

31 March 2023

Market Review

Global investment-grade corporate bonds rose in March. Sovereign bond yields fell, with 10-year German bund yields closing the month 36 basis points (bps) lower at 2.29% and the 10-year US Treasury yield falling by 45bps to 3.47%. Credit spreads widened. As a result, the total index return for the period was 2.03% (hedged to Australian dollars).

Most major global central banks raised interest rates in March, in spite of an unfolding banking crisis. The European Central Bank raised rates by 50bps, noting it is closely monitoring banking problems. Preliminary data showed an unexpected moderation in the Eurozone's inflation rate, with March prices increasing by 6.9% year on year.

The Bank of England and US Federal Reserve (Fed) both pressed ahead with interest-rate hikes of 25bps apiece. In the US, annualised GDP growth was revised downwards to 2.6% for the fourth quarter of 2022. However, in the UK, quarterly GDP growth was revised up to 0.1% for the final three months of 2022, meaning the country avoided a technical recession.

Portfolio Review

The Fund outperformed its benchmark in March, owing to good performance from BBB rated bonds.

Amid turmoil in the banking system, our bank holdings performed well. We had no exposure to Silicon Valley Bank (SVB), and benefited from positioning in Bank of America, Citigroup and Wells Fargo. Deutsche Telekom also outperformed. On the downside, property holdings were among the detractors, including LEG, Sirius and CBRE.

In the primary market, we bought attractive new issue bonds including the 2033 US dollar bonds of Medtronic, the 2033 US dollar bonds of General Mills, the 2053 sterling bonds of Engie and the 2031 and 2028 euro dual issue from Anglo American.

In the secondary market, we added the bonds of US insurer Prudential, a conviction name which cheapened up amid the wider weakness in financials. We switched telecommunications holdings from Comcast to Charter, as we considered our Comcast holdings to be fully valued. We also sold our long-dated Salesforce bonds, as the firm has announced large stock buybacks which could hurt bondholders.

Outlook

The failure of the SVB in the US and the emergency takeover of Credit Suisse by UBS have caused massive volatility in credit and rates markets, raising the question if these banking crises are systemic or idiosyncratic. We think the latter, as both banks had very specific problems that are very different to other banks, exacerbated by a loose deposit base (start-ups and private wealth clients that were not covered by the respective deposit insurance schemes) that took flight in light of very bank-specific negative news flow. The central banks and regulators in the US and Switzerland stepped in effectively to resolve the situation in order to avoid wider contagion and will do so in the future if needed. What are the wider market implications? Banks will have to pay up for deposits, which will reduce their interest rate margins and likely lead to tighter lending standards, reducing the supply and increasing the price of credit in the economy.

This will likely slow growth further in the second half of 2023, with an increased risk of a recession in the US and Europe, hence we are underweight cyclical sectors. It also means that central banks will likely hike less as this tightening of financial conditions will help to reduce inflation, which in turn is positive for the higher-quality parts of the bond market.

Banks have materially underperformed in this environment, but have recovered some of the losses into month-end. We have maintained our bank overweight as we believe that these bank failures are very specific basket cases, which will not cause a systemic crisis. Banks in Europe and the US are well capitalised, better regulated than they were prior to the financial crisis in 2008 and, in almost all cases, have a much stickier deposit composition compared to Credit Suisse and SVB. They are therefore less exposed to a bank run, which also needs bank-specific negative news flow to be triggered.

On the macroeconomic side, Europe has seen relatively positive growth numbers, helped by lower gas prices and resilient labour markets. Supported by a still-strong labour market, the US growth numbers have been solid recently, although there have been signs of weakness in manufacturing data.

Investment strategy

The Fund is actively managed and may invest in a wide range of bonds (e.g. corporate bonds including high yield bonds, government backed securities, overseas bonds, index-linked bonds, floating rate notes ('FRNs') and asset backed securities ('ABSs')) and/or money market instruments) in order to take advantage of opportunities identified.

Investment objective

The Fund aims to provide long term growth and outperform the Benchmark over rolling 3 year periods (before deduction of fees, costs and taxation) by investing predominantly in global investment grade bonds.

Europe will also benefit from China's reopening via the export channel and tourism flows. Headline inflation continues to come down, while core inflation still increases, which will likely lead to a few further moderate rate hikes. Credit spreads have reached recessionary levels in March, driven by the sell-off in banks, and we see these levels as attractive and expect spreads to tighten from here in the short term

Specific share class performance is available on the relevant factsheet.

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Companies selected for illustrative purposes only to demonstrate the investment management style described herein and not as an investment recommendation or indication of future performance.

Contact us
Telephone:
1800 636 888 or +61 2 9950 2853 if
calling from outside Australia
Email: client.service.aust@abrdn.com

abrdn.com.au

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