SALT

Salt Sustainable Global Fixed Income Opportunities Fund Fact Sheet – August 2024

Manager Profile

Salt Funds Management is a boutique investment management firm wholly owned by its employees which specialises in actively seeking to maximise returns while managing the risks of the investment. Salt examines investments for their environmental and social impact as well as the quality of their governance.

Investment Strategy

The primary objective of the Fund is to target and generate an attractive rate of return over a full three-to-five-year market cycle. To achieve this, the Fund targets a portfolio of global fixed income securities with enhanced total return potential and superior Sustainability characteristics.

The objectives of this top-down selection process are to:
1. Reduce exposure to material ESG risk and negative sustainability impacts, through restriction screening of controversial sectors such as weapons, tobacco and some fossil fuels, as well as international norms violations;
2. Tilt the portfolio in favour of the 80% strongest sustainability performers across corporates, by sub- sector, and sovereigns; and
3. Contribute to positive outcomes based on key sustainability themes, with a particular focus on low carbon intensity.

The Fund will invest at least 50% in investment grade bonds, and a minimum of 15% in sustainable bonds. The fund targets its returns to be 100% hedged to the New Zealand dollar.

Fund Facts at 31 August 2024

Benchmark for ESG purposes	Bloomberg Global Aggregate Index (NZD hedged)
Fund Assets	$164.87 million
Inception Date	10 February 2023
Underlying Manager	Morgan Stanley Investment Management
Average credit rating	Standard & Poor's A / Moody's A2
Effective Duration	3.27 years

Unit Price at 31 August 2024

Application	1.0532
Redemption	1.0521

Investment Guidelines

The guidelines for the Sustainable Global Fixed Income Opportunity Fund are:

Global Fixed Income securities	95% – 100%
Cash	0% – 5%

Fund Allocation at 31 August 2024

Global fixed income securities	96.5%
Cash, FX, short term & sundry	3.5%

Fund Performance to 31 August 2024

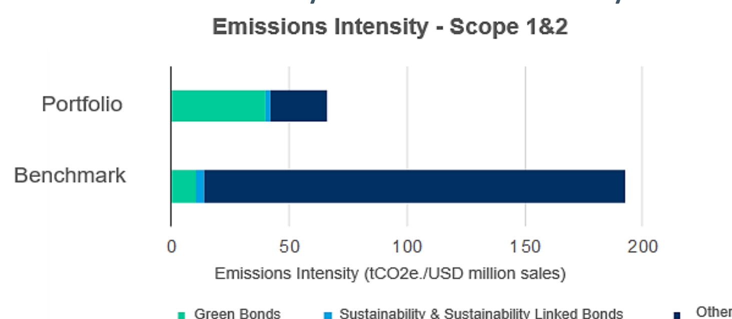
Period	Fund Return (Gross incl. ICs)
1 month	1.02%
3 month	3.14%
6 month	4.10%
1 year	8.46%
Since inception p.a.	6.39%
Since inception cumulative	9.99%

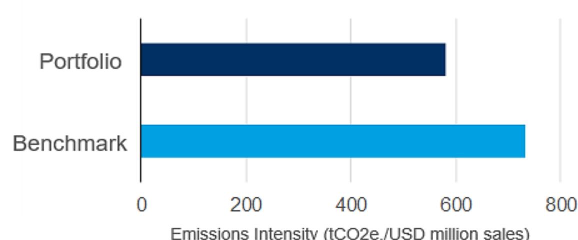
Performance is gross of fees and tax. Data as of 31 August 2024.

Fund ESG Dashboard	Portfolio	Index	2024 YTD change
Exposure to Corporates with CO2 footprint reduction targets	96%	90%	-
Green, plus Social, Sustainability and Sustainability-linked bonds	30.1%	3.0%	+11.5%
Sustainable SBTi approved / committed targets	52.1%	39.5%	+5.4%
CO2 Footprint Scope 1&2 (tCO2e/$mn emission intensity)	66	193	+35.1%
CO2 Footprint Scope 3 (tCO2e/$mn emission intensity	581	731	+18.3%
MSCI ESG Score (Adjusted)	7.08	6.09	-0.16
- Environment score	7.21	5.95	+0.33
- Social score	6.18	6.66	+0.11
- Governance score	6.46	6.49	-0.11

