Royal London High Yield & Multi Asset Credit Strategies

Quarterly Report

31 December 2022

For professional clients only, not suitable for retail clients

Market overview

- The fourth quarter rounded off a turbulent year in markets, with high inflation and central banks upping interest rates continuing to dominate headlines. Inflation first surfaced in the aftermath of the Covid-19 pandemic, but was exacerbated by the Russian invasion of Ukraine in February and retaliatory sanctions that sharply increased the prices of oil & gas and other commodities. Growing fears of recession swarming the US, UK and Europe remained at the forefront of investors' minds.
- Central banks have responded to the continued strength of inflation by further tightening monetary policy and reiterating that they will do whatever it takes to suppress rising prices. In the US, the Federal Reserve ended 2022 with the Fed Funds target range of 4.25% to 4.50%, following a further 2% in hikes over the final quarter of the year. At its final meeting of 2022, in December, the Fed cautioned that further rate rises would be needed, consistent with a 5-5.25% target range for Fed funds. With inflation falling more than expected in November, and core inflation only rising slightly, the market expects these rate rises to slow.
- In the UK, the Bank of England continued to hike rates in December, following their 75bps hike in November with a 50bps rate rise against a backdrop of elevated domestic wage and price pressures. The forward guidance offered at the December meeting was relatively vague, but the language was similar to the November meeting: further hikes are to come. As for UK data released in December, year-on-year CPI inflation fell to a, still very high, 10.7% from 11.1%.
- In the fourth quarter, the Chinese government set out to loosen its strict Covid restrictions. By the end of December there were reports of Covid outbreaks moving beyond their peaks in some major cities, with high frequency activity data picking up somewhat.
- Bond markets were shaken by the ongoing interest rate rises and hawkish commentary from central banks throughout the year, but were able to eke out some gains to close out a rough year. Over the three months to December 31, the 10-year US treasury yield rose slightly, inching higher to 3.87% from 3.83%, while the UK benchmark 10-year gilt yield slipped to 3.67% from 4.09%, and the 10-year German bund yield rose to 2.57% from 2.11%. As a result, overall government bond returns for the year were poor in absolute return terms, with the US treasury market returning -12.9%, bunds -17.6% and gilts -25.1%.
- In the high yield market, the spread tightened to 440bps, with a generous 'all-in' yield of 8.1%, which has increased from 4.2% at the start of 2022. In the broader-based high yield index, which includes CCC rated bonds, spreads tightened to 520bps from 620bps. By our estimates this implies a 24% cumulative default rate over a five-year period. Looking to 2023, however, default rate expectations have slid back as investors have taken a brighter view of the depth of the widely anticipated recession. This compares to cumulative default rates of 25% during the Global Financial Crisis and 30%+ in the 1990s and early 2000s.The all-time high was 41% in the long and deep depression of the 1930s.

Portfolio commentary

RL Global High Yield:

- The fund underperformed its ICE BofAML (BB-B) Global Non-Financial High Yield index benchmark in the quarter driven by idiosyncratic security factors outweighing macro asset allocation.
- On an asset allocation front our underweighting of the R.O.W. was offset by our overweighting of Europe and the UK and our underweighting of BB rated bonds (particularly at the beginning of the period) was offset by our higher CCC exposure which also outperformed.
- Sectorally our overweighting of media was a detractor with the sector underperforming on idiosyncratic credit factors.
- Idiosyncratic factors hurt us in three media names in particular, Our Altice USA position was impacted by the cancellation of a proposed sale of part of its business, the market reaction to this news was significantly negative at an illiquid time (December). In addition AMC Networks was impacted by a downgrade from BB to B and VTR finance by continued negative earnings.
- While at very low levels, there was still some new issuance in the period. However, we continued to be very selective, passing on companies with weak business models or poor fundamentals, and preferred to build up a cash buffer in the expectation of better quality new issues in the future.
- Over the course of the quarter, as part of our overall view of a looming recession, the fund's exposure to CCC names was reduced. We are cautious on overall risk levels resulting in a theme behind a number of trades which was to heighten exposure to higher quality credit and to increase duration, given the outlook for lower inflation in 2023.

