LIONTRUST

GLOBAL FIXED INCOME PROCESS

Quarterly strategy – remaining overweight credit, with macro risks mostly priced in.

Executive summary

We believe there is a mild recession coming. Central bankers view a slowdown as a necessary condition to tame wage inflation and, by extension, core inflation. There is still further to go in this tightening cycle, but expectations of peak or terminal rates have reduced as economic data has weakened. The risks to the downside for European economies are higher due to the spectre of energy rationing. The good news is a lot of this risk is already priced into the markets.

It is illustrative of just how cheap high yield bonds got in Q2 2022 that, in July, when economic data – particularly in Europe – has been poor, returns in high yield have been very strong. Despite strong recent returns, we still believe there is lots 'in the price' and continue to favour an overweight position in credit, both high yield and investment grade, despite a clear deterioration in the macroeconomic environment. If these strong returns continue in the short term, we may well tactically look to reduce high yield exposure, but will still be strategically overweight to some degree.

The situation in Europe is extremely uncertain, driven mainly by the spectre of a sustained period of reduced energy supply. Although we retain a decent exposure to European credit, we have limited exposure to cyclical credit and believe stock-picking within credit will add value in a negative growth environment.

Although Europe is at the coal face, data out of the US is also deteriorating, as you might expect given the tightening in monetary conditions to date. The housing market, for example, is slowing and that will affect consumption. We note that certain consumers are funding their spending, which at the macro level in US remains resilient, with borrowing. This is not as confidence-inducing as the pot of savings that previously drove our comfort with the US consumer. However, we still believe there is a sizeable gap between a 'soft landing' and a harsh recession, and US fundamentals (e.g. savings, health of banks) point to something at the moderate end of the recession scale.

In terms of rates we have been adding to duration, reducing the size of our underweight position, throughout 2022 as valuations improved. . Admittedly, we were perhaps a little quick to reduce duration back down to 4, having taken positioning to neutral (4.5 years) for the first time in the history of the strategic bond funds when yields on 10-year US Treasuries came close to 3.5%. Given the deterioration in economic data and the lack of quick fixes for the various problems in the macro-economy, our likely next move in duration is higher. We are certainly in no rush to sell duration despite the recent drop in bond yields. The decision earlier in the year to increase Euro duration has proven wise. At 1.25 years, Euro duration makes up close to a third of the strategic bond funds' duration, with the rest in US and a small NZ exposure. We retain our preference for the 5-10-year maturity buckets. If the yield curve between 5-year and 30-year US Treasuries continues to steepen we will reduce the size of our long-end underweight position.

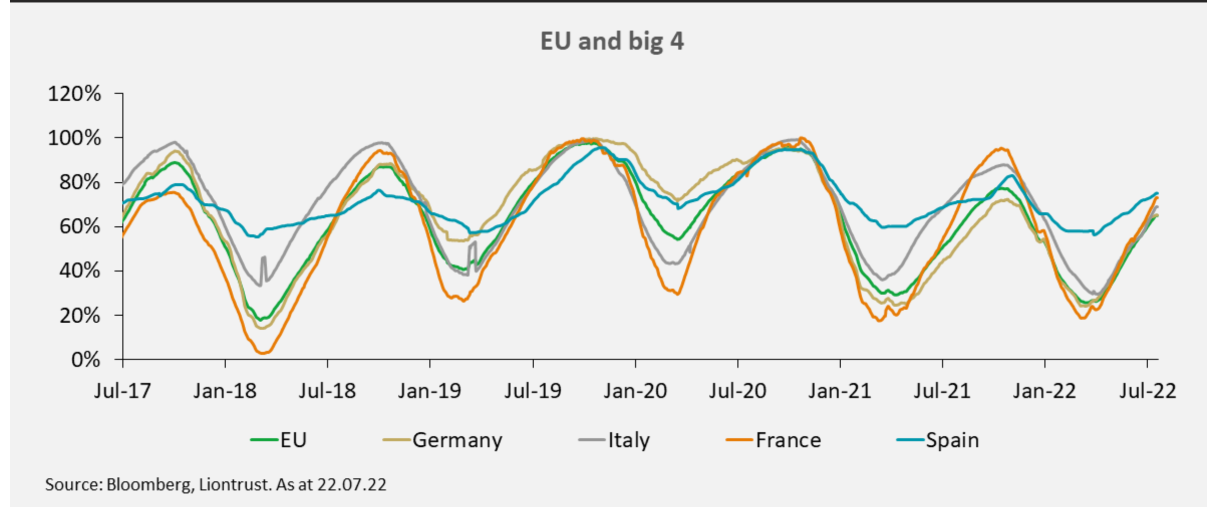
Macroeconomics

Consensus global growth forecasts into the second half of the year are largely unchanged versus our spring meeting. However, economic forecasts feel even less reliable than usual in the current geopolitical climate.

