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.

Global bond market returns experienced significant dispersion during the last three months as localised factors proved more influential than usual. Despite incidences of renewed lockdowns, developed market economies have begun to reopen. Higher input prices and supply bottlenecks added to base effects to boost recent headline inflation, with the wider debate focusing on how transitory price pressures will prove to be. The narrative within developed market central banks has shifted towards tighter monetary policy, whilst numerous emerging markets have already begun raising rates. A seemingly insatiable appetite for credit saw credit spread approach historically tight levels. Within foreign exchange markets, the US dollar weakened throughout April and May but began to strengthen post the more hawkish Federal Open Market Committee (FOMC) meeting in mid-June. The Fund returned 0.7% for the second quarter and 3.2% for the last 12 months, versus a benchmark return of 0.0% and 0.2%, respectively.

US growth expectations for 2021 have continued to trend higher as vaccine deployment has allowed most of the economy to reopen. The US Federal Reserve (Fed) boosted its forecast for growth in 2021 to 7% in June from 6.5% in March. Whilst the US unemployment rate remains higher than the Fed would like to see, the underlying details are more robust. In fact, firms report labour shortages as coronavirus concerns, childcare responsibilities, and expanded unemployment benefits have kept workers out of the labour force. While overall employment numbers are 4.4% (6.7m jobs) lower than the pre-pandemic levels of February 2020, leisure and hospitality is 13% (2.2m jobs) lower, a figure that is beginning to heal, as evidenced in the 343,000 jobs created in the sector during June. If jobs growth continues at the current pace, the Fed's criteria of "substantial further progress" will arguably have been achieved.

It seems highly likely the Fed will signal a date for the tapering of asset purchases either at Jackson Hole in late August or at the Federal Open Market Committee's (FOMC) September meeting, with actual tapering beginning most likely in early 2022. As Larry Summers has pointed out, the case for $40bn a month of Asset Backed Security (ABS) purchases looks weak when house prices are rising at over 15% year on year (yoy). In light of economic developments, the upward move in the Fed's June Dot plot should come as no surprise, but it is a testimony to how dovish the Fed's language has become that it was perceived as hawkish and that markets began to re-interpret the Fed's resolve in light of Average Inflation Targeting (AIT). While break-even rates of inflation were broadly unchanged during the quarter, they did moderate during June as the transitory inflation narrative gained more traction; the Fund sold 2027 maturity Treasury Inflation Protected Securities and increased its exposure via 2029 maturity instruments as the longer maturity securities were deemed better value in the context of the Fed's longer-term inflation target.

Not surprisingly, the two- to five-year yields rose post the move in the Dot plot but perhaps more surprising has been the move lower in longer-dated yields, which have been trending lower since the end of March (the US ten-year ended the quarter at 1.47% down from 1.74% at the end of March). This move lower seems at odds with the economic data but is most likely explained by the scaling back of supply ahead of the 31st of July when the suspension of the current debt ceiling expires. In addition to the Fed's normal $120bn of monthly asset purchases, the running down of the Treasury General Account (TGA) has been draining another $100bn a month principally via lower T-Bill issuance.

The lack of supply comes when bank deposits and money market fund flows have been rising, with the excess demand driving short-dated yields to zero. Eligible counterparties turned to the Fed's reverse repo facility, where they can lend cash in return for Treasury collateral on an overnight basis. The sum involved reach almost $1 trillion after the Fed increased the rate on such reserves to 0.05% from zero post the FOMC meeting. T-Bill yields subsequently rose towards 0.05% from zero to reflect the change. These dynamics are likely to persist for some time as the TGA is set to shrink by a further $300bn. However, it would be wrong to assume the effects of the TGA are confined to the short end. Short term deposit takers have been actively seeking to deflect inflows, with some of these funds subsequently finding their way into longer maturities, banks too have had to hold higher levels of High Quality Liquid Assets (HQLA) post the removal of Liquidity Coverage Ratios exemptions, and the dearth of short assets has seen HQLA become longer in tenure. A further source of demand for longer-dated Treasuries has come from pension funds, which have been de-risking as their funding ratios have improved. We expect the recent technical aspects of the market to continue for a few more months, especially in light of the short positioning of the market, but ultimately the reset higher will be more dramatic when it does arrive, most likely in the latter half of 2021. The Fund duration shortened marginally during the quarter. The managers also used declining interest rate volatility to buy five- and 20-year swaptions that will appreciate if yields do rise aggressively.

