

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.

Government bond yields rose during the quarter as expectations for global growth increased in response to the pace of vaccine rollouts accelerating. US Treasuries posted the weakest quarterly returns in 40 years as rising inflation concerns led to a significant rise in yields. Despite the continuation of a very dovish narrative from the US Federal Reserve (the Fed), investors moved to price earlier rate hikes. The passing of President Joe Biden's \$1.9 trillion US stimulus package and the unveiling of a \$2.25 trillion infrastructure programme put additional pressure on yields. Credit markets were more relaxed with the expansionary stance, with spreads modestly tighter. The US dollar strengthened against most currencies as it benefited from wider interest rate and higher growth differentials. The Fund returned 0.41 during the first quarter and 6.44% over the last 12 months versus a benchmark return of 0.06% and 0.36%, respectively.

In late 2020, the passing of the \$900 billion pandemic relief bill set the scene for more expansionary fiscal policy, and the Democrats' victories in Georgia in the early January runoff elections gave the party control of the Senate and, with it, power to pass further stimulus. That additional stimulus came in the form of 'The American Rescue Plan Act, passed on the 11th of March and amounting to \$1.9 trillion. President Biden also announced his infrastructure proposal, the 'American Jobs Plan' of which the first phase amounts to \$2.25 trillion and is set to be disbursed over a period of eight years. The intention is to fund this by raising corporate tax rates from 21% to 28%. The second yet-to-be-announced phase will focus more on social spending and may amount to as much as \$1.5 trillion, funded by high taxes on higher-earning Americans. All segments of the legislation are likely to prove more challenging than the stimulus passed to date. What is apparent is that the front-loaded stimulus will significantly boost GDP in 2021 but become contractionary in 2022.

Against this backdrop, US bond yields rose sharply at the beginning of January and continued to selloff throughout the quarter, with the US 10-year yield rising from 0.91% to 1.74%. This resulted in the worst quarterly performance (-4.3%) since 1980. The initial selloff came through wider breakeven rates of inflation, but this began to change in mid-February, with the subsequent rise increasingly coming via higher real yields. With the Fed maintaining a very dovish stance, the nominal yield curve steepened significantly.

At the very front end of the curve, money market rates have been pushed lower as reserve growth, and money market inflows outstrip a decline in the amount of Treasury Bill issuance as the Treasury manages down the Treasury General Account (TGA) ahead of the debt ceiling deadline at the end of July. The current backdrop is likely to continue unless the Biden administration addresses the issue sooner as part of the fiscal stimulus plan. The Fed's decision not to extend the exemption for holding Treasuries and deposits under the Supplementary Leverage Ratio (SLR) calculation may cause banks to move towards shedding deposits, accelerating flows into money market funds. The Fed is monitoring the situation and may adjust the Interest on Excess Reserves (IOER) and Reverse Repo Programme (RRP) rates if deemed necessary to drain excess liquidity from the system. Despite the Fed keeping the dot-plot unchanged and Chairman Powell's openly dovish communiques, markets have begun to price in rises in the Fed Funds rate as soon as the second half of 2022, with between three and four hikes priced by the end of 2023 in contrast to the Fed's unchanged dot plot.

Within the Treasury Inflation-Protected Securities (TIPS) market, shorter-dated breakeven rates of inflation rose most, reflecting the near-term concerns surrounding inflation. When combined with the shape of the nominal curve, this has resulted in deeply negative real rates in short-dated maturities and a steeper real yield curve over the quarter. Five-year breakeven rates of inflation rose to 2.60% at the end of March from 1.97% at the year-end, with 10-year breakevens ending the quarter at 2.37% (up from 1.99% at the end of 2020). The Fund switched its shorter-dated holdings longer, as short-dated levels now look increasingly stretched.

In assessing current valuations, it is worth noting that five-year forward five years out (5y5y) has risen from 1% in mid-2020 to 2.6% today - a similar move to that experienced during the Taper Tantrum of 2013 and a level that leaves them broadly in line with the Fed's current expectations of the median long-term target rate. However, with inflation concerns persisting and headline CPI to move higher in coming months (likely peaking just over 3.5% due to base effects), the Fed's ongoing dovish stance against the large issuance pipeline is likely to mean the path of least resistance may still be higher, especially with real yields remaining historically low. The Fund's duration position remains defensive at 0.8 years and concentrated in the two to four-year segment of the curve, with additional exposure via our holdings in Europe and, more recently, in Australia and Canada.

Within Europe, the selloff in bond yields was more contained as cohesive policymaking was once again absent, leading to a slow vaccine rollout, renewed lockdowns and a downgrade in growth expectations to below 4% for 2021. The European Central Bank (ECB) also sought to limit rising yields by front-loading its Pandemic Emergency Purchase Programme (PEPP). Fears of a slower-than-anticipated deployment of the EU's Recovery and Resiliency Facility have also surfaced, adding to the downbeat sentiment towards Europe. But just as US sentiment has soared, perceptions towards Europe could change materially should it be able to catch up with its initial vaccine rollout timetable. We find little value in European government bonds, where real yields are at historically low levels. Within shorter-dated corporate bonds, the level of the cross-currency basis swaps and tighter credit spreads has meant hedging instruments into US dollars has been less appealing during the quarter. The only purchase the Fund made was some Berkshire Hathaway 2024 debt.

