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 Omicron variant injected some uncertainty into markets, particularly during November, but overall, the principal narrative was one of more hawkish central banks in the face of continued upward surprises in inflation. Volatility picked up across most asset classes, which is not surprising given the policy transition underway. Shorter dated government and investment grade corporate bonds underperformed cash during the quarter. The Fund returned 0.04% for the fourth quarter and 1.1% for the last 12 months, respectively, versus a benchmark return of 0.03% and 0.17%.

The US yield curve pivoted around the 10-year point, where yields ended the quarter only two basis points (bps) higher at 1.51%, while five-year yields rose 30bps and 30-year yields declined 14bps.

Headline inflation rose to its highest level in 40 years, with the consumer price index (CPI) up 6.8% year on year (y/y) in November and core inflation just shy of 5%. While supply disruptions have played a part, most noticeably in sectors such as Autos (a side effect being that second-hand auto prices are 49% higher y/y), excess demand's role in driving prices has become more apparent. In the near-term, upward pressures remain, most notably via Owner Occupied Rents, where pressures are only expected to moderate in the second quarter when base effects kick in materially. The most recent New York Federal Reserve survey of consumer inflation expectations one year from now rose to 6%, the highest since the survey began in 2013 and expectations three years out are 4%. US TIPS (inflation-linked government bonds) outperformed by around 2% in five-year maturities and 3% in 10-year maturities as the breakeven rate of inflation widened (peaking in November at 3.2% in five-year and 2.75% in 10-year maturities).

The December Federal Open Market Committee (FOMC) meeting marked a significant shift in the US Federal Reserve (Fed) outlook. Its reference to inflation as transitory was finally abandoned and views surrounding maximum employment evolved. The updated dot plot (showing members' median expectations for the Fed Fund's rate) showed a baseline of three hikes in 2022 and 2023 (both 0.625% higher than in September) and two hikes in 2024 (now 0.375% higher). For now, the terminal rate remains unchanged at 2.5%. The pace of asset purchase tapering was also doubled to $30bn a month, consistent with an end to asset purchases by the end of March 2022. The minutes of the meeting also included a discussion of quantitative tightening, acknowledging this would likely occur closer to policy lift-off than previously, giving rise to expectations that this may occur around the end of 2022. It is unclear at this stage what the amounts involved will be, but after an initial ramp-up, it's likely to be larger than the $50bn a month (UST and MBS combined) that took place during the 2017-19 taper. It's worth noting this does have the propensity to reduce the cumulative amount of rate rises required by the Fed.

Longer-dated bonds performed surprisingly well, taking heart from the projected unchanged terminal rate, still modest longer-term breakeven rates of inflation and a reallocation by pension funds from equities as the US defined benefits pension funds funding ratios rose to 96% their highest levels since 2007 (Willis Towers Watson estimates).

In Washington, US politicians took until mid-December to pass a $2.5 trillion increase in the debt ceiling that should allow the Treasury sufficient headroom until after the November 2022 mid-term elections. The supply of US Treasuries had been constrained by the delay in approving the increase, helping to suppress yields and leading to a record $1.9 trillion to be parked with the Fed under its reverse repo operations. President Biden signed off on a $1.2 trillion ($550bn new funds) infrastructure bill, but to date, the second Build Back Better bill has been unable to muster sufficient votes.

Core European bond yields were little changed over the quarter, with shorter-dated bonds marginally outperforming the US and longer-dated bonds lagging. Bonds issued at the periphery lagged as investors reflected on the likelihood of less support from asset purchases (Italian bonds suffered most as political uncertainty created by Presidential elections exacerbated moves), with the Pandemic Emergency Purchase Programme set to come to an end at the end of March and the European Central Bank's Asset Purchase Programme only increasing by a modest amount. The expectation is that rates will only rise after asset purchases cease, which is expected to be sometime in early 2023. In the meantime, inflation continues to surprise to the upside (All-items Harmonised Index of Consumer Prices of 5% y/y in Dec) for the most part due to surging energy prices (with Russian tension adding to uncertainty), which are 26% higher y/y, (house prices, which are not currently captured in inflation have also seen robust increases). With the Omicron variant leading to renewed mobility restrictions and energy prices likely to depress industrial production during the first half of 2022, inflationary pressures are likely to prove less entrenched than in the US.

In the UK, it was a similar story to the US, inflation continuing to surprise on the upside (5.1% HICP index and 7.1% RPI) across a broad range of goods. Labour shortages post Brexit have been driving higher wage settlement, and once again, higher energy costs and the associated cost of living (alongside rising house prices) will fuel demand for more. The Bank of England could now move base rates as soon as February, with four moves, like the US, priced in for 2022.

