Royal London International Government Bond Fund

Quarterly Report 31 March 2022

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	0.7	0.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	4.1	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	88.4	100.0
Foreign index linked sovereign	6.7	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	7.2 years	7.5 years
Gross redemption yield [4]	1.37%	1.54%
No. of stocks	105	956
Fund size	£509.1m	-

Source: RLAM, based on the M share class. Launch date: 01.11.2011.

[1]Benchmark: JPMorgan Traded World ex-UK Government Bond Index (£ Hedged).

[2]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.

[3]Excluding cash

[4]The gross redemption yield is calculated on a weighted average basis.

[4]Real yield shows the inflation-adjusted redemption yield for the underlying portfolio and therefore does not include the impact of fees. For share class level yields, please see the latest factsheet.
Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q1 2022	**-3.77**	**-4.48**	**0.71**
Year-to-date	-3.77	-4.48	0.71
Rolling 12 months	-2.23	-3.62	1.40
3 years p.a.	1.40	0.71	0.69
5 years p.a.	1.71	1.32	0.39
10 years p.a.	2.51	2.34	0.17
Since inception p.a. 0.11.2011	2.54	2.41	0.13

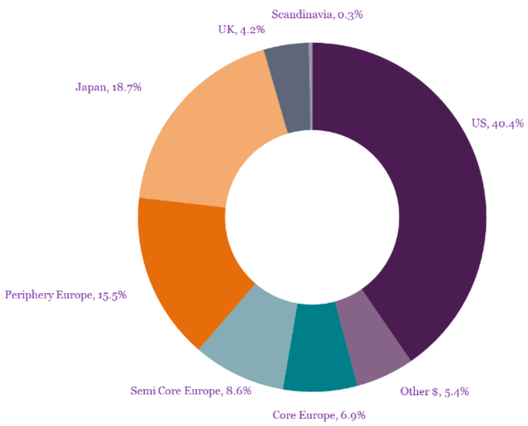
Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.
Source: RLAM, based on the M share class.
[1]Benchmark: JPMorgan Traded World ex-UK Government Bond Index (£ Hedged).
Performance for the Royal London International Government Bond fund is based on pricing at noon, while index performance is based on pricing at close of business, preventing direct performance comparison. The significance of this timing discrepancy is likely to be smaller for longer measurement periods.
As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.

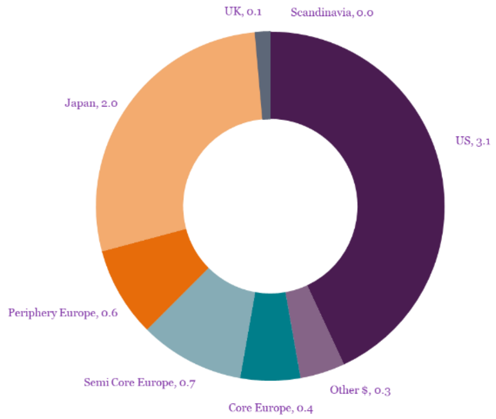
Ten Largest Holdings

	Weighting (%)
US Treasury 0.75% 2026	4.4
UK Treasury 0.125% 2023	4.1
Japan Govt 0.1% IL 2026	3.6
Italy Buoni Poliennali Del Tesoro 0.9% 2022	3.2
US Treasury 2.25% 2024	2.9
Japan (govt Of) 20 Yr Issue 1.8% 2030	2.5
Japan (govt Of) 20 Yr Issue 0.4% 2039	2.4
US Treasury 0.625% 2026	2.4
Italy Buoni Poliennali Del Tesoro 1.4% IL 2025	2.3
Italy Buoni Poliennali Del Tesoro 1.0% 2022	2.3
Total	**30.0**

