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 fixed income markets had a stellar start to the year. After a particularly aggressive and sustained period of monetary tightening in prior months, anticipation swung towards the end of such campaigns for the US and many other major central banks early in the new year. These beliefs co-mingled with more benign inflation expectations, providing an additional boost to both interest rate and credit markets. However, this was a relatively short-lived episode across markets as data flow from both Europe and the US suggested continued strong underlying economic momentum, undermining the notion that central banks had gotten ahead of price formation and had won the war on inflation. And to complicate matters even further, a flare-up in bank risk on both sides of the Atlantic proved a focal point for markets in the quarter.

The failure of Silicon Valley Bank (SVB) in early March represented the largest of any bank since the Global Financial Crisis (GFC) of 2007-08 and the second-largest bank failure by assets in US history (after Washington Mutual). While the antecedents to SVB's collapse may appear well laid out in hindsight, the speed and severity of the bank's failure and placement in receivership caused substantial damage in confidence towards the wider US financial sector, but especially around the smaller, regional banks. Indeed, while only weeks have passed since the failure of SVB, sentiment remains fragile, and the risk of confidence withdrawal continues to weigh over the (perceived) weaker regional US banks. However, there is an emerging consensus that SVB was very much an outlier and failed largely because of poor risk management and exceptionally unusual concentrations on its balance sheet. Indeed, the root causes of SVB's collapse stand in stark contrast to the stresses that caused the GFC, where poor asset quality and uncertainty around who was exposed to credit losses characterised that crisis. Rather, SVB was the victim of a classic bank run: depositors left the bank en masse in a rush, fearing an inability of the bank to redeem them – which became largely a self-fulfilling event. While the similarly rapid demise of Credit Suisse (through a forced sale to its national rival, UBS) was slightly more complicated, the very same dynamic of a classic bank run was also at play.

The downstream effects of these events in quick succession to each other in the US and European banking sectors was meaningful. Aggressive re-pricing of financial debt – and especially sub-ordinated bank paper – occurred practically overnight. And the re-pricing of bank debt certainly wasn't where the fall-out ended. For even as there is growing unanimity that these bank failures don't represent systemic fractures within the US and European financial architectures, there is equally widespread acknowledgement that pricing of bank risk needs to adjust. There is likely to be a formidable regulatory response to these events in the medium term and overall bank risk-taking, through credit extension, will be curtailed in the immediate aftermath, at the very least.

Asset class performances

With a few exceptions on either side, developed sovereign bond markets were reasonably stable over the first three months of the year. Following the banking sector stress of early March, core government bond markets strengthened, partly as a consequence of elevated safe-haven demand, but also as policy rate expectations, which had undergone a meaningful reset higher over the prior weeks, were rapidly reversed.

Indeed, the key theme was a strong outperformance from longer-duration bonds as both financial and real economy consequences of the banking sector stress were incorporated into enhanced demand for defensive assets. In the US, the 10-year bond started the year around 3.90% before closing the quarter close to 3.40%; similarly, the 30-year long-bond ended 2022 touching on 4.0% before closing out Q1-23 around 3.60%. A very similar profile was seen for German bunds: the 10-year started Q1-23 around 2.60% before ending around 30 basis points (bps) stronger at 2.30%; the 30-year moved from c.2.50% to c.2.35%.

Within developed economy inflation-linked markets, a similar format was seen. Indeed, in the US, break-even rates (the difference between equivalent maturity nominal and inflation-linked bond yields) ended the quarter largely unchanged, reflecting that the bulk of the move of US Treasuries was a function of real yield declines. Across the developed market linker spectrum, the best performing markets tended to be the longer-duration pools, which had also undergone persistent re-pricing in prior quarters. Leading the pack was the UK (+7.1%), followed by Italy (+6.6%) and Australia (+5.7%).

Unsurprisingly, within the local currency Emerging Market sovereign debt arena, the first quarter of the year had a far wider range of dispersion of returns, depending on the issuer and whether considering local currency versus unhedged returns in US dollars. The overall market (JP Morgan's GBI-EM Global Diversified Index) did reasonably well, posting a total return in local currency of c.+2.8%. With better performances from most EM currencies against the US dollar, the index return was boosted to a respectable c.+4.8%. There were a few stand-out performances in USD terms: at the top of the leader board was Colombia (+13.3%), followed by Hungary (+12.6%), Mexico (+9.9%) and Chile (+9.9%). The laggards were Egypt (-22%), Turkey (-9.1%) and South Africa (-2%).

In hard currency EM sovereign debt, a less impressive overall asset class performance was achieved relative to the local currency version. Here, the index (JP Morgan EMBI Global Diversified Index) return was c.+1.9%, which for the additional duration and credit risk of the constituents relative to its local currency counterpart, is somewhat disappointing. Dispersion within the asset class was, however, particularly substantial over the quarter. The largest gainers were almost exclusively part of the select club of defaulted and distressed entities (Maldives, Sri Lanka, Ethiopia, Tajikistan, Venezuela, and El Salvador). While double-digit returns from heavily subdued levels isn't a particularly demanding outcome, they do come with all the attendant risks of distressed debt.

Within developed market spread products, the first quarter of 2023 was particularly eventful, especially from an excess return perspective. For the US investment grade (IG) market (ICE BofA US Corporate Index), total returns on the quarter were decent at +3.4%, similar to the +3.5% seen in Q4-22. However, this was mostly a function of interest rate movements, as excess returns in the quarter only amounted to +0.3% (vs +2.9% in the prior quarter). However, the small aggregate return contribution from spread movements belies the substantial volatility seen in DM credit markets across the quarter. Aggregate US IG spreads started the year around 138bps, reached a low of 120bps and a peak of 164bps, before closing the quarter around 145bps.

