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 final quarter of 2022 (Q4-22) was characterised by cross-currents of macroeconomic dataflow and oscillating expectations for the policy stances of core central banks. Indeed, debate around potential policy pivots – especially for the US Federal Reserve (the Fed) – dominated interest and currency market swings over the last few months of the year.

In the US, the interplay between macroeconomic dataflow and Fed guidance provided an unsettled peak to short-rate expectations. The clear peak in US CPI was already published in Q3-22 (at 9.1% in June), but the sharper descent than anticipated by analysts spurred optimism for a quicker return to more palatable levels in 2023. Indeed, after many months of consecutive inflation outcomes printing higher than forecast, to see even two months in a row of better outcomes has been instrumental in colouring a better prognosis for US inflation over the medium term. However, what has complicated the outlook for Fed policy has been two-pronged messaging. Guidance during Q4-22 was clearly for a willingness to embrace a slower pace of rate hikes after the 75 basis points (bps) rise at the beginning of November. However, this was offset by a deliberate re-centring of the debate by the Fed on the appropriate terminal rate level and the extent to which this elevated rate will be sustained. And the Fed's communication here was tilted towards the need for a higher terminal rate than had been previously envisioned. To further muddy the waters, macroeconomic dataflow specific to the US has also been conflicting. Leading activity and labour market data was quite volatile over the last three months. The tension lay between activity data that increasingly signalled an increased potential for meaningful recession in the US during 2023 and employment data that suggested a still strong labour market and solid wage growth. To close the year, the Fed hiked 50bps in mid-December, but simultaneously pencilled in new projections that incorporated higher inflation than previously anticipated, but weaker growth over 2023. The dot plot for end-2023 also showed a higher peak (5.125%) than September's update.

In Europe, the final quarter of 2022 started with a dovish pivot from the European Central Bank (ECB). Despite hiking 75bps, communication from the Governing Council was notably dovish with respect to the interest rate outlook, although not without conflicting elements from different Council members. In addition, other policy adjustments intended to solidify monetary transmission, reaffirmed the messaging that the ECB leadership believed; that significant progress had already been made in tightening monetary conditions and that a pivot could be in the offing soon enough. However, macroeconomic data was initially strong and unambiguous at the start of Q4-22 in the eurozone, which added more weight to the hawkish component of the Governing Council. This also swayed ECB President Christine Lagarde to stress the need for higher rates to combat multidecade high inflation, even as economic growth slowed down over the rest of 2022 and into 2023. To close off the year, the ECB hiked their policy rate by 50bps – meeting expectations which had adjusted beforehand. Forward guidance for reinvestments of its Asset Purchase Programme was tweaked and the initiation of passive QT (Quantitative Tightening) was also announced – but these were both overwhelmed by the accompanying commentary to the rates decision, which still slanted unequivocally hawkish.

From a global macro-financial perspective, the tail end of both the quarter and the 2022 calendar year held two potentially meaningful shifts with wide-ranging implications across asset classes and geographies. The lesser change – but still momentous as a single event – was the adjustment in late December of the Bank of Japan's Yield Curve Control policy. What had been inexplicably maintained throughout 2022 was partially relaxed in the final hour, potentially heralding a more coherent alignment in monetary and currency policies within Japan and loosening a distortionary component of global cross-border capital flows. The second, potentially more impactful, surprise to close off the year and quarter was the particularly significant moderation of Chinese Covid-19 restrictions. Just how far these will be relaxed and whether such an about-turn will be echoed in other parts of China's control-economy that have been growth supressing at the expense of other policy objectives remains to be seen. However, the pervasive reversal of what had recently been non-negotiable elements of Chinese governance has evoked wide-spread surmise about what other components of seemingly unwavering policy prescripts could be favourably overturned in the foreseeable future?

Overall for risk assets, Q4-22 was a period of modest recovery. Key to the recovery broadly seen over October and November across global equity markets was a sense of inflation peaks achieved relatively widely and the accompanying increased potential for central bank 'pivots'.Within equities, real estate counters performed worse than the broader markets across most regions. Indeed, among 'defensive' sectors, REITs had an especially torrid time over the course of 2022, in many instances also underperforming many cyclical sectors. While rising interest rates enervated a traditionally indebted sector, and fears for a consequential recession as well as receding investor appetite impacted all property counters, some areas have been much better protected than others. Indeed, with the wide feasible range of particularly poor secular futures for office sectors globally, it is hardly surprising that this has been an especially de-rated corner of the equity REIT universe.