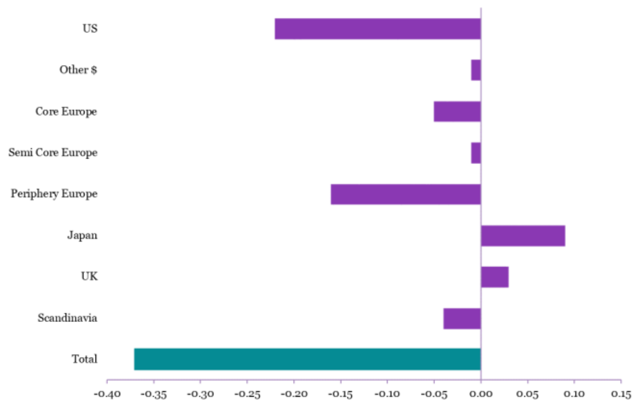
Geographic split by percentage



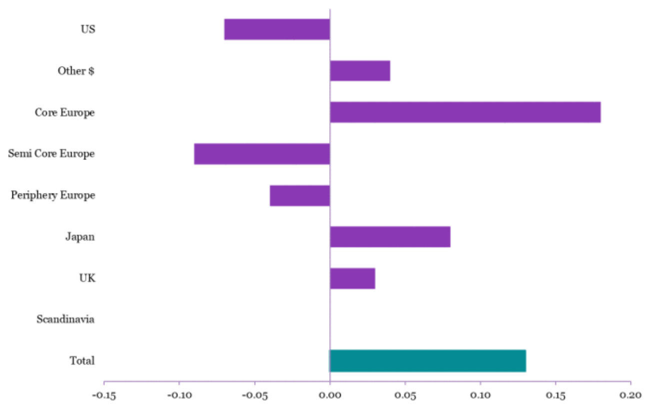
Geographic split by duration



Current position (by duration)