Source: MISM Monthly Investment Report/ MSCI ESG Research at 31 Aug. 2024

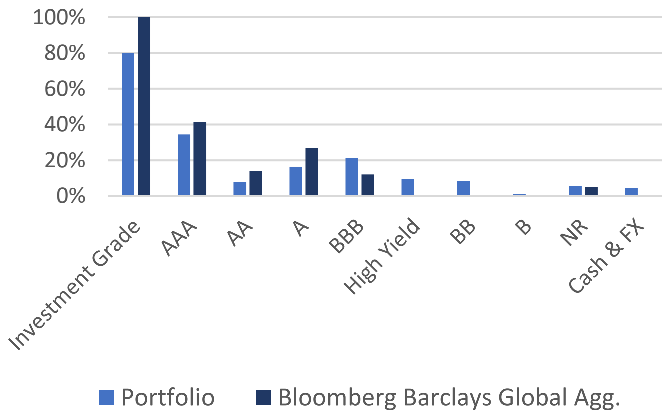
Fund CO2 Emissions Intensity characteristics as at 31 July 2024





Source: MISM Monthly Investment Report as at 31 August 2024

Fund credit ratings vs. Bloomberg Barclays Global Agg.



Source: MISM as at 31 August 2024

Portfolio Review

- In the one-month period ending August 31, 2024, the portfolio returned 1.02%. The performance can be attributed to the following factors:
- Both macro decisions and the portfolio's positioning within spread sectors contributed to performance.
- Regarding macro decisions, the long exposure to the US and the Euro-area were the largest contributors as interest rates fell over the period. The short Japan duration at the beginning of the month detracted from performance as yield fell.
- Higher risk-free rates continued to benefit performance.
- Within FX, the long AUD vs. CAD contributed to performance as the AUD strengthened over the period while the EM FX positioning detracted marginally from performance.
- Regarding the portfolio's positioning within spread sectors, the exposure to high yield corporates added to performance as spreads tightened over the month, despite the volatility at the start.
- The long exposure to securitized credit also added to August performance, mainly within ABS and CMBS.

Strategy changes

- Overall, the duration of the portfolio was raised by 0.37 years, mainly via bonds in US, New Zealand and Canada, closing August at 3.27 years. Reduced duration in Japan and Euro area.
- Regarding macro positioning, the portfolio added 0.37 years of duration, mainly in the US, New Zealand and Canada.
- Reduced duration in Japan and Euro-area.
- Trimmed non-agency RMBS and ABS exposure, whilst increasing the agency-RMBS and CMBS positioning.
- Reduced exposure to investment grade industrials.

Market Review and Outlook

Fixed income put in another solid performance in August despite unprecedented volatility in the first two weeks. Government bond yields generally moved lower again with U.S. Treasuries leading the way. Economic data continued to underwhelm, supporting the dovish central bank narrative and increasing confidence that rate cuts will continue in those countries that have already begun the rate-cutting cycle but, more importantly, that the Federal Reserve (Fed) will imminently embark on its easing cycle.

The surge in volatility seen in the first half of August was a result of a sea change in the narrative of the U.S. and global economy. A series of underwhelming U.S. data prints, concluding with a surprisingly weak July nonfarm payroll report and a surprise Bank of Japan rate hike conspired to send volatility soaring. VIX, a standard measure of market volatility/anxiety, rose from 16.36 on 31 July to 38.57 on 5 August before retreating to 15 by 15 August. This extreme volatility helped send U.S. Treasury yields sharply lower. Interestingly, despite significant underperformance over the first two weeks of the month, credit spreads ended the month unchanged to slightly lower and the S&P 500 Index higher. But the surge in VIX reflected a sea change in the attitude about the risks of a recession and the likely trajectory of monetary policy.

Until August, markets had not been overly concerned with recession risks. Yes, U.S. growth looked to be slowing both in terms of output and employment, but a soft landing, trend-like growth, falling inflation and stable unemployment was the assumed most likely outcome. Then, in August, weaker-than-expected data in the U.S., no signs of strength anywhere else in the world and worries that the artificial intelligence (AI)-led equity rally was stalling led markets to push bond yields lower and increase expectations of significant rate cuts, particularly in 2024.

This was despite no overt signs of significant weakness in U.S. data. U.S. growth will be weaker in 2024; this was to be expected given its strong performance in 2023. However, a rising unemployment rate (faster than either we or the Fed expected) has changed the narrative. The Fed has a dual mandate: keep inflation low AND employment high. The Fed and the bond market are now worried that signs of incipient weakness in the U.S. labour market will turn into something more sinister.

With U.S. inflation looking well contained, the outlook for the labour market is now the key factor in determining the timing and magnitude of rate cuts. With the rise already seen in the unemployment rate, the Fed will likely cut rates in September. Fed Chairman Powell has all but guaranteed a rate cut at the September Federal Open Market Committee (FOMC) meeting. This has led to a strong debate among market participants about how much and how fast rates will be cut.