Topics previously considered 'leftfield' have become normal material in this section of our strategy meetings, with European gas storage capacity a new input this summer. The supply of gas to Europe remains a key leverage tool for Putin's Russia. The other is the supply of Ukrainian wheat to Eastern Europe, Middle East and North Africa. This is, of course, not new news, but the length of the conflict to date and the lack of any meaningful light at the end of the tunnel has increased the dominance of these issues in the market psyche.

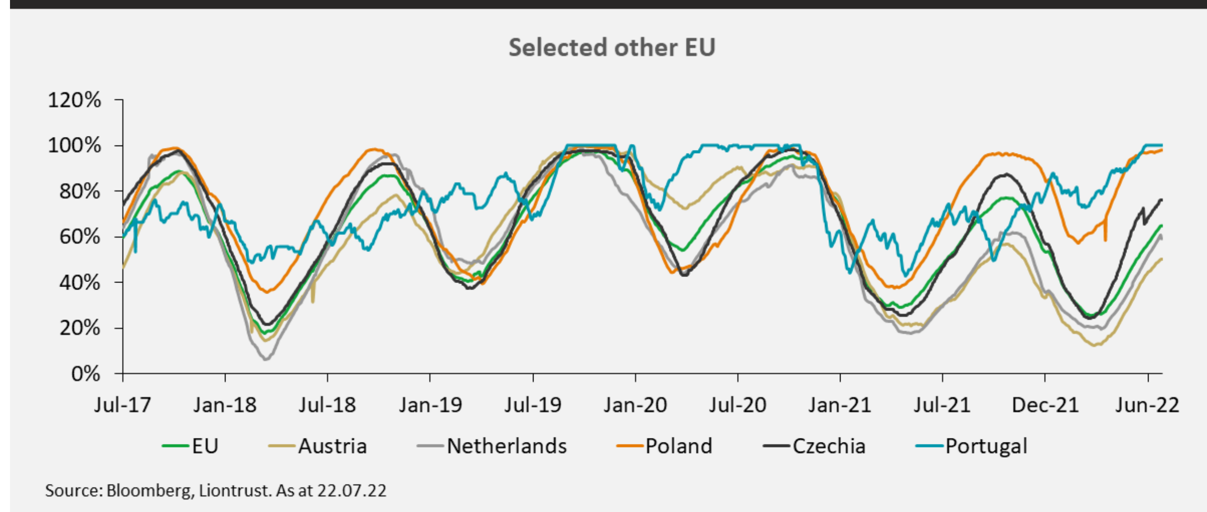
We can see in the first chart below that Germany has the lowest storage capacity utilisation among the bigger European countries, though Austria and Netherlands are also low in stored gas. Gas rationing, voluntary or otherwise, has entered the conversation.

Gas storage capacity utilisation (%)



Source: Bloomberg, Liontrust. As at 22.07.22

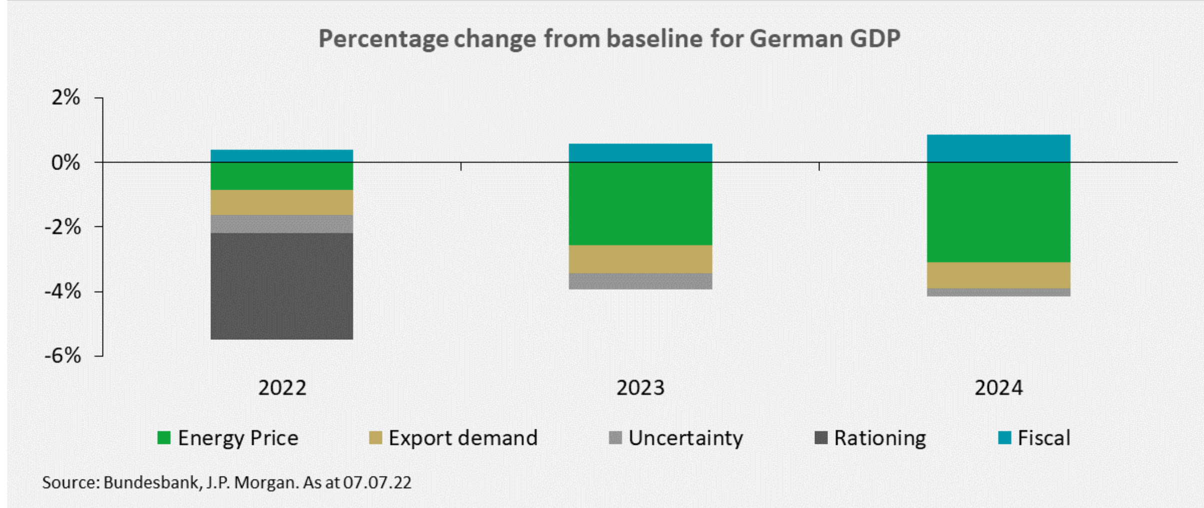
Gas storage capacity utilisation (%)



Source: Bloomberg, Liontrust. As at 22.07.22

The data and analysis we've looked at suggests Germany has emerged as one of the most vulnerable to a potential shut off in Russian gas. For example, a study from the Bundesbank suggests a scenario with full gas rationing could see a 6% hit to Germany GDP. The weather in Europe will play a major role in how this plays out over the winter, should Putin continue to flex his gas muscles.

