For professional investors only

Liontrust Strategic Bond Fund

August 2022 review

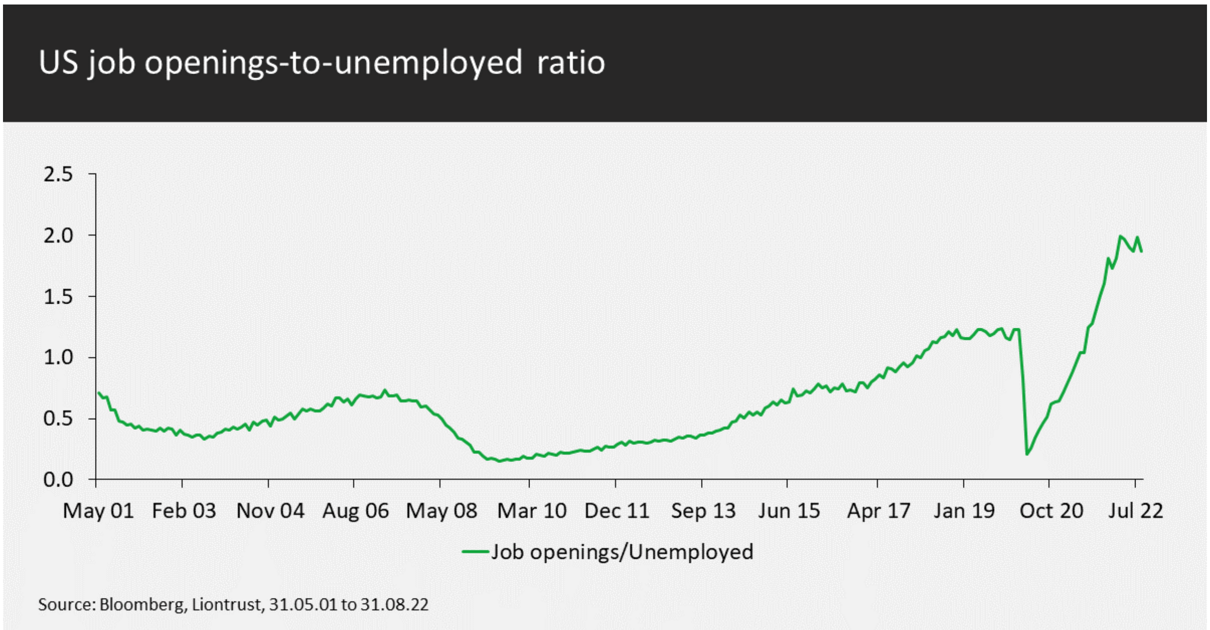
Fund managers: Phil Milburn and Donald Phillips

The Liontrust Strategic Bond Fund returned -2.2%* in sterling terms in August. The average return from the IA Sterling Strategic Bond sector, the Fund's comparator benchmark, was -2.0%.

