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

Developed market interest rates remain low and look set to remain for an extended period, with most central banks remaining accommodative in order to assist the economic recovery. Low interest rates and negative real rates continue to push investors into higher beta asset classes, resulting in another quarter of good returns. Most gains were front-loaded as economic activity recovered, but a growing sense of second-wave Covid-19 infection led to a further decrease in sentiment during September. Corporate bonds outperformed government bonds, with high yield outperforming investment grade. Within developed markets, performances of local currency denominated bonds 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 2021 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 zero until 2023. The composition and quantitative of the easing programme remains unchanged ($120bn a month, of which $80bn is US 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 -4.5% in June to -3.7% in September, future expectation were revised lower (2021 to 4%, from 2022 to 2.3% and 2023 expected to be 2% respectively). An unemployment forecast reflected a similar pattern, with fourth-quarter unemployment of 7.6% expected to reach 6.8% in 2022. The Federal Reserve’s balance sheet 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. When asked about the potential 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 instability risks.

The US national debt is now above $27tn (up $7tn since 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 exceed a mere 108% of GDP by early 2023 – 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 concerns whether the Federal Reserve will have to continue to 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 and the large US authorities’ stimulus programme appear to have reached a stalemate, with Fed representatives becoming increasingly supportive of the market in the medium term. When asked if the Fed has reached a stalemate, with Fed representatives becoming increasingly supportive of the market in the medium term and the Fund took advantage of cheap levels of funding, 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 €60bn). By mid-2021, the ECB is likely to hold around a third of the bonds eligible under the Corporate Sector Purchase Programme only priced in 10 basis points (bps) of yield by the end of 2020. 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 instability risks.

In recent weeks, the perception has been that Biden’s stronger pollings 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 2018 midterm election in Florida in 2020, make investors understandably cautious of backing perceptions with actions and helps explain why option premiums in the Corporate Sector Purchase Programme compared to only around 1% of the US investment grade corporate sector at the time. While the Fund may have underperformed the market held by the Federal Reserve. This should be seen in the context of a historically defensive asset class repertoire of the Federal Reserve. Issuance year to date now stands at $1.5tn 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 proceeds 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 economic recovery fund on sustainable and low-carbon investment, raising the prospect of €200bn of possible issuance from the EU. The US 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 Covid-19 background of recent years will likely bring a few nasty surprises for some as appears to be happening in the leveraged loan market, where new lenders are negotiating terms that supersede the arrangements of existing lenders. The Fund’s purchases were biased 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 has also bought several convertibles (BP, Michelin and Unibail), where credit spreads were more appealing than their US counterparts at the time. The Fund sidestepped the more expensive yields on the US 6.5% in June to 0.9% in September. The Fund’s purchase of property remains low, at 0.8%, down from 1.0% at the end of June. Sadly, most of the reduction represents the underperformance of mall operators (Hammon, Unibail, Klepierre and Simon Property Group), which have been hit by a perfect storm of declining footfall, higher expenses and tenants reluctance to pay rent. Overall, global property, as measured by the EPRA/NAREIT Developed Index, delivered 2.3% during the quarter, with the US housing sector performing poorly. Within the depressed office and retail sectors, there is undeniably 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 low real yields and political uncertainty attracted flows. 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 benefited 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 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 exposure was used to protect the Fund’s capital in the event of rising rates. Despite the continued fragile economic backdrop, spreads on corporate bonds still look appealing in an environment that is not strong enough to outweigh accommodative central bank policies and not strong enough for the punchbowl to be withdrawn. As a result, we see corporates as relatively well placed versus other asset classes, but remain bias towards shorter-dated instruments.

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