



Royal London Liquidity Strategies

Quarterly Report
31 December 2022



Market overview

- The macroeconomic backdrop was little changed in the fourth quarter: the outlook for growth remained poor, while inflation and its impact remained a key concern for policymakers, investors and consumers alike.
- Central banks responded to the continued strength of inflation in the fourth quarter by further tightening monetary policy and reiterating that they will do whatever it takes to suppress rising prices. The US Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) each raised rates by 1.25% in aggregate over the period. Since March, the Fed has raised rates seven times by 4.25% in total – its 0.75% increases in June, July, September and November were the biggest single increases for nearly 30 years. Investors expect further hikes in 2023 as the services sector of the US economy has remained notably strong.
- The ECB was slower to react, partly due to a more fragmented backdrop with a gap between Germany and ‘peripheral’ economies. However, it ended its bond buying programme in July and increased rates by 0.75% (its first hike for 11 years and a bigger increase than the 0.50% expected by economists). Further increases followed in September, October and December with a clear commitment to raise rates further in 2023. The BoE increased rates to 3.5% over the quarter, taking its tally to eight increases in 2022 and nine so far in this cycle.
- The UK economy continued to be impacted by the ill-fated experiment with Liz Truss and Kwasi Kwarteng as Prime Minister and Chancellor, respectively. Following the ‘mini-Budget’ on 23 September, after comments in support of sterling, the BoE was forced to intervene in the gilt market in the last week of the third quarter as problems with levels of collateral in the ‘liquidity-driven investing’ (LDI) part of the pensions industry pushed down the prices of long-dated gilts. Although this calmed financial markets temporarily, the volatility continued for several weeks until Mr Kwarteng was sacked on 14 October and replaced by Jeremy Hunt, and Rishi Sunak took over as Prime Minister on 25 October. The policies adopted by Mr Hunt and further detailed in the Autumn Statement in mid-November served to stabilise sterling and reduce the yield premium demanded by investors in UK government bonds.
- As a result, the UK gilt market was the strongest major government bond market over the quarter, delivering a return of +1.7% as the benchmark 10-year gilt yield fell by 42 basis points (bps) from 4.09% to 3.61%. Shorter-dated gilts performed best; gilts with five years to maturity or less provided positive returns of 2.7%, whereas the 15 years or more to maturity segment returned -1.9%. Otherwise, most other significant markets delivered negative returns over the period as yields rose (prices move inversely to yields): the 10-year US treasury yield rose by 5bps to 3.87%; and the 10-year German bund yield rose by 46bps to 2.57%. The sterling investment grade credit market returned 5.74% over the quarter, boosted by the fall in gilt yields and the significant tightening of the average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) from 1.99% to 1.61% (iBoxx).
- UK money markets therefore saw mixed moves on yields, with short rates moving higher with BoE moves, while longer tenors generally moved less due to expectations around where the BoE may peak in this rate cycle, while longer maturity yields fell in line with the gilt market. SONIA started the quarter at 2.19% and ending at 3.43%, while ICE Term SONIA three-month rates rose from 3.23% to 3.75%. Two-year gilts, often seen as a proxy for market expectations of BoE rates, dipped from 3.92% to 3.56%. Reverse repo rates also increased over the quarter, ending at around 3.30% for high quality names, although this was slightly constrained late in the quarter as year-end approached.

Performance and activity

- The latter months of 2022 are dominated by the events around the short-lived Truss premiership and impact this had on pension funds, and in turn, gilt and cash markets. Following the change of leadership, markets were relatively normal – able to focus on macro backdrop and the impact on rates and rate expectations. For the various funds we manage, we saw investors start to come back to liquidity funds as volatility subsided and the short-term dash for cash ended.
- During this period, we have been able to continue to increase the yields on the various strategies we manage right across the range of assets we invest in, including traditional money market instruments such as treasury bills and certificates of deposit (CDs), as well as other assets such as repo, covered bonds, mortgage-backed securities and short-dated investment grade credit. While the mix of such instruments varied according to the strategy risk / reward target, we were able to find opportunities to add yield to our portfolios.
- Money market exposure was generally a modest positive over the quarter, as the additional yield on paper bought in previous months continued to outpace the rise in SONIA. For most of the quarter, we were happy to add slightly longer paper – meaning three-four months for the Sterling Liquidity and Short Term Money Market funds, or anything up to one year for the funds with longer investment horizons. At the margin, we were inclined to go slightly longer as short-dated paper increasingly looked expensive as investors wanted to avoid having excessive exposure to 2022 paper, and hence we saw rates in January 2023 fall as investors chased this. We were happy to selectively sell some of our January 2023 exposure into that additional demand and roll into February / March and April maturities.