European government bonds yields rose further during the second quarter (German 10 years rose from -0.3 % to -0.2%), and the broad market underperformed US Treasuries by 2.5% in local currency terms. Unlike the US, issuance has been more plentiful, and the market has begun to worry about the level of official support from asset purchases that will follow the phasing out of the Pandemic Emergency Purchase Program (currently around €80bn a month). The European Central Bank (ECB) will likely increase its Asset Purchase Program (APP) to cover some of the shortfall, but peripheral spreads may be more vulnerable to the shortfall. Europe issuance is also rising on the back of the Next Generation EU (NGEU) Fund, which will eventually grow to €750bn, the first €20bn of which was issued very successfully in mid-June.

The ECB will also be publishing its strategy review, which amongst other things, will likely see the inflation target focus on a symmetric inflation target rather than one targeting the current 2% reference point as a cap. Core inflation remains closer to 1%, and the ECB remains dovish even though headline Harmonised Index of Consumer Prices (HICP) has risen to its highest level (2%) in the last two years and will likely rise further in late 2021 on base effects caused by the German VAT cut in mid-2020.

Growth expectations have also moved higher, with the EU expecting the region to grow 4.8% in 2021 and 4.5% in 2022. The Fund exposure to the region was broadly unchanged during the quarter at around 14%, but this masks underlying movements that saw maturing securities replaced with three- to five-year instruments. The foreign currency basis has been trending tighter for the last few years, reflecting ample US dollar liquidity. With the Federal Reserve now draining liquidity via its reverse repo operations, we may see this begin to widen slightly, which would enable the Fund to secure more hedged Euro-denominated positions.

In other developed markets, the lower yield backdrop of the US set the scene for generally positive returns. One other noticeable feature of developed markets was the strong rise in house prices, a reminder that the persistence of ultra-low rates is having a significant effect on asset prices more widely. This has become a more central issue for government and central bankers, with New Zealand broadening the remit of its central bank to consider movements in the asset class. Within all the major central banks, the subject of winding down asset purchases is now a central policy theme. At the Bank of England, the outgoing chief economist Andy Haldane made his feeling clear that excessive asset purchases in the face of recovering economies may pose an upside risk to inflation.

Emerging markets continue to face multiple challenges, with Covid-19 presenting significant challenges to those with poor health care systems, poor political guidance, or insufficient access to vaccines. Inflationary pressures have also been especially acute in nations sensitive to oil and food prices. Several emerging markets have begun to hike rates, including in Russia, Mexico, Brazil and several countries in Eastern Europe, to contain inflationary pressures. Growth has turned out better than expected, with strong commodity prices providing a strong tailwind, but growth momentum is beginning to falter compared to developed markets as the vaccine gap and Delta variant cast a shadow (although vaccine availability and deployment are ramping up). Another concern is the deceleration in the credit cycle in China (backed up by talk of extra stimulus) which tends to be a strong lead indicator for imports. While we believe some of the rate expectations now built into markets are excessive (particularly in Latin America), a premium is likely necessary given the recent widespread political upheaval and more challenging foreign exchange backdrop. Unlike in 2013, when the US taper tantrum occurred, emerging markets are structurally sounder and have relatively low market participation by foreign accounts, which should dampen volatility. The Fund bought some shorter-dated locally currency Mexican government bonds, some of which were inflation-linked. Within hard currency emerging markets, bonds performed well, benefitting from the wider compression in credit spreads. The Fund sold its Moroccan government bonds and bought exposure in Columbia, Indonesia, and Mexico.

