Silverdale Bond Fund

AUGUST COMMENTARY

Helicopter View: Fixed Income

Whilst we can never be sure of the bottom, we cannot be very far from it. After the first half of 2022 which was the worst half-year since 1865, the markets have recovered in the last few weeks. Today, the majority of fixed income assets yield more than 4.50%, which is in strong contrast to over 15% of the fixed assets universe giving negative returns about 2 years ago. For investors, this is good news because the current yields on bonds are amongst the highest in the past decade. While the price of bonds falling makes interesting headlines, for investors, this represents a good investment opportunity because of P2P (Pull-To-Par) i.e. barring bond defaults, the bonds pay "Par Value" upon maturity. The prevailing higher interest rates imply higher carry for investors.

This is also evident from Silverdale Bond Fund's NAV appreciation of 4.25% post the recent trough on 15th July 2022 (refer to Figure-1).

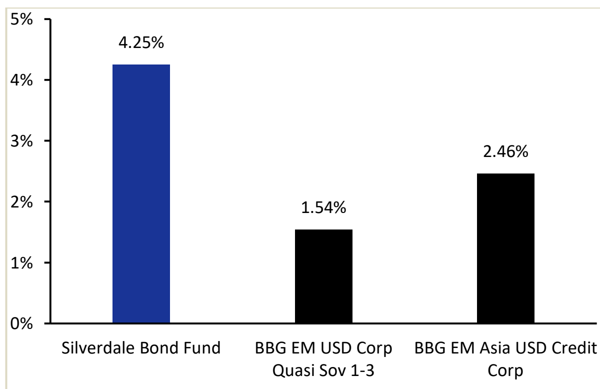

Figure-1: **Silverdale Bond Fund performance from the latest trough to today** *(15 July 22 to 26 Aug 2022)*

Tactical Move

Having said that, tactically, we utilized the rally to further improve our portfolio quality, increase diversification, marginally increase unutilized credit limits to ride out any further re-pricing of the rate hikes and to be able to opportunistically deploy funds to take advantage of the elevated yields for higher returns for our investors.

Inflation: Higher for Longer

The reason for the tactical move is that we expect inflation to be higher for longer. The key driver of inflation is energy cost. We do not see any near-term resolution to the Russia-Ukraine conflict which could ease the energy situation. Rather, we see the US stopping the release of oil from its strategic reserves at the end of October 2022, providing further tailwinds to energy prices.

The balance sheet of consumers in the US is still very strong (thanks to the COVID-induced circa US$ 2.6 trillion largesse). The US banks' loan-to-deposit ratio is 60-65 as compared to 90+ at the time of the Great Financial Crisis (2008). Hence, we do not expect any sharp drop in demand. We are actively watching the unemployment numbers, and expect them to decrease in the short to medium term.

Across the Atlantic, Europe is likely to face the worst drought in 500 years. This could force food production in Europe to drop by around 16%. Already, the majority of the Rhine River in Germany has dried up, stalling almost 20% of the German heavy sea traffic. While the French nuclear power stations have reduced power production as water level in the rivers have dropped and the river water is too hot to be used for cooling. Soon, Europe would be entering energy-intensive winter months.

The Asset Class for Recession

Historically, the best performing asset class, 6 months before and 12 months after the onset of recession has been fixed income (refer to Figure-2 and Figure-3).

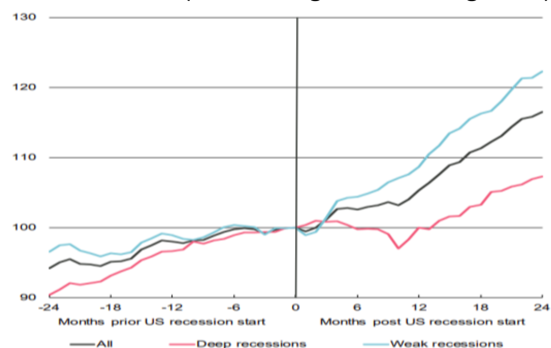

Figure-2: **US Corporate IG Performance around US Recessions**

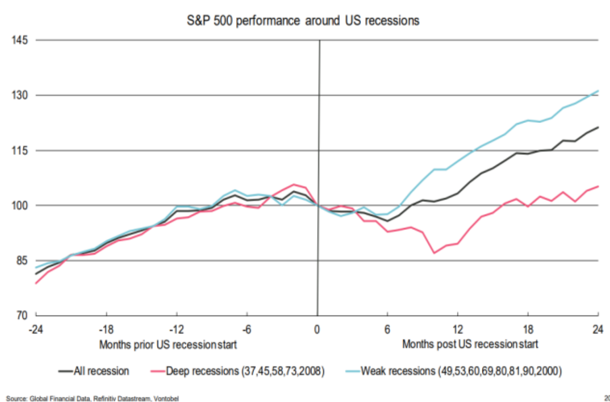

Figure-3: **Equity returns before and at start of recessions are weak, especially during deep economic downturns**

Hence, from the cross-asset portfolio allocation perspective, it would bode well to consider increasing exposure to fixed-income assets, as already being seen from the inflows into fixed income from pension funds and insurance companies.

The August Action

Given the fall in CPI to 8.5% YoY in July compared to 9.1% in the prior month, the month of August started on a positive note with market expectation of Fed pivot for a lower rate hike(s). However, not entirely unexpected, the last fortnight of August reversed some of the rally and the market catapulted on the last day, following Powell's speech at Jackson Hole where he indicated interest rates would be kept higher for longer. For the month, 2-year US Treasury rates increased by 51 bps whereas 10-year rates increased by 39 bps. S&P 500 was down 1.76%. The market is currently pricing in 70% probability of another super-sized rate hike of 75bps on the 21st of September taking the Fed Rate to 3.00%-3.25%.

Looking ahead, your fund remains well positioned and agile to benefit from prevailing higher yields and continues its focus on carrying, maintaining its short duration, high-quality bias, and a conservative amount of leverage, in order to deliver superior fund performance in the coming quarters.

Silverdale Bond Fund: Performance

For the month of August, Silverdale Bond Fund delivered a positive total return of 0.67%. Geographically, Chinese, Indian and Hong Kong credits were the key positive contributors, which were partly offset by negative contribution from Russian, French and German credits. Sectorally, Financial, Basic Materials, and Utilities sectors were the key positive contributors, countered by the negative contribution from the Energy sector. We did not have any default/fire-sales in the portfolio. The year-to-date drawdown can be primarily attributed to the increase in rates, spread widening and leverage.

The Takeaway

From a historical perspective, fixed income valuations today look attractive. With recession risk on the horizon, it becomes more attractive as compared to equities (which are likely to suffer PE multiple compression). While further interest rate risk from persistent inflation continues to be an overhang, it is also mitigated by the natural higher carry of the asset class.

Silverdale Bond Fund continues to be positioned defensively, with 77% of the portfolio being high quality Investment Grade bonds with short duration of 1.70 years, yet having leveraged YTM of 15.66%, pointing towards potential higher returns.

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