Within emerging markets, returns were volatile. China and Asia generally outperformed, but elsewhere markets struggled as inflationary pressures continued to surprise to the upside, prompting central banks to continue raising rates and fuelling expectations of further tightening. Emerging market currencies outside Asia were also weak, with political uncertainty a significant factor. Elections in Latin America have continued to see leftist presidents elected at the expense of the moderate centre. With global investors now relatively underweight emerging markets, illiquidity in some segments does throw up opportunities, and we do remain open to opportunities, both in hard and local currency, especially where they are relatively short-dated in nature. More recently the Fund exposure to Mexico has risen because of a holding in short-dated Mexican inflation line bonds and short-dated exposure in euros and sterling to Pemex, the state-owned oil and gas company.

Investment-grade corporate bonds lagged government bonds by around 0.4% during the quarter, while high yield issuers outperformed by around 1%. November proved to be a pivotal month as spreads widened by the most during 2021, with the Omicron variant causing sectors susceptible to mobility movement to underperform and swap spreads widen materially (especially in Europe) as investors sought to hedge rising rate risks. The recovery in December was among the largest outperformance of corporates versus government bonds all year, but the rebound in higher quality bonds was not quite enough to recover November's losses. While investment-grade spreads within Asia have remained relatively well behaved, the high yield sector remains weak as several Chinese property companies have defaulted. Without direct government support, the sector will continue to struggle as liquidity dries up and more redemptions become due. The overall credit duration of the Fund remained relatively low during the quarter at around 1.3 years. We slightly reduced its high yield exposure, principally via ETFs, while exposure to BBBs increased. We also reduced several shorter-dated positions where breakeven protection appeared minimal. In November, the spread widening was welcomed, and we used the wider spreads, particularly within Europe and the UK, in conjunction with moves in the FX basis, to add positions into the year-end. The Fund's credit hedges matured but were not replaced given the modest levels of portfolio risk and heightened levels of implied volatility, which made options relatively expensive into the year-end.

Property performed well during the fourth quarter, apart from a brief spell in November when uncertainty surrounding Omicron was at its peak, with the US and UK particularly strong. At an index level, the EPRA/NARIET Developed Index was up 10.4%, bringing the return for 2021 to 27.2%. During October, we added to the Fund's holding of Instone, a German developer, and added Vici, the US gaming operator and owner of Caesars Palace, and reduced our holding slightly in Equites Property Fund. In November, we added UK Commercial Property REIT, which trades at a healthy discount to its current NAV. At the end of December, property represented 1.6% of the Fund versus 1.3% at the end of September.

The US dollar was marginally stronger on a broad-based trade-weighted index within foreign exchange markets but was 3% higher against the yen and 2% versus the euro. The Chinese Renminbi was once again a noticeable outperformer, benefitting from attractive real yields and an improved current account. Within emerging markets, Asian currencies appreciated while those in Latin America, Africa and Eastern Europe were weaker as politics and strong inflation outturns undermined confidence. The Fund's FX options matured during December; around 35% of the Fund's assets were non-US dollar-denominated at the year-end, but these were fully hedged into US dollars.

Omicron disruption within developed markets is likely to ease towards the end of the quarter. From a growth and risk perspective, it remains to be seen whether China's current zero-Covid-19 strategy can be maintained without significant economic disruption. A more hawkish Fed is likely to keep upward pressure on real rates and inject great volatility into markets. This will create a more challenging backdrop for riskier assets than in recent years. We expect the Fed's actions to ripple out along the yield curve and believe long-dated yields remain too low currently. The outlook for the US dollar remains finely balanced with high real yields on a relative basis key to its strength. This is especially true versus some higher-yielding currencies, which will become more attractive when there is greater certainty over the Fed's path on interest rates and asset purchases. Corporate fundamentals and the demand backdrop for corporate bonds remains healthy and should provide a backstop for spreads, but November's move is a reminder that breakeven protection remains low and spread volatility is likely to pick up as central banks taper asset purchases. The Fund duration remains relatively lower and includes inflation-linked assets. As bond yields rise and breakeven protection increases, we are likely to modestly increase the Fund's exposure to rates, particularly in shorter maturities. The recent widening in credit spreads also gives us the opportunity to deploy resources and lock in returns at more attractive levels. Overall, the outlook for returns has improved for the Fund.

Portfolio managers
Nishan Maharaj and Seamus Vasey
as at 31 December 2021