R&S Sterling Bond Fund

Q4 2022 Commentary

Performance with principles®

PERFORMANCE

	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Fund Performance (B Class)	5.1%	-2.9%	-13.6%	-8.4%	-2.7%	25.7%
R&S Sterling Bond Benchmark	5.7%	-5.9%	-17.7%	-14.0%	-6.8%	14.9%
IA £ Strategic Bond	4.1%	-0.9%	-11.7%	-5.5%	0.7%	23.3%
Sector Quartile	1	4	3	3	3	3

Source: Morningstar. Figures compared on a Bid to Bid basis with Net Income Reinvested.

YIELDS

	Dec-22
Distribution	3.93%
Underlying	3.38%
Historic	3.85%

MARKET REVIEW

Although central banks continued to pursue tighter monetary policy, global bond yields declined in the final quarter of the year as market participants contemplated a less hawkish outlook. The Bank of England delivered its first ‘outsized’ 0.75% interest rate hike in October and then raised its base rate by 0.5% in December in a bid to rein in inflation. UK fiscal policy concerns eased after 2022’s second change in UK leadership, which also supported gilt markets. The 10-year gilt yield began the quarter at 4.09% and rose to a high of 4.47% before falling to a low of 3.04% in December and ending at 3.67%.

The US Federal Reserve also raised its benchmark interest rate twice in the fourth quarter of 2022 by a combined 1.25%. Despite the downward shift in pace of rate hikes, elevated consumer prices led policymakers there to signal further tightening and emphasise commitment towards their price stability objective. The European Central Bank enacted interest rises of similar magnitude, increasing its policy rates by 0.75% in October and 0.5% in December.

Credit spreads tightened notably in October. Risky assets rebounded sharply as the debate over near-term peak benchmark interest rates gained traction. Corporate debt considerably outperformed government bonds over the period therefore, with lower-rated and higher-beta debt staging a significant rally, thereby recouping some of the relative underperformance registered in prior quarters of the year.

PERFORMANCE & ACTIVITY

The Sterling Bond Fund’s total return outperformed the IA Strategic bond sector, despite lagging behind its iBoxx Sterling Non-Gilts benchmark over the period. Whilst the Fund’s shorter relative duration held back relative performance as longer-maturity credit rebounded following the Bank of England’s targeted market intervention and the subsequent resolution to the UK’s Liability Driven Investment crisis, its overweight exposure to BBB-rated debt as well as subordinated debt proved beneficial, with lower-quality bonds materially outperforming higher-rated credit.

Having scaled back interest rate hike bets as headline inflation data showed initial signs of easing, market sentiment improved. The higher yields on offer vs. equities proved attractive. Risk premia tightened in October and November. This was more apparent on lower-rated securities, which rallied to a greater extent compared to higher quality debt. As underlying gilt yields fell, this left corporate debt significantly ahead of sovereigns across the yield curve.

Over the quarter, we added interest rate sensitivity to pare back the Fund's relative short duration position. We purchased the newly issued Vodafone Group 5.125% 2052 and Severn Trent 4.625% 2034. We initiated holdings in Zurich Finance 5.125% 2052 (2032 call), UK Treasury 4.25% 2049, UK Treasury 4.25% 2046 and Church Commissioners 3.625% 2052 sustainable bond whilst also adding to the Fund's position in UK Treasury 1.125% 2073.

OUTLOOK

The market remains focused on the path for inflation in anticipating the terminal level of interest rates set by global central banks. Should consumer prices slow decisively, hiking cycles may peak. In restoring price stability, central banks are also likely to be wary of 'over-tightening' given the lag with which monetary policy effects materialise.

As such, global central banks have moderated the pace of hawkish policy action for the immediate future even while maintaining guidance that there is more work to do. In addition, a slowing global economy indicated by survey data dampens the outlook for demand, which could also have adverse implications on labour markets. For the UK in particular, labour market disquiet has been a growing theme. The latter could well persist through the year with core inflation proving stickier and as targeted temporary fiscal support on energy costs wears off, further hampering real wage growth. A cautious stance towards credit is warranted, given heightened recession risks that could well result in increased corporate default rates. We retain a bias towards higher quality corporate bonds, which now offer more attractive risk-adjusted yield, complemented by a larger allocation to government debt to guard against wider risk premia as the global economy decelerates.

We remain vigilant in seeking out opportunities to add to high quality credits, scrutinising the robustness of business models and cash flows to ensure adequate compensation for risk. Whereas, we are adding interest rate sensitivity, we continue to view the Fund's overall shorter relative duration profile as appropriate. Having reduced cash, we are also relying on higher credit quality to enhance overall portfolio liquidity whilst preserving capital.

YIELDS

The Distribution Yield reflects the amounts that may be expected to be distributed over the next 12 months as a percentage of the mid-market share price of the Fund as at the date shown. The Underlying Yield reflects the annualised income net of expenses of the Fund (calculated in accordance with relevant accounting standards) as a percentage of the midmarket share price of the Fund as at the date shown. Both Yields are based on a snapshot of the portfolio on that day. The yields do not include any preliminary charge and investors may be subject to tax on distributions. The Distribution Yield is higher than the Underlying Yield because the Fund's expenses are charged to capital. This has the effect of increasing the distributions for the year and constraining the Fund's capital performance to an equivalent extent.