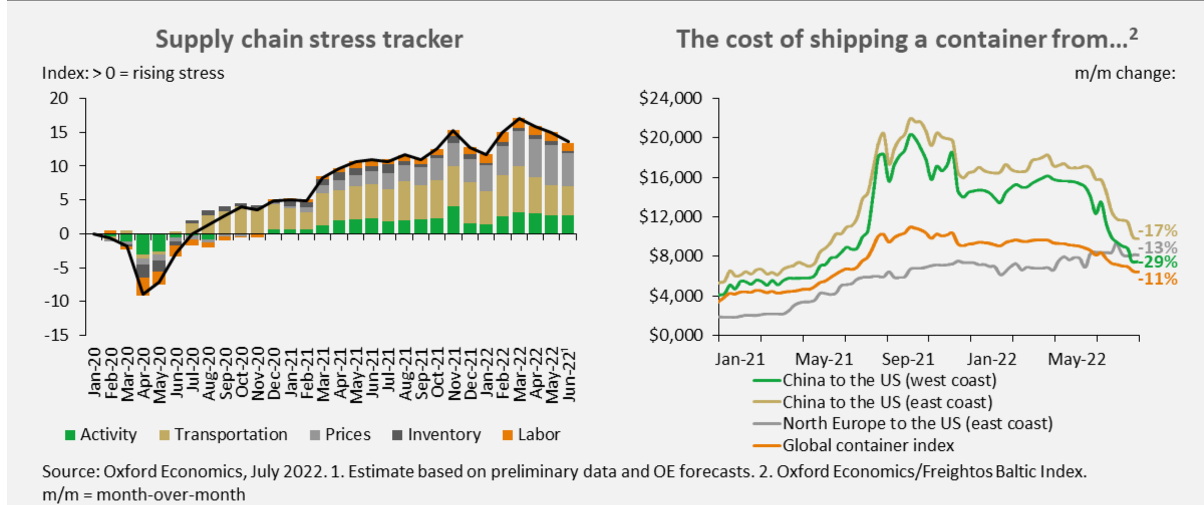
Bundesbank study on energy import ban



The toll this is taking on German business confidence, for example, is clear; German PMIs (a measure of purchasing manager intentions), fell to below 50 in June, a headline which is consistent with Germany moving into recession.

Our discussion was more upbeat on improving supply constraints, which have been a major part of global macroeconomics in the last couple of years. Any optimism over improving supply bottlenecks is, however, tempered by how much the economy is slowing. This is probably very good news for the inflation hawks, but much less comforting for those worried about growth. It has been this dichotomy, growth versus inflation, which has driven markets in recent months.

US



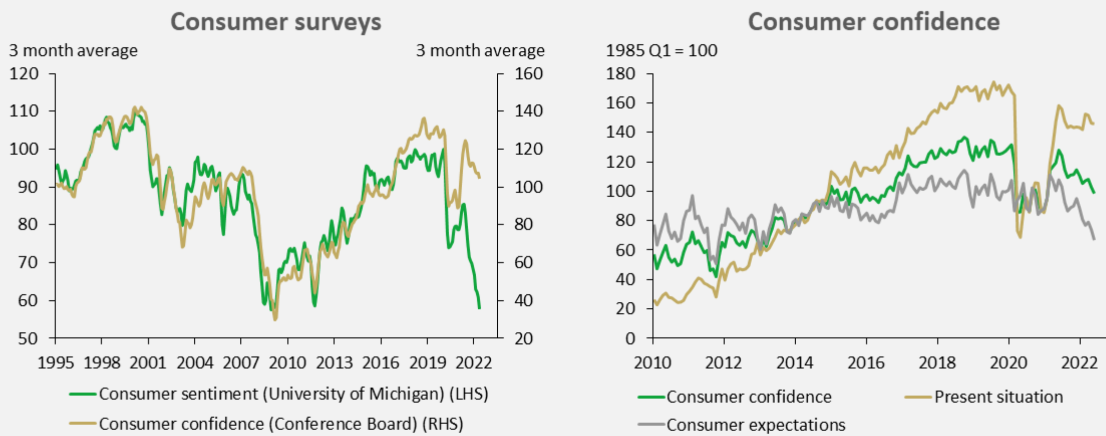
Regarding the improvement in supply constraints, we have considered the role China could play in supporting slowing global growth in the second half of 2022 and beyond. If the extent of lockdowns in China are reduced in the second half, then the economy is likely to see a significant rebound in growth, albeit the official target of 5.5% for 2022 is unachievable using any honest statistics. It is clear that the global growth dynamic is shifting eastwards as the year progresses and the West tries to tackle its inflationary problems.

