COVERING JUNE 2016

FUND COMMENTARY
THREADNEEDLE (LUX) GLOBAL OPPORTUNITIES BOND FUND

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Summary

- The fund underperformed its benchmark in June.
- The surprise vote in the UK's European Union membership referendum dominated markets this month and fuelled safe-haven demand.
- We reduced overall credit risk in the run-up to the referendum.
- We have a positive view on the US dollar.

Market Background

The surprise outcome of the UK's referendum on European Union (EU) membership was the chief market-moving event of the month. The result helped push core government market bond yields lower as demand for risk-free assets was augmented by expectations for more accommodative central bank policies in many areas.

Other safe-haven assets such as the Japanese yen also performed well, and it additionally benefited from the Bank of Japan disappointing market expectations for policy easing. Credit spreads widened markedly following the UK referendum result but ended the month only modestly wider.

The key economic event of the last few weeks was the extremely disappointing labour market data from the US, which saw expectations of Federal Reserve tightening pared back to the end of the year.

Performance and Activity

In June, the fund generated a negative return and underperformed the benchmark.

We entered the month invested with a short duration in core markets such as the US. This position was taken at the long-end of the yield curve, as we were concerned that evidence of rising inflation pressure did not sit comfortably with the ongoing dovish rhetoric from central banks. Later in June, we closed this position as we felt that the uncertainty after the EU referendum in the UK was likely to overwhelm these considerations and lead to ongoing demand for risk-free assets such as core government bonds. In gilts, where we have held a long-duration position, we used the sharp rally to pare back this position after the referendum.

In terms of currency strategy, we maintained a long position in the US dollar. We feel that US interest rate expectations are under-pricing the risk of change and the US currency will be a beneficiary when expectations more closely align with economic reality. However, we moved the shorts held against this position to European currencies away from the Japanese yen.

Over the month, we reduced overall credit risk in the portfolio in the run-up to the UK referendum. Later, at the end of the month, however, we increased our US high yield exposure via index credit default swaps (CDS) after this market had somewhat cheapened.

Outlook

The outcome of the UK's referendum is likely to rein in global growth prospects, and particularly for the UK. We expect uncertainty to curtail investment and hiring and the prospect of a UK recession is heightened.

Global financial markets have been roiled by the UK's vote to leave the EU, but have started to be soothed by expectations of further easing from the Bank of England, as well as markedly lower expectations for Federal Reserve tightening. Easier global monetary policy will keep bond yields and term premia supressed, and we are moving to a more neutral position on government bonds, with some emerging markets offering value in a world of low yields.

In terms of corporate bonds, global investment-grade credit spreads are wider than the long-term average, while we believe high-yield credit spreads are around fair value. Corporate credit remains supported by easy monetary policy conditions and reasonable market valuations. However, corporate behaviour is more equity than bondholder friendly and the weak economic background remains a concern. Demand for income will continue to support credit markets.

Benchmark Index is the USD 1 month deposit rate. Performance attribution source FactSet, calculated using a daily time-weighted methodology based on gross returns as at global close on the last working day of the month.

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