Strategic Bond Opportunities Fund

August 2020 Fund Commentary

MARKET DEVELOPMENT

During August, there was no shortage of reasons for concern: the uncontrolled COVID-19 pandemic, the conflict between the White House and Congress on support for the unemployed, the increasing popularity of Democratic candidate Joe Biden following the selection of Kamala Harris as his running mate, and the ongoing tensions with China. We believe that the major risk facing those looking for a correction of long-term interest rates is the Federal Reserve (Fed). It is unthinkable that in the event of stress on the 10-30 year part of the US yield curve, the Fed will not react. Although the Fed has not made any announcements regarding the issue of yield curve management, it is bound to intervene in the event of an excessively sharp rise in long-term yields. An insignificant rise in long yields will not worry Wall Street, but if a sharper correction were to occur, it could be bad news for equity markets, which may react negatively.

All these uncertainties and concerning news stories ought to have kept US rates at their end of July levels, but this did not take into account the inflation fears which resurfaced at the end of August, resulting in the 30-year inflation breakeven to climb significantly. This shows that the primary source of concern just before the post-holiday resumption is indeed inflation. The Fed's policy has been deliberately vague: the minutes of the last Federal Open Market Committee meeting revealed nothing important, while the Jackson Hole symposium sent out mixed signals. The Fed will "allow inflation to run above its target" but, at the same time, control of the yield curve will not be abandoned, even though no official announcement has yet been made on this subject.

MARKET OUTLOOK

Our outlook remains focused on the macroeconomic situation (including growth and inflation), Central Banks' behaviour, and the evolution of equity markets. We believe inflation risk will remain low in the US and Europe in the coming months, but inflation fears could continue to increase gradually. Global growth is expected to stabilise in the coming months in Asia, Europe, and the US. In the short term, the US yield curve could continue to steepen slightly, but the Fed's purchases and the strong demand for safe-haven assets should stabilise long-term yields at low levels.

In this context, we believe that long-term US Treasuries remain attractive, but considering the long-term inflation expectations, we will maintain significant exposure to US inflation protection securities (30-year TIPS), anticipating higher breakeven expectations during the second half of the year. We believe that the best strategy today is to invest in a timely manner, maintaining a selection of high-quality corporate bonds, combined with a barbell strategy on the US Treasury yield curve, with an overweight of 1-2 year combined with long-dated US Treasuries (predominantly real yields).

In Europe, we are of the opinion that the current macro conditions, Brexit uncertainties, and the recent coronavirus outbreak support the recent accommodation measures from the European Central Bank.

We are still avoiding investing widely in Emerging Markets, but continue to closely monitor the spreads' patterns (both governments and corporates) in order to seize opportunities once spreads have widened sufficiently, probably sooner rather than later. At this stage, any significant increase in the weight of Emerging Markets is still premature, but this may change in the coming weeks.

Eric Vanraes
PORTFOLIO MANAGER

INVESTMENT APPROACH

The Fund is a diversified bond fund, investing in bonds predominantly denominated in USD, including Sovereigns, Supranationals and Agencies (together SSAs), corporate bonds across all sectors and financials. A strong conviction portfolio of 30-60 issuers, seeking exposure to all continents (including developed as well as emerging markets), all types of ratings from AAA/Aaa to BB/Ba2 (Standard & Poor's/Moody's) and non-rated bonds (10% maximum), senior or subordinated debt (hybrid corporates and Tier II bank debt) with either fixed or floating coupon rates.

INVESTMENT OBJECTIVE

To achieve a total return through a combination of capital growth and income by investing in a globally diversified portfolio of fixed income securities.

A sub-fund of E.I. Sturdza plc. Registered in Ireland.

CONTACT

E.I. Sturdza Strategic Management Limited

+44 1481 722 322

info@ericsturdza.com

ericsturdza.com

In conclusion, we believe that in the current environment, the best performing portfolio is a mix of hybrid bonds issued by high-quality corporates combined with long-term US Treasuries, real (TIPS) in particular, and short-dated investment grade investments.

FUND STRATEGY

During August, we implemented the most significant change in the Fund's strategy since the beginning of the COVID-19 pandemic. The weight of US Treasuries has been reduced significantly in favour of credit spreads (denominated in dollars and euros) and Emerging Markets. In the USD Investment Grade sub-portfolio, we bought Italy 2029, Enel 2025, Unicredit AG 2022, Export-Import Bank of Korea 2025, Korea East-West Power 2025, EDP 2021, Mamoura 2026, and UnitedHealth 2030.

In the euro sub-portfolio (with EUR-USD currency risk fully hedged) we invested in Saipem 2025, Orano 2023, and Exor 2028. The allocation to Emerging Markets has also been increased with purchases of Alibaba 2027, Baidu 2025, and Grupo Bimbo hybrid. At the end of the month, in order to reduce the modified duration to below five, we sold some US Treasuries with 10 and 30 year maturities. Finally, due to our ESG/SRI investment process and guidelines, the position in Volkswagen hybrid has been sold and replaced by Repsol hybrid.

IMPORTANT INFORMATION

The views and statements contained herein are those of Banque Eric Sturdza SA in their capacity as Investment Advisers to the Funds as of 08/09/2020 and are based on internal research and modelling.

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