All-industry output PMI

Source: S&P Global, JP Morgan, July 2022

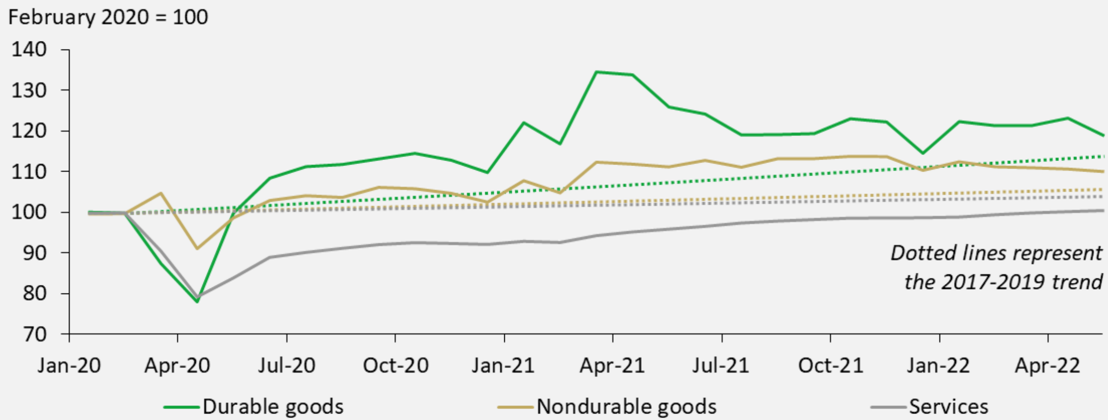
Consumption: Persistent inflation has not been good for US consumer confidence surveys, though consumption has remained in pretty good shape, with services stronger than goods.

US



Source: Oxford Economics/Haver Analytics, July 2022

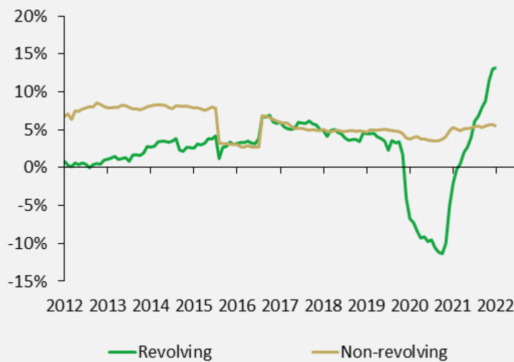
US: Resilient goods spending, but services pick up

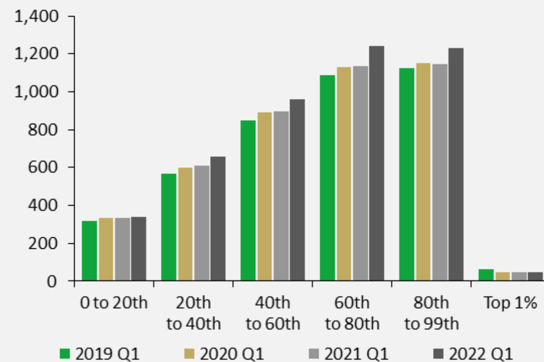


Source: Oxford Economics/Haver Analytics, July 2022

The level of savings in the aftermath of the pandemic remains high, which been a source of comfort for us in terms of the consumer. The power of these savings is made a little uncertain by their socio-economic breakdown. Indeed, it would appear that less wealthy Americans are supporting spending with borrowing. As we approach an economic slowdown, this might not be the most sustainable funding source, though we do note that banks remain in very good health.

US

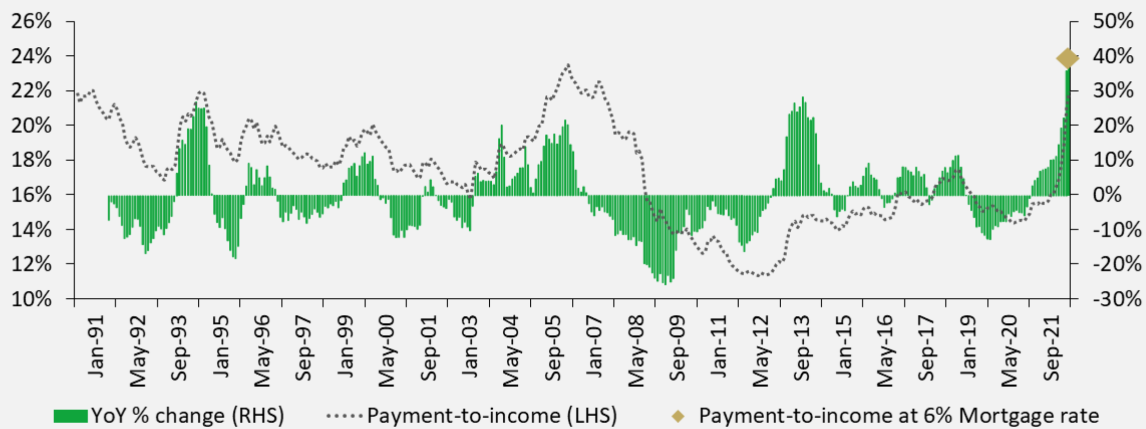




Source: Oxford Economics/Haver Analytics, July 2022. bn = Billion

US mortgage rates were very quick to move higher, introducing tightness into the US economy before Jay Powell's Fed had really started to move the needle on base rates. Given the role property values play in underpinning US consumption, it is certainly worth noting the slowing housing market. Housing affordability has dipped and some 15 million Americans have been priced out of the market, according to Haver Analytics.

