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## Liontrust GF Strategic Bond Fund

### July 2023 review

Fund managers: Phil Milburn and Donald Phillips

**The Liontrust GF Strategic Bond Fund returned 1.1%\* in US dollar terms in July. The average return from the EAA Fund Global Flexible Bond (Morningstar) sector, the Fund's reference sector, was 1.0%.**

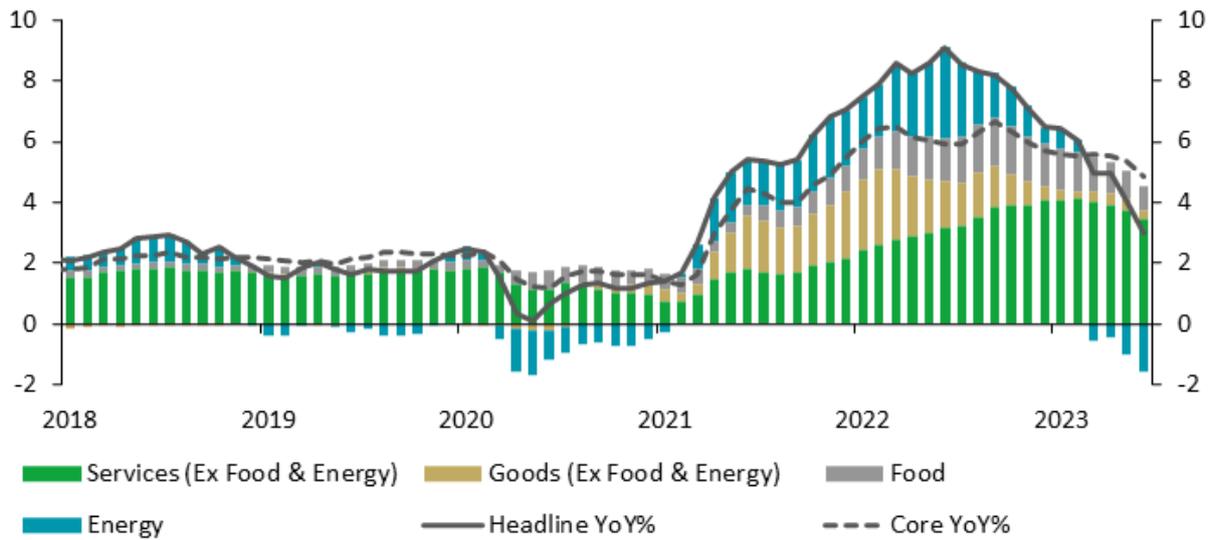
- Market sentiment shifted towards a soft landing during July, but we continue to assign a very low probability of the Federal Reserve successfully engineering this.
- Except for the Truss/Kwarteng disastrous budget period, gilts have been yielding less than US Treasuries for the last few years. However, the differential turned positive in March 2023 as the UK's relatively more entrenched inflation problem came to the fore. From a recent June peak of approximately 75bps extra yield on gilts versus US Treasuries, the spread is down to around 35bps.
- The Fund is positioned for gilts to continue this rebound. The Fund now has 2.4 years' exposure in the UK. It is the second largest duration contribution to the Fund, after US Treasuries, and the largest overweight versus the Bloomberg Barclays Global Aggregate Index.
- Overall Fund duration was unchanged in July at around 7.5 years' exposure and asset allocation was stable, with investment grade and high yield exposures close to their neutral levels of 50% and 20% respectively.

#### Market backdrop

A combination of stronger economic data and slowing inflationary figures led to a shift in market sentiment during July towards a soft landing. Starting on the inflationary front, headline US Consumer Price Index (CPI) inflation fell to 3.0% in June (consensus 3.1%, prior 4.0%) with core CPI also undershooting expectations at 4.8% (consensus 5.0%, prior 5.3%). On the month, core CPI was expected to be up by 0.3% but the actual figure was 0.2% or an unrounded 0.158% for those that like the extra decimal places.