A very similar outcome was seen within the US high yield (HY) market. The total return for this asset class (ICE BofA US High Yield Index) amounted to a respectable +3.7% (vs +3.9% in Q4-22); excess returns for the index were +1.4% vs +2.9% in the prior quarter; index spreads opened at c.480bps and closed near 460bps, after having followed the same circuitous route as that of IG spreads – but with commensurately more vim.

On an aggregate basis, the total and excess return profiles of the European corporate credit markets faithfully echoed that seen in their US cousins over Q1-23. More interesting than the differentiation across geography, rating bucket or term structure among corporate credit markets was that found across sectors and specifically among financials vs non-financials.

With the forced sale of Credit Suisse to UBS in particular, various capital instruments were bailed-in during that process. Aside from the volatility and fluidity that banking stress episodes bring to financial markets more generally, but most especially financial sectors themselves, the additional complication of this most recent risk event arose specifically from added uncertainties surrounding the nature and true riskiness of banks' junior subordinated debt instruments. Indeed, while non-financial Euro corporates saw aggregate spread compression over the quarter, their equivalently rated financial sub-ordinated and LT2 counterparts experienced the opposite and this from an already more punitive starting spread level.

Finally, across global real estate equity markets, it was a sombre period as most markets came under renewed pressure after what had been a generally perky first few weeks of the year. The global index eked out a modest +1% gain with the best performance from the major markets coming from Singapore (+4.7%) and Hong Kong (-7.2%) bookending the worst performers. Europe (-6.6%) remained at the centre of the negative news-flow given still high inflation and higher leverage than other markets. Indeed, with policy rates potentially further to rise and cap rates still at objectively low levels, the risk within this sector of hardening headwinds has grown and consequently been reflected in counter performances over the quarter. The US (+2.6%), conversely, actually had a defensible quarter, although with a fair amount of differentiation across sectors and individual counters.

Fund activity

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 cheaply priced. This tends to take place within the higher-rated credit buckets, involving short-dated issues (usually 1-3 years) of better-quality issuers. Names added during the quarter included: American Tower, Bayer AG, Energy Transfer, General Motors, Nissan, VW, and AT&T.

Indeed, the first half of the quarter bore witness to a net reduction in risk within the Fund, as more holdings that had appreciated beyond their fundamentally justified values were trimmed and not replaced with better valued alternative issues. Issuers sold included: Ryanair, Simon Property Group, PAA, Prosus and JD Group.

Other shifts within the Fund included reducing the placeholder assets (debt ETFs in the UK and US) with individual exposures from within these same markets that were more attractive on a risk-adjusted basis than what the market average could provide.

Within the real estate allocation in the Fund, opportunities presented themselves very selectively in the quarter, primarily within the debt space, as this sector became heavily denigrated in the face of macroeconomic concerns, elevated inflation and central banks asserting their inflation-fighting credentials.

On the duration front, the Fund positioned fluidly but lightly. On the whole, interest rate risk was not emphasised as a significant performance lever, given that credit opportunities remained more compelling – especially in the latter part of the period. Overall, established interest rate ranges were traded – which proved the correct approach. Elsewhere, the Fund added to direct inflation-linked exposures in the US, favouring longer tenors.

But most significant for the Fund in Q1-23 in terms of activity was the addition of both sub-ordinated and senior bank paper in the wake of the financial sector stresses seen in the US and Europe. Favoured names were typically the G-SIBs (Global Systemically Important Banks) alongside strong national entities, as even the higher quality institutions that were unblemished by the travails within the sector experienced asset re-pricing in the immediate aftermath of the SVB/Credit Suisse fallouts. Issuers added included: UBS, Wells Fargo, Société Générale, NatWest, National Bank of Canada, Barclays, Citi, and HSBC.

Outlook

The end-phase of any interest rate tightening cycle is usually difficult to navigate for fixed income markets. This time will be no different; indeed, there are probably more reasons why this episode may prove particularly challenging.

Firstly, the current high degree of synchronisation across major central bank interest rate cycles complicates policymaking in any single jurisdiction. Secondly, the stresses in the US and European banking sectors – also felt elsewhere – may yet translate into an impact on financial conditions. And the magnitude may be material enough to influence the course of monetary policy. Thirdly, and perhaps most concerningly, there is also the lingering possibility that additional underlying fractures within banking systems haven't all surfaced yet. If these were to arise, the potential for more significant downturns beyond 'technical' recessions in key economies would become significantly greater.

There are other concerns that have the possibility of breaking the surface within the coming months. In the US, the 'x-date' for financing the deficit through extraordinary measures is likely to be hit in August – however, this is just an estimate, and it could be as early as June, assuming that corrective measures won't have been implemented prior to that. The long history of political wrangling around the debt ceiling does suggest there isn't a high likelihood of partisan brinkmanship actually bringing the US government into some form of technical default. But if this does happen, the impact on both US Treasury markets and financial markets more broadly, could well be significant. Hence, the closer the x-date draws without resolution, rightfully the more concerned markets will become as the potential for a very small probability event with a very high impact outcome grows larger.

A final high-impact risk (although certainly not the last!) that's worth highlighting lies with the change in personnel at the Bank of Japan (BoJ). While all indications thus far are for policy continuity, there is the latent chance that new leadership may inspire a new direction for the BoJ's monetary and exchange rate stance that has placed this economy very much at odds with the rest of the G10.

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 remain 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 March 2023