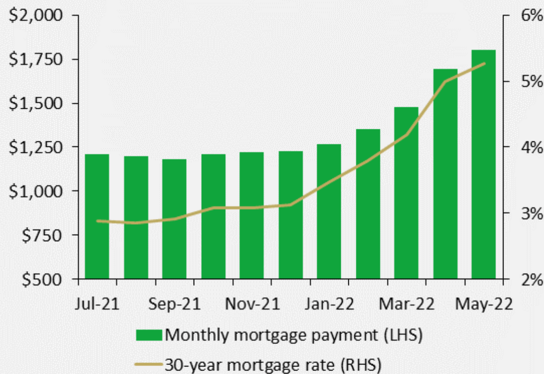
Affordability has deteriorated more in the past 12 months than in any year since at least 1990



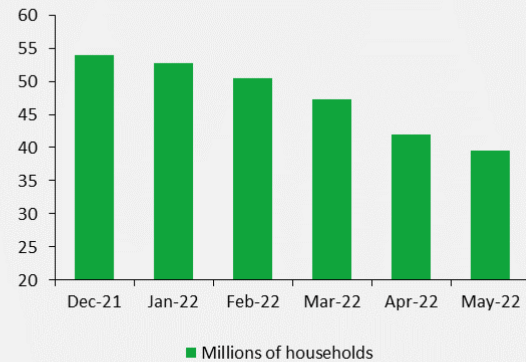
Source: Morgan Stanley Research. As at 08.07.22

US

30-year mortgage rates and monthly mortgage payment



Households who can afford an existing home



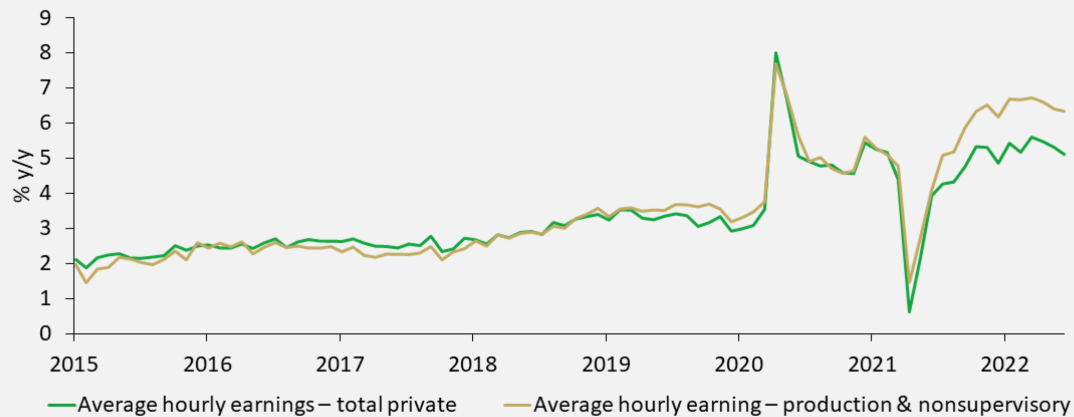
Source: Oxford Economics/Haver Analytics, July 2022

Employment: The jobs market remains tight, but anecdotally we are seeing an increasing number of headlines about companies reducing hiring intentions. The Federal Reserve and other central banks wish to take some of the heat out of the jobs market and therefore wage expectations and inflation.