- As a result of our strategic shift we exited a number of names that are higher risk/lower quality: Harbour Energy, Birkenstock, Bway holdings, Ceramtech, Edreams, Mclaren, Picard, Sani Ikos, TK Elevator, Vistajet.
- We replaced these names with low risk, high quality names with longer duration: **Amazon, Apple, Bristol-Myers, Salesforce, Deere, Disney, Google, Oracle, Walmart**.

Short Duration Global High Yield:

- The fund performed strongly over the quarter outpacing its Sterling Overnight Index Average Rate (SONIA) benchmark significantly.
- We took a cautious approach for the quarter, in keeping with this defensive strategy. Our focus is on keeping duration short by reinvesting shorter than the final maturity of the fund's assets.
- We still find the global high yield curve technically very interesting and the front end very cheap. Over the course of the second quarter, we lost some names to redemptions (including **Nielsen Group**, **Royal Caribbean**, **Verisure**), reduced position sizing (**Amc Networks, Bway, Gray TV, Nexstar, Viasat**) and exited names (**Digicel, Bausch Healthcare**). These positions were replaced with some new holdings (**Adevinta, Axalta, Heathrow, Ladbrokes, Telecom Italia, Thames Water**).

Multi Asset Credit:

- The fund outperformed its Sterling Overnight Index Average Rate (SONIA) benchmark significantly in the quarter.
- Over the quarter, the fund reduced its exposure to asset backed credit, leveraged loans and lower-rated high yield credit in favour of higher quality investment grade credit and shorter duration high yield credit. The exposure to investment grade credit increased the Fund's interest rate duration by six months to 3.8 years.
- The asset allocation at the beginning of the quarter aided returns as investment grade credit outperformed whilst asset backed securities were a detractor from performance.
- While at very low levels (particularly compared to expectations), there was still some new issuance in the period. However, we continued to be very selective, passing on companies with weak business models or poor fundamentals, and preferred to build up a cash buffer in the expectation of better quality new issues in the future.
- Over the quarter we added amongst others: **Apple, Amazon, Bristol-Myers, Cox Communications, Ecolab, Deere & Co., Walt Disney, Google, HCA, Meta, Microsoft, Oracle, Walmart**. The fund exited the following names: **Ammega Group, BB Hotels, Kersia, Madison IAQ, Petsmart, Phillips, Picard, Sani Ikos, Hess Midstream, Hilcorp, Mclaren Xella** amongst others.

Outlook

- Our focus will remain on the Fed. With inflation expected to fall back towards the long-term target, the levels that the Fed is happy with and when it then begins to lower rates will be the key factor for the upcoming year.
- Following a year of weakness in government bond markets and negative returns, the high yield market is now pricing in a recession, and we believe therefore offers excellent value.
- It is also worth mentioning the implied default rate takes no account of the much higher quality and more robust nature of the high yield market today, compared to 2008/9; nor of the current financial state of issuers as we head towards the downturn. Most issuers are in a stronger position than normal at this stage of a cycle and our default and recovery expectations remain extremely benign.
- While this sounds compelling, we don't feel that a higher-risk strategy is necessary. With current yields at attractive levels and appealing potential returns, we believe we will be paid sufficiently for maintaining a lower-risk position for at least another quarter until there is more clarity about the outlook. Unlike equities, given the asymmetry of risks in credit investing, it doesn't pay to take excessive risks when heading into periods of more negative sentiment.
- In our view, the way through difficult markets is to focus on those risks that you can control and know what you own. We will keep spread duration low and focus on the quality of issuers' financials, rather than relying on third-party ratings: at a sectoral level, cashflows are the key

factor, so we need to know about on- and off-balance sheet leverage. We prefer not to wait for defaults as the recovery process can take time: however, should they occur, the key is to have an adequate solvency cushion.

Find out more

- Our *2023 Outlook* is available here, and includes an overview from RLAM Chief Investment Officer Piers Hillier and articles from some of our leading fund managers on the risks and opportunities in their asset classes for the new year. Articles, videos and webinars explaining our latest investment thinking can be found in the *Our Views* section of www.rlam.com, including regular *JP's Journal* blogs from Head of Fixed Income Jonathan Platt.

IMPORTANT INFORMATION

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