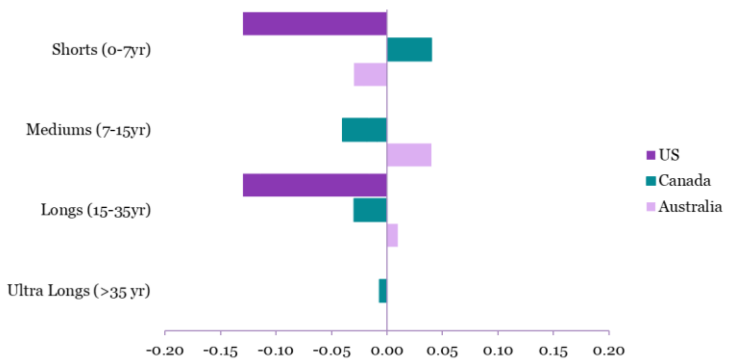


Change on quarter by duration

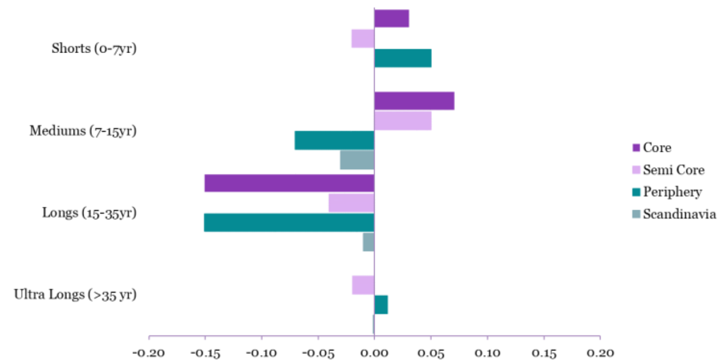


Yield curve

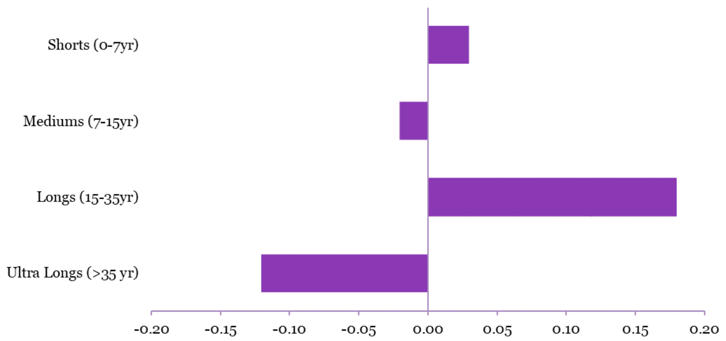
Dollar bloc



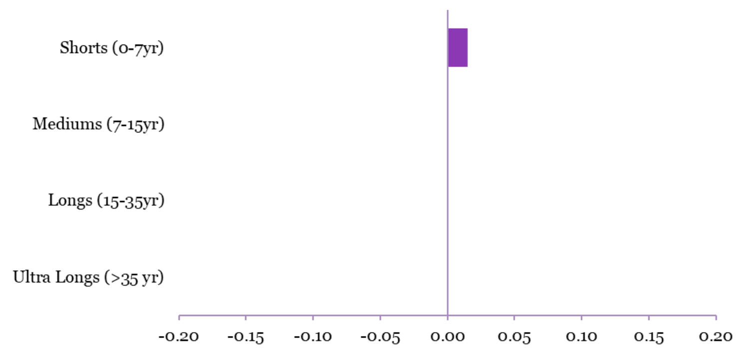
Euro bloc



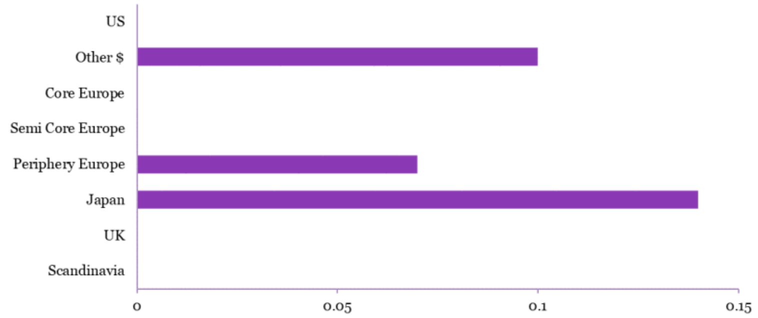
Japan



UK



Inflation breakeven



Market Overview

- Russia's invasion of Ukraine in late February shocked the world, triggering a humanitarian crisis in Europe on a scale not seen since the Second World War. War has been met by a unified response from Western powers, enforcing far reaching sanctions upon Russia. Shockwaves have reverberated through global financial markets following these events, and although a sense of calm had returned to markets by mid-March, the unpredictability of war means that stability is fragile.