US job openings to unemployed ratio

Source: Bloomberg, Liontrust, 31.07.20 to 30.06.22

US: Stronger wage growth for lower wage workers

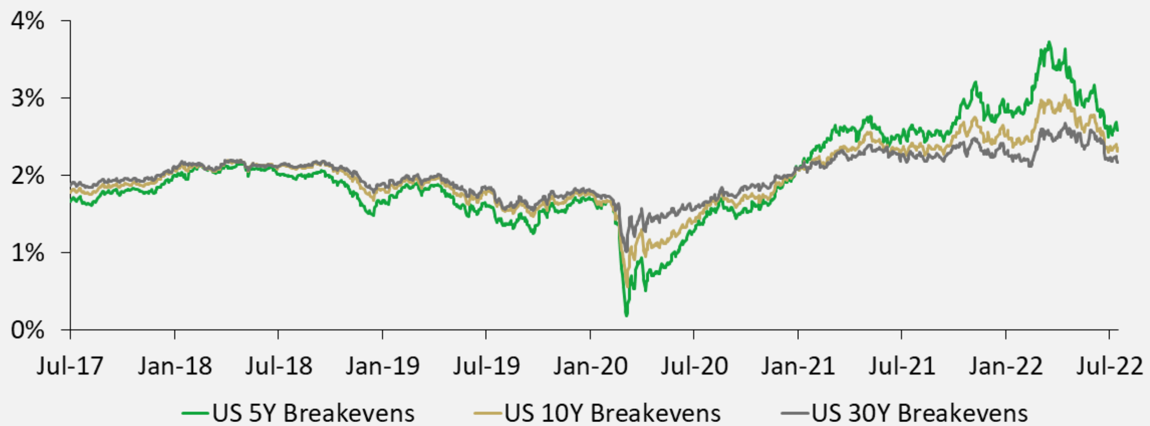


Source: Oxford Economics/Haver Analytics. As at 30.06.22

We have been positing that the Federal Reserve wants to address the supply/demand imbalance in the labour market, a relationship illustrated in the charts above. If continued, the nascent signs of reduced hiring intentions should feed through to a meaningful fall in job openings over the coming months. Over its last few meetings, the Fed has been forced to admit that monetary policy tightening will need to trigger a rise in unemployment to keep wage demands under control.

Inflation: We wrote in our last strategy note that we saw signs of inflation peaking in the US. This was proved wrong by the strong data in both May and June, with the last print coming in at 9.1%. Interestingly, market expectations of inflation, as measured by breakevens, did peak around this time.

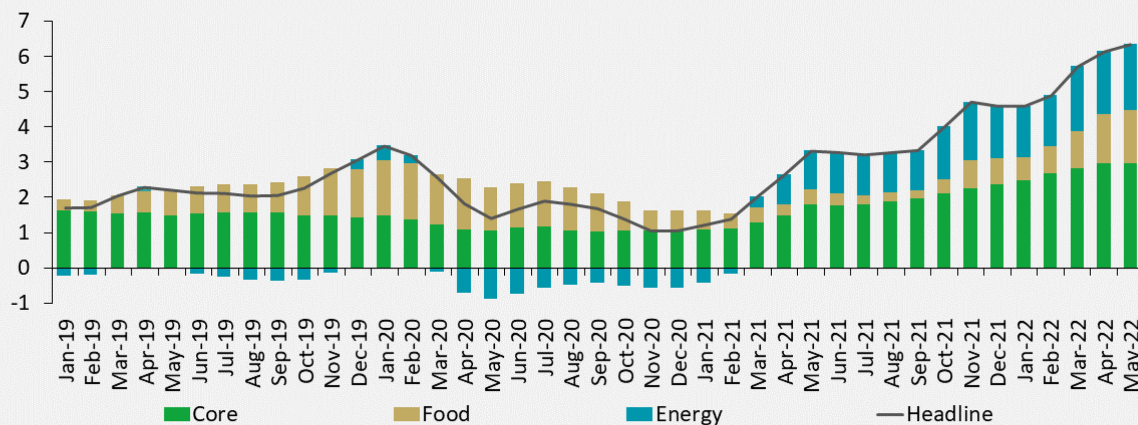
US inflation Breakevens



Source: Bloomberg, Liontrust. As at 22.07.22

Food and energy continues to play a major role in stubborn global inflation. Energy prices have come off, but for those economies with a weak currency versus the dollar, this will have been less of a benefit. In a similar vein to gas exports, Putin's actions on grain exports and finding consensus on safe trade routes could be a huge factor for food availability in certain countries and food prices globally.

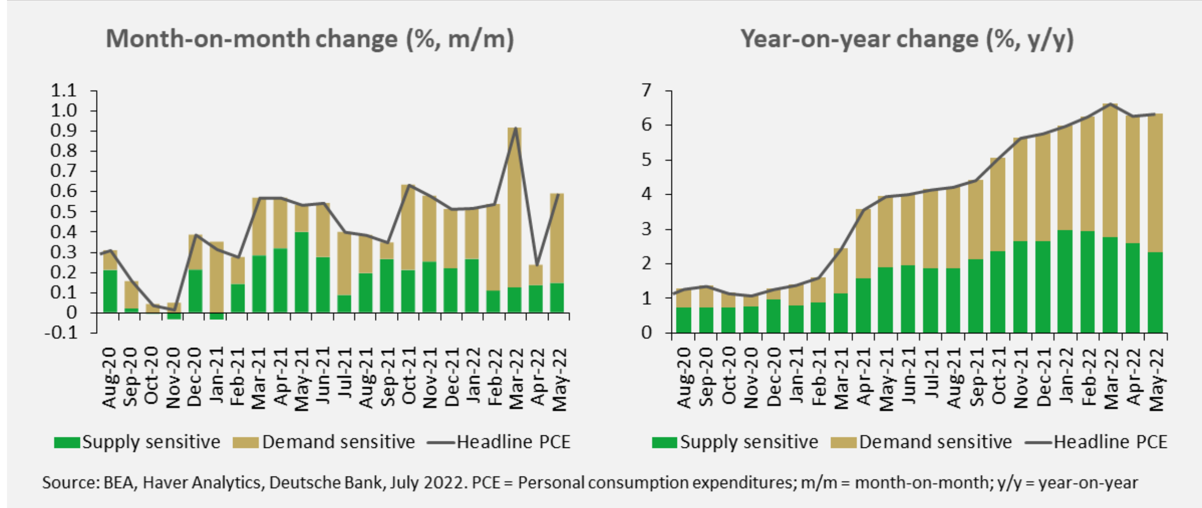
Global CPI and components (%Y)



