Royal London
Index Linked 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.
- 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%.
- UK index-linked markets were also volatile. Real yields swung wildly – in the UK, 30-year real yields started the quarter at -0.04%, reached a high of 1.57% on 11th October, then a low of -0.09% in mid-November before ending the year at 0.55%. These are extraordinary moves for a risk-free asset – especially after similar volatility in the third quarter, and reflected the combination of global pressures on inflation and interest rates, but exacerbated by the removal of Truss as PM. Real yields on 10-year bonds showed a similar story – in the UK, yields moved within a range of just over 2% over the quarter, while in the US and Germany, equivalent bonds moved in a range of less than 1%.
- The UK index-linked market underperformed on a global basis in the period, providing negative returns of -6.02% (FTSE Actuaries UK IL Gilts All Maturities), compared to global index-linked returns of 0.08% (Barclays Global IL). Longer-dated bonds were weaker due to their greater sensitivity to changes in the interest rate (their longer duration), while short-dated index linked bonds saw positive gains for the quarter, boosted by demand for short-dated assets and the positive carry on these bonds. For the year as a whole, UK index linked bonds returned -33.60%.

Performance and activity

- Performance was broadly positive in our index linked strategies over the quarter. However, it is worth noting that the large moves in the markets on the last day of the quarter will distort like for like returns between funds priced at midday and benchmarks priced at 4.15pm. For instance, on the last day of the third quarter, the longest dated UK index linked bond rallied 18% between noon and 4.15pm. Obviously this effect will drop out when we come to look at performance for the year as a whole, but is worth noting for the context of quarterly returns – essentially this massively boosted index returns for the third quarter and then massively depressed these for the fourth quarter.
- Duration positioning was positive for returns. We have a strategic bias towards a short stance, but will trade market volatility tactically, and this was helpful during a period where volatility was at almost unprecedented levels. We moved to a long duration stance early in the quarter as UK real yields hit 1.5%, moving short once more after the U-turn in fiscal policy and we were happy to maintain this stance into the

syndication seen in November. This tactical approach is likely to remain in place into the first quarter of 2023, although we expect trading ranges to be less pronounced.

- Curve positioning was negative for our strategies. We generally had a flattening stance or bias through the period, but the real yield curve steepened significantly through the first two months of the quarter, before flattening somewhat in December. We retain this flattening bias into 2023, predominantly due to the lack of scheduled long-dated linker supply.
- Cross market exposure has been a significant source of returns in recent years, with the UK market looking expensive relative to peers since the Brexit vote. During the fourth quarter we traded UK vs Global positions tactically, benefiting from the heightened volatility caused by the UK LDI crisis. Early in the quarter we added to Global exposure, buying US and European bonds, before taking profits as UK markets underperformed around the time of the change in government. However, following the installation of the new Prime Minister and a new budget, UK markets rallied strongly and we therefore added Global exposure once more. The majority of these positions were closed at the 2073 syndication in late November with all positions closed by the end of the year to leave funds with no explicit UK vs Global bias.
- Our inflation-linked strategies can move underweight inflation (selling linkers and buying conventionals) when market pricing presents opportunities. We started the quarter with a small underweight in inflation, taking profits early on as the new Chancellor ruled out parts of the Kwarteng plan. We reinstated the stance ahead of the 2038 gilt syndication in November, and then closed this at a profit on the day of the 2073 linker syndication.
- Credit exposure was a modest positive for performance. Credit spreads tightened over the period, although the moves were relatively small and hence the impact was marginal.

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. In UK inflation markets, inflation is now priced near the low end of the last years range and with spot inflation likely to remain relatively high to target all funds are invested 100% in inflation linked bonds.
- 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 likely interest rates, means we are comfortable to run a strategic short duration position, but ongoing volatility around supply events and central bank meetings will provide opportunities to add value through tactical positioning.
- Relative to global index-linked markets, long-dated UK index-linked bonds, and to a lesser extent shorter dated bonds, ended 2022 close to the lows in the range since the Brexit vote in 2016. Supply is very light in the first quarter with only a 2031 auction in January and a 2051 auction in March. The Bank of England has also completed its sales of index-linked bonds under the emergency programme. Given this light supply and real yields once again in positive territory we have sold back all of the global positions in the UK funds and are flat UK in the global funds looking for improved valuations to add once more to global exposure. For the two global funds, after the strong performance into year end, the funds are now underweight Italy relative to France. These funds also have a US curve flattener position, reflecting our view that we expect US short-dated bonds to underperform longer-dated bonds as US inflation continues to fall.

Additional information

- As we highlighted in our Annual Report, RLAM has ambitious targets for the next few years, notably in international growth as well as investment in infrastructure and people. This investment is to make sure that we continue to provide clients with the service they need and positioning us to for future regulation changes and market development.
- As part of that ambition, we are pleased to announce that we are moving to a new investment platform and have selected the industry leading 'Aladdin' platform. This decision has followed months of analysis and pre-implementation planning with the vendor BlackRock. Aladdin will help us improve our service offerings to our clients, as well as delivering operational efficiencies.
- As you would expect, implementation is an extended task, and the project is expected to complete in 2024, but we believe it is important to be transparent about such projects with our clients. Throughout the implementation, the project and management of your client portfolios will be closely monitored by our Board and Risk functions to ensure that this transition is achieved smoothly, and we will keep you updated on our progress. This is an important part of our long-term strategic goal to ensure that we continue to meet your needs today and into the future.

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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