But of course, it wasn't just equities and REITs among risk assets that faced a reckoning during 2022. Corporate credit markets had an extremely challenging calendar year. Indeed, as an example in total return terms, 2022 was the absolute worst year ever, by a huge margin, for the European investment grade market (c.-14% vs the prior worst at c.-4% in 2008). Underpinning the exceedingly challenging circumstances facing corporate credit assets over 2022 was the sharp rise in base rates. However, on an excess return basis (i.e. hedging/excluding the impact of base interest rate changes), corporate credit markets around the globe faced a very challenging year – but not as staggeringly damaging as an all-in basis. However, this was a year of two halves, as H1-22 wasn't kind on either a total or excess return basis for corporate credit assets, but H2-22 saw fairly substantial credit spread compression from the year's highs. Indeed, while Q3-22 saw a strong recovery in credit spreads initially, this was reversed to new wides for investment grade (IG) credit by the start of Q4-22. However, the final months of the year witnessed a solid compression in spreads, across both Europe and the US.

In the US, the 2022 total return for IG was c.-16%, but a much more manageable c.-1.3% on an excess return basis. By rating, AAA and AA cohorts were very modestly negative on the year on an excess return basis, with A and BBBs underperforming quite clearly. There were merely a handful of sectors in the US that managed a positive excess return for the year: these were all energy or mining related and even then, performances essentially hovered around zero. At the other end of the spectrum with sizeable negative excess returns were, essentially, all the losing but also particularly vulnerable sectors from the post-pandemic re-opening. These included several property subsectors (office, healthcare, retail), as well as media, gaming, and satellite.

Within the High Yield (HY) market in the US, at c.-11% total returns for the overall market were less negative than those seen in IG; principally a function of the shorter-dated feature of the HY market. However, at the excess return level, HY did fare relatively worse across the entire year, declining c.-4%. The poorest quality names (CCC bucket), not unexpectedly given the combination of macroeconomic and financial shocks incurred, fared especially badly on both a total (c.-16%) and excess (c.-11%) return basis. By sector, practically no corner of the HY market was left unscathed on a total return basis. In other words, only one sector managed to provide a positive performance over the entire course of 2022 (oil field services at c.+4.3%). The other least bad sectors were tobacco (c.-1.4%), defence (c.-3.7%) and gaming (c.-4.4%). The worst performing sectors were pharmaceuticals (-25.6%), retailers (-20.9%), wireless (-17.3%), and media entertainment (-16.3%).

In the European IG market, the picture was one of broad similarities to that of the US. For the overall market, total returns were c.-14%, while excess returns weren't nearly as punitive at c.-1.9%. At a broad sector level, there were absolutely no positive performances, even on an excess return basis. The least-worst sectors were banks senior preferred (c.-0.6%), healthcare (c.-0.7%) and telecoms (c.-0.7%). By broad rating bucket, AAs did manage to eke out a paltry +0.06% excess return for the whole of 2022, while all other lesser rated buckets were firmly within negative territory. Just absolutely no safe place to be for the entirety of the year, even among short-dated and highly-rated entities.

In a slight twist, the aggregate excess return performance for European HY names (excluding financials) was positive for the year, at c.+0.07%. Of course, in total return terms, this was deeply negative at c.-8.9%, but the strong performance in H2-22 in spreads terms, the higher starting yield (relative to IG certainly), and more contained approach by the ECB towards monetary tightening more broadly, allowed for relatively modest spread widening of the better quality HY European credit spreads and the commensurate, nominal positive excess return outcome overall.

For Developed Market sovereign bonds, Q4-22 was broadly one of stabilisation around the closing levels of Q3-22 – albeit with a fair degree of oscillation around this during the quarter, in most instances reaching the year's yield highs sometime during Q4-22. In the case of the US, long-dated rates reached their peaks in early November (around 4.5% for the US Treasury 10-year), before finally closing in December, very close to where they opened the quarter. For core European long-dated yields, the weakest levels were obtained very late in the year (for example, the German aggregate reached c.2.5% on 30 December), spurred on by a hawkish ECB. For non-core European yields, the close of the quarter and year was a bit more harshly felt and spreads versus Bunds widened again after having put in a fair degree of spread compression in the prior months.

