

**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 rates available to investors in the shorter end of markets remain very low, especially compared to the higher levels of inflation emerging. Longer-dated global bond yields rallied during July as a slower growth narrative took hold but were weaker during August and September as the supply side challenges behind the slowdown gave way to price pressures. With developed central banks globally on the cusp of tightening policy and emerging market tightening underway, investors spent much of the quarter scrutinising central bank comments and waiting on announcements. As vaccination rates continue to rise and markets reopen, investors are increasingly considering life beyond Covid-19. The potential development of an antiviral pill reinforces this view. Riskier asset classes struggled against the backdrop of slower global growth, rising price pressures and the prospect of tighter monetary policy. The Fund returned 0.1% for the third quarter and 2.6% for the last 12 months, respectively, versus a benchmark return of 0.04% and 0.2%.

The yield on the US five-year Treasuries rose from 0.89% to end the quarter at 0.97% and proved to be the pivot point of the Treasury curve as the curve flattened beyond this point with 10-year yields only two basis points (bps) higher. However, five-year yields spent most of the quarter lower at around the 0.8% level and briefly traded as low as 0.6%. The lower yields reflected several dynamics. The US Treasury was restricting supply (principally via lower T-bill issuance) as it managed down the Treasury General Account ahead of the expiry of the debt ceiling suspension on 31 July. At that point, the ceiling was reset to \$28.4 trillion and has been the subject of political infighting in Washington ahead of 18 October, when cash on hand was expected to be exhausted, threatening an unprecedented default. Senate leaders have now stuck a deal to extend the ceiling by \$480bn, which is intended to fund the Treasury until 3 December by when a solution will need to have been brokered. The lack of Treasury bill issuance has also led to a shortage of paper for banks and money market funds, with increasing amounts of money (\$1.6 trillion as at the end of September) parked at the Federal Reserve via its Reverse Repo Facility. As a result of the shortages, the yield on three-month T-bills has been around 3bps for most of the quarter.

Meanwhile, estimates for growth were beginning to fall as data outturns surprised to the downside. Forecast measures such as the Atlanta Fed and New York Fed 'GDP now' measures for third-quarter GDP fell from around 6% to 2.3% (in the case of Atlanta at the end of September) as supply disruptions became increasingly apparent, with the chip shortage and port congestion now well documented.

Employment also remains well below pre-pandemic levels, although the data reveals a more complicated picture. While the unemployment rate fell to 5.2% in August from a peak of 14.8% in April 2020, it remained above the 50-year low of 3.5% in February 2020. But the unemployment rate only measures those actively looking for a job, and the participation rate has fallen to 61.7%, well down on the 63.4% at the start of 2020 as some of those previously employed choose to remain at home to care for children, to shield from Covid-19 and for lifestyle reasons, including early retirement or because of enhanced unemployment benefits that remained on offer until September. Despite there being 5.5m fewer Americans employed than before the pandemic, the number of available positions rose to 10.9m in July, 4.3m more than those hired over the comparable period, which put upward pressure on wages and increasingly prompted employers to offer signing on incentives.

The reopening of economies has presented policymakers with unique challenges in gauging the underlying strength of economies and potential longer-term price pressures, which naturally makes a clear narrative more complex to articulate and gives rise to greater market uncertainty. In the US Federal Reserve's case, despite the hawkish-leaning Fed speak ahead of Jackson Hole in late August, Fed chairman Jerome Powell proved to be relatively dovish, emphasising the transitory view on inflation and the need for clearer progress within labour markets. Markets were therefore surprised when the September Federal Open Market Committee (FOMC) Dot plot emerged, implying three hikes for 2023 and 2024, alongside the likely taper of asset purchases beginning in November but concluding by mid-2022. Up until now, the Fed has been noticeably more concerned with the healing of the job market than the inflationary pressures, which, it has suggested, will prove to be transitory. Chairman Powell's assertions that previously stated goals of "substantial further progress" within employment markets had likely been met gives the Fed more scope to tackle inflation where bottlenecks and supply-side problems are likely to hold up inflation longer than initially thought by the Fed. In the wake of the September FOMC, yields rose by around 20bps, with five-year yields breaking above the end of June levels. The Fund ran a conservative duration position of about 0.7 years during the quarter, with 0.3 years each in the US and Europe.

