Close Brothers Asset Management

Close Select Fixed Income Fund

Monthly fund manager update

DECEMBER 2021

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FUND PERFORMANCE

The Close Select Fixed Income Fund returned 0.3% in December, bringing the return for 2021 to +3.8%. This compared very favourably to the Investment Association (IA) Sterling Strategic Bond Sector, which returned 0.1% in December and +0.78% for the year.

Despite rising Gilt yields (the IA UK Gilts Sector fell -5.4% over the year) the Fund was able to generate a positive return. This was helped by the higher yields we have been able to find in the corporate bond sector, being short duration, benefitting from credit rating upgrades (Burford Capital is a good example of this form earlier in the year), and finding some good value in the new issue market (such as Lancashire 2041 which provided a double-digit return despite only holding it since March).

The team's record on the Fund now reads as five calendar years of 1st quartile performance, two calendar years of 2nd quartile performance and one calendar year of 3rd quartile performance.

MACRO BACKDROP

News flow in December was dominated by the spike in Omicron Covid-19 cases. 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 ACTIVITY

We added a new holding in Abrdn Perpetual 5.25% (Abrdn is the new name for Standard Life Aberdeen). We invested in the two previous Aberdeen Perpetual bonds many years ago, and whilst the yields were higher back then (7.9% and 7%), this was in a time of higher sovereign yields. The current spread, the compensation above the sovereign yield for taking on the corporate risk, is at the average level of these two previous issues at 470bps (4.7%). This was a very popular new issue, being eight times oversubscribed, and as a result we were scaled back a little from the position we would have liked to acquire. The bond currently has a 0.68% weighting in the Fund.

In general, we remain convinced that our strategy, focused on taking concentrated position in core bonds at attractive valuations, is appropriate in the current market environment.

On the portfolio construction side, cash levels remain elevated at 15.5%; duration is short at 3.2 years; and the yield to expected call is 2.6% (Yield to Maturity is 3.3%, but we believe the lower figure is a more accurate measure of yield). The average credit rating on the rated portion of the portfolio is BBB, while the unrated portion of the fund currently amounts to just 5%.

OUTLOOK AND STRATEGY

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

- **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; 10yr average of 360bps and 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.