Schroders

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Schroder ISF* Global Corporate Bond
Monthly Fund Update
October 2019

At a glance

Fund manager: Rick Rezek and Alix Stewart

Performance: The fund returned +0.6% (I Acc share class) over the month, outperforming the Bloomberg Barclays Global Aggregate Corp, USD hedged, which returned +0.4%.

Largest contributors: Security selection in banking.

Largest detractors: No standouts.

**Source: Schroders, as at 31 October 2019. Net of ongoing charge, bid-bid, with net income reinvested.

Calendar year performance (%)

(%)	Fund (A Acc)	Fund (I Acc)	BM**
2018	-2.3	-1.3	-0.5
2017	5.0	6.1	5.4
2016	6.1	7.1	5.7
2015	-1.5	-0.5	-0.1
2014	5.7	6.8	7.5

Source: Schroders, as at 31/12/18, net of fees (where applicable), NAV to NAV (bid to bid), USD returns.

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 overview

In October, there were positive developments on the trade front as there were signs the US and China might be progressing towards a Phase I trade deal. While there is uncertainty surrounding this deal, in addition to the fact that it would not solve all the outstanding issues, markets saw this as capping the downside by limiting further damage to both economies.

While the labour market in the US remained resilient through October, the global manufacturing slide deepened. The US and EU economies continued to post contractionary manufacturing index readings. This contributed to the general uneasiness regarding global growth and its trajectory. On the Brexit front, uncertainty is set to continue as the EU granted an extension until 31 January. Short term, the extension reduced the risk of the UK crashing out. To close the month, US 3Q19 GDP came in at a better-than-expected 1.9%. The consumer continues to serve as an anchor, while business investment continues to weaken. Following the release the Federal Reserve (Fed) delivered another rate cut, bringing the upper bound limit of the Fed Funds rate to 1.75%. Commentary surrounding the cut indicated further cuts will be more difficult to justify.

In credit markets, global investment grade (IG) returned +0.4%, outperforming global high yield (HY), which returned +0.25%. This was driven by spread widening in global HY, while the spread on the global IG index compressed 6 basis points (bps) to 122bps. The yield also declined, closing at 2.19% from 2.24% at the end of September. Risk-free rates continued to back up in October as the market digested the Fed commentary regarding the future rate path. The 10-year US Treasury yield peaked at 1.84% in late October, up from a low of 1.53% earlier in the month.

Regionally, the US dollar market (+0.61%) outperformed euro (+0.03%) and sterling (-0.11%). In terms of quality, the BBB (+0.50%) hot streak persisted as the group outperformed AAA (+0.05%), AA (+0.17%) and A-rated (+0.34%) credit.

In corporate sectors, the leaders were other utility (+2.85%), other financial (+2.45%) and natural gas (+1.66%). The laggards were other industrial (+0.47%), energy (+0.54%) and technology (+0.76%).

Fundamentally, credit metrics have largely been stable despite some weakness in top and bottom lines for US IG issuers. It has become increasingly clear that the 2H19 earnings rebound thesis will prove to be false, as earnings forecasts have been revised downwards

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

consistently for the remainder of 2019. Importantly, gross and net margins are still healthy despite the top line weakness. Additionally, the BBB part of the index, which represents about half of the market, has been making significant strides towards de-leveraging. The uncertain atmosphere, while reducing confidence and investment, has in some ways been a positive as it forces the most exposed issuers to manage their balance sheets more conservatively.

Technicals remain a strong tailwind for US credit. The increasing amount of negative yielding debt, which is still close to $13 trillion, has made yields in the US look attractive on a relative basis. This, combined with stabilized hedging costs due to expectations that the Fed will cut rates further, has significantly bolstered demand for the US segment of Global IG. The large universe of negative yielding debt has also provided support on the supply side as well. We've seen a number of potential USD IG issuers borrow as reverse yankees (an American company issuing in non-USD) to take advantage of the historically low yields across Europe.

In terms of supply, the US dollar new issue market was again active in October. Fixed-rate, gross investment grade supply for October was about $107.2 billion. The euro and sterling markets were equally active, seeing €57.4 billion and £4.9 billion in new supply respectively. The markets ability to absorb this supply with ease exemplifies the strength of the current demand for IG credit with so much global debt negative yielding.

Portfolio overview

The fund outpaced the benchmark in October. Security selection was the primary driver of outperformance. Regionally, the fund's underweight in Canada contributed modestly to relative returns.

In terms of quality, the fund's overweight in triple-Bs added as the group outperformed the broader market. As mentioned previously, triple-Bs have posted stronger than expected credit metric improvement, which has been awarded with spread tightening. This group has also seen a strong bid from investors reaching for yield who are unable to tap into HY markets, placing a cap on spreads.

Asset allocation in corporate sectors was not a meaningful driver in October. Security selection was positive, driven by strong picks in banking. UBS and BB&T both rallied.

Portfolio trading was relatively quiet as we did not make major adjustments to our positioning. We added exposure in consumer non-cyclical, a more defensive sector. A number of these purchases were in longer dated bonds. We are currently overweight the longer end of the curve and underweight the short end.

Outlook and strategy

On the macro front, our view is currently cautiously optimistic. Global central banks have unleashed a fresh round of stimulus via balance sheet expansion, and the full effect of recent global rate cuts has yet to be experienced as there is typically a lag. In the US, the job market has yet to show cracks and has posted strong positive surprises, and manufacturing has shown signs of stabilizing. However, there are still concerning trends in global growth statistics and a sizable amount of leading indicators in the US are still flashing caution. Many of the developed market economies remain in slowdown territory, and we are waiting for additional evidence things have stabilized.

Our estimates put current valuations at about fair value, as the fair value spread level has dropped recently with the stabilization of manufacturing data and drop in volatility. While we do feel relative value persists and the technical environment is supportive given the strong overseas demand for USD, the highest yielding IG market, we feel that the large recent compression has capped the upside. The index is just off the tights of last October.

Fundamentally, we feel the universe is leveraged but healthier than many headlines suggest. Margins are still close to peaks and the key low BBB issuers have showed promising signs of deleveraging. A large portion of the BBB- minus issuers (the lower end of BBB) are on positive ratings watch.

Overall, we will maintain our defensive posture moving forward as we feel the opportunity to generate significant outperformance via idiosyncratic risk is limited. We feel the overseas bid for USD risk assets remains strong and will anchor spreads over the coming months. As we enter the final months of the year, we will grow dry powder for deployment in January as seasonal illiquidity creates buying opportunities.

Risk Considerations

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.

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 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.

The fund enters into financial derivative transactions. If the counterparty were to default, the unrealised profit on the transaction and the market exposure may be lost.

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