To date, the UK has had one of the most successful vaccine rollout programmes and one of the most aggressive fiscal stimulus programmes. This has helped alleviate concerns surrounding the fallout from the UK's exit from the EU, which has given rise to considerable trade disruption. The planned reopening of the economy has boosted business confidence, but trade disruption and potential job

losses as furloughed workers are not reabsorbed into the labour force remain significant challenges. As a result, the Bank of England has continued to adopt a very accommodative monetary stance. Overall, yields look unattractive, and hedging opportunities have been less evident, as has been the case with Europe.

Emerging markets struggled during the first quarter bar one significant exception - China. Index-driven flows into Chinese bonds (as investors upweight holdings) do appear to be detracting from flows into other local currency emerging markets, where flows remain benign (in contrast to hard currency flows). Aside from China, other local currency emerging markets performed poorly in the face of rising US rates and ongoing Covid-19 outbreaks. In addition, political events weighed heavily on some countries, such as Turkey, Brazil and Russia. The Fund purchased some short-dated AAA exposure in India and Indonesia, which it hedged out. We also purchased some longer-dated exposure in South African government bonds that trade much cheaper than the hard currency equivalent instruments.

Corporate bonds continued to perform well as investors took heart from both the prospect of economies reopening and large fiscal support packages. To date, the rise in government bond yields has not detracted from the hunt for yield within corporate credit. Overall, a broad US investment-grade index outperformed government bonds by 0.9% during the quarter (despite losing 4.5% in absolute terms), with lower-rated and longer-dated bonds performing best. February produced the strongest monthly outperformance. Despite continued high issuance during the quarter, new issue premiums remain modest. High yield bonds outperformed investment-grade bonds by 2.8% as spreads tightened by 50 basis points (bps) to 336bps, and with a shorter duration, managed to post positive returns of 0.9%. US High yield supply was a record \$59 billion in March, bringing the year-to-date issuance to close to \$150 billion - double that of 2020. Within Europe, the outperformance of investment-grade bonds was less, at 0.4%, but absolute returns were higher, down 0.7%, as government bond yields rose less. European high yield bonds returned 1.5%, 2% above similar duration government bonds.

In contrast to local currency markets, emerging market hard currency debt performed well, with the spread on the Emerging Markets Bond Index rising only by 2bps to 324bps. Unlike corporate credit, it was the higher quality issuers who provided the best excess returns (0.7% vs -0.2%) within high yield issuers, but once again high yield issuers outperformed in absolute terms (-4.25% vs -5.3%) as their higher yield and lower duration prevailed over longer duration investment grade issuers. The Fund sold its exposure in Hewlett Packard Enterprise and bought instruments issued by Société Générale and Tencent, while numerous instruments matured or were tendered for. The Fund was also active in several convertibles, selling its exposure in Michelin, BP and CAPC and investing in Weibo, Deutsche Wohnen and LEG. Overall, the Fund's credit duration fell from 1.4 years to 1.2 years during the quarter, reflecting what are now quite fully priced valuations.

Property valuations continued to recover with the EPRA/NAREIT Developed Index up by 6.1%, led by gains in February and March as the reopening trade boosted many depressed stocks in sectors such as retail. Markets that were perceived to be making the most progress on vaccine deployments, such as the UK and US, did best. After a slight reduction in the Fund's exposure to property during January, it marginally increased exposure again to end the quarter at 1.4%. During the quarter, the Fund continued to reduce some retail exposure, selling Simon Property Group and reducing exposure to Klépierre and Hammerson. The Fund also reduced some exposure to MAS Real Estate after a strong recovery and rotated the proceeds into Growthpoint Properties Australia, NEPI Rockcastle and LEG Immobilien, as well as adding to Vonovia, Deutsche Wohnen and Segro.

Within foreign exchange markets, the US dollar reassessed itself, strengthening against all but a handful of currencies (Canadian dollar +1.3%, pound Sterling +0.8% and Norwegian Krone +0.3%), with the Fed's broad trade-weighted index appreciating 2.3% over the quarter. The US dollar index (DXY), which has a higher weighting to the yen and euro, rose by 3.7%. Within G10 currencies, the yen was the weakest, down 6.7%. This decline was due to the ever-widening interest rate differentials between the US and Japan. Elsewhere, the euro was 4% weaker, as Europe's vaccine rollout struggled to gain traction in contrast to pound Sterling, given the UK is having one of the most successful rollouts to date. Apart from the Chinese renminbi, emerging market currencies performed poorly against the backdrop of rising US rates, rising cases of Covid-19 and weaker inflows. In the near term, US dollar shorts have largely corrected, and the scope for further growth divergence may be limited, suggesting the US dollar strength may begin to wane against other G10 currencies. The outlook for emerging markets is more difficult, as the ongoing damage to the fiscus from Covid-19 makes them more vulnerable to adverse movements in foreign flows and risk sentiment.

Despite the selloff in medium-dated rates, the Fund's interest rate duration remains low at around 0.8 years and credit duration modest at 1.2 years. The recent selloff in bond yields and the steeper yield curve is beginning to present value, but we believe the selloff may have a little further to run. Corporate bonds should gain comfort from an upturn in global growth, supporting improvements in credit quality, but investors should be mindful that valuations largely reflect this, and breakeven protection remains relatively low. We see opportunities within property, but one needs to be conscious of the current positive sentiment towards equities and scale positions accordingly. As we alluded to at the end of 2020, US policy changes under the Biden administration may have repercussions for various asset classes, and this view continues to be the case.

Portfolio managers
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