Energy prices were actually up 0.6% in June, but on an annual basis were down 16.7%. The contribution of the energy component (blue bars in chart below) to annual headline inflation is now -1.54%. Food inflation (grey bars) continues to ease, now 5.7% on an annual basis, representing a 0.77% contribution to overall CPI. Given the fall in market prices of agricultural commodities, this category should ease further over the coming months although the disruptive impact of El Nino weather patterns might cause a temporary reversal later in 2023. Core goods (gold bars) moved back into deflationary territory in June, partly due to a fall in used car prices of 0.5% after the prior two months having seen 4.4% increases. The all-important services inflation (green bars) is witnessing an easing in pressure too. Core services ex-housing saw flat CPI in June, with a small decrease in hotels and a large fall of 8.1% in airfares helping to generate this. Overall services inflation was 0.25% on the month – both rents at 0.46% and owners' equivalent rents (OERs) at 0.45% decelerated, continuing a trend through 2023. As a reminder, the methodology behind the measurement of these costs of shelter leads to about a 12-month lag between movements in market rents and the reported data. One of our key inflationary themes has been that the contribution from shelter would fall significantly from Q3 2023 onwards and the current momentum is supportive of this coming to fruition. Overall, core CPI of 4.8% is far too high but the majority of contributing factors are heading in the correct direction.

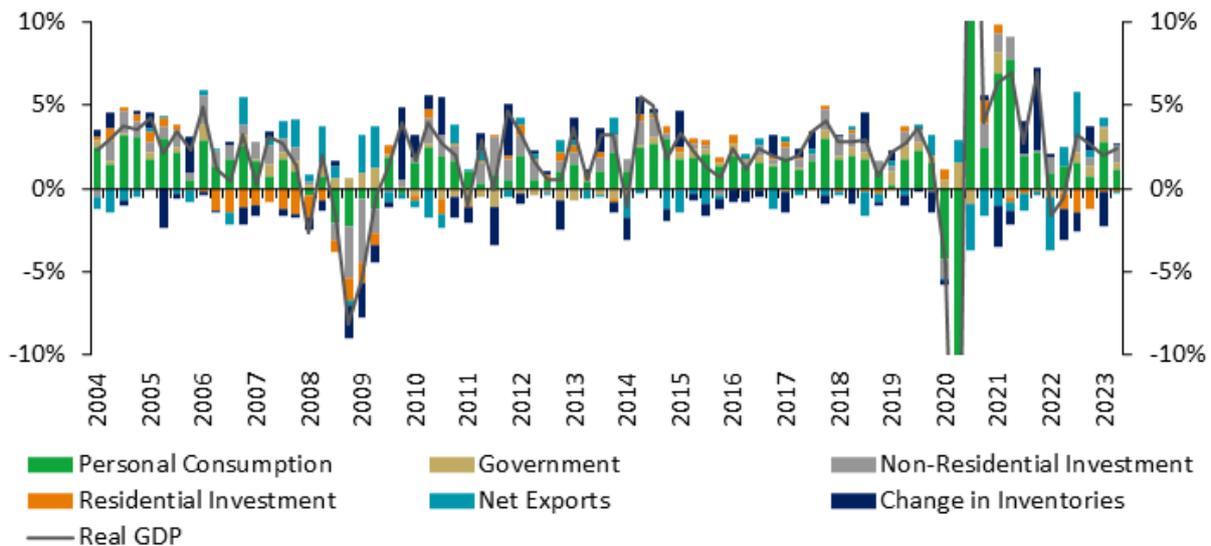
### US CPI Year-over-Year (%)



Source: BLS, Bloomberg, Liontrust as at 30.06.23. CPI = Consumer Price Index.

Staying stateside, the advance estimate of second quarter US GDP beat expectations at 2.4% (consensus 1.8%, prior 2.0%). We are big fans of looking beyond the headline number – which can be swung around by volatile items – into the details; in this case the underlying details were reasonably strong too. Firstly, the most important growth driver remains consumption (green bars); this grew at 1.6% in the quarter to contribute 1.1% to the GDP figure. Whilst the 1.1% contribution is low by historical standards, I had expected more of a payback from the 2.8% in Q1 which had been flattered by unseasonably warm weather. Note that the expiry of the student loan repayment moratorium will pressure consumption later in 2023. The volatile items of net exports (light blue bars) and inventories (dark blue) both had a low impact and summed to close to zero. After the great rebuilding of inventories connected with economies re-opening post lockdowns and compensating for supply chain disruption, I would now expect a further drift downwards as higher interest rates increase the cost of working capital.

### Contributions to US Real GDP Growth



Source: BLS, Bloomberg, Liontrust as at 30.06.23.

Residential investment (orange) remains a small negative, but new house building will trundle along to help satiate demand as existing home sales are low due to owners staying put to avoid refinancing at much higher mortgage rates. There was a surprising increase in non-residential investment (grey) – this does chime with a

few of the recent business surveys but is not consistent with what you normally see this far into a monetary tightening cycle. Perhaps it is a result of the subsidies for manufacturing industries arising from the Inflation Reduction Act. Which leads neatly onto the final positive contributor: increased government expenditure (gold bars) added just under 0.5% to growth in the quarter.

