Schroders

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Schroder ISF* Global Inflation-Linked Bonds

Fund Manager: Paul Grainger, James Ringer and Global Fixed Income and Currency Team | Fund update: Fourth Quarter 2022

Performance overview

- Markets ended the year on a mixed note in the final quarter, bringing a very difficult year to a close. Risk sentiment improved, particularly around China's reopening. The big surprise during the final quarter of the year was the abrupt change in the Bank of Japan's (BoJ) yield curve policy, which was earlier than expected.
- News on inflation continued to be the key driver of markets. Inflation pressure remained high across the board, though showed some signs of slowing, particularly in the US where official measures surprised to the downside in both headline and core.
- US Treasury 10-year yields ended the quarter broadly where they started (from 3.8% to 3.9%) as the market started to price in a slower pace of rate hikes in reaction to moderating price pressures.
- In the UK, a change in government helped stabilise the markets and bond yields pulled back from the highs seen in the previous quarter. The 2-year yield fell from 4.2% to 3.5% and the 10-year yield fell from 4.1% to 3.7%.
- The European government bond market was the clear underperformer. Inflation remains challenging across the region, prompting a hawkish response by the European Central Bank (ECB). Germany's 10-year yield increased from 2.1% to 2.6%, while Italy's 10-year yield rose from 4.5% to 4.7%.
- Risk sentiment improved, particularly around China's reopening. Credit markets (both investment grade and high yield) performed well both on a total return basis and relative to government bonds.

Drivers of fund performance

- The fund finished the quarter in positive territory and beat the benchmark.
- In terms of relative performance, our currency strategy worked well, capturing the strength of the US dollar through our overweight position versus a basket of cyclical currencies, including sterling.
- The overweight to UK breakeven inflation was beneficial as the market interpreted the new Prime Minister's anticipated fiscal response as inflationary and requiring the Bank of England to act more aggressively on interest rates.
- On the negative side, an initial overweight to US nominal rates detracted as did an off-benchmark allocation to European credit.

Portfolio activity

- Our rates strategy continues to focus on cross-market opportunities.
- Core Europe is our preferred short in terms of nominal duration given relatively worse inflation dynamics and the continued hawkishness of the ECB. We are more constructive on US nominal duration, where we see evidence of disinflation and we think that the US economy has the potential to disappoint relative to other major economies. This should see US breakevens fall.
- We also continue to focus on those economies where housing vulnerabilities have the potential to curtail tighter monetary settings. This is expressed through an overweight nominal and inflation duration in the UK and on the currency side through underweights to sterling, the Swedish krona and the Canadian dollar. However, global sentiment has improved on several fronts, including signs of peaking headline inflation and China's re-opening. With this in mind, we have increased the cyclicality of our currency strategy, with the euro and the Australian dollar the biggest overweights.

Outlook/positioning

- 2022 was a challenging year for global fixed income markets as persistent inflation forced central banks to act aggressively in order to stem broadening price pressures. As we head into 2023, supply chain issues and commodity prices show signs of easing and the lagged impact of monetary policy tightening is beginning to cool both growth and inflation. We expect the US to lead this disinflationary trend in the first half of the year driven by a further softening of goods prices. Although we believe the path to target inflation may ultimately prove difficult due to the stickiness of service inflation, the rapid pace of initial improvements should lead to a more favourable backdrop for global bonds.

*Schroder International Selection Fund is referred to as Schroder ISF throughout this document

- Meanwhile, as global rate hiking cycles mature, we expect to see greater divergence in terms of central banks' reaction functions. While monetary policy will continue to be principally determined by the inflation outlook, we think that those central banks that face downside risks to their economies thanks to overleveraged consumers (through mortgage debt) and are the past the peak in inflation are more likely to turn dovish.
- Developments unfolding in China have the potential to be market moving. The country's rapid re-opening and lifting of many Covid restrictions has the potential to boost growth prospects for the broader Asian region and help support global sentiment. While we hold a relatively pessimistic view on global growth (and especially on growth in the US), an improvement in the outlook for China could also provide significant benefit to Europe.

Calendar year performance (%)*

Year	Fund (A Acc)	Fund (I Acc)	Target
2021	-5.7	-4.8	-4.7
2020	8.4	9.2	9.3
2019	8.8	9.7	6.8
2018	-3.5	-2.6	-1.2
2017	7.1	8.0	7.4
2016	2.1	3.1	2.1
2015	-5.1	-4.2	-3.2
2014	0.9	1.9	0.6
2013	-2.5	-1.6	-2.6
2012	6.4	7.4	4.3

Source: Schroders, net of fees (where applicable), bid-bid, with net income reinvested as at 31 December 2021. Target is BBgBarc Global Aggregate TR.

- Past performance is not a reliable indicator of future results. The value of investments 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.

Risk considerations

- **Capital risk / distribution policy**: As the fund intends to pay dividends regardless of its performance, a dividend may represent a return of part of the amount you invested.
- **Capital risk / negative yields**: The fund may lose value when interest rates are very low or negative.
- **Counterparty risk**: The fund may have contractual agreements with counterparties. If a counterparty is unable to fulfil their obligations, the sum that they owe to the fund may be lost in part or in whole.
- **Credit risk:** A decline in the financial health of an issuer could cause the value of its bonds to fall or become worthless.
- **Currency risk**: The fund may lose value as a result of movements in foreign exchange rates.
- **Derivatives risk**: Derivatives may be used to manage the portfolio efficiently. The fund may also materially invest in derivatives including using short selling and leverage techniques with the aim of making a return. A derivative may not perform as expected, may create losses greater than the cost of the derivative and may result in losses to the fund.
- **IBOR risk**: The transition of the financial markets away from the use of interbank offered rates (IBORs) to alternative reference rates may impact the valuation of certain holdings and disrupt liquidity in certain instruments. This may impact the investment performance of the fund.
- **Interest rate risk:** The fund may lose value as a direct result of interest rate changes.
- **Liquidity risk**: In difficult market conditions, the fund may not be able to sell a security for full value or at all. This could affect performance and could cause the fund to defer or suspend redemptions of its shares.
- **Market risk**: The value of investments can go up and down and an investor may not get back the amount initially invested.
- **Operational risk:** Operational processes, including those related to the safekeeping of assets, may fail. This may result in losses to the fund.
- **Performance risk**: Investment objectives express an intended result but there is no guarantee that such a result will be achieved. Depending on market conditions and the macro economic environment, investment objectives may become more difficult to achieve.
- **Sustainability risk**: The fund has environmental and/or social characteristics. This means it may have limited exposure to some companies, industries or sectors and may forego certain investment opportunities, or dispose of certain holdings, that do not align with its sustainability criteria chosen by the investment manager. The fund may invest in companies that do not reflect the beliefs and values of any particular investor.

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