SARASIN
STERLING BOND FUND

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ECONOMIC AND FUND REVIEW

During the first quarter, sterling non-gilts produced total returns of -6.2% and excess returns (versus maturity-matched government bonds) of -1.6%. Gilt yields rose sharply during the period to reach new post-pandemic highs, while prices dropped. The 10-year yield reached 1.75%, as inflationary pressures mounted. The Bank of England (BoE) delivered two rate hikes of 0.25 percentage points during the period, raising the UK interest rate to 0.75%. The ICE UK Gilt index returned -7.1%. Russia's invasion of Ukraine caused energy prices to surge and led to a substantial widening of credit spreads through early March. However, they have been retracing rapidly tighter through quarter-end.

Over the quarter the fund performed broadly in line with the benchmark after fees. Our long headline duration stance detracted from performance. However, the portfolio's long inflation – UK 30-year and US 2-year – positioning helped offset this. Exposure to emerging markets local currency debt – particularly to Brazil and South Africa – also countered the negative impact.

In February we took portfolio beta down to below one for the first time since the advent of the pandemic in Q1 2020, as we anticipated a 'tradeable move' wider in spreads. By the second half of March we had raised beta back above one: the panic that followed the Russian invasion of Ukraine took spreads well beyond levels consistent with the still relatively robust economic environment.

This was particularly notable in euro and US dollar credit, with pound sterling markets proving relatively more resilient. Hence, we added risk predominantly via foreign currency-hedged euro and US dollar-subordinated bonds of 'national champion' banks such as HSBC, Credit Agricole, Credit Suisse and Deutsche Bank.

We participated in green bond new issues from Bazalgette Finance – the financing arm of the Thames Tideway Tunnel – as well as renewable energy firm Greenko Wind. We also took part in a social bond issue from housing association Peabody Capital.

OUTLOOK

The momentum in G10 fixed income has been resoundingly negative over the past quarter, except for a brief 'flight to quality' rally after Russia's invasion of Ukraine. There are some tentative indications that the sell-off may slow in the coming months, with oil prices stabilising in the range of $100-120 per barrel. Technical studies also indicate that government bonds are exceptionally oversold.

Additionally, a significant amount of rate hiking is already priced into the market. The BoE rate is expected to reach 2.5%, while investors anticipate the US Federal Reserve will raise rates to 3% by mid-2023. The risk of a recession this year appears low and spreads have widened to attractive ex-recession levels. Hence, the outlook for sterling credit for the remainder of the year appears quite positive. However, volatility is likely to remain markedly higher than in 2021, though less than in the first quarter of this year. These conditions require us to remain nimble in our approach and it is quite possible that we would have moved back to a more defensive stance by year-end.

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IMPORTANT INFORMATION

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The investments of the fund are subject to normal market fluctuations. The value of the investments of the fund and the income from them can fall as well as rise and investors may not get back the amount originally invested. If investing in foreign currencies, the return in the investor's reference currency may increase or decrease as a result of currency fluctuations. Past performance is not a guide to future returns and may not be repeated.

There is no minimum investment period, though we would recommend that you view your investment as a medium to long term one (i.e. 5 to 10 years). For efficient portfolio management the Fund may invest in derivatives. The value of these investments may fluctuate significantly, but the overall intention of the use of derivative techniques is to reduce volatility of returns.

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