

# Strategic Bond Q4 investment update

January 2024

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**Investment manager Torcail Stewart and investment specialist Sandy Jones give an update on the Strategic Bond and Global Strategic Bond strategies covering Q4 2023.**

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Your capital is at risk. Past performance is not a guide to future returns.

**Sandy Jones (SJ):** Welcome to the Q4 2023 Strategic Bond update. My name is Sandy Jones. I'm an investment specialist in the income team. And I'm joined today by Torcail Stewart, co-manager of the Strategic Bond strategies. As a reminder, these are global best ideas, corporate bond portfolios. We seek to add value through bond selection and active management of portfolio credit risk.

Torcail, 2023 didn't quite pan out as markets anticipated. For example, US growth continued to surprise to the upside. When you look back on last year, what are your key thoughts and reflections on corporate credit markets in 2023?

**Torcail Stewart (TS):** So 2023, Sandy, was the year of records. It was the warmest year on record in 125,000 years. So that led to a number of wildfires across the world and other climatic events that had impacts upon the economy. A good example of that was the Panama Canal. It saw throughput down by 5 per cent year-on-year due to scarcity of water, and credit markets didn't disappoint either. We saw historically high volatility within those markets as well.

So, what is quite intriguing, when we reflect going back to the start of the year, we saw a number of economists predicting recession by year end, and that proved erroneous in spite of some pretty big challenges. We saw several US regional banks getting into difficulty going to the wall, ultimately. We saw Switzerland's second largest bank getting into difficulty and have to be bought over. And also, we saw sticky inflation. We saw further rate hikes, rate hikes on top of the bumper year of rate hikes we had in 2022. So that really led to some volatility in credit markets. Indeed, at one point in both sterling and dollar investment grade corporate bond markets, we saw a drawdown of close to 8 per cent. Pretty high.

Now, what's intriguing, is if we look further ahead, the Fed has really convinced markets we've got a soft landing ahead of us. Indeed, inflation is trending down, and the US is, as you detailed,

providing pretty strong growth. And all else equal, we think that's probably what's going to happen. And indeed, that's led to investment grade and high yield doing well this last year.

But there are some pretty big fat-tail risks out there that could destabilise that. What are they? Well, we've got the US-China relations that are pretty torturous just now. We're also seeing the grinding conflict in Ukraine and the tragic conflict unfolding in the Middle East. All of these have the potential to escalate and create inflation to a certain extent once more.

However, you'll be pleased to hear we do not think that is going to happen.

**SJ:** Very pleased indeed, Torcail. I think we've all had more than enough of inflation surprising to the upside.

Before we go on to talk about outlook for 2024 in more detail. I want to spend a bit of time talking about performance. So, as you've alluded to, credit markets had a much stronger 2023 after a very, very challenging year for fixed income in 2022. Did the portfolios perform as you expected over the last 12 months?

**TS:** So, the final quarter was very strong for these strategies, indeed. We saw total return for the year being in excess of 9 per cent. The Strategic Bond strategy was broadly in line with benchmark, and the Global Strategic Bond strategy was slightly behind benchmark. Now that's in spite of both these strategies running with a high level of dry powder, and also allocating to balance sheet secure BBBs, short-dated BBBs in particular, BBBs being the lowest rung of the investment grade credit spectrum.

Through the year, actually, high yield was the best place to allocate for most of the year. But as we go into the final quarter, our decision to be overweight investment grade bore fruit and we saw a strong rally of duration at that point in time. That thesis for being overweight investment grade is, as we discussed, there was quite a lot of macroeconomic headwinds that were kicking around. So, we felt that was a prudent position to be allocated to there.

And as we look through the portfolio, at this juncture, what we see is a number of our best ideas that still have a lot of their positive catalysts still outstanding and haven't actually played out yet. So, we think there's a lot of potential in the portfolio at this point in time.