Source: Haver Analytics, Morgan Stanley Research. Global inflation excludes Russia, Ukraine, Turkey and Argentina. China's CPI weights are the ones inferred by Bloomberg. As at 11.07.22. %Y = % year-on-year

Tying back into the improvements we've seen in supply constraints, supply-sensitive inputs into inflation are dropping. The dichotomy between growth and inflation has played out in markets in recent months, with concerns over the extent to which central banks will seek to choke off demand drivers. For now, inflation remains too stubborn for central banks to think about loosening monetary policy intentions. In July the ECB instigated its first rate rise in over a decade with a 50bps hike.

Decomposition of change in headline PCE



Source: BEA, Haver Analytics, Deutsche Bank, July 2022. PCE = Personal consumption expenditures; m/m = month-on-month; y/y = year-on-year

Rates Positioning

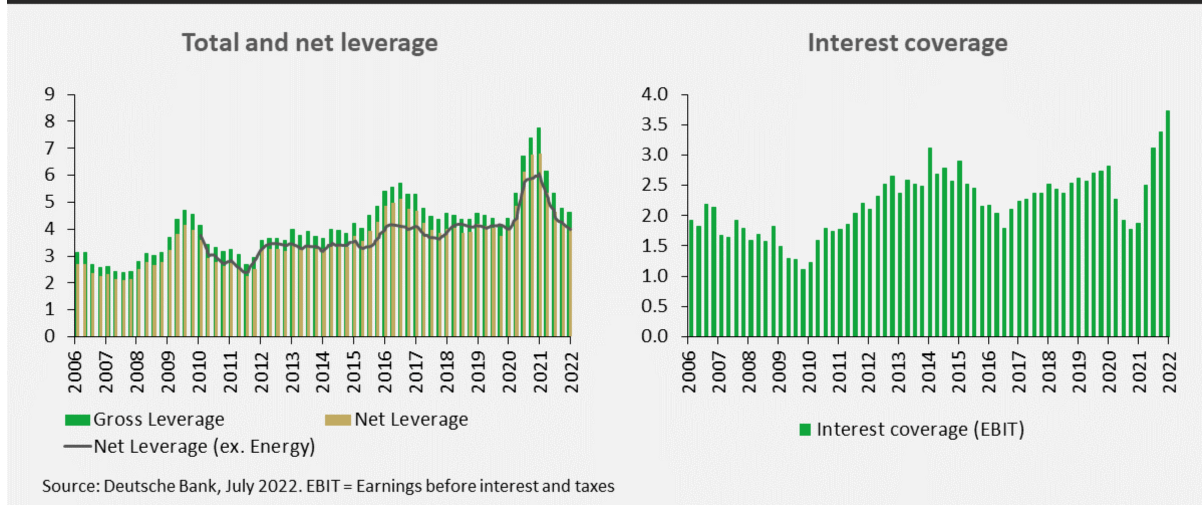
Since our last strategy meeting, we increased duration to 4.5 when ten-year treasuries were around 3.5%. This is neutral in our process and the highest duration has been since we launched the strategy in 2018. The speed of the move down towards 3.0% led us to take some duration off again, with the funds now down to 4.0. Given the downside risks we have discussed, we are now more likely to add duration back than reduce further.

The vast majority of duration is in the US, at ~2.5 years. During the period, we traded Euro duration in a range between 0.75-1.25 years, and currently the funds are at the high end of that range. We also offset some of the US duration between Canada and US, locking in some profit, but now have zero Canadian exposure. Lastly, the funds retain a small duration exposure in New Zealand government bonds. Overall, the fund continues to be positioned primarily in the 5–10-year duration bucket.

