Close Brothers Asset Management

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Close Select Fixed Income Fund

Monthly fund manager update

OCTOBER 2022

FUND PERFORMANCE

The Close Select Fixed Income Fund returned +1.8% in October, bringing the year-to-date (YTD) return to -12.2%. In comparison, the Investment Association (IA) Sterling Strategic Bond Sector peer group returned +1.3% in October, and has fallen -13.3% YTD.

The Fund has therefore outperformed the IA sector by +1.2% in the first 10 months of 2022.

MACRO BACKDROP

Newsflow in October was dominated by expectations of continued Central Bank interest rate hiking, and political volatility in the UK. The latter led to Rishi Sunak becoming Prime Minister and the UK government reversing the vast majority of tax cuts announced in September.

The Bank of England (BoE) did not meet in October, but are expected to raise the policy rate to 3.00% (from 2.25%) on 3rd November.

The Federal Reserve (Fed) did not meet in October, but are expected to raise the policy rate to 4.00% (from 3.25%) on 2nd November.

The European Central Bank (ECB) raised the Depo Rate to 1.50% (from 0.75%); and the Refi Rate to 2.00% (from 1.25%). The ECB – in-line with the BoE and Federal Reserve - also signalled further rate hikes to come in December.

In the UK, Composite Purchasing Managers Index (PMI) data declined to 47.2 (September was 49.1). Consensus 2022 GDP growth forecasts actually increased to +4.2% (September was +3.5%), albeit consensus 2023 GDP growth forecast is -0.4%. Inflation forecasts reduced following the announcement of the energy price cap, but remain elevated with end of year 2022 Consumer Prices Index (CPI) inflation forecast to reach c. 10% (likely peaking in October 22). Unemployment data improved to an exceptionally strong 3.5%.

In the US, Composite PMI data declined to 47.2 (September was 49.5). Consensus 2022 GDP growth forecasts increased to +1.7% (Septemberwas +1.6%), albeit consensus 2023 GDP growth forecast is +0.4%. US inflation forecasts for the end of 2022 increased slightly to +7.3% (September was +7.1%), while unemployment remained strong at 3.5%.

In the Eurozone, Composite PMI data weakened to 47.1 (September was 48.1), while consensus 2022 GDP growth forecasts increased for the third consecutive month to +3.0% (September was +2.9%), albeit consensus 2023 GDP growth forecast is -0.1% End of year 2022 inflation expectations increased to 9.6% (September was 9.5% and March was 5.1%) given ongoing concerns over Russian gas supplies. Unemployment remained stable at 6.6%.

PORTFOLIO ACTIVITY

The Fund continued to take advantage of attractive opportunities during the month – routinely buying bonds at record yields for the fund. As a result of our trading activity, 26% of holdings offer a yield of over 10%, and 77% of holdings offer a yield of over 8%. Key investments during the month include:

1 – Increasing our holding (to 2.5%) in the EUR International Personal Finance 2025 bond at a yield of 23% (rated BB-);

2 – A new 1.2% holding in the GBP Bupa 2035 bond at a yield of 8.3% (rated BBB+). This is one of 3 longer-dated bonds in the portfolio (i.e. due to mature in over 10 years), alongside Siemens 2047 (1.2% position) and M&S 2037 (0.1% position).

3 – Increasing our holding (to 3.9%) in the GBP Rothesay Life bonds by adding to the Rothesay 2028-PERP bond at a yield of 11.6% (rated BBB-);

4 – Increasing our holding (to 1.2%) in the GBP Legal & General 2031-PERP bond at a yield of 9.3% (rated BBB);

5 – Increasing our holdings in a series of high quality Issuers (Aviva, Enel, Nationwide, Lloyds, Barclays, Iberdrola, Rabobank, HSBC, Pension Insurance Corporation) at yields of 7% – 12%. These bonds are rated A- to BBB- (i.e. all Investment Grade).

On the portfolio construction side, the yield to expected call is 9.0%; duration is 4.2 years; the average credit rating of the fund is BBB; cash levels are 4%; and the unrated portion of the fund is just 3%.

OUTLOOK AND STRATEGY

Fixed Income sub-asset classes:

- **Sovereign bond yields** are volatile and reactive to macro data – and offer fair value in the UK, US and Eurozone.
- **Sterling Investment Grade** bonds are cheap versus all historical timeframes, with sterling 'BBB' credit spreads at 274bps, versus their 5yr average of 178bps; 10yr average of 189bps; and 20yr average of 215bps.
- **Sterling High Yield** spreads are cheap versus history, with 'BB' spreads at 571bps versus their 5yr average of 341bps; 10yr average of 344bps; and 20yr average of 429bps).

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 investment grade, high yield and unrated sectors. We maintain our focus on stock selection reinforced by in-depth credit research.