**SJ:** I'm very, very keen that we spend a bit of time talking about some of those ideas in more depth. Before we do, let's talk about valuations and positioning. So, valuations for corporate credit, as you've said, rallied quite strongly towards the back end of last year, leaving very little room for error, arguably in valuations, quite tight. Is there a place for corporate credit in a balanced portfolio, looking ahead to 2024?

**TS:** Well Sandy, I'm going to flip that. I think corporate credit should be right at the heart of a balanced portfolio. Because what we saw in the last quarter could potentially be a taster of some of the returns that could transpire if you see further reduction in inflation, getting back to target. What we've seen over the last couple of years, investors have put a lot of money into money market funds. That's a rational decision when you see a period of rate hikes coming through. But it could be a suboptimal allocation, if we do see inflation tempering and it's getting into a slow growth environment. You cannot lose sight, we think, at this point in time, of looking at how high

investment grade yields are relative to the historic context. If we look at BBB, both sterling and dollar markets corporate bonds, we are seeing the highest yield since the fallout of the global financial crisis, a yield of close to 6 per cent.

So, when we look at what's going on in markets, we're seeing headline inflation across major geographies starting to trend down. We think that will ultimately feed through to core inflation, when you strip out energy and food costs. And really, we think corporate credit is really well positioned for the two main scenarios that most are predicting. That of a hard landing, and that of a soft landing.

In a hard landing scenario, you have to remember, a large portion – about two thirds if its sterling BBBs, or three quarters of your total yield if it's dollar BBBs – is derived from government risk, underlying government bonds. And that does well if we see a hard recession transpiring.

In a soft landing scenario, which is the optimum condition for bonds, where you've got low growth and low target inflation, you've got that extra spread on top of that government bond through the corporate. In sterling markets, that's about a third of the total yield in the BBB, and in dollar markets a quarter of the total yield for BBB.

**SJ:** So what we're saying is, if you're unsure about the market outcomes that might transpire in 2024, corporate credit actually looks like quite an attractive hedge for either of those two scenarios.

That brings us quite neatly on to talking about positioning. Let's start with credit risk. How are the funds currently positioned in terms of their allocation to investment grade and high yield bonds?

**TS:** So, the strategies are overweight investment grade bonds at this point in time. Why is that? Because the yield on offer from investment grade is very high by historic levels and you can't lose sight of the last time we had yields this high in investment grade. We actually even saw further spread compression from where we are now. That was an environment of target inflation and reasonable growth.

We're underweight high yield just now, particularly the lower depths of the high yield market. Why is that? Well, that's because we're concerned that there have been rate hikes. And when those more indebted high yield companies start to reprice, it could be a bit penal for them. So we're underweight with that portion.

Where we see the optimum risk return is in BBB-rated corporates. BBB generally offer you a lower rate of default through time, and as I've detailed earlier, they're offering close to a 6 per cent yield, which is really quite compelling. So, both of the strategies are out-yielding their respective indices without going too far down the rating spectrum.

**SJ:** What about companies, Torcail? Last quarter we talked about a new addition in shape of Veritext. Where do you see the most attractive opportunities? Looking ahead to 2024.

**TS:** So, there's a couple of themes within the portfolio. One of the top ones is really senior property company bonds. So those are bonds that are near the top echelons of the capital structure, and they're offered on quite attractive yields, but are also offered at prices well beneath their par

redemption level. So what does that give you? That gives you quite a lot of downside protection in the case of default, as the price of those bonds is quite low. But also, you've got the spread compression potential from the very high yield, the excessive spread that's being offered. What we've seen is the strong property company bonds selling off with the weak, and, on a three-year view, if inflation continues to temper, we think these could be some of the top-performing bonds within our strategies.

Now, a really good example of that, Sandy, is CTP. CTP is the largest and leading logistics and industrial real estate group in Central and Eastern Europe. It is in the sweet spot of real estate. So, it's in that space of logistics, which benefits from ecommerce growth and on-shoring. It has a blue-chip tenant base, which has been doing pretty well because we're seeing the most recent results, like-for-like rental growth, of 7.5 per cent for CTP.

