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

Performance

The Fund returned 0.94% for the quarter, compared to the benchmark return of 1.46%. Over the past 12 months, the Fund returned 5.19% versus the benchmark return of 5.09%. Since inception, the Fund return is 0.8% p.a. ahead of the benchmark.

A continued obsession with inflation remained particularly consequential for macro markets over the third quarter (Q3-23). However, while headline inflation continued its global descent over the period – as widely anticipated – the undercurrents of pricing dynamics were much more complicated. Generally, core inflation remained stickier across key economies, even as this continued to trend downward. And a renewed surge in energy prices (WTI moved from c.$70pb to c.$90pb) and the falling away of beneficial energy base effects meant that headline CPI measures bounced just as vigorously as they had fallen earlier. This is particularly the case in the US but echoed in other jurisdictions. Indeed, persistently firm labour markets and solid wage pressures provided minimal relief to be recognised in the US from lower headline inflation and despite services inflation continuing to cool. In the eurozone, a similar dynamic unfolded, although with much more dispersion across the member states and also far less buoyancy in the labour markets.

From a global growth perspective, most high-frequency activity measures suggested a slowing of momentum during the quarter as prior high inflation and the lagged impact of interest rate increases ostensibly took hold. The relative dynamics on either side of the Atlantic seen in Q2-23 were reflected again in Q3-23: the US holding up better, with Europe continuing to falter. Indeed, the consensus growth forecast for 2023 in the US rose from c.1.3% at the beginning of the quarter to 2.1% by the end. In contrast, peak consensus expectations for 2023 for the eurozone reached a paltry 0.6% in Q1-23 and slipped to 0.5% during Q3-23. In the other major global growth engine, China, the third quarter seemed to reflect continued slippage of an increasingly worrisome recovery, accompanied by large-scale, concerning developments within the property sector. The silver lining in this case was that – arguably – the data deterioration may have stabilised during the quarter and that the authorities became a bit more proactive in providing more widespread policy support.

Asset class performances

The shifts in Developed Market (DM) sovereign debt over Q3-23 were broadly harmonised. Yield curves across the G10 mostly experienced bear steepening over the quarter out to around the 10-year point and then mostly parallel weakness in yields in longer-dated maturities. This was as macro markets remained particularly sensitive to monetary policy expectations and any indications of whether core central banks were approaching the end of their tightening cycles.

With strong messaging from the US Federal Reserve Board (Fed) suggesting a policy rate profile for persistently high rates for an extended period, rates markets responded accordingly. Thus, even as the Fed only chose to hike 25 basis points (bps) at the July FOMC meeting and pause at the September meeting, longer-dated rates sold off more vigorously. This was achieved by firmed up growth forecasts by the Fed, as well as the median FOMC dot in 2024 and 2025 moving up by 50bps in each year, implying a widening consensus in the US central bank that interest rate easing over the next two years is set to be shallower than previously indicated. Helping to propel the adjustment higher in long-dated yields was a surge in supply in US government debt, partially as a result of the debt ceiling impasse earlier in the year being (temporarily) resolved. The US 10-year bond started the quarter trading at 3.84% before undergoing progressive weakness and ending Q3-23 at 4.57% – levels not seen since before the Global Financial Crisis (GFC).

European sovereign yield curves also experienced bear steepening in Q3-23. The European Central Bank (ECB) hiked in July but diverged from the Fed's pause in September by raising another 25bps and taking the policy rate to 4.5%. Even as headline inflation in Europe continued to descend more rapidly than in other regions over the third quarter, core inflation measures have been kept more elevated than anticipated by stickier services inflation. The ECB also shifted its messaging to suggest that policy rates may remain elevated for longer than markets were pricing. The 10-year Bund weakened over the quarter from 2.39% to 2.84%. Within Europe, there was spread widening against the German curve. Italy's 10-year yield sold off to c.4.80%, the highest within the eurozone and approaching the top of the range seen outside of the episodes of the European sovereign debt crisis.