Spread product

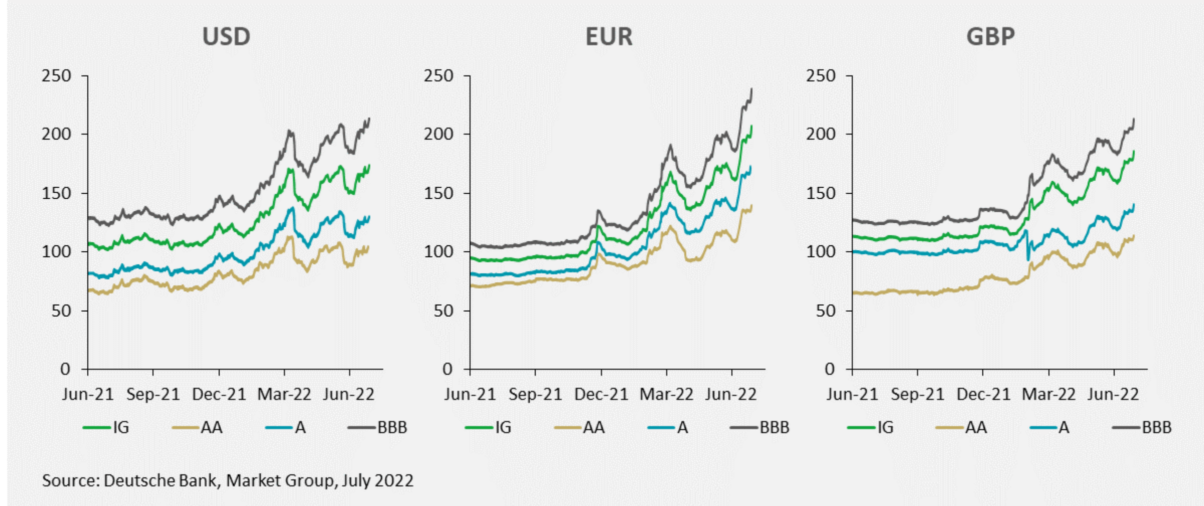
We have increased investment grade exposure to 55%, a small overweight. Corporate fundamentals remain strong. We accept they are likely at a peak but view the movement in spreads as attractive compensation for long term investors to weather a more tricky macroeconomic environment.

US High Yield



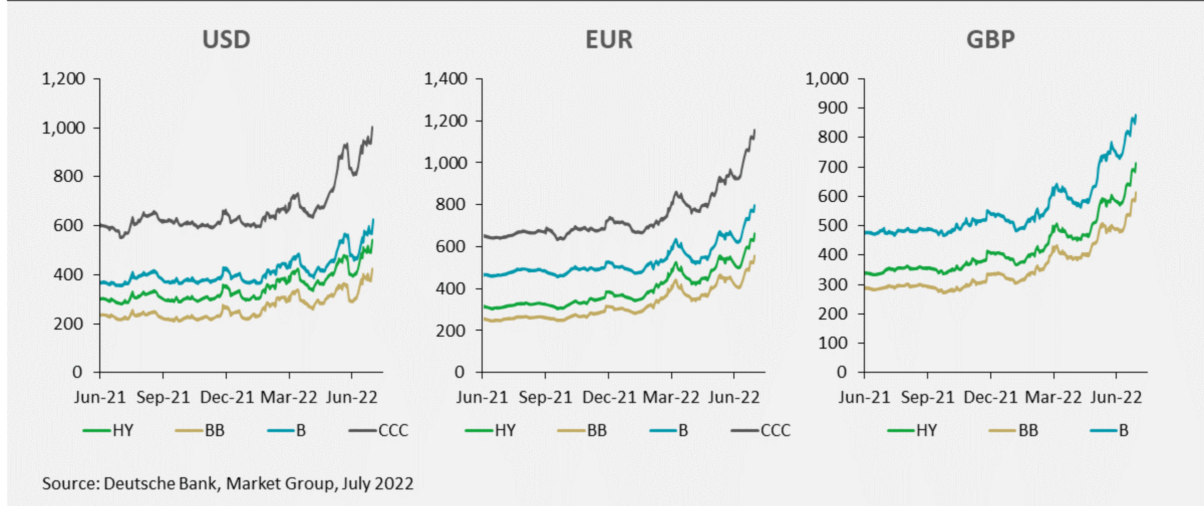
Source: Deutsche Bank, July 2022. EBIT = Earnings before interest and taxes

Investment Grade Benchmark Spreads



Source: Deutsche Bank, Market Group, July 2022

High Yield Benchmark Spreads



Source: Deutsche Bank, Market Group, July 2022

We would own more investment grade bonds, but we continue to have conviction in the long-term valuation opportunity in high yield, particularly at the quality end. High yield exposure is just below 30%, above our 20% neutral position and below our 40% maximum. High yield had an extremely strong July; we have tactically sold a couple of percent exposure in European high yield into this rally. We would look to reinvest the proceeds if we saw a market setback, our bias being to add more to US high yield exposure. Reflecting the uncertainty in the world, our stock-picking and sector selection tends to avoid the more cyclical areas of the economy. Furthermore, the slight reduction in exposure also provides us with dry powder if improving conditions in corporate debt markets leads to an increase in issuance, which remains extremely subdued.

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/glossary

To read more articles like this, please go to: www.liontrust.co.uk/insights

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Past performance is not a guide to future performance. The value of an investment and the income generated from it can fall as well as rise and is not guaranteed. You may get back less than you originally invested. The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

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