The US economy has remained stronger than one would normally expect after so much tightening in monetary policy. We believe that the same factors that are delaying the recession will conspire to make it a relatively mild one. However, we continue to assign a very low probability of the Federal Reserve successfully engineering a soft landing. Having had so much difficulty in hiring, many companies will hoard labour through the downturn, but we expect a significant increase of the current 3.6% unemployment rate once the recession starts. The aforementioned labour hoarding might mean the unemployment rate doesn't peak above 6% as we saw in the early 2000s, and definitely not at the 10.0% rate post the financial crisis; somewhere around 5% makes intuitive sense. We would not classify forthcoming anaemic consumption growth and roughly 5% unemployment, assuming this figure is in the right ballpark, as a soft landing.

#### UK inflation data

It was not just in the US that inflation data improved during July; after a run of upside surprises in the UK, we finally saw a more benign outcome than market consensus. Headline consumer price inflation (CPI) for June was below expectations at 7.9% (consensus 8.2%, prior 8.7%). More importantly, core CPI also undershot at 6.9% (consensus 7.1%, prior 7.1%). Prices for "all goods" were down 0.2% on the month, taking the annual inflation rate down to 8.5% in June from 9.7% in May; importantly, within this, core goods inflation also undershot prior levels. Services inflation did not fall by as much, coming in at 7.2% in June compared to 7.4% in May, but at least it is off its peak.

Examining what drove the reduction in annual inflation, the ONS states "*...Falling prices for motor fuel led to the largest downward contribution to the monthly change in CPIH and CPI annual rates, while food prices rose in June 2023 but by less than in June 2022, also leading to an easing in the rates.*" The pace of inflation in food and non-alcoholic beverages eased again in June with the monthly change at 0.4%; this takes the annual rate to 17.3% compared to 18.3% in May. The impact of falling fuel costs within the transport classification was enough to take the annual impact into negative territory.

Looking forwards, the contribution from electricity and gas prices (captured in "housing and household services") will reduce by 0.8% in July due to the lower Ofgem price cap; another drop of about 1.5% should be anticipated in October. With the caveat of the El Nino risk mentioned above, food price inflation should continue to abate. Food producer output inflation has fallen to 8.7% and, with lags, this should flow through to consumer prices. A similar theme exists across the goods spectrum: the annual PPI (producer price index) output measure was 0.1% (consensus 0.5%, prior 2.7%) and PPI input was -2.7% (consensus -1.6%, prior 0.4%). Some of this will have been aided by the appreciation in trade-weighted sterling, albeit the undershoot of the CPI data did cause a partial retrenchment alongside the gilt rally.

One part of the inflation data that it is important not to get too excited about is the services inflation figure. Although there was a fall from 7.4% to 7.2%, this was partly driven by the unwinding of May's suspiciously large jump in hotel prices and some seasonality around air fares; for next month's data, July tends to witness a seasonal increase in air fares. In addition to this, one should expect rents to increase somewhat. Thus, services inflation will remain around its current level for a few months before falling later in 2023; the pace of the fall will remain high (inversely) correlated to wage inflation.

The gilt market made up a little ground in July versus both US Treasuries and German Bunds. Except for the Truss/Kwarteng disastrous budget period, gilts have been yielding less than US Treasuries for the last few years; the differential turned positive in March 2023 as the UK's relatively more entrenched inflation problem came to the fore. From a recent June peak of approximately 75bps extra yield on gilts versus US Treasuries, the spread is down to around 35bps.

The Fund is positioned for gilts to continue this rebound. For the first four years of managing the Fund, we averaged a duration contribution of close to zero in sterling (-0.02 years average duration contribution) – as a global developed market bond fund, we only buy gilts when we think they are cheap. We started averaging in last summer, adding more around the Truss/Kwarteng debacle to finish 2022 with 1.1 years' exposure. As part

of our increasing overall duration exposure since April, sterling duration has been one of our preferred places to add to; we now have 2.4 years' exposure. It is the second largest duration contribution to the Fund after US Treasuries, and the largest overweight versus the Bloomberg Barclays Global Aggregate Index.