UK gilts actually performed relatively well in Q3-23 – at least shorter-dated bonds. Here, the Bank of England (BoE) hiked their policy rate in August from 5.00% to 5.25% but also paused later in the quarter. Inflation data in the UK has been volatile, but the combination of worsening activity data and evidence that core inflation is rapidly declining has increasingly convinced the market that the BoE has completed its tightening cycle and would be easing within three quarters. This, despite the BoE still projecting more of a hawkish stance. Longer-dated UK bond yields, however, fared poorly, and yields were up by +50bps from the 20-year point and further out. This divergence in performance was largely driven by poor immediate fiscal dynamics, continued quantitative tightening by the BoE, and lingering long-term inflation concerns.

Elsewhere in DM sovereign debt markets, Japan made a significant policy adjustment in their yield curve control by allowing a wider trading band for the 10-year bond. The JGB yield curve also experienced bear steepening over the third quarter, although absolute yield levels remain very subdued; the 10-year ended September at 0.77%, while headline inflation last printed at 3.2% y/y.

Real yield adjustments were primarily responsible for the moves higher seen across DM bonds. In the US, the 10-year inflation-linked bond yield shifted from 1.74% at the end of June to 2.36% by the end of September. This is significant, as levels higher than this were only seen briefly during the GFC and structurally only in the 1990s and earlier. Except for very short maturities, the US real yield curve ended Q3-23 particularly flat (2.4% - 2.6%) after having been more inverted earlier in the year.

Against a backdrop of meaningfully higher long-dated real yields, it is unsurprising that Emerging Market (EM) local currency sovereign bonds also struggled to produce positive returns. On an unhedged basis, the overall market was down by 3.26% on the quarter in USD, dragged lower by poor currency performances against the USD, but also declines in bond prices. In local currency terms, Turkey was the clear outlier (c.-23%) to the downside, while Egypt was the best performer (c.+5.4%). The past quarter also saw divergence in the paths of relative monetary policy, as several EM central banks solidified a turn in their cycles with rate cuts in the third quarter (most notably Brazil, Chile and Poland).

For hard currency EM bonds (EMD), the third quarter was an almost exact unwinding of the gains of Q2-23 (-2.23% vs +2.19%). While July saw continued spread compression for the overall market, following the good momentum seen in May and June, this was partially unwound over the course of August and September. But the much larger contributor to the negative total return for the quarter came from the increase in base rates. Indeed, at an index level, hard currency EMD yielded 8.37% in USD at the end of June – but this had leapt up to 9.04% by the end of September. By country, there was limited ability to swim against the tide of rising US Treasury yields, with most sovereigns posting low single-digit declines in returns. Outliers included Argentina (-14%), El Salvador (+23%) and Ukraine (+21%) – all very idiosyncratic stories and all at the much higher end of the risk scale.

US Investment Grade (IG) corporate credit faced headwinds in the prior three months. The market was down by 2.7% in total return terms, driven entirely by the move upward in base rates. Excess returns (i.e., the return from credit spread moves in isolation) were actually reasonable at +1% as spreads remained well contained in a tight trading range below the quarter's starting level (c.130bps). Supply/demand dynamics remained favourable for US IG – and indeed for DM spread products more generally – while the US earnings season reported in Q3-23 was well received by the market. For the overall US IG market, yields adjusted higher from 5.55% to 6.07%. Absolute yield levels higher than Q3-23's closing rates were last seen during the GFC and before that in the very early 2000s. The best place to have been during Q3-23 from a total return perspective was in the shortest maturity possible credits, given that short-end base rates in the US were the most anchored over the period on a relative basis. Interestingly, however, credit spreads in the longer maturity issues compressed the most. The net result was that by the end of September, the US IG credit curve had swung to levels that are exceptionally flat, even by very long-term historical standards.

US High Yield (HY) bonds had a sedate quarter. Total returns for the market were mildly positive at +0.5%, while excess returns were a bit better at +1.3% as spreads traded tighter for almost the entire quarter before weakening into the close to end the quarter broadly unchanged. Absolute spread levels across the quarter were relatively tight on a historical basis (i.e., pre-Covid), helped by limited refinancing and reasonable fundamental corporate data flow.

The IG and HY markets in Europe fared better than their US counterparts during the quarter. A good part of this relative outperformance came from European base rates being a bit stickier. European IG markets gained 0.3%, while HY was up +1.7% – very similar to Q2-23. Spread trends echoed those seen in the US, although outright levels in Europe remain more elevated from a relative historical perspective.