And yet the bonds of CTP continue to trade at a discount, an excess of yield, relative to that of other BBB industrial corporate bonds. That feels pretty anomalous when you consider that their debt to their value of assets ratio is below 50 per cent.

**SJ:** So, a really attractive opportunity in property bonds at the moment. But I think the other key message is you want to lend to those companies with really strong underlying fundamental characteristics like CTP. What other names in the portfolio are getting you really excited at the moment, looking ahead to 2024?

**TS:** Well, one of the top ones is actually Admiral, the UK motor insurance company. Now, that's suffered from quite a bit of claims inflation over the last couple of years. But what we're seeing in that market is you're seeing prices hardening, and that should improve both profits and margins going forward.

Another company is that of InPost, the parcel delivery company, which is expanding its locker network across Europe. We think as it grows in scale and scope, that will result in it ultimately achieving an investment grade rating.

And another business, a more recent purchase, is that of Nissan. You'll know Nissan had pretty good performance a while back. But after the somewhat dramatic departure of their chief executive, Carlos Ghosn, led to a period of political infighting and also poorer margins and profits.

What we are seeing however, now, is there's been quite a bit of corporate restructuring, there's been some board changes. And we also can see that they've got a really bumper electric vehicle schedule in the coming years. And we think the combination of these factors means that Nissan is really likely on an improving trajectory, going forward. So, we have bought the long-dated dollar bonds of Nissan.

So really, this is just a taster, Sandy, of a number of the ideas within the strategies from a number of different sectors, credits that we think are offered on attractive valuations, offering higher income and the potential for price return over the long term.

**SJ:** So, in summary, we're optimistic about returns from the asset class, looking ahead to 2024. That's really because all-in yields continue to look attractive relative to history. In terms of

positioning, the strategies continue to out-yield their respective indices. That's really driven by an overweight to BBB-rated bonds. So those bonds at the lower end of the credit spectrum, within the investment grade rating space. That's where we see the most attractive relative value at this time.

Finally, the portfolios are full of potential. We've heard about Nissan and CTP. These are just two examples of the individual positions that hold potential to add value through bond selection in the year ahead. Thank you for your time, Torcail. And thank you for joining us.

## Strategic Bond (including Strategic Bond and Global Strategic Bond strategies)

### Annual past performance to 31 December each year (net %)

	2019	2020	2021	2022	2023
Strategic Bonds Composite - GBP	11.7	5.9	-0.6	-16.1	9.6
Strategic Bond Benchmark* - GBP	10.4	6.7	-0.9	-15.5	10.2
Fixed Interest Global Strategic Bond Composite - USD	12.9	9.8	0.6	-14.7	9.1
Global Strategic Bond Benchmark** - USD	12.1	7.5	0.2	-13.2	10.2

### Annualised returns to 31 December 2023 (net %)

	1 year	5 years	10 years
Strategic Bonds Composite - GBP	9.6	1.6	3.5
Strategic Bond Benchmark* - GBP	10.2	1.7	3.3
Fixed Interest Global Strategic Bond Composite - USD	9.1	3.0	3.4
Global Strategic Bond Benchmark** - USD	10.2	2.9	3.3

\*The composite's benchmark is composed of the following: 70% ICE BofA Sterling Non-Gilt Index, 30% ICE BofA European Currency High Yield Constrained Index (Hedged to GBP). The benchmark is re-balanced quarterly.

\*\*The composite's benchmark is composed of the following: 70% ICE BofA Global Corporate (Hedged to USD), 30% ICE BofA Global High Yield (Hedged to USD). The benchmark is rebalanced daily. Prior to 15 January 2021 the composite's benchmark was Bloomberg Barclays Credit (Hedged to USD).

Source: Baillie Gifford & Co and ICE. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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