Schroders

Schroder Value Short Duration

Quarterly Commentary

1Q 2019

Market review

The first quarter of 2019 was generally positive for risk assets. January experienced the majority of the positive excess returns for risk assets as investors rushed to capitalize on the attractive valuations created by the selloff in Q4 2018. Although much of the spread movement and excess returns are attributable to January, it's not to say the rest of the quarter was uneventful. Increasingly dovish comments by the Fed at the March FOMC meeting and weak manufacturing data out of Germany resulted in a material rally in interest rates and an inverted yield curve from cash out to ten year maturities. The notion that the inverted curve is a predictor of recession in addition to the Fed's own comments regarding the diminishing outlook for the US economy further exacerbated the rally in Treasuries. By the end of the quarter, ten year Treasuries had rallied 32 bps; however, the reaction for risk assets was surprisingly muted. Equity markets as well were fairly sanguine about the move in Treasury rates and ended the quarter higher. In fact, the S&P 500 had the best quarterly performance since Q3 of 2009.

For the quarter, spreads as measured by the Bloomberg Barclays Corporate Bond Index were tighter by 35 basis points (bps). Within the corporate sector, industrials (+ 296 bps) were the leaders in terms of excess returns to Treasuries as the sector benefitted from the recovery in the price of oil. Financials (+256 bps) and utilities (+150 bps) lagged industrials however they did post positive excess returns to Treasuries.

Within the broader sectors of the Bloomberg Barclays Aggregate Bond Index, Sovereigns (+328 bps) were the leaders however securitized (49 bps) and supranational (21 bps) were obvious under-performers. Tax-exempt municipals (+120 bps) rallied posting positive excess returns to Treasuries however the results were more mixed against corporates depending on duration with long tax-exempts out-performing duration neutral corporates. Finally, Treasuries rallied materially on the comments by the Fed and the concerns about slowing global growth. The result was that the ten year tenor rallied 32 bps to the lowest yield since December 2017 and the yield curve inverted from cash out to ten years, for the first time since 2007.

Performance and strategy

The portfolio beat the benchmark for the quarter by 61 basis points (bps), before fees. Sector selection was the main driver of outperformance given the portfolio's overweight to corporates, financials and industrials, and the all Treasury benchmark. There was an additional smaller contribution from the securitized asset class however the bulk of excess returns came from corporates as spreads rallied materially. Yield curve and duration in addition to security selection were not material factors.

Outlook

Despite the return of volatility and rising concerns about the global economy, corporate spreads remained stable throughout the quarter and not far off the lowest levels so far this year. At these levels, valuations are ordinary at best (using a 5 year lookback) and fairly expensive when looking at long term averages (10 year lookback). Given the rich valuations, the reliable implications of the inverted yield curve and the Fed's own comments regarding future growth of the economy, it's difficult to justify adding corporates risk back to the portfolio at this time. We expect the portfolio allocations to remain as is with the possible exception of adding securitized assets in exchange for Treasuries or even corporates. Data for the domestic consumer, albeit soft, has held up better than the global equivalent and is further supported by strong employment thus making the asset class more attractive than corporate credit.

Risk disclosures

All investments involve risks including the risk of possible loss of principal. The market value of the portfolio may decline as a result of a number of factors, including interest rate risk, credit risk, inflation/deflation risk, mortgage and asset-backed securities risk, US Government securities risk, foreign investment risk and liquidity risk. Frequent trading of the portfolio may result in relatively high transaction costs and may result in taxable capital gains.

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Source: Schroders, as of December 31, 2018. Firm assets include assets under management and administration.

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