STRATEGIC BOND FUND Y INCOME SHARES

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Market Environment

Fixed income markets posted positive returns over the quarter, as government bond yields slumped to record lows, many of them below zero. Concerns over a protracted US-China trade war, geopolitical tensions and continued uncertainty over Brexit stoked unrelenting demand for safe haven assets. On the economic front, factory output in major economies declined due to punitive tariffs and US consumer confidence posted the biggest decline since the start of the year, pointing towards a faltering global economy. Against this backdrop, major central banks adopted an accommodative monetary stance. The US Federal Reserve (Fed) cut interest rates twice by 0.25% each at its July and September meetings. The European Central Bank (ECB) also cut its deposit rate by 0.1% to a new all-time low of negative 0.5% and revamped its quantitative easing programme of buying €20 billion worth of bonds every month from November. Consequently, 30-year US Treasury bond yields declined below 2% for the first time ever and the 10-year Treasury yield touched a three-year low, with inversion becoming a prominent feature across the US yield curve. In the UK, 10-year government bond (Gilt) yields fell below 0.5%, which is below its previous trough in August 2016. Yields across the German government bond market slipped into negative territory for the first time ever, with 10-year German bunds touching a record low of negative 0.716%. Emerging markets posted mixed returns, with hard currency bonds outperforming local currency bonds as a fall in US Treasury yields supported hard currency bonds.

Fund Performance

The fund posted positive returns over the quarter, underperforming global government bonds and investment grade corporate bonds, but performing broadly in line with global high yield credit.

Interest rate strategy added value
The fund's interest rate risk exposure was the primary driver of returns as core government bond yields fell. Against this backdrop, the skew towards US dollar duration (a measure of sensitivity to interest rate changes) was the most significant contributor to returns. The exposure to sterling and euro interest rate risk also supported performance.

Credit exposure detracted from returns
The holding in Thomas Cook was the top detractor from performance from an issuer perspective as it filed for bankruptcy. The exposure to Intu also weighed significantly on returns amid rising expectations that it will trigger an event of default in the near term. Elsewhere, the weakness in energy bonds persisted over the quarter, taking the full-year returns for the sector into negative territory. Consequently, the allocation to US energy names such as Occidental Petroleum, Denbury Resources and Western Midstream were significant detractors from performance. Holdings in sterling denominated corporate bonds such as Virgin Money and Rac Bond Co also held back gains as sterling credit spreads widened.

Fund Positioning

Risk assets continued to perform strongly over the year-to-date period, particularly due to the supportive stance adopted by global central banks. However, there are growing headwinds from a macroeconomic perspective, including the trade war and Brexit, as well as a global manufacturing recession that is gaining momentum. Therefore, while we remain positive credit beta, we are not getting too carried away with regards to risk as markets could turn volatile once again.

Focus on attractive opportunities but in a cautious way
We increased our exposure to Chinese property names as valuations look attractive given the recent underperformance. We continue to like the Chinese property sector as a source of yield, as Chinese authorities are becoming more supportive of the economy. We are also finding value in the European investment grade space as the ECB restarted its corporate sector purchase programme (CSPP). We also reduced the position in European high yield names as we do not expect spreads to compress further unless there is a pick-up in growth.

Interest rate strategy
The fund's headline duration has remained in a tight range over the last 12 months, staying between 5.5 and 6.0 years. We remain biased towards US rates, although we reduced some exposure to US dollar duration amid expectations of a steeper US Treasury yield curve. Instead, the exposure to euro duration was increased as macroeconomic data in the eurozone has been very poor. Our aim is to keep duration neutral across the board as it is too risky to stay short in the current market environment.

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