Royal London Cash Strategies

Quarterly Report 31 March 2022

Market overview

- Geopolitical events and a changing outlook for growth and inflation have been the backdrop to a volatile quarter for investment markets. The year began with markets starting to focus on inflation, with hawkish comments from the Federal Reserve (Fed) and Bank of England (BoE) leading to expectations that rates would rise faster and further than just a few months ago. Both the Fed and BoE increased interest rates during the quarter citing inflation concerns, while European Central Bank has accelerated the end of its net asset purchases programme.
- The US showed a reasonably solid start to the year, with stronger than expected retail sales and industrial production. Although war in Ukraine has increased uncertainty in markets, Federal Reserve Chair Powell noted that "with inflation well above 2% and a strong labour market, we expect it will be appropriate to raise the target range for the federal funds rate." In the euro area consumer confidence weakened but the PMIs were consistent with a relatively strong pace of growth. Economists ramped up expectations for an ECB hike this year after a hawkish ECB press conference, although more recent comments have been more dovish, reflecting the Ukraine crisis. However, with inflation rising fast, the ECB has confirmed that it is accelerating its exit from its bond buying programme (the Pandemic Emergency Purchase Programme, or PEPP)
- In the UK, BoE hawkishness was the feature of the quarter. While the bank increased the base rate by 25bps to 0.50% in February, four Monetary Policy Committee (MPC) members voted for a 50bp hike. The BoE also decided to stop reinvesting maturing assets and signalled an intention to sell its holdings of corporate bonds. As a result, market pricing of future hikes changed dramatically: in the space of four months, expectations have gone from rates reaching 0.75% by 2024, to rates reaching 1.75% by the end of this year. The Russian invasion of Ukraine might have been expected to lead these expectations to be scaled down, but a consensus quickly emerged that while higher energy prices would slow growth, it would also push inflation still higher. February saw a CPI (inflation) print of 6.2% - the highest seen since 1992, with the BoE expecting this to rise to 8% or even higher this year.
- In UK bond markets, the benchmark 10-year gilt yield rose from 0.97% to 1.61%, leading gilts to return -7.2% on an all-maturities basis (FTSE Actuaries). Although newsflow during the quarter was dominated by Ukraine, government bonds did not exhibit their traditional safe haven status, with the combination of higher implied inflation and rising real yields proving a painful combination for investors. Although broad sterling credit indices outperformed government bonds, returning -6.2% in the period (iBoxx Sterling Non-Gilt index), this reflected their lower duration. Investment grade spreads (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened by 22bps.
- UK money markets therefore unsurprisingly saw yields rise as well. After some 20 months trading at or just over 0.05%, SONIA had risen to 0.19% in December 2021, then jumped to 0.69% by the end of the first quarter of 2022. Three-month Libor rose from 0.48% at the start of the quarter to end March at 1.03%. Two-year gilts, often seen as a proxy for market expectations of BoE rates, rose from 0.68% at the end of 2021 to end the first quarter 1.35%.

Performance and activity

- Our cash funds are standalone vehicles. However, we know that many clients use a combination of these as part of a cash laddering strategy – using short maturity funds for more immediate liquidity needs and using other strategies for cash needs beyond six months or so. The return profiles of these funds will differ, but all are underpinned by a common philosophy and process. We focus on creating diversified portfolios that with high credit quality in the underlying banks. These portfolios also screen out tobacco, fossil fuel and armaments, but also factoring in ESG considerations when considering the banks that make up the majority of the portfolios. In this way we believe we create portfolios that meet client needs.
- There is no direct Russian exposure in our portfolios, and there has been no exposure given Russian banks failed our screening process. We are monitoring other names in the portfolios that may have indirect exposure to Russia. Where identified, we are allowing short-dated paper to mature and are not rolling this, using proceeds to reinvest elsewhere.
- Funds with a much greater focus on near-term liquidity such as the Sterling Liquidity or Short Term Money Market Fund are invested almost entirely in classic money market instruments such as treasury bills and short dated certificates of deposit. In the former, we also use repo which is an ideal instrument for a fund focused on liquidity offering T+0 dealing. Repo markets were slightly tighter in the period, as demand typically increases in more distressed market conditions.
- Money market exposure was generally a modest positive over the quarter. Although rising yields are a headwind for money market funds (as these yields often rise faster than a portfolio can rotate into those higher yielding securities), we had added selectively to longer date paper at the more attractive rates available in December, and were able to add further as market rates rose over the quarter. For the **Short Term Money Market Fund**, activity remained focused on CDs out to around three month through names such as **Toronto Dominion** and **ING**,

and with our view that the market was pricing in too many rate hikes, we added selectively beyond that, including four-month CDs from **Nordea.** We also added a short-dated covered bonds in the secondary market when available. Purchases included **Toronto Dominion Bank**, **Royal Bank of Canada** and **TSB** – both providing a small premium over SONIA, but also mitigating interest rate risk due to their floating rate structure. We also added floating rate CDs – again, these providing some protection in a rising rate environment – including six-month paper paying a premium to SONIA from Norwegian bank **DNB**.

