Schroders

Schroder Value Core

Quarterly Commentary

1Q 2021

Market review

The first quarter of 2021 was remarkable for the sharp rise in interest rates and consequently the worst performing quarter for Treasuries in 10 years. The outcome of the elections in Georgia back in January assured that Democrats would have control (albeit tenuously) of the House and Senate and essentially complete the "Blue Wave". The subsequent approval of President Biden's stimulus package and successful rollout of the vaccine left many investors believing that improved growth and by extension increased inflation expectations could only lead to higher rates. To be fair, much of the increase in rates had less to do with inflation expectations and more to do with increasing real yields as the economy picks up momentum. At various times during the quarter Fed Chairman Powell reassured investors that the move to higher rates was transitory and that he has no plans for raising rates for some time. However, with marked improvement on the battle against COVID-19 and the quarter ending with details of President Biden's infrastructure plan, there was little reason not to believe the narrative that higher yields could be expected. Notably, spreads ended the quarter nearly unchanged reflecting investor confidence in risk assets despite the turmoil in Treasuries and the second highest first quarter volume on record.

Performance and strategy

The Schroder Value Core strategy beat the benchmark for the quarter due primarily to positive sector selection. The underweight to Treasuries and overweight to taxable municipals were the main factors however the corporate allocation was also constructive to a lesser degree. Within corporates, the overweight to industrials was the main factor whereas the overweight to financials, primarily banking, detracted. Issue selection was close to neutral as positive impacts from taxable municipals and agency MBS were offset by corporates, both industrials and financials. Yield curve impacts were negative given the sharp rise in rates and steeper yield curves. This was more a reflection of the asset allocation (i.e. underweight to Treasuries) than an expressed view on the direction of yields.

Outlook

As we enter the second quarter, it's important that we distinguish between cyclical and structural drivers of bond valuations. While the short term argues for higher yields, the longer-term structural drivers of "lower for longer" remain in place. Any move towards 2% yields in 10-year Treasuries would be considered a buying opportunity. Structural impediments to higher yields remain in place with the highest global debt burdens since World War II, deteriorating demographics, deflationary impulses in the form of technology and limited bargaining power for labor with only 10% of workers in a union today, compared to 20% in the 1980s. US bonds remain a global opportunity and with $13 trillion of bonds globally still with negative yields, there is a limit to how much US yields can rise. In addition, if yields move too high and start to impact financial conditions, the Fed has a variety of mechanisms to cap the rise in yields. This includes extending the maturity of their bond purchases or implementing yield curve controls, similar to what we have seen in Japan and Australia. The bottom line is given the amount of debt in the US and global economy, the US cannot function with significantly higher bond yields.

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.

About Schroders

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Source: Schroders, as of December 31, 2020.

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