Finally, within listed real estate markets, the third quarter saw capitulation late in the quarter as pressures from the first half of the year escalated, motivating both earnings downgrades and cautionary rerating. The key common thread came with higher debt servicing costs as short-term interest rates crept upwards, and markets absorbed the medium-term re-pricing of policy rates – in most significant jurisdictions – possibly needing to be 'higher for longer'. The FTSE EPRA NAREIT Global TR Index (USD) was down 6.5% on the quarter, taking the total return performance c.28% off the post-Covid recovery highs seen in late 2021. Naturally, dispersion within and across regional real estate markets remains wide enough to select favourable long-term opportunities. But with interest rates undergoing meaningful adjustments over the quarter – and the real estate sector especially sensitive to this influence – even the best-placed names struggled to do well.

Fund activity

With respect to Fund activity over the quarter, as is mostly the case, the bulk of transactions related to recycling existing exposures that had drifted into modestly expensive territory and were replaced by new issues perceived to be relatively cheaply priced. This tends to occur within the higher-rated credit buckets involving short-dated issues (usually one to three years). There is also the natural recycling of maturing issues, given that the Fund tends to have a meaningful and continuous liquidity ladder spanning from one quarter to the next.

Aside from the Fund's continuous turnover relating to value-driven recycling across the high-quality, short-dated buckets, activity during the past quarter was contained. With elevated US short-dated rates and bolstered by expectations for further Fed interest rate hikes, there is plentiful opportunity to achieve the Fund's objectives within the short end of the US yield curve. Indeed, with base rates as elevated as they are, there is even less call to pursue additional yield through alternative avenues. Furthermore – as is always the case in late-stage tightening cycles – investors need to be especially cognisant of the fundamental risks posed by the lagged effects of rapidly increased borrowing costs. With tightening monetary conditions necessary to subdue inflation and control inflation expectations, corporate fundamentals will become more challenged. In this circumstance, there is always the potential for policy errors to arise and monetary tightening to be pushed too far, raising the risk of a much deeper and more damaging economic slowdown. This risk undoubtedly grew throughout Q3-23.

Through the quarter, the Fund elevated its stand-alone interest rate exposure. After starting at relatively subdued levels, this was progressively increased as US Treasury yields progressed fairly uniformly higher over the period. The best value was perceived to be in the two- to four-year area of the US yield curve, although late in the quarter, assertive curve steepening meant that the valuation of longer-dated maturities also improved. The net result was that the Fund added duration across different parts of the US yield curve. In addition, this wasn't limited to just nominal instruments – inflation-linked bonds also improved in valuation over the quarter, with real yields at longer maturities ending the quarter above 2%. With increases in real yields to levels that are attractive on a long-term basis, yet break-even rates remaining fairly well anchored, the addition of TIPs to the portfolio provides for well-priced protection against unexpected inflation surges in the quarters ahead.

Regarding idiosyncratic risk added to the portfolio in the prior three months, the selection here was particularly circumspect. With global spread markets proving solidly unwavering at not particularly cheap levels, the opportunity set was seen as relatively contained. In addition, it was significantly easier to replace richly-valued credits sold with straight US Treasury yield exposure. The result was only a handful of non-routine, higher-yielding names added. These included two Meituan (Chinese internet shopping platform) convertible bonds, a EUR VW hybrid and a short-dated Imperial Brands senior unsecured GBP issue.

The Fund also added selectively into the generalised weakness seen across global REITs in Q3-23 to a few existing property exposures. In particular, weakening macro fundamentals, higher cap rates and increased funding costs in Australia saw real estate under pressure. However, the extent of the de-rating seen was both overly punitive and more widespread than reasonable, and higher-quality names got caught up in this. As such, the Fund added further to its holdings of Charter Hall Long Wale REIT (diversified AUD6.8bn property portfolio) and GrowthPoint Properties Australia (AUD4.8bn, quality office and industrial) – these now constitute some of the largest property exposures in the Fund.

Portfolio managers
Nishan Maharaj and Seamus Vasey
as at 30 September 2023