Schroders

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Schroder ISF* US Dollar Bond

Fund Update

October 2019

At a glance

Fund manager: Neil Sutherland & Lisa Hornby

Performance: The fund made a total return of 0.3% (I Acc share class) over the month**, in-line with the Bloomberg Barclays US Aggregate Bond Index.

Largest contributors: The overweight allocations to financials and industrials, and the underweight allocation to Treasuries.

Largest detractors: The overweight position in asset-backed securities, issue selection within mortgage-backed securities

**Source: Schroders as at 31/10/2019. Gross of fees, net of ongoing charge, bid-bid, with net income reinvested.

Historic performance

(%)	Fund (A Acc)	Fund (I Acc)	BM***
2018	-1.87	-0.99	-0.01
2017	4.07	1.81	3.54
2016	2.46	6.02	2.65
2015	-1.44	0.95	0.55
2014	5.60	6.41	5.97

Source: Schroders, net of fees (where applicable), bid-bid, with net income reinvested as at 31/12/2018, USD.
***Bloomberg Barclays US Aggregate Bond Index.

Past performance is not a reliable indicator of future results, prices of shares and the income from them may fall as well as rise and investors may not get the amount originally invested.

Some performance differences between the fund and the benchmark may arise because the fund performance is calculated at a different valuation point from the benchmark.

Please see the respective fund factsheets for the performance of other share classes.

Market review

After a turbulent end to the third quarter, positive headlines from the usual suspects led both equity and fixed income markets higher in October. Market volatility fell precipitously during the month as positive developments with the Brexit resolution and US-China trade deal caused risk assets to rally. The influx of generally soft economic data (September retail sales, ISM and CPI all below consensus estimates) seemed to support the market's belief that the Federal Reserve (Fed) would once again cut rates at the end of October.

However, given stronger housing data and the Atlanta Fed's Q3 GDP tracker pointing to an on-trend 1.8%, there was very little to suggest that a recession is imminent. Nevertheless, the Fed cut rates for the third time this year, with forward guidance signalling no further cuts. Fixed income markets reacted accordingly, with Treasury yields dropping and spreads widening, evidence of investors concern over the Fed's post-meeting statements. Overall, October was a positive month for risk assets as the Fed continues to be a dominant force supporting investor sentiment.

Investment grade corporate spreads, as measured by the Bloomberg Barclays US Corporate Bond Index, were modestly tighter (5 bps) ending the month at 110 bps. Investment grade corporates performed well during the month, posting positive excess returns of +0.60%. At the sector level, utilities led the index with excess returns of +0.72%, while financials and industrials returned +0.63% and +0.58% respectively. US high yield bond total returns, as measured by the Bloomberg Barclays US Corporate High Yield Index were modestly positive (+0.28%) in October as investors digested better than feared earnings, a partial trade deal with China and the third Fed rate cut of the year.

Ongoing central bank accommodation continues to support the search for yield. However, we remain mindful that idiosyncratic risk persists and volatility is likely to spike, especially given the political uncertainty in both the US and the UK. Although Treasury rates were higher to start the month, yields fell following the Fed meeting in late October, with the 10-year note ending October at 1.67%. The yield curve steepened during the period with the spread between the two-year and 10-year note ending the month 14 bps higher.

*Schroder International Selection Fund is referred to as Schroder ISF.

Emerging market debt posted positive total returns across the board in October. The sovereign (JPM EMBI-GD) and corporate (JPM CEMBI-BD) indices returned +0.28% and +0.85% respectively while local currencies (JPM GBI-GD) performed best, returning 2.90% supported by a weaker dollar. Geopolitical concerns resulting from protests in Chile and Lebanon contributed to some caution across emerging markets to start the month. However, bonds rallied in the latter half of the month on the above-mentioned positive headlines.

Within the sovereign index, Europe was the top performing region while the Middle East underperformed the index, weighed down by Lebanon. In the corporate index Jamaica and Israel were the top performing countries with total returns of +8.88% and +4.22% respectively, while Mongolia and Ecuador lagged the index posting monthly returns of -1.62% and -1.73%. In the corporate index, consumer sectors performed best in October returning +2.19% while pulp and paper names underperformed.

The securitized sector posted modestly positive excess returns for the month led by agency mortgage-backed securities (AMBS) and commercial MBS. Agency MBS performed best with excess returns of +0.09% as measured by the Bloomberg Barclays US MBS Index. Asset-backed securities (ABS) slightly underperformed, with excess returns of -0.05%, while CMBS performed in line with mortgages returning +0.08% for the period. Taking into account the recent rate cuts by the Fed as well as the pick-up in housing market indicators and strong fundamentals, we continue to favour mortgages over other spread sectors at this time.

Performance

Positive sector selection was offset by negative issue selection. The overweight to financials and industrials as well as our underweight to Treasuries aided excess returns for the period given the relative outperformance of risk assets in October. This was partially offset by the negative contribution from the overweight ABS, specifically AAA-rated collateralised loan obligations (CLO).