Despite higher-than-anticipated inflation data, break-even inflation rates were relatively stable during the quarter, with the five-year rate around 2.5%. However, the higher-than-expected near-term inflation releases boosted returns, leading medium-dated US inflation-linked bonds to outperform fixed rate bonds by around 2% over the quarter. August's headline inflation release was 5.3% year-on-year, and markets had anticipated that, as the 2020 base effects from Covid-19 passed, this would prove to be a peak. However, the well-documented supply chain problems, rising energy prices and house prices growth of 20% (which will filter into the owners' equivalent rent component of CPI, with a 31% weighting) will likely only see inflation begin to moderate in the second quarter of 2022 if knock-on effects don't lead to further price pressures. The Fund holds around 6% of its assets in US TIPS and just under 2% of its exposure in emerging markets inflation-linked bonds.

Not surprisingly, movements in core European fixed-rate bond yields were strongly correlated with those of the US, but, unlike the US where break evens were stable, European break-even rates rose by 50bps in five years and 30bps in 10 years, which led real yields to record low levels (German five-year real yields of -2.3% and 10-year of 2%), this is partly explained by the difference in seasonal accruals but also reflects the strong rise in European inflation expectations after years of depressed readings. With energy representing just under 10% of Eurozone HICP, the recent rise in oil prices and tripling of wholesale natural gas prices means further upward pressure (from 3% currently to 4% if inflation swaps are correct). How much will ultimately depend on the rate of pass-through and any government measures to soften the blow. Despite the near-term inflationary pressures, the European Central Bank (ECB) believes the key is not to overreact to transitory supply shocks and continues to project a dovish stance, with rates unlikely to rise before 2023 at the earliest. European yields have also seen upward pressure because of the €1.85 trillion Pandemic Emergency Purchase Programme (PEPP) ending in March 2022 (although maturing proceeds are set to continue until 2023). However, the ECB is set to announce a recalibration of its Asset Purchase Programme (APP) in December, while total ECB purchases under various programmes may be lower, so will government requirements, so

net issuance post asset purchases should remain close to zero. The Fund has around 13% of its assets in Europe, principally in two- to five-year maturities and property.

Increasingly, the Bank of England (BOE) is concerned about rising wage and inflation expectations. Expectations for an increase in the base rates now project a 50% chance of a move this year, with the BOE confirming rates will move ahead of any asset purchase removal. UK Gilts were the weakest of developed markets during the third quarter, with five-year yields rising 30bps to 0.64%. The ruling Conservative Party appears to be in post-Brexit denial, and the real yield on UK government debt still doesn't look that attractive in the context of the economic uncertainty. The Fund holds around 7% of its assets in Sterling via short-dated credit, convertibles, and property.

In Asian markets, Japan has a new Prime Minister after the ruling LDP elected Fumio Kishida to replace Yoshihide Suga; new national elections have been called for the end of October, where polling suggests the LDP will win a similar share of the vote. Japanese yields were largely unchanged during the quarter, with Yen closely tracking interest rate differentials with the US. Of more significance for investors have been developments in China, where President Xi Jinping's policies are having a material impact on investors. To date, government bond investors have been insulated as 10-year yields have fallen by 20bps to 2.88%, and the currency is largely unchanged versus the US dollar (and rising against other trading partners). But within the corporate sector, policies aimed at narrowing the wealth gap (dubbed common prosperity) and exerting more state control have been more impactful. Property financing rules (three red lines policy) introduced in late 2020 aimed at averting a property bust may have emerged too late, as, to date, two developers have defaulted recently, and Evergrande looks set to follow. The yield on the China dollar junk bond index has risen to 16.9% - a decade high. Investors will be watching closely to see how foreign investors are treated in any insolvency proceedings. China is also increasingly assertive on the world stage and within the South China Sea, and we are seeing Western governments, led by the US, rallying to counter the effect. China's focus on control at all levels of society is prompting many companies and investors to reassess how they deploy capital. Longer-term, the potential partial reversal of globalisation has material implications for growth and inflation.

