Close Brothers Asset Management

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Close Sustainable Bond Portfolio Fund

Monthly fund manager update

DECEMBER 2021

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FUND PERFORMANCE

The Close Sustainable Bond Fund returned -0.4% in December, bringing the return for 2021 to -1.4%. In comparison, the Investment Association Sterling Corporate Bond Sector returned -0.8% in December and -1.9% over 2021.

The Sustainable Bond fund is focused on risk-adjusted returns and has historically operated with lower duration than the corporate bond sector. As a result, the Fund has outperformed the sector 86% of the time in 'down' markets, and 91% of the time when the sector is down by -25bps or more (since February 2014).

As of 31 December 2021, the Sustainable Bond fund maintained an average credit rating of BBB+.

MACRO BACKDROP

News flow in December was dominated by the spike in Omicron Covid-19 cases, casting question marks over whether further social restrictions would be imposed and for how long. Markets behaved differently than in previous waves and did not price in a significant drop in inflation or fewer interest rate hikes. Relatively low hospitalisations have now pushed nominal rates back up to pre-Omicron levels.

In the UK, December Composite Purchasing Managers' Index (PMI) data dropped markedly to 53.2 (from 57.6 in November) as the Manufacturing reading dropped to 57.6 – a -0.5 Month-on-Month (MoM fall - and the Services reading weakened to 53.2 (-5.3 MoM). The 2022 GDP consensus forecast was further downgraded from 5.0% to 4.8%, but the upward trend in rates continued as 2022 inflation is now forecasted at 4.0%, vs 3.6% in November and 2.6% in October. The Bank of England (BoE) has already started lifting interest rates, with a 0.15% increase announced in December.

In the US, December Composite PMI data dropped to 56.9 (-0.3 MoM), with Manufacturing PMI dropping to 57.7 (-0.6 MoM) and Services PMI weakening to 57.5 (-0.5 MoM). The 2022 GDP forecast remained flat at 3.9%, while 2022 inflation expectations were revised further upwards from 3.7% to 4.4%. We expect the upward trend in rates to continue.

Data in the Eurozone was the most benign for rates and credit. December Composite PMI data weakened to 53.4 (-2.0 MoM), with Manufacturing PMI down to 58.0 (-0.4 MoM) and Services PMI down to 53.3 (-2.6 MoM). GDP expectations for 2022 remained flat at 4.2%, while inflation expectations for the year ahead strengthened modestly to 2.5% from 2.3%, and forecasts for 2023 remain comfortably below the ECB's 2% target at 1.5%. GDP expectations could fall further and, without as much inflationary pressure as the UK and the US, EU 'safe havens', such as German Bunds, should face a less bumpy ride ahead.

PORTFOLIO CHARACTERISTICS

The average credit rating on the portfolio remained strong at 'BBB+' and 50% of fund holdings are in AAA to A- rated bonds.

The fund currently offers a yield of 2.2% and duration of 6.2 years. We believe the very strong credit quality of the fund helps de-risks it from potential future volatility.

OUTLOOK AND STRATEGY

All Fixed Income sub-asset classes continue to appear rich:

- **Sovereign bond yields** remain low across the US, UK, and Eurozone.
- **Sterling Investment Grade** bonds are rich versus all historical timeframes, with sterling 'BBB' credit spreads at 138bps, versus their 5yr average of 171bps; 10yr average of 202bps; and 20yr average of 215bps.
- **Sterling High Yield** spreads are rich versus history, with 'BB' spreads at 280bps (versus the 5yr average of 317bps;

the 10yr average of 360bps and the 20yr average of 435bps).

In an effort to preserve capital and deliver a good level of monthly income, we continue to seek out the best risk / reward ideas across the investment grade, unrated and high yield bond sectors. We maintain our focus on stock selection reinforced by in-depth credit research.