GLOBAL SHORT DURATION INCOME FUND A-ACC-EURO (EURO/USD HEDGED)

30 SEPTEMBER 2018

Portfolio manager: Peter Khan

Market Environment

Global bonds posted mixed returns over the quarter, with corporate bonds outperforming government bonds. Growth momentum in many European, Asian and emerging markets was lacklustre, as a result of which the US was increasingly the main driver of global growth. Over the quarter, US markets posted mixed returns. While data remains supportive, US assets had to contend with the last-minute signing of a new trade agreement with Mexico and Canada; the ongoing trade spats between the US and China; and a deterioration of the relationship with Iran. Economic activity nevertheless remained positive, which prompted the US Federal Reserve to upgrade its growth forecasts and raise interest rates as expected. In Europe, the focus remained on Italy and on the ongoing Brexit negotiations, where little progress was achieved. Risk sentiment was hit towards the end of the quarter as the Italian government announcement that it would maintain a deficit target at 2.4%, well above market expectations. European bonds posted mixed returns, with corporate bonds outperforming core government bonds. Elsewhere, the Bank of Japan (BOJ) introduced greater flexibility to its bond buying programme, allowing the ten-year Japanese government bond yields to trade in a wider range. The central bank also introduced explicit forward guidance in its monetary policy statement. In credit markets, credit spreads tightened and the US outperformed other regions, supported by strong economic data. The uptick in US consumer sentiment in September was largely driven by an improvement in consumers' confidence in the near-term economic outlook.

Fund Performance

Credit allocation supported performance
The exposure to corporate bonds aided returns as credit spreads tightened. The allocation to a mix of sectors such as financials, consumer-non-cyclicals, energy and telecommunications added value. The holding in Wind Tre in the telecommunication sector was the top contributor to performance. The positions in financial sector giants Commerzbank and Barclays also supported returns owing to the sector' higher beta. These gains were partially offset by the exposure to index credit default swaps (used to reduce credit risk in the portfolio), which held back gains.

Emerging market bonds had a positive impact on returns
Hard currency bonds outperformed local currency bonds. Spreads tightened over the quarter, supported by technical factors and proactive interest rate hikes from several emerging market central banks.

Interest rate strategy held back gains
The exposure to US dollar and euro duration (measure of sensitivity to changes in interest rates) weighed on returns as government bond yields edged higher.

Fund Positioning

The US-led trade war will remain a dominant theme in the market, but robust US economic data should support high yield earnings. The spread between short and long-term interest rates has continued to shrink, which is usually a signal that economic growth is peaking. Elsewhere, the currency crisis in emerging economies, including Turkey and Argentina; and an uncertain outcome of Brexit negotiations are likely to slow down the pace of economic expansion in the eurozone. The risks are more balanced, but global rates are likely to rise. On balance, we are maintaining a cautious stance towards credit.

Sector strategy
We looked to improve the fund's liquidity through increased allocation to government bonds. We also took advantage of the recent spread widening in investment grade credits to increase our exposure to the asset class. We tactically added Italian credit amid the recent volatility in Italy. At the sector level, we reduced the position in basic industry and consumer non-cyclicals, while adding to financials. We bought holdings in Barclays and Wells Fargo.

Duration strategy
The portfolio's headline duration was reduced marginally over the quarter, mainly through US dollar as US Treasury yields are expected to edge higher. Overall, the fund's duration remains skewed towards the US dollar interest rate risk.

Inflation strategy
We are tactical and look for better opportunities to reload our real duration positions. We reduced exposure to euro inflation-linked bonds over the quarter, thus decreasing the fund's real duration position.

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Past performance is not a reliable indicator of future results. Currency hedging is used to substantially reduce the effect of currency exchange rate fluctuations on undesired currency exposures. There can be no assurance that the currency hedging employed will be successful. Hedging also has the effect of limiting the potential for currency gains to be made.

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