- The Cash Plus and Enhanced Cash Plus funds were renamed during the period, to Short Term Fixed Income Fund and Short Term Fixed Income Enhanced Fund respectively. However, no changes were made to objective, process or performance targets. Both funds 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. These all contain limited interest rate and credit risk.
- For the Short Term Fixed Income Fund (formerly Cash Plus fund) , covered bonds still account for the majority of non-money market exposure. These aided performance earlier in the quarter, partly due to the additional yield over SONIA these offer, but also due to the floating rate nature of these instruments that mitigates the impact of rising yields. However, credit spreading widening later in the quarter was negative for the fund, although this impact was mitigated by our reducing exposure earlier in the quarter as spreads tightened on the asset class as investors priced in further rate hike – we were able to sell at spreads of 12-13bps compared to the 30-40 levels being paid just six months ago. We generally replaced these with one-year CDs from the likes of **BNP**, **First Abu Dhabi** and **Barclays**, based on our view that rates will adjust lower once the market re-prices rate hike expectations.
- For the Short Term Fixed Income Enhanced Fund (formerly Enhanced Cash Fund), performance over the quarter was negative in absolute terms. Although the portfolio has a significant yield, this was not enough to offset wider credit spreads and rising yields over the quarter. While one consequence of the recent market volatility is that these assets have seen mark-to-market losses, these losses are only locked in if we sell the asset. Our strategy does not tend to trade holdings – the short-dated nature of these means that we tend to hold to maturity to harvest the yield available at purchase. In general, therefore, we fully expect these holdings to repay in full realising the original yield they were bought at, and we believe that higher yields will ultimately benefit investors through higher returns.
- Short-dated senior bank bonds remain the principal source of added yield for the Enhanced fund. These hurt performance in the quarter as banks tend to sell off when fears of recession increase. However, while the Ukraine situation means that there is a greater risk of recession, we still see this as very much an outside case. Growth may be slower, but after the global financial crisis, bank balance sheets look very good, and central banks have spent the last two years not only keeping rates low, but bolstering the banking system. During the quarter we participated in new issues of four and five-year bonds from **DNB Bank**, **Toronto Dominion**, **Santander** and **Bank of Nova Scotia**. Our participation was biased towards the end of the quarter when spreads and overall yields were higher, locking in significant premia to SONIA. Earlier in the quarter we reduced exposure to covered bonds where valuations looked very tight – selling names such as **Barclays**, **Westpac** and **Sparebank** and adding to short-dated gilts as a short-term liquidity home. Outside of financials, we added a secondary market purchase of asset-backed bonds from student accommodation provider **Unite**.
- The yields on our funds have now risen materially – the Short Term Fixed Income Fund is yielding around 1.7% and the and in the case of the Short Term Fixed Income Enhanced Fund is now just over 2%. We believe this is an attractive proposition in a market where SONIA is around 0.7%. There may be further short-term impacts as the Bank of England and other central banks either raise rates or give their views on future monetary policy, and of course the Ukraine conflict has yet to end and its full effects become visible. However, over the medium term, we expect the funds to continue to meet their objective of SONIA plus 0.5% and plus 1% respectively over the medium term.

Outlook

- The market is pricing in five further rate hikes this year, which would take base rates to 1.75%. At the time of writing, we feel that the Bank may in fact hike less – rhetoric from MPC members in March were clearly around the impact of cost of living, and wanting to avoid hiking fast and helping push the economy into recession. While understandable, we see definite risks to this approach: historically, being slow to hike rates eventually means more hikes are needed. We also feel that inflation will be stickier than some are expecting. While it is tempting to see much of the recent increase as a year-on-ear 'base effect' phenomenon, we feel that this is only one aspect of recent inflation increases. Alongside the temporary effects of higher energy prices, we believe that the Russian invasion will have longer-term impacts: deglobalisation, as countries look to be more self-sufficient and move production close to local markets; and tighter labour markets, as more emphasis on local production and lower participation rates push wages higher.
- A background of rising rates is a difficult one for all cash and very short duration bond funds. As we said in January, with interest rates now having risen, and expectations of further increases already in prices, positioning around duration, becomes more dynamic, rather than simply

sitting as short as possible. While we feel that the market is overly hawkish about the prospects for rate increases, we will generally look to extend maturities to pick up attractive yields in names we are comfortable with. Our strategy is to remain cautious, in keeping with the risk profile of our funds, ensuring that we continue to deliver on the security and liquidity expectations of the funds, looking for opportunities to mitigate the impact of rising yields on overall returns, while also taking advantage of market pricing in excessive rates to achieve additional yield.

- For exposure outside of these areas, our approach has always placed an emphasis on security and credit quality, both in the nature of assets we buy (such as covered bonds) but also in the way we assess credit quality, with our preference for bonds with security or covenants that we feel offer a degree of protection to investors. A high proportion of the assets in our funds are exempt from bail-in, and we will continue to favour such assets given these provide our clients with greater security.

Additional information

- RLAM recognises that the Ukraine invasion is a human tragedy, and one that we hope is resolved swiftly. As stewards of our investors' assets, we are monitoring the situation closely, and of course are complying with all restrictions and sanctions issued by relevant authorities. RLAM has no exposure to Russian companies in our active funds. We had limited exposure (less than 0.1% of total assets) in our tilt and Emerging Market Tracker funds at the time of the invasion, but subsequently sold every holding we were permitted to. In our Emerging Market Tracker fund, we removed this in line with the MSCI index changes in early March.
- You can find regular updates on our investment thinking in the *Our Views* section of www.rlam.co.uk. This 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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