Royal London Asset Management Market Review and Outlook

Quarterly Overview

31 December 2025

Overview

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Markets were focused on the US during the fourth quarter, with rate cuts from the Federal Reserve bookending the longest US Federal Government shutdown in history. The decision was accompanied by language suggesting a pause after three cuts in the final four months of 2025.

In the eurozone, the European Central Bank left rates unchanged – with inflation concerns causing reluctance to cut further after four cuts in the first half of 2025. The Bank of England (BoE) cut rates from 4% to 3.75%, the sixth cut since mid-2024 from the recent peak of 5.25%. The BoE noted that inflation was still a concern (reflected in a 5-4 vote) but concerns over downside risks including an unemployment rate that has edged to its highest rate since the Covid pandemic.

Risk assets closed the year strongly – the third consecutive year of double digit returns for equities. After the sharp fall in the wake of the Trump tariff announcement in early April, global equity markets generally ground higher, including during the fourth quarter, helped by ongoing optimism over AI as well as supportive corporate earnings. For the year as a whole, there was strong performance from all major markets – the US, Europe, UK and Japan – with the US lagging in common currency terms after the US dollar weakened significantly. Global credit has benefited from falling interest rates and the strong corporate backdrop leading to tighter credit spreads.

Benchmark 10-year gilt yields fell from 4.70% to end at 4.55%, meanwhile UK 30-year gilt yields took a step back from their highest levels in almost 30 years seen in the summer. In the US, 10-year Treasury yields rose slightly to 4.14% from 4.13% at the end of September but saw volatility in the interim. The German 10-year Bund yield was 2.82% at the end of the fourth quarter, rising from 2.67% three months prior.

The sterling investment grade credit market (iBoxx non-gilt index) returned 2.58% over the period under review. Gilts outperformed credit over the quarter, helped by the longer duration of this market in a quarter where UK government bond yields edged lower. The average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) was relatively unchanged over the period. Spreads began and ended the quarter at 0.77% (iBoxx), compared to the narrowing of spreads seen during the second and third quarters after the widening seen in the first quarter. Sector returns were generally positive, led by banks, insurance and structured bonds.

Government bond yields were mixed, with US and German government bond yields edging higher, while UK yields moved lower on hopes that the November budget announcement would be gilt-friendly. Gilts rallied as Budget news broke but the initial volatility was absorbed during the course of the day, with expected tax hikes backloaded and some action to curb short-term inflation announced.

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Global and UK Government Bonds

During the fourth quarter, benchmark 10-year gilt yields fell from 4.70% to end at 4.55%, meanwhile UK 30-year gilt yields took a step back from their highest levels in almost 30 years seen in the summer. In the US, 10-year Treasury yields rose slightly to 4.14% from 4.13% at the end of September but saw volatility in the interim. The German 10-year bund yield was 2.82% at the end of the fourth quarter, rising from 2.67% three months prior.

Leading into the Budget, weeks of policy speculation and partial leaks kept focus on three questions: whether the Chancellor could credibly address the fiscal shortfall with sufficient headroom against fiscal rules; whether the inflation-supportive measures would tackle the UK's inflation problem, keeping the BoE in play to cut rates further over the next 6-12 months; and, how the UK Debt Management Office (DMO) would adjust the gilt remit for the remainder of the 2025/2026 fiscal year.

The Budget ultimately increased the fiscal buffer and set out policies supportive of lower inflation. The gilt remit rose by c.£4bn, enabling the DMO to cancel five auctions, leaving the market with little to no long-end supply until April 2026 at the earliest. This dynamic lowered long-end yields and supported performance both on the curve and cross-market.

In December, the BoE delivered a 25bps rate cut from 4% to 3.75%, broadly in line with market expectations that had built through October and November as economic data softened. The only real uncertainty was what the vote split would be. In the end, only Governor Bailey shifted from his November stance leaving the committee split 5-4 in favour of a cut. The decision helped anchor short-end rates, while long-end dynamics remained driven by supply and cross-market factors.

The DMO drastically reduced the percentage of long-dated bonds as part of its ongoing financing operations given the changing demand dynamics, the steepness of the curve and the outright level of yields. As a result, issuance is being skewed shorter, helping stabilise the longer end relative to the 10-to-15-year part of the curve.

Global Credit and High Yield

The high yield market experienced a benign fourth quarter with spreads tightening and yields falling but both small moves. We did see spreads shot 30bps wider on news of the US-China trade war potentially escalating at the start of the quarter, but this was quickly reversed as these fears lessened. Despite grabbing a lot of headlines earlier in the year, we have yet to see the fallout or negative impact on the high yield market of the tariffs announced by US President Donald Trump. We could still see lagged effects but companies have so far been able to pass on any increase in production without demand taking a hit.