With regards to issue selection, Apache Corp and Plains All American Pipeline were the largest individual detractors. Issue selection within MBS was also negative in aggregate, although no individual security stood out. Yield curve positioning contributed for the period due to the portfolio's curve steepening bias, expressed through Treasury futures, as the yield curve steepened during the month.

Outlook and Strategy

The first nine months of 2019 saw remarkable gains across a variety of asset classes, with many fixed income sectors posting double-digit returns. A large part of this rally is attributable to the notable pivot made by global central banks with a number of central banks cutting rates so far through 2019 in response to escalating trade tensions and protracted weakness in global manufacturing. The Fed has been no exception cutting rates in both July and September and thereby lowering the Federal Funds target rate from 2.5% to 2%. The market is discounting roughly another 75 bps of cuts by the end of 2020.

This has led to tremendous returns in Treasury markets, in addition to continued momentum in credit assets. With risk assets now having retraced nearly all of the weakness from late last year, we think the easy money has been made and would suggest investors tread with a degree of caution when it comes to the higher-beta sectors such as high yield and emerging markets. Our expectation is that fixed income broadly will remain well supported in the coming months, but will post more modest, coupon-like returns.

Global growth has slowed sharply over the last 12 months with global GDP in 2020 expected to be the lowest since the financial crisis. Growth in Europe will be barely above stall speed in 2019 and Chinese growth has dropped to its lowest levels since 1990. US growth has been more resilient helped by the strength of the US consumer, but the pace of expansion has slowed as trade policy uncertainty takes its toll on business confidence and capital expenditures. The current US expansion is now officially the longest on record. What investors need to reconcile is whether consumer momentum can continue to sustain the expansion in the face of global and manufacturing headwinds. Given the record low unemployment rate, modest consumer leverage, and continuing wage gains, we believe recession will be avoided through 2020. However, vulnerabilities are building, and these are not being fully reflected in the elevated pricing of many risk assets.

At the moment, risk assets appear to believe in the omnipotence of central banks. Easier monetary policy has buoyed risk assets for the better part of a decade, and investors continue to chase returns in response to lower bond yields. One only needs to look at global equity indices (nearly every major market is posting half-year returns in excess of 10%) as compared to their fundamental underpinnings. Earnings growth in 2019 US equities was essentially flat from a 20% run rate in late 2018. Multiple expansion, instead, has driven equities higher, as markets perceive the monetary-policy driven liquidity environment to be enough to keep things going. Another example of

liquidity trumping fundamentals is short maturity Italian bonds trading with a negative yield. With flows rather than fundamentals driving returns we would suggest investors should proceed with caution at this current juncture. Markets will need to navigate various cross-currents in the coming months: uncertainty with regards to trade, a Fed that is easing amidst a cyclical slowdown, Brexit and the ramp-up of the 2020 election cycle to name just a few.

Our view is that the easy money in most markets has been made and that risk assets will face some challenges ahead. This is particularly true as valuations in the credit sectors are now approaching the more expensive end of their cyclical range. The liquidity environment will likely keep risk assets supported, but it's difficult to see material appreciation from here without a change in the underlying fundamentals.

So where does this leave us in our asset allocation? With headwinds building and valuations full we remain cautious on riskier segments of fixed income. Our allocation to the corporate sector remains as low as it has been in a number of years. Conversely, our allocations to highly liquid Treasuries and mortgages are at their highest levels. We prefer mortgages over other spread markets as valuations are near their cheapest levels of the post-crisis period. Fundamentals are also preferable as debt growth in the mortgage market has significantly lagged that of the corporate market. We believe that the ensuing months will present opportunity in markets and we want to have the liquidity available to take advantage of it.

With regard to rates, we believe the peak in yields was seen in 2018. A Fed in easing mode and slower growth suggest that fixed income assets are likely to remain well supported. We believe higher quality fixed income products still offer value in both absolute terms and relative to other asset classes, especially in an environment where volatility is likely to remain high and central banks globally are continuing to embrace easy money.

Risk factors

The capital is not guaranteed.

The capital may be subject to circumstances and periods where returns could be negative. Therefore the capital is not guaranteed and may decrease.

Non-investment grade securities will generally pay higher yields than more highly rated securities but will be subject to greater market, credit and default risk.

A security issuer may not be able to meet its obligations to make timely payments of interest and principal. This will affect the credit rating of those securities.

Investments in money market instruments and deposits with financial institutions may be subject to price fluctuation or default by the issuer. Some of the amounts deposited may not be returned to the fund.

Currency derivative instruments are subject to the default risk of the counterparty. The unrealised gain and some of the desired market exposure may be lost.

Investments denominated in a currency other than that of the share-class may not be hedged. The market movements between those currencies will impact the share-class.

Investment in bonds and other debt instruments including related derivatives is subject to interest rate risk. The value of the fund may go down if interest rate rise and vice versa.

The issuer of Mortgage or Asset backed securities may have a limited ability to recover amounts due if the underlying borrowers become insolvent or their collateral drops in value.

The fund may hold indirect short exposure in anticipation of a decline of prices of these exposures or increase of interest rate.

The fund may be leveraged, which may increase its volatility.

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