

Please note that the commentary is for the retail class of the Fund.

The effects of the nasty surprises that blindsided global markets in the first three months of the year deepened in the second quarter (Q2-22). Risk assets experienced significant weakness with few exceptions. Concerns around further upside inflation shocks comingled with fears around the increased likelihood of recession in major markets taking hold within a few quarters. This was particularly apparent across equity markets. The return of the MSCI World Index was -16.2% in Q2-22, after stumbling -5.2% in Q1-22. As a comparison, during Q1-20 - the quarter that Covid-19 initiated abrupt lockdowns globally - world equities were down 21.4%; extreme weakness that ultimately proved short-lived in the face of exceptional monetary and fiscal interventions. However, prior to this, one would have to reference 2011, and the Global Financial Crisis in 2008 before that, to find larger quarterly losses. Aside from the quantum, another key difference with the drawdowns experienced in Q1-22 is just how widespread these were, across both geographies and sectors. Indeed, the few areas that demonstrated resilience in the first part of the year (e.g., energy, materials, and utilities), were not left unscathed in Q2-22.

Listed property came under particularly heavy pressure over the quarter. The worst of the large cap property names were European equities, which were down c26% in euros, considerably worse than the c14% decline seen in the US equivalent. By major geography, the best-performing market was in Japan, which saw a loss of only -2.2%. While broader growth concerns certainly played their role in dampening return expectations for real estate sectors, and ongoing construction cost difficulties hadn't abated either, it was the effect of elevated interest rate expectations that was most impactful. Wildly higher commercial and personal mortgage rates in recent months in major markets have been record-setting in many instances, naturally adjusting expected underlying property demand much lower. But on top of this has been the abrupt rise in base rates and widening credit spreads; both problematic for a sector that relies substantially on debt financing.

The extreme weakness in asset markets wasn't confined to equities. Indeed, by certain measures, credit markets have experienced even more historically noteworthy drawdowns with respect to both their scale and speed during 2022 than other asset classes. US investment-grade (IG) corporate bonds lost 6.7% in Q2-22 on a total return basis, following on from an exceptionally poor -7.7% in Q1-22. At c-14% year to date (YTD), there hasn't been a calendar year since at least 1977 that has been anywhere as close to as bad. The next worse was the GFC (2008), where the total return for the asset class was -6.8% for the full 12 months. The sources of strain on fixed income assets have been three-fold: inflation; the easing of a decade of financial repression; and cyclical weakness, even potentially recession within a couple of quarters being a feared possibility.

The significant post-pandemic inflation pressures that built in 2021 were then hugely exacerbated by the Russia/Ukraine crisis and the impact on commodity prices, especially energy and food. Continued evidence of exceptional tightness in many developed market (DM) labour markets during the quarter enforced the shift away from a 'transitory-only' inflation narrative to widespread recognition of a potential secular shift in inflation globally. This came with a more assertive stance by most key central banks, although the biggest shift belonged to the Federal Reserve (Fed).

The Fed raised rates twice in Q2-22. After several months of increasingly hawkish rhetoric, the Federal Open Market Committee (FOMC) decided to accelerate the pace of hikes to 50 basis points (bps) in May and laid out their plan for shrinking the central bank's balance sheet. Yet a little over a month later, the Fed raised by 75bps, even as increased evidence of slowing activity had accumulated. In addition, FOMC expectations revealed a significant shift to a much faster tightening cycle than had been signalled before, with the Fed funds rate expected to reach 3.4% by year-end versus only 1.9% before. Elsewhere, the European Central Bank (ECB) had initially remained committed to ensuring maximum policy flexibility - with the impact of the Russia/Ukraine conflict literally much closer to home and little evidence of significant domestically-driven inflation - this deliberate ambiguity was more justifiable. However, by the early June monetary policy meeting, dataflow had evolved to the point that the ECB effectively signalled policy rate increases at both the July and September meetings, even hinting at the potential for a 50bps rate hike in September and confirming the end of net bond purchases through its Asset Purchase Programme (APP) by the start of July. The Bank of England (BoE) started the quarter as the most dovish of the major central banks, actively voicing concerns around recession risks in the UK. Indeed, after the 25bps rate hike in early May, it appeared as if the BoE were looking to remain on hold for the rest of the year. But similarly to elsewhere, by June, guidance from the central bank had taken a significant notch more hawkish. The risk of at least one 50bps hike in the UK in the second half of this year is now quite high, despite persistent recession concerns.

Indeed, to varying degrees across Q2-22, most G10 central banks have needed to communicate greater wariness around potentially unanchored inflation expectations and to back this up with policy actions. And this has occurred, more often than not, in the face of rising recession risks within these economies.

For government bond markets, there was no safe harbour during the quarter. Across debt markets in both DM and emerging markets (EM), yield curves came under pressure, largely driven by a meaningful re-pricing upward of G3 yields (denominated in US dollars, euros, or yen). In aggregate, the US Treasury market lost 3.8% over Q2-22. Following on from the 5.6% decline in Q1-22, this makes for the worst six-month period since at least the 1970s. The largest yield movements naturally came from shorter-dated maturities (6 months to 1 year), as monetary policy expectations were vigorously reset. However, longer-dated maturities also experienced historically substantial rises over the quarter, resulting in significant total return losses for longer duration bonds. This pattern was echoed across nearly all DM sovereign yield curves.

