Royal London
Government Bond Strategies

Quarterly Report
31 December 2022

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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.
- The BoE was active in selling bonds that it had acquired to stabilise markets in the last three years. Despite delays following the 'mini-Budget', the BoE also made good progress in reducing its holding of corporate bonds that were bought in the aftermath of the initial impact of Covid-19. Although some commentators were concerned about this overhang, as we expected the BoE has so far been able to do this without a discernible impact on spreads.
- 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).
- For 2022 as a whole, UK government bonds returned -25.06% while also exhibiting exceptional short-term volatility. The yield on the 10-year gilt rose from 0.97% to 3.67% over the 12 months, touching 4.5% in the turmoil at the end of September. In big picture terms, any gilt with more than 30 years to maturity lost at least half its value in the course of 2022; even five-year gilts lost over 10% of their value. The increase in yield on the sterling investment grade credit index over 2022 was equally dramatic, up from 1.83% to 5.34% at year end.

Portfolio commentary

RL UK Government Bond Fund

- The latter months of 2022 were dominated by the events around the short-lived Truss premiership and the impact this had on pension funds, and in turn, gilt and cash markets. Following the change of leadership and Bank of England intervention, UK bond markets stabilised – meaning investors could focus more on the macro backdrop and the impact of growth, labour markets, and inflation on rates and rate expectations.
- The fund was generally short duration during the quarter, as it was for much of 2022, although continued to use market volatility to trade relative duration tactically. This helped performance during both the quarter and for the year as a whole. Despite yields falling over the quarter, we were happy to end the year with a modest short duration position.
- The gilt curve steepened over the quarter. Following the Kwarteng budget, the market moved quickly to price in a number of rate rises – including potential intra-meeting hikes. At its peak, the market was pricing in a BoE peak of around 6%. Early in the fourth quarter, the change in government leadership and resulting adjustments to fiscal policy meant that market expectations for base rates adjusted swiftly lower and

the front end rallied quite strongly – reflecting a 'new' peak of around 4.5% in base rates. Conversely, long-dated gilt yields rose.. The fund had a steepening position, particularly in the 30s-50s part of the curve, where the fund has long been underweight the longest bonds in issue, and this aided performance.

- In addition, our positioning at the very short end was also positive. During November, we took advantage of the market preference for very short-dated gilts, switching some of our six-month exposure into treasury bills. Despite these having the same issuer, the yield on these was around 3.6%, compared to 2.8% on the gilt with the same or similar maturity, and this position helped performance.
- Cross market positioning was also positive. Although gilts outperformed other government bond markets over the quarter, this was focused in the early part of the quarter when the Kwarteng sell-off was unwound. After this strong period of gilt outperformance, we held positions in Australian and US bonds, which both outperformed, aiding performance. We took profits on the 10-year maturity Australian position in early December and the US bias shortly afterwards. Towards the end of the year we bought 30-year Australian bonds once more; the market sold off aggressively post the Bank of Japan announcement and into year end.
- The fund added to inflation trade in fourth quarter for first time in some time. This was driven by our view that with the BoE coming to the end of the sale programme for index-linked gilts bought during the Kwarteng sell-off, these bonds looked cheap thanks to this technical factor outweighing inflation expectations. We sold 30-year gilts, buying equivalent linkers. We exited the position by year end for a modest profit.

RL Short Duration Gilt Fund

- The fund was generally short duration during the quarter, as through most of 2022, although continued to use market volatility to trade this tactically. This helped performance during both the quarter and for the year as a whole. Despite yields falling over the quarter, we were happy to end the year with a modest short duration position of around 0.3y short relative to the benchmark.
- Cross market positioning was also positive. Although gilts outperformed other government bond markets over the quarter, this was focused in the early part of the quarter when the Kwarteng sell-off was unwound. After this strong period of gilt outperformance, we held positions in 2024 US bonds, which outperformed, aiding performance.
- In addition, our positioning at the very short end was also positive. During November, we took advantage of the market preference for very short-dated gilts, switching some of our six-month exposure into treasury bills. Despite these having the same issuer, the yield on these was around 3.6%, compared to 2.8% on the gilt with the same or similar maturity, and this position helped performance.
- The fund held no exposure to UK or global inflation markets in the period.
- The fund's highly rated sterling credit exposure had a small positive impact on performance in the quarter, as credit spreads (the average extra yield available from corporate bonds compared with government debt of equal maturity) tightened over the quarter. The fund's credit exposure remains focused in highly rated fixed rate credit, and CDs, and we added marginally over the quarter, picking up structured bonds from student accommodation provider Unite at an attractive yield pick-up over equivalent maturity gilts.

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, the magnitude and speed of hikes will be more limited. In the UK, the market is pricing in around 100bps of rate increases from the BoE, expecting a peak in late spring / early summer and then holding steady before starting to come down in Q1 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 the unemployment rate. If labour markets are buoyant and unemployment remains relatively low, then the wage pressures we have seen in 2022 will continue for much of 2023. Headline inflation will 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.
- Supply will be an issue for the market over the next few years, with around £200bn per annum forecast over each of the next five years. Alongside quantitative tightening (where the BoE is selling its gilt holdings back into the market), this will represent a headwind for gilts, and alongside elevated base rates for longer, means we are comfortable to run a strategic short duration position.

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.

IMPORTANT INFORMATION

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