A trend seen throughout the year, which continued in the final quarter, was a regional deviation in values. European bonds lagged, while US bonds have performed strongly, rebounding from the tariff-induced weakness. This led to some relative underperformance in the fund as it was underweight versus the benchmark in the US.

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Global Credit and High Yield continued

In the high yield market, the ICE BofAML (BB-B) Global Non-Financial High Yield Index (sterling hedged) benchmark returned 1.42% in the fourth quarter with spreads ending the three-month period at 245bps, tightening from 252bps at the start of the quarter. At the end of the period, the index's yield-to-worst stood at 5.86%, drifting lower over the quarter. In the broader-based high yield index, which includes CCC rated bonds, spreads were largely unchanged at 299bps.

UK Credit

The sterling investment grade credit market (iBoxx non-gilt index) returned 2.58% over the period under review. Gilts outperformed credit over the quarter, helped by the longer duration of this market in a quarter where UK government bond yields edged lower. The average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) was relatively unchanged over the period. Spreads began and ended the quarter at 0.77% (iBoxx), compared to the narrowing of spreads seen during the second and third quarters after the widening seen in the first quarter. Sector returns were generally positive, led by banks, insurance and structured bonds.

Sterling credit spreads have continued to tighten through 2025 and are now at levels last seen before the Global Financial Crisis. We see this as logical: defaults are low, company balance sheets are generally healthy, and investors have been buying credit because of attractive yields. At a fundamental level, we still believe that credit spreads over-compensate investors for default risk, and that the all-in yield on sterling credit remains attractive. Furthermore, we continue to find attractive investment opportunities, partly through the new issue market but also by focusing on exploiting market inefficiencies. By focusing on bottom-up analysis, we continue to build overall portfolios that we believe offer attractive risk / return profiles with above-market yields.

Equities, Commodities

Global equities rose over the quarter, adding to a positive year as a whole. There was strong performance from all major markets – the US, Europe, UK and Japan – with the US lagging in common currency terms after the US dollar weakened significantly. But beneath the surface there were some signs of rising risk awareness and concerns about the ongoing trajectory of technology sector earnings.

Most major economies produced growth in the fourth quarter, continuing to show some resilience in the face of this year's higher US tariff rates and global trade tensions. Despite inflation generally remaining above central bank targets, there were further rate cuts, from the US Federal Reserve and Bank of England. However, the US rate cut in December was accompanied by language suggesting a pause after three cuts in the final four months of 2025.

Asian and emerging markets again performed strongly over the quarter, despite some profit taking in the fourth quarter at the end of an excellent year. Chinese equities were among the strongest gainers over the quarter. Advances in Chinese AI stocks boosted the technology sector, while investors also took confidence from evidence that China has succeeded in diversifying its trade partners to help offset the impact of US tariffs.

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Equities, Commodities continued

Japan was one of the standout markets over 2025 and the fourth quarter, powered by technology stocks. Sentiment was also boosted by election results. The country's new Prime Minister, Sanae Takaichi is regarded as supportive of corporate reform and likely to enact growth policies, including an increase in government spending.

The effect of currency movements had a strong impact on returns. European equities underperformed in local currency terms during 2025 and over the quarter. However, for sterling- and euro-based investors, actual returns were very different. Over 2025, the trade weighted US dollar suffered its steepest decline since 2009. The euro and sterling were major beneficiaries and after accounting for currency moves, European equities were among the top performers.

Cash Markets

Money market rates fell in line with the Bank of England rate cut in December at the short end. Longer maturities held their levels, ending the quarter little changed as there were no material changes to longer-term BoE expectations over the quarter. Money market returns, using SONIA as a proxy, remained attractive.

Performance was positive over the quarter compared to the SONIA benchmark. At a portfolio level, we had built up a yield premium to the benchmark, and the diversification of the fund meant that when the Bank of England cut interest rates by 0.25%, we saw a smaller impact on portfolio yield. Our money market exposure was the main driver of returns, reflecting that this makes up the bulk of the fund's assets, but our diversified approach paid dividends, with positive contributions from exposure to T-bills and repo activity – the latter providing opportunities to lend at higher rates on a secured basis than was sometimes available in the unsecured overnight market. Being nimble allows us to lend at lower risk but achieve a better return.

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Issued in January 2026 by Royal London Asset Management Limited, 80 Fenchurch Street, London EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

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