In EMs, a handful of countries managed to eke out very modest gains in their sovereign debt markets over the quarter - but only in local currency terms. Once exchange rate movements are included, not a single investable local EM government bond market posted a positive return over Q2-22. Indeed, for this asset class, aggregate returns were -8.6% in Q2-22 in US dollars. EM sovereign bonds denominated in US dollars also fared very poorly. This asset class saw a loss of 11.4% over the quarter, dragged down by the particularly poor performance of its lower quality constituents. Indeed, at the very fringes of the sovereign debt market, liquidity, and solvency risks among the most fragile of borrowers have risen significantly through the YTD as consecutive external shocks have battered these nations. While Russia and Ukraine face very specific issues

around their debt status, the potential for distressed sovereigns to join Sri Lanka in non-payment during 2022 is worryingly high. The most at-risk borrowers include Ghana, El Salvador, Pakistan, Egypt, and Tunisia.

Corporate credit markets also fared particularly poorly during Q2-22, hurt by both rising base rates and wider spread levels. While there was some discrimination on a sector basis, for the most part both total and excess return performances were directly related to duration and quality. But while higher quality corporate bonds with less interest rate exposure performed better than the converse, quarterly losses here were still mostly at multi-decade highs. This over-arching return profile was mirrored across major DM corporate credit markets. However, after holding up much better in prior months relative to the equivalent sub-asset classes in the US, European corporates were materially weaker over Q2-22. Some of this relates to relative changes in the macro fundamental outlook for Europe versus the US, but mostly this is a function of ECB support for continental corporate paper fading. While both investment-grade and high yield corporate spreads have notched up meaningfully over the course of the YTD, and at a particularly rapid pace, absolute levels aren't at distressed heights, or even yet at levels associated with cyclical lows. So, while fundamental valuations are certainly attractive - default and recovery compensation embedded in spread levels is generous - a degree of continued caution is necessary. With an uncertain outlook around longer-term inflation regimes and additional markers of recession risk accruing, a deepening of these concerns would make for a particularly credit unfriendly environment.

Fund activity over the quarter was focused more on individual instrument recycling, than making significant adjustments to aggregate portfolio risk. Indeed, duration (interest rate risk) in the portfolio had been kept below the one-year level for the bulk of the last three months, even as DM yield curves came under continual pressure. Only during the last few weeks of June did the Fund modestly extend duration, but very selectively. Where monetary policy expectations had become fully priced, the Fund added incremental interest rate exposure. The most attractive area of any curve has been very near-term maturities (<9 months) in the US. Overall, interest rate risk exposure in the Fund is proportionately quite heavily skewed towards the US again - back to levels last seen in Q3-20. In addition, the Fund had - several quarters ago - accumulated a basket of deep-out-the-money options aimed at providing protection against substantial interest rate increases. With the exceptionally quick and large increases in US rates over the first half of this year, these options had provided a beneficial offset. This was monetised towards the end of Q2-22.

Aggregate credit exposure was maintained at stable levels over the course of Q2-22, even as individual credit sales and purchases proved relatively active. The bias in new assets acquired was towards senior, short-dated high-quality financials (e.g., Nordea, Amex, Barclays, Rabobank, UBS, JP Morgan). Some of this was funded from maturing assets, but also from a short-dated USD credit ETF, which had been previously accumulated into generalised weakness as a placeholder. Another modest bias of the Fund's additional asset purchases during the quarter has been towards floating rate notes (FRNs), rather than fixed rate bonds. Unusually, it has been possible to find FRNs that have been substantively cheaper than their fixed rate equivalents. The Fund now has c23% in FRN instruments, up from c13% at the start of 2022.

In non-USD markets, the Fund continued to find attractive relative value opportunities of cheaper instruments issued outside of the US, relative to their USD equivalents. This was mostly due to differential pricing of the credits (found mainly in GBP), although actual cross-currency basis opportunities (i.e., favourable hedging terms) had started to make themselves apparent in Q2-22 (mainly in yen, Canadian dollar, and Australian dollar). Non-USD issues purchased included BNP Paribas and Berkshire Hathaway in yen; Westpac and Bank of Montreal in Australian dollar; and Rabobank, Wells Fargo, and Volkswagen in pound sterling.

The Fund's aggregate property activity saw additional top-up purchases of GOZ (higher-spec industrial and office in Australia), Leg Immobilien (specialist residential landlord in Germany) and Instone (established residential property developer in Germany). However, overall net property exposure was reduced over the quarter as the Fund sold out of Vici (US casinos) and Mercialis (convenience shopping centre specialist in France), after solid performances. Another Fund holding, MAS (Romanian-focused shopping centre developer and landlord), was also sold down in its entirety, as performance here had been unusually robust and steadfast relative to most other European retail commercial real estate entities. So, this was an exercise in risk management, rather than a changed view on the underlying entity, which remains favourable.

There has been no cessation of the extreme uncertainty unleashed across global markets in the first half of 2022. Indeed, on most key macro concerns facing fixed income investors, the outlook for the second half looks more unsettled and potentially as treacherous as the months that have just passed. However, a significant degree of monetary policy normalisation over the medium-term has now been priced in; longer-dated interest rates are much more commensurate with their fundamental fair values and corporate bonds undoubtedly offer much better break-even protection and reasonable yields - especially shorter-dated maturities. As such, the Fund has been front footed in maintaining aggregate credit and property exposures at more assertive levels than those seen across the second half of 2020 through 2021, reflective of the value that has been unearthed in the last six months. But with a constant eye on maintaining cash plus returns through-the-cycle, the Fund continues to sustain sufficient flexibility to accumulate additional risk in the event of sustained weakness in the months ahead.

Portfolio managers
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