## **Fund positioning and activity**

### **Rates**

Duration was effectively unchanged in July at around 7.5 years' exposure. As a reminder we deem 4.5 years to be neutral and have a limit of nine years. The geographic split of the duration is 2.7 years in the US, 2.4 years in the UK, 1.7 years in Europe and 0.6 years in New Zealand. We increased the size of the US 2s10s yield curve steepener position (discussed in more detail in last month's commentary) from 0.25 years to 0.5 years.

### **Allocation**

There was no significant change to asset allocation during July. Investment grade exposure is very close to 50%, a weighting we view as being neutral. The Fund's high yield weighting in bonds is 24%; there is a 5% overlay in place to reduce risk using the iTraxx Xover credit default swap index, thus net high yield exposure of 18% is very close to our 19% neutral level. There is good long-term value in credit, but with the tensions between rate rises and recessionary risk there will inevitably be further volatility in credit markets. If credit spreads widen enough to make valuation levels become very compelling again, we will increase allocations significantly.

### **Selection**

Stock level activity was relatively low during July. The Fund predominately retained its exposure to our favoured credits, with a strong bias towards more defensive sectors within the economy. Within high yield, we sold Ardagh Metal Packaging after weak quarterly results added further delays to its deleveraging plans. It remains a company we like, so an improvement in its balance sheet would make the risk reward equation more attractive for re-establishing a position.

A new purchase was made in Intesa, a solid, well-diversified, leading Italian bank with a robust capital position. While Intesa is investment grade rated, its sterling denominated 9-year maturity tier 2 bonds that were purchased are BB+ rated. This is the highest rung in the high yield rating category, sitting in the 'crossover' area on the cusp of investment grade, where its often possible to find good value relative to credit risk. With a credit spread of over 450bps and all-in yield of almost 9%, we think these bonds offer compelling value.

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

	Jun-23	Jun-22	Jun-21	Jun-20	Jun-19
Liontrust GF Strategic Bond B5 Acc	3.4%	-13.3%	5.4%	5.5%	7.6%
EAA Fund Global Flexible Bond - USD Hedged	3.6%	-10.3%	6.5%	6.1%	6.1%

\*Source Financial Express, as at 31.07.23, total return, B5 share class.

\*\*Source Financial Express, as at 30.06.23, total return, B5 share class.

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.

**Key Features of the Liontrust GF Strategic Bond Fund**

Investment objective & policy <sup>1</sup>	The investment objective of the Fund is to maximise total returns over the long term through a combination of income and capital. The Fund will seek to achieve its objective by investing in bond and credit markets worldwide. The Fund invests in a wide range of bonds issued by corporates and governments, from investment grade through to high yield. The Fund invests in developed and emerging markets, with a maximum of 40% of its net assets invested in emerging markets. Investments may be made in "hard" currencies, such as US Dollar, Euro and Sterling, and up to 25% of the net assets of the Fund may be invested in soft currencies, such as those of emerging markets. Where the Fund invests in non-US Dollar assets, the currency exposure of these investments will generally be hedged back to US Dollar. Up to 10% of the Fund's currency exposure may not be hedged, i.e. the Fund may be exposed to the risks of investing in another currency for up to 10% of its assets. The Fund may invest both directly, and through the use of derivatives. The use of derivatives may generate market leverage (i.e. where the Fund takes market exposure in excess of the value of its assets). In addition, the Fund may invest in cash or cash equivalents, such as deposits and Money Market Instruments, for cash management purposes. Within the limits stated above, there are no geographical or economic sector restrictions on the Fund's investments. The Fund has both Hedged and Unhedged share classes available. The Hedged share classes use forward foreign exchange contracts to protect returns in the base currency of the Fund. The fund manager considers environmental, social and governance ("ESG") characteristics of issuers when selecting investments for the Fund.
Recommended investment horizon	5 years or more
Risk profile (SRRI) <sup>2</sup>	4
Active/passive investment style	Active
Benchmark	The Fund is actively managed without reference to any benchmark meaning that the Investment Adviser has full discretion over the composition of the Fund's portfolio, subject to the stated investment objectives and policies.
Sustainability profile	The Fund is a financial product subject to Article 8 of the Sustainable Finance Disclosure Regulation (SFDR).

Notes: 1. As specified in the KIID of the fund; 2. SRRI = Synthetic Risk and Reward Indicator. Please refer to the KIID for further detail on how this is calculated.

For a comprehensive list of common financial words and terms, see our glossary at:

<https://www.liontrust.co.uk/glossary>

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#### **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 GF 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 emerging markets/soft currencies and in financial derivative instruments, both of which may have the effect of increasing volatility. 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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