Economic pessimists who worry that a recession is just around the corner think the Fed should cut aggressively, front-loading 100 basis points of rate cuts this year, with a 50 basis point cut in September considered appropriate. More sanguine investors believe that although policy rates are too high given improvements in inflation and the growth outlook, it is premature to cut rates aggressively given the still resilient state of the economy.

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Currently, the pessimists have the upper hand in market pricing. Cuts are fully priced for September, November and December FOMC meetings as well as multiple cuts in 2025. Other central banks including the European Central Bank (ECB) and Bank of Canada are also expected to cut rates significantly over the next 12 months. Effectively, the pessimistic scenario of a significant risk of recession or hard landing is discounted by market pricing. While this scenario is possible — as recent data flow has been going this way — this expected aggressive easing cycle is contingent on activity data slowing in the future. In fact, the size of rate cuts currently priced into bond markets usually only occurs when a significant recession occurs. That said, policy rates are too high, and adjustments are coming. We continue to be worried that the pace and size of forecasted rate cuts are too high, but it is probably too early to fight the bull market. Indeed, long-term U.S. Treasury yields already discount a sub 4% policy rate.

Going forward, much is still unclear about the depth and pace of the global easing cycle. While we believe bonds can continue to perform well in the near term, we remain cognizant that a sustained rally would require a material slowing of activity data to suggest a recession and central banks globally to move away from the conservative approach they have embraced so far. Longer term, the level that U.S. and global 10-year yields will go to depends on the extent of the easing cycle. For now, we believe a neutral-ish duration position seems appropriate with U.S. Treasury yields looking a bit low relative to other countries that have weaker economic outlooks (U.K., Canada, New Zealand).

As mentioned above, credit markets ended August having performed quite well given the rise in volatility and increased anxiety on the economic outlook, especially considering yield spreads on investment grade and high yield corporate bonds are at the low end of their historical ranges. We can certainly say that credit markets do not seem to exhibit signs of economic anxiety that exist in the rates markets, although, to be fair, that could be because credit markets do expect the Fed to come to the rescue and prevent serious economic damage.

Our stance on credit remains solidly unchanged. There is no reason to believe spreads will materially widen when economic growth is decent (and coming in around expectations) and central banks are beginning to engage in a modest rate-cutting cycle. Yield-oriented buying should contain spread widening, but one factor we are paying close attention to is the level of all-in yields and their impact on demand for corporate bonds. It is possible that if yields fall further, buyer demand could begin to wane, and spreads could widen, especially under a rising recession probability scenario. This risk is offset, however, by central banks' rate-cutting bias, which should serve to truncate spread widening risk. We remain modestly overweight credit in portfolios.

Emerging market (EM) local market returns were generally solid with several countries performing quite well. If a country has a solid economic outlook, decent growth, falling inflation, and a central bank able and willing to cut rates, we believe bonds can perform well. But as with corporate credit, when bad news hits or markets are disappointed, bonds and currencies can be hit badly. Performance varied, with positive returns from duration but mixed currency returns. In Latin America, Mexican and Brazilian bonds and currencies continue to struggle with domestic issues, overwhelming the benign backdrop the Fed is providing. We remain focused on idiosyncratic opportunities that feature favourable risk/reward characteristics.

Given global economic and policy uncertainty, we continue to find the most attractive fixed income opportunities in mortgage-backed securities and other securitized credit. U.S. households with prime credit ratings have strong balance sheets, and this should continue to be supportive of consumer credit and ancillary structures, especially as house prices remain firm. U.S. agency mortgages still have value compared to investment grade credit, at least in higher coupons, and we believe they are likely to outperform U.S. Treasury bonds.

In currency markets, the outlook for the U.S. dollar remains uncertain. It has weakened as U.S. interest rates have fallen relative to the rest of the world. The Fed's employment mandate may continue this trend with the Fed responding to higher unemployment, while other central banks, faced with stickier inflation, cannot match Fed rate cuts. But the U.S. economy, even with a slowdown, is still growing faster than most other countries, implying that rate cuts in the U.S. could eventually bolster the U.S. economy and currency. As of now, however, it remains unclear who will inherit the position of global growth leader. Europe and China are seeing lacklustre cyclical data in addition to grappling with structural woes. Emerging markets continue to be confronted with idiosyncratic challenges (as well as opportunities). In the middle of the month, carry trades began to unwind, owing to a variety of catalysts including equity market volatility, intervention in the yen by Japanese authorities, a hawkish shift by the Bank of Japan and political uncertainty in the U.S. We look to mainly capitalize on idiosyncratic mispricings where there are clear fundamental and value differences. For now, the dollar is likely to remain under pressure.

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