Emerging markets performed poorly during the quarter, as yields rose sharply on the back of higher US yields but also stubbornly high inflation. Rising energy prices further compounded the problem of high food inflation. With emerging market central banks not afforded the same latitude as those in developed markets, they have begun to tighten policy quite significantly in some cases. Year to date, Brazil has raised rates by 4.25 percentage points (2% in Q3-21) to 6.15% as inflation has topped 10%, and Russia has tightened by 2.5 percentage points (1.25% in Q3-21) to 6.75% as inflation has risen to 7.4%. Countries in Eastern Europe and Latin America have also increased rates to a lesser extent. The Fund has exposure within South Africa and Indonesia hedged back into US dollars.

Corporate bonds underperformed government bonds during July, the first underperformance for nine months as concerns surrounding the Delta variant rose, US investment-grade credit recouped most of its losses during September and ended the quarter flat as credit curves flattened and ratings compressed. Europe fared slightly better, with the ECB continuing to absorb most of the net issuance. On a cross-currency basis, spreads in Europe appear slightly wider to government bonds but are comparable to US issues after cross-currency hedging. The starting yield on sub-investment grade bonds meant they outperformed government bonds by around 1% over the quarter. Asian high yield proved to be the weak spot, with several Chinese property developers defaulting and the China dollar yields approaching 20%, with offshore investors bracing for an Evergrande default. The Fund's credit duration was steady at around 1.3 years during the quarter, with a sizable hedge in place via credit options. The Fund invested in a number of short-dated positions from well-known banks and corporates, such as Prosus, Bidvest, PAA, and ET. The Fund also topped up its exposure in Mail.ru and Weibo convertibles and added exposure to Shaftsbury via the Capital & Counties convertible. The Fund reduced some high-yield exposure by selling its short-dated US ETF.

Property performed well during July and August, as economies reopened and workers began to return to offices, and residential property prices remained very strong. However, the bounce back in yields during September and China's property woes wiped out the gains at an index level, leaving the EPRA/NAREIT Developed Index down by 0.7% over the quarter. The Fund's exposure remains low and was 1.3% at the end of the quarter. The Fund sold its holding in TR Property after the discount to NAV closed and sold its exposure to Alstria after it rallied on takeover speculation. The funds were recirculated into Cofinimmo (Belgian office and healthcare), Equites Property Fund (SA & UK logistics), Klépierre (European shopping centres), Instone (German residential and care) and Segro (logistics).

The US dollar was 2% stronger on a broad trade-weighted basis within foreign exchange markets, and the Russian ruble and Chinese renminbi were the only mainstream currencies to appreciate. Latin American currencies were the weakest in spot terms, followed by the high beta South African rand and the South Korean won (hit by chip shortage). The Fund continues to hedge its non-US exposure (currently 32%) back into dollars but from time to time uses FX options to express a view on currencies other than the dollar.

While the impact of Covid-19 remains significant, the vaccine rollout, economies reopening, and the prospect of an antiviral pill means investors are increasingly confident of a return to normality of sorts. We believe upward pressure on rates will continue as central banks move to tighten policy to contain current inflation and future expectations. How much of the Democrats' infrastructure and future tax proposals can be brought to bear will also prove important, as a failure to deliver doesn't bode well for Joe Biden's presidency. We assume the debt ceiling will get resolved but have long viewed it as an opportunity for the Republicans to be obstructive. Unless global growth recovers and China is an important driver, emerging markets will continue to face headwinds. The level of rate moves implied by markets may prove to be too high, but the demand for a risk premium is likely to persist. The US dollar's fortunes are also likely to mirror those of global growth. Credit spreads have remained remarkably insulated to date, but higher government yields and a reduction in central bank asset purchases should see a reversal of the tailwinds and, with break-even protection low, caution is advisable.

**Portfolio managers**  
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as at 30 September 2021