 infections means the European growth rebound has lost momentum and, with European inflation once again languishing, the ECB is expected to increase stimulus at its December meeting by boosting its €1.35 trillion bond-buying programme (last expanded in June by €600bn). By mid-2021, the ECB is likely to hold around a third of the bonds eligible under the Corporate Sector Purchase Programme compared to only around 1% of the US investment-grade market held by the Federal Reserve. This should be supportive of the market in the medium-term. The Fund increased its holdings of European-denominated credit in the sub 5-year part of the curve during the quarter to take advantage of spreads that were deemed relatively more attractive than those in the US.

Despite the late hour, a Brexit deal remains to be done if the political will exists for compromise on both sides. Prime Minister Boris Johnson's recent leadership strategy on Covid-19 has come in for considerable criticism. Given that a no-deal scenario would significantly compound the economic damage of Covid-19, a compromise deal with the EU may be politically preferable, despite concerns surrounding sovereignty. Ultimately, issues over maintaining regulatory equivalence, state aid, fisheries and the Northern Ireland border still require a framework under which differences can be resolved. Brexit aside, the UK still faces huge economic challenges (a GDP contraction of close to 10%), with the second Covid-19 wave resulting in renewed shutdowns. With official rates in the UK of 0.1%, the Bank of England (BOE) now finds itself discussing the potential of negative rates. Given the ever-expanding issuance needs of the UK government and the BOE reluctance to embrace negative rates, an expansion of £745bn quantitative easing looks more likely in the first instance. Around 15% of the Fund's exposure has ties to the UK, although many operate globally. All of our exposure is short-dated and only 1% is subordinated. The most impacted from a hard Brexit would be the banks, which are relatively well capitalised.

While emerging markets (EM) local currency bond returns lagged those of developed markets, hard currency-denominated EMs performed better, with the JPM Emerging Market Bond Index (EMBI) spread narrowing from 433bps to 398bps. This resulted in investment-grade bonds returning around 2.7%, but sub investment-grade issuers lagged at 1.6%, dragged lower by those rated below BB. The Fund has around 14% of its assets in investment-grade EMs, of which 9% relates to sovereign holdings. Of the Fund's 9% exposure to sub investment-grade assets, around 4% is EM-related.

Corporate bond markets continued to recover during the third quarter, with the bulk of spread tightening during July. August saw spreads consolidate, and September saw spreads widen for the first time since March. Supply continues to be a dominate feature, with July the only month not to see record monthly issuance since March, initially driven by a pandemic-fuelled liquidity grab, which has given way to a historically attractive funding landscape courtesy of the Federal Reserve. Issuance year to date now stands at $1.54tn within US investment-grade and $335bn within high yield. A good portion of the new funding has been used to repay bank revolving credit facilities drawn down during March and April, but companies are increasingly using the low coupon environment to refinance existing debt (several of the Fund's holdings have been tendered) and term-out maturities. There has been a noticeable rise in Green bond issuance, where the proceed are ringfenced for environmental initiatives, and global issuance has now surpassed a trillion dollars, including over $200bn in 2020. The EU has pledged to spend 30% of its pandemic recovery fund on sustainable and low-carbon investment, raising the prospect of €200bn of possible issuance from the EU. The EU has also pledged to issue €100bn of SURE bonds under a social bond framework, the proceeds of which will be used to alleviate the social impact of the coronavirus pandemic. Investment-grade Europe fared marginally better, returning 2% versus 1.7% in the US, with the ECB more active than the Fed in the secondary market. Within high-yield, returns were much stronger in the US, up 4.7% during the quarter versus 2.6% in Europe, partly reflecting some catchup after the US lagged Europe in the second quarter. Despite the strong returns, default rates have continued to increase in the US, particularly within the energy sector, and, in the absence of a new fiscal package and further income support, this will likely continue. The Covlite issuance background of recent years will likely bring a few nasty surprises for some as appears to be happening in the leverage loan market, where new lenders are negotiating terms that supersede the arrangements of existing lenders. The Fund's purchases were bias towards euro-denominated issues during the quarter as spreads were deemed as more attractive (and accounts for the increase in the Fund's credit duration from 1.3 to 1.6 years). The cross-currency basis remains relatively small and hasn't been a driver of positioning in recent months. The Fund also bought several convertibles (BP, Michelin and Unibail), where credit spreads were more appealing than underlying fixed rate issues. Among some of the higher-yielding and more interesting names purchased during the quarter were Ryanair, General Motors Finance, Hammerson and VW.

The Fund's exposure to property remains low, at 0.8%, down from around 1.07% at the end of June. Sadly, most of the reduction represents the underperformance of mall operators (Hammerson, Unibail, Klepierre and Simon Property Group), which have been had to weather a perfect storm of Covid-19 lockdowns, higher expenses and tenants reluctant or unable to pay rents. Overall, global property, as measured by the EPRA/NAREIT Developed Index, delivered 2.3% during the quarter, with Japan the best-performing region. Within the depressed office and retail sectors, there is undoubtably value, but investors remain concerned that a prolonged return to normal will necessitate capital raises to stabilise debt metrics and lead to value traps. Interestingly, private equity has begun to deploy some of the capital that has been built up.

Within foreign exchange markets, US dollar weakness was the overriding theme, particularly in July and August, as lower real yields and US policy uncertainty underlined its attractiveness. At the same time, the ability of EU member states to adopt some burden-sharing via the recovery fund boosted the euro's appeal. The Fund's performance has benefitted from the out-of-the money options purchased in mid-June struck against the euro, SEK, CHF and yen, which expire in mid-December, well after the US elections. While we see increasing headwinds for the US dollar, a significant weakening suggests other currencies need to appreciate, and that seems likely to meet resistance in regions such as Europe and Japan.

The US election has been dubbed as the most important in a generation: election hype perhaps, but very influential, nonetheless. Not only will the fiscal actions of the next US administration set the tone for developed market yields, but the foreign policy stance (think China) will prove to be an important backdrop for riskier asset classes and have far-reaching implications for regions exposed to global trade, such as emerging markets. The Fund's overall duration remains relatively short, and our options provide additional protection from a sudden regime change in bond yields. Despite the continued fragile economic backdrop, spreads on corporate bonds still look appealing in an environment not weak enough to outweigh accommodative central bank policies and not strong enough for the punch bowl to be withdrawn. As a result, we see corporates as relatively well placed versus other asset classes, but remain bias towards shorter-dated instruments.

Portfolio managers
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