Corporate bonds continued to perform strongly, outperforming US Treasuries by 1% over the quarter and marking the ninth consecutive month of outperformance. Investment-grade spreads are now at historically tight levels (whereas high yield bonds were marginally tighter in the mid-2000s) when normalising the rating and maturity composition of indices. The tightening move was broad-based with a consistent move tighter across ratings and maturities. Aside from the better economic outlook and a general 'risk-on' backdrop, the supply backdrop exacerbated moves. Lower US government issuance has seen money flow into credit when net issuance has shrunk, resulting in excess demand. Within US high yield, which outperformed government bonds by 1.8%, supply proved to be stronger, boosted by new names, M&A funding and corporates taking advantage of low absolute yields to raise additional funds or term out maturities. European markets' excess returns were a little lower at 0.6%, with high yield at 1.7% as supply dynamics were less extreme. Asian markets were the laggards, especially within high yield as several highly leveraged Chinese names posted negative headlines.

At current levels of credit spreads, we have become much more cautious, reducing positions in UBS, Growthpoint, Société Générale and Citi Bank. The Fund invested in investment-grade issues from JBS, the US meat producer, the African Export-Import Bank and the Industrial & Commercial Bank of China. Within high yield issues, the Fund participated in new issues from Absa Group and MAS Securities, a property company operating in Central and Eastern Europe, and the Mexican bank Banco Mercantil del Norte. The Fund remains alert to opportunities within the convertible market, where lower volatility and tighter fixed-rate credit spreads make valuation potential more attractive. The Fund adding to MailRu and Weibo convertibles and sold out of Deutsche Wohnen convertibles after the takeover offer from Vonovia. Overall credit duration remains modest and broadly unchanged over the quarter. The managers did take advantage of the tight spreads by taking out credit protection via options on US investment-grade indices.

Property performed well during the second quarter, with the EPRA/NARIET Developed Index up close to 10%, European and US-listed companies leading the way and Asia lagging. The Fund exposure declined very slightly from 1.4% at the end of March to 1.2% at the end of June. The Fund sold its holding of Mercialys after a rise of 50% YTD and its holding of Deutsche Wohnen after the takeover by Vonovia at a three-month premium of 25%. Growthpoint Properties Australia was another stock sold after a strong run. A new position for the Fund was Equities Property Fund, a logistics focused REIT, in early June. While US valuations now feel very full, there appears to be value elsewhere if economies continue to reopen and the Delta variant doesn't derail events.

Within foreign exchange markets, the US dollar weakened throughout April and May but began to strengthen post the more hawkish FOMC meeting in mid-June. On a broad trade-weighted measure, the US dollar was 3% weaker at one point but recovered to close the quarter 1% weaker. Within G10 markets, the Swedish Krona and Swiss Franc performed best, up around 2%, while the Australian Dollar was the laggard, down 1.3%. Brazil was the standout performer within emerging markets after a very weak start to 2021; Eastern European currencies also performed well, up between 3% and 4%, as central banks turned more hawkish in light of the higher inflation outcomes. The weakest currencies aside from Turkey, down 5%, were principally in South America, where politics has become more left of centre, unsettling investors. The Chinese Renminbi performance mirrored that of the broader dollar index.

Fundamentally we believe the US dollar should weaken against most other developed market currencies, in part due to its large deficits. However, in the near term, a host of other factors, such as positioning, short-term rate expectations and general risk sentiment, are proving more influential. Considering the declining levels of foreign exchange volatility, the Fund bought a series of longer-dated out of the money FX options, expressing a weaker dollar view against the Euro, Yen, SEK, CAD and AUD.

The recent retracement in medium- and longer-dated bond yields appears excessive given the large amounts of funding necessary in most countries, and the Fund remains defensively positioned. While we acknowledge the recent hawkish tilt from central banks, markets should remember that a tapering of asset purchases will precede rate rises in developed markets. Real yields once again appear unappealing against this backdrop. It also feels the pendulum has swung from full-blown inflationary concerns to accepting the transitory narrative too quickly, hence our upweighting of inflation-linked securities. Corporate bonds remain in a sweet spot, but this too can change rapidly, especially as investor behaviour has been predicated on the belief that a wall of cash will step in to limit any selloff.

If the last year has demonstrated anything, it's that the world is a highly uncertain place, and it strikes us as odd that volatility in many areas of the market has fallen to such low levels; hence the Fund's greater use of option protection within rates, credit and FX markets. Markets tend to become more volatile in September and October after the northern hemisphere's summer, the policy timetable certainly picks up around then, so perhaps history will repeat itself.

Portfolio managers
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as at 30 June 2021