For local currency Emerging Market (EM) sovereign bond markets, Q4-22 was a relatively favourable period, although the year's peak weakness in aggregate was seen briefly in late October before a fairly consistent strengthening move into year end. The notable exceptions to this broader trend (driven by global inflation expectations, risk appetite and core interest rate moves) were Brazil, China, and Egypt. Country-specific influences were at play in each of these markets that overwhelmed external factors and ensured both idiosyncratic trading patterns and notable overall weakness during the quarter for these three markets. For the year as a whole, it was a highly variable set of performance outcomes – especially when viewed on a local currency basis. The best performances often came from significantly undervalued and fundamentally challenged economies that had been taken to particularly undemanding valuations by the end of 2021. However, these were often also the least visible markets with substantial country-specific (often political) risks associated with them.

For hard currency EM sovereign debt, the return profile in Q4-22 echoed that seen at the aggregate local currency EM debt market level. While the peak in spreads was firmly topped in July, this market started Q4-22 very much on the back-foot and saw spreads rising further to a local maximum in October from already elevated levels in September. Thereafter, consistent spread compression into year-end allowed for a strong end to a year – with the caveat being, of course, that 2022 was an extremely challenging one for this asset class in particular. Overall for 2022, the spread return from hard currency EM sovereign debt was a manageable -4.4% - but in total return terms, this was an eye-watering -17.7%.

With respect to Fund activity over the quarter, as is mostly the case, the bulk of transactions related to recycling of existing exposures that had drifted into modestly expensive territory to be replaced by new issues that were perceived to be relatively cheap. Examples of names added within the quarter include NatWest, Swedbank, Svenska Handelsbanken, Standard Chartered, Santander (UK), and Berkshire Hathaway. Names recycled from included Nationwide, Energy Transfer, Bank of Nova Scotia, and AbbVie.

Within the short-dated, but modestly lower quality space, after substantial credit spread compression – beyond what would be fundamentally justified – the following entities were sold without a commensurate replacement of similar risk: Colombia (2024 USD bond), Bidvest (2026 bond; good credit quality – but excessive spread tightening), and British American Tobacco (2023 – a favoured name, but a good opportunity arose to take profit).

Interesting issuers that were added during the quarter included Sirius (a German/UK niche property company; fundamentally solid but unsupported with listed debt markets – a very favourable acquisition); and Investec Plc (sub-ordinated debt – severely undervalued due to UK macroeconomic distress).

Within the Fund's modest property allocation, there were a few adjustments over the quarter. After a strong bounce from exceptionally weak levels achieved during the period of peak macroeconomic distress in the UK in Q3-22, the Fund took profit on holdings of Land Securities and British Land. The Fund also cut its remaining holding of Simon Property Group to zero during November.

The outlook for 2023 remains fraught. While the re-pricing of base rates and expectations for additional core market monetary tightening remain relatively high, these levels may stay elevated for an extended period. In addition, which headline inflation continues to decline, there remains the risk of persistent second-round effects over 2023 and beyond, across practically all jurisdictions to a greater or lesser degree. With necessarily revitalised aggression shown by most of the core central banks once again revived in Q4-22, the corresponding potential for more severe slowdowns across much of the globe's growth centres has scaled upwards accordingly. And while there isn't especially persuasive evidence that wage-price spirals have taken hold assertively in any major economy, it is far too early for any central bank to definitively claim victory here either. While a re-acceleration of rate hikes in most core jurisdictions now appears improbable, this concern has been replaced with uncertainty around the required persistence of an elevated terminal rate.

The Fund recognises the tension between a stagflationary outlook and asset prices that already acknowledge this potential environment. As such, where specific cases of asset price weakness have become exaggerated, the Fund retains both the appetite and ability to continue accumulating these exposures. But this needs to be executed in a judicious manner. For particularly cyclically exposed entities, the very worst economic outcomes are only partially priced – deep recessions within either the US or Europe would still manifest themselves very painfully across many risk assets, if to arise. As such, and given the attractive outright yield already produced by the portfolio, the Fund retains sufficient flexibility to accumulate additional risk in the event of further weakness in the months ahead. This is available across all the primary risk buckets available to the Fund and provides a favourable base to set the Fund up for the ensuing phases of the cycle to come.

Portfolio managers
Nishan Maharaj and Seamus Vasey
as at 31 December 2022