Market backdrop

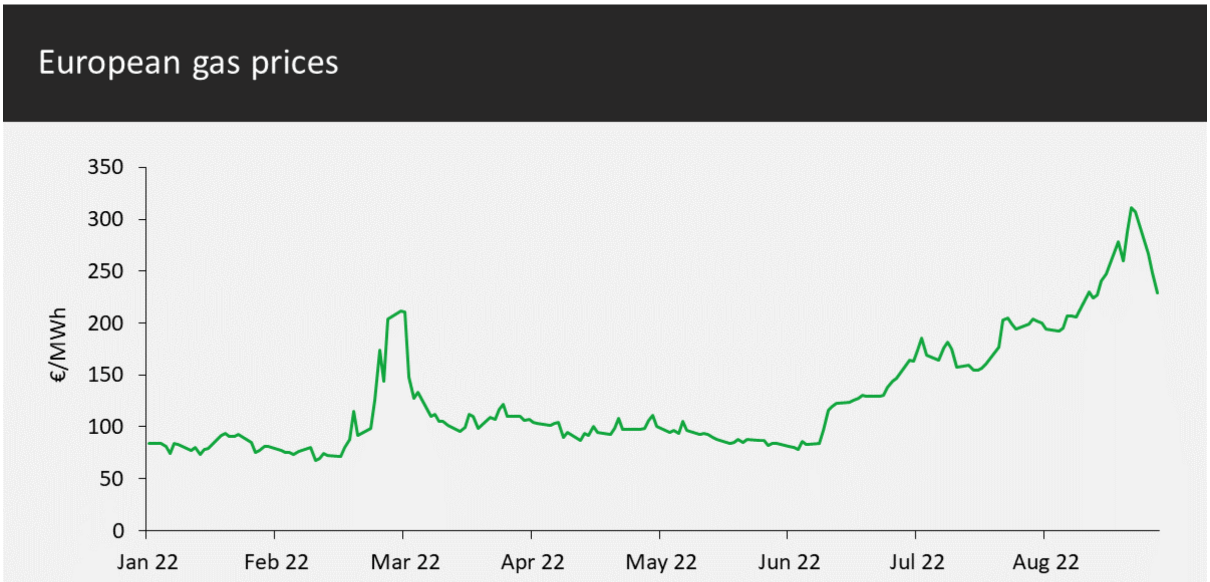
US employment: US job openings defied gravity at 11,239k for July (consensus 10,375k, prior revised to 11,040k). Nonfarm Payrolls for August came in line with expectations at 315k (consensus 298k, prior 526k). Private payrolls represented 308k of these, so nearly all of the total. A rise in the participation rate, possibly caused by the plethora of jobs available, to 62.4% (consensus 62.2%, prior 62.1%) was a pleasant surprise and the better way for society to create a small increase in unemployment to 3.7% (consensus 3.5%, prior 3.5%).

One of our key macroeconomic themes for this cycle is the imbalance between labour demand, as measured by the job openings data, and supply (unemployment). The Fed needs to see this imbalance correct before it will stop raising rates. Even though the numerator was above expectations, the rise in participation has led to a slightly bigger jump in the denominator; the ratio is shown below:



The year-on-year change in average hourly earnings was 5.2% (consensus 5.3%, prior 5.2%). We need to await the latest Atlanta Fed data to see whether the small shortfall was due to a mix effect or a true like-for-like measure. Overall, the employment data was quite strong but probably not strong enough to tip undecided Fed officials from the 50bps camp into the 75bps one. There is one more crucial data point for them to see first anyway: CPI on the 13th of September.

European energy: With the Nord Stream 1 gas pipeline due to have 3 days of maintenance at the end of the month, fears arose during August of supply not coming back onstream to its recent 20% of capacity. These fears of a shortage led to another spike in European gas prices; the chart below shows the price evolution in 2022 to August's month end close:



Source: Liontrust, Bloomberg, 07.01.22 to 31.08.22

On a brighter note, by the end of August, German gas storage was up to 84% full, a decent achievement aided by the fall in industrial usage. Whether or not gas is rationed this winter in Germany will continue to depend on how cold the winter is, but at least measures are being taken now to try to reduce demand (with a 20% reduction targeted, prior experience showed that a mild winter reduced demand by 14%).

The biggest driver for European headline inflation remains the immense pressure throughout the energy sector and the extent to which any government intervention lessens the pass-through to consumers and businesses. Eurozone consumer price inflation (CPI) for August came in at 9.1% (consensus 9.0%, prior 8.9%), a small overshoot in the headline figure; there was a slightly bigger rise in core CPI, which was 4.3% (consensus 4.1%, prior 4.0%). Energy and food continue to drive the headline figures; core goods inflation increased by 0.5% to 5.0% and core services marginally increased by 0.1% to 3.8%. The discounted German rail fare is due to expire in September, so a small move higher in services inflation should be expected then. Hawkish rhetoric from ECB members has shifted the 'Overton window' of rate rise discussion to a choice between 50bps and 75bps. The market is slightly closer to the latter, currently pricing at 68bps; we will find out whether the hawks gained the upper hand on Thursday 8th September.

One of the key data releases in the UK was CPI, which came in above the psychological 10% figure, 10.1% to be precise. The peak in inflation next year depends on how the government reacts to soaring energy prices, with forecasts ranging from 12% to 18%. The new Ofgem price cap was announced at £3,549, with current prices in the energy forwards markets suggesting the January cap could be above £5,300 and April £6,600. Clearly, government aid will be needed in the UK to prevent many millions of people being unable to heat their homes, and to stave off mass bankruptcies of small businesses.