- For the **Sterling Liquidity Fund**, we still focus on short paper – reflecting the fund's objective. This means we focused on three-month maturities, complementing overnight deposits and repo to provide a good yield but keeping a very liquid profile, with a particular emphasis on this earlier in the quarter when clients were looking for liquidity. As volatility subsided, we focused more on short-dated gilts, treasury bills and three- and four-month maturity CDs, both to push maturity beyond year end where liquidity can be lower, but also reflecting that current market demand for very short dated paper meant that rates available looked less attractive. Examples included **Bank of Nova Scotia, KBC, Santander UK Credit Agricole** and **UOB**. We added six-month floating rate CDs – these also came with attractive spreads over SONIA – from the likes of **Rabobank, Toronto Dominion, National Australia Bank, BMO, CIC and Nordea**. We also used the market dislocation early in the period to make opportunistic purchases of covered bonds, adding 2023 bonds from **Barclays** and **Lloyds** at attractive levels over SONIA.
- We took a similar approach in the **Short Term Money Market Fund**, with a particular emphasis on liquidity earlier in the quarter when clients were looking for liquidity, and then looking to take advantage of distortions caused by year end later in the quarter. As volatility subsided, we focused more on short-dated gilts, treasury bills and three- and four-month maturity CDs, both to push maturity beyond year-end where liquidity can be lower, but also reflecting that current market demand for very short-dated paper meant that rates available looked less attractive. Examples included **BNP, KBC, Santander UK and Credit Agricole**. We also used the market dislocation early in the period to make opportunistic purchases of covered bonds, adding 2023 bonds from **Toronto Dominion** and **Barclays** at attractive levels over SONIA. We also added six-month floating rate CDs – these also came with attractive spreads over SONIA – from the likes of **Toronto Dominion, CBA, BMO, CIC** and **Lloyds**.
- The Short Term Fixed Income Fund and Short Term Fixed Income Enhanced Fund (formerly named Cash Plus and Enhanced Cash Plus respectively) look to provide cash investors with returns over and above those on more traditional liquidity funds, by adding targeted exposure to non-money market instruments. Both use covered floating rate notes as part of this strategy, while the Enhanced fund also adds limited exposure to very short-dated investment grade credit and secured bonds such as mortgage-backed securities. As a result, both strategies contain limited credit risk. The Short Term Fixed Income fund has little or no interest risk due to the focus on floating rate notes, while the additional of fixed income instruments means Short Term Fixed Income Enhanced Fund typically has a duration of around one year.
- For the **Short Term Fixed Income Fund** (formerly Cash Plus fund), covered bonds still account for the majority of non-money market exposure. These were helpful for returns over quarter with tighter credit spreads, while overall portfolio carry was also helpful. Activity early in the period was very muted – we took profits on a number of covered bonds to ensure that we kept a balanced portfolio, trimming the likes of **Bank of Nova Scotia** and **Commonwealth Bank of Australia**. As the period progressed, we added one-year CDs from the likes of **Nordea, Barclays, DNB** and **UBS** where we felt yields on offer reflected on overly negative view of future rate increases. One trade of note during the period in the covered area was a switch in **Bank of Montreal** covered bonds, where we took advantage of a new issue of 2025 bonds to take profits on 2026 bonds from the same issuer.
- For the **Short Term Fixed Income Enhanced Fund** (formerly Enhanced Cash Fund), performance over the quarter was positive in absolute terms – as tighter credit spreads and falling yields – offset most of the moves seen in the third quarter, while the portfolio also benefited from the additional yield we have built into the portfolio. Activity early in the period was very muted – we took profits on a number of short-dated bank bonds to ensure that we kept a balanced portfolio, trimming the likes of **Credit Suisse** and **Royal Bank of Canada**. As the period progressed, we added one-year CDs from the likes of **Nordea, Natixis** and **UBS** where we felt yields on offer reflected on overly negative view of future rate increases, also adding small allocations to selected credit exposure such as subordinated **Swedbank** bonds and structured bonds from student accommodation provider **Unite**.
- At the end of 2022, the yields on our funds have risen materially –the Short Term Fixed Income Fund is yielding around 4.3%, a significant premium to current SONIA levels, while Short Term Fixed Income Enhanced yields around 4.9%. We believe that the funds are well-positioned for the uncertain rate environment in 2023.

Outlook

- Having started 2022 knowing that rate rises were coming – although underestimating just how many – the market has ended 2022 with the expectation that although there are still rises to come, these will be more limited, and will reach a peak. In the UK, the market is pricing in around 100bps of rate increases from the BoE, expecting a peak in late summer / autumn, and then holding steady before starting to come down in 2024.
- Assessing whether these expectations are realistic is obviously dependent on central banks. We believe that the BoE and other central banks will remain very focused on the labour market and unemployment rate. If labour markets are buoyant and unemployment remains low, then the wage pressure we have seen in 2022 will continue. Headline inflation will probably fall in 2023 simply due to base effects, but if wage



inflation remains in the 5-6% range, then even a fall in CPI back towards 3-4% will not be enough to stay the BoE's hand. If the expected recession turns out to be deeper than expected, then a rise in unemployment and knock-on effect to wage increases could mean we reach the peak earlier.

- When looking at portfolio strategy, we are not attempted to decide between those two scenarios. If we see base rates and short yields hit 4% and above, then we will consider shifting overall portfolio durations longer. Until then, we are comfortable with a more tactical approach – picking up occasional paper at higher yields to boost returns, but without taking a material position on where rates peak. History suggests that the latter can be very painful if called incorrectly, and we believe that there are enough opportunities to help our investors meet their needs without such increases in risk.

[Find out more](#)

- Our 2023 Outlook is available [here](#), and includes an overview from RLAM Chief Investment Officer Piers Hillier, as well as individual articles from RLAM investment managers providing a unique insight into the risks and opportunities in their asset classes for the new year. Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, which also contains includes regular updates from Head of Fixed Income Jonathan Platt, Head of Equities Peter Rutter, and Head of Sustainable Mike Fox.



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