Fund positioning and activity:

Rates

August saw large rises in government bond yields, with European rates markets faring worse than those across the Atlantic. We took advantage of the higher sovereign bond yields to add to duration in the Fund, finishing the month at our neutral level of 4.5 years, an increase of 0.5 years during August. As economic pressures continue to mount, particularly due to the energy crisis in Europe, our direction of travel is to add further duration over the coming months.

The geographic split has US duration a little under 2.4 years, Europe 1.3 years, New Zealand 0.3 years and the UK just over 0.5 years. The UK rates market was a new addition during the month as gilts have hugely underperformed other bond markets. We have had a long-held stance of not liking the UK market and said we would look to start to add if the spread between 10-year gilts and US Treasuries got to 60bps or below. We added half a year of gilt duration (mainly out of the US) at a spread between the US and UK in the mid-50s. We have room to buy a lot more UK duration if the gilt market continues to underperform.

Allocation
There was a small increase in the investment grade weighting during August from the mid-50s percentage weighting area to the high-50s. This was due to a combination of market moves and a couple of attractive new positions added to the Fund, discussed in Selection below.

The high yield weighting remained at 28%, above our neutral 20% level but below the 40% maximum. As a reminder, we have a large quality bias within this, limited exposure to the most cyclical parts of the credit market, and the Fund owns no CCC-rated bonds.

Selection

The month got off to a tremendous start with the announcement from NatWest Group of a tender for some very long dated bonds. The premium was only a few points, but the bonds were 100bps tighter already this year, so it is still a great result. Some of the proceeds from the tender were re-invested in NatWest sterling 5-year senior debt at a yield of 5.25%, which we believe represents a very attractive risk-return trade-off.

A new 7-year deal in euros from Chorus, New Zealand's telecommunications fixed line infrastructure provider, was purchased. A credit spread of 240bps for a regulated monopoly with defensive characteristics appeals for the long-term. At a similar spread of just over 250bps in US dollars, we bought some Ashtead bonds in the secondary market; although the equipment rental industry is cyclical, the market underestimates the ability these companies have to manage their cashflows by flexing their fleet sizes through the cycle. On the sales side of the ledger, the Fund's Pershing Square US dollar holding was trimmed. We still really like the credit and this was just managing the position size.

Within high yield selection, Eircom bonds were sold. The bonds have held up relatively well due to the expectations of a tender with asset sale proceeds. Slightly weak results and a recent €300m dividend payment to shareholders have led us to look for better value elsewhere. An example includes a new position taken in Sensata's bonds, which offer a yield of over 6% for a BB-rated company with a market leading position in sensors across a diverse set of end industries.

Discrete 12 month performance to last quarter end (%):**
Past Performance does not predict future returns

	Jun-22	Jun-21	Jun-20	Jun-19
Liontrust Strategic Bond B Acc	-12.5%	5.1%	2.8%	5.5%
IA Sterling Strategic Bond	-10.2%	6.1%	3.8%	5.3%
Quartile	3	3	3	2

*Source: Financial Express, as at 31.08.2022, accumulation B share class, total return (net of fees and income reinvested.
**Source: Financial Express, as at 30.06.2022, accumulation B share class, total return (net of fees and income reinvested. Discrete data is not available for five full 12-month periods due to the launch date of the portfolio (08.02.18).

Fund positioning data sources: UBS Delta, Liontrust.
†Adjusted underlying duration is based on the correlation of the instruments as opposed to just the mathematical weighted average of cash flows. High yield companies' bonds exhibit less duration sensitivity as the credit risk has a bigger proportion of the total yield; the lower the credit quality the less rate-sensitive the bond. Additionally, some subordinated financials also have low duration correlations and the bonds trade on a cash price rather than spread.

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

Key Risks:

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.

Investment in the Strategic Bond Fund involves foreign currencies and may be subject to fluctuations in value due to movements in exchange rates. The value of fixed income securities will fall if the issuer is unable to repay its debt or has its credit rating reduced. Generally, the higher the perceived credit risk of the issuer, the higher the rate of interest. Bond markets may be subject to reduced liquidity. The Fund may invest in derivatives. The use of derivatives may create leverage or gearing. A relatively small movement in the value of a derivative's underlying investment may have a larger impact, positive or negative, on the value of a fund than if the underlying investment was held instead.

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