- After the relatively benign impact of the Omicron variant of Covid-19, central banks globally maintained their hawkish pivot into the turn of the year, as they focused on tackling persistently higher than expected inflation rates. Government bonds have been badly impacted by the subsequent rise in interest rate expectations, and delivered extremely negative returns to investors on a global basis as a result. The UK government bond market underperformed on a global basis due to its longer duration (longer-maturity assets are more sensitive to increases in interest rates).
- War in Ukraine has exacerbated inflationary pressures, leading to some opposing dynamics with respect to monetary policy: tighten policy to address inflation or give some slack on further policy moves until the growth consequences become more evident – rising commodity prices are driving up the cost of energy, food, and materials, leading to concerns around what potential impact the withdrawal of monetary support might have on general financial conditions and growth. In the US, where the economy is better insulated from rising commodity prices (it is a net energy exporter) the Federal Reserve (the Fed) doubled down on its hawkish stance on inflation, highlighting the potential for a diversion in monetary policy between central banks going forward. The Fed ended its quantitative easing (QE) programme at the end of March as planned, and increased its base interest rate by 25bps to 0.75% – markets are now pricing eight more rate hikes in 2022, raising the Fed Funds Rate to 2.5% or higher by the end of the year.
- Inflation in Europe was especially buoyant in the period, given the region's greater dependence on Russian oil and gas – German 10-year breakeven (implied) inflation rates increased by 83bps in the first quarter as a result, to 2.64%, compared to a rise of 23bps in the US to 2.83%. This has led the European Central Bank to accelerate its winding down of QE – it brought the Pandemic Emergency Purchase Programme (PEPP) to a close at the end of the period, but announced it will wind down the Asset Purchase Programme (APP) during the first half of 2022, rather than closing it at the end of 2022 as initially planned. The bank also signalled that rate rises will follow the closure of the APP, although was ambiguous on timing – markets are expecting rises to come soon after closure, with pricing implying rates reaching 0.50% by year-end.
- In the UK, Bank of England (BoE) Governor Bailey cited concerns of a potential squeeze on consumer but increased the UK base rate to 0.75% nonetheless, the UK's second rate hike in consecutive months. The UK's Spring Budget Statement drew more attention than usual given the potential for policy manoeuvres to help relieve consumers from the rising costs. Chancellor Rishi Sunak took some small measures to limit the impact of forthcoming tax rises, mitigating around one third of impact of rising costs on consumers. Markets are still pricing in a further five rate hikes in the UK this year, taking the base rate to 2%.
- In the UK, government bond markets returned -7.49% to investors for the quarter (ICE BoAML >1 year), slightly more negative than in the US (-5.56%) and the Germany (-5.11%), as a result of the longer duration of the market. The benchmark 10-year gilt yield rose from 0.97% to 1.61%, an increase of 64bps – it was a similar story across maturities, as yields rose to a similar extent across the curve. The Russian invasion of Ukraine drove a significant if only temporary dip in yields in the period: 10-year gilt yields reached around 1.55% in late February, fell to around 1.20% following the onset of war – the flight to safety proved only temporary as yields again trended higher from the second week of March. The same pattern was visible in the US and Germany, where yields rose throughout the period but temporarily dipped following the onset of war in Ukraine: in the US, the benchmark 10-year US treasury yield rose from 1.51% to 2.34% in the quarter, while the German 10-year bund yield rose from 0.14% to 0.55%. Periphery markets in Europe were the weakest of major global government bond markets, with the 10-year Greek yield rising by over 134bps in the quarter. Japan was the strongest market, as yields rose by just 15bps – the Bank of Japan (BoJ remained supportive in the period, and continued to actively manage its yield curve target in the first quarter, as inflation, while rising, remains below the BoJ's target.

Portfolio commentary

- The fund performed strongly relative to its benchmark over the quarter, returning -3.84% gross of fees (M class) versus -4.48% benchmark returns (JP Morgan Traded World ex-UK Government Bond Index - hedged). However, the fund and the benchmark are priced at different times – on a like-for-like basis, the fund outperformed by around 69 basis points.
- Cross-market strategies were a significant contributor to outperformance in the quarter. The fund benefitted from being underweight periphery markets in Europe against a backdrop of a less supportive ECB, while also benefitting from being underweight US treasuries, and overweight Japan. The underweight to US treasuries – around 0.25 years short at the end of the period – was the strongest strategic cross-market position at the end of the period. During the quarter, the fund shifted overweight in France relative to Belgium – France underperformed ahead of the first round of French presidential elections early in April.
- The fund began the year 0.6 years short duration, which benefitted relative fund performance as government bond yields rose globally following an increase in hawkishness from central banks. We covered duration to 0.3 years short into the end of the quarter, given the rise in yields and the conflict in the Ukraine.

- On the curve, the fund started the quarter positioned for higher long-dated yields (a steepening bias), as a result of supply and reduced central bank buying. However, as curves flattened over the period, the steepening bias tempered performance. Curve flattening is typical when market expectations for interest rates rises grow, as yields for short-dated bonds rise further relative to longer-dated bonds in this environment. This was visible in Europe in the quarter, as markets priced in a 50bps increase in interest rates by the ECB by the end of the year.
- The fund started 2022 0.5 years long breakevens, holding index-linked positions in France, Germany, Italy and Japan. This benefitted the fund, as inflation-linked assets outperformed traditional bonds over the quarter, as real yields rose by less than nominal bond yields. As longer term breakevens exceeded the ECB's 2% inflation target and the central bank turned more hawkish, we trimmed some exposure in France, Germany and Italy, taking profits.

Outlook

- There is considerable uncertainty about the year ahead. The war in Ukraine has worsened existing trends and has given central banks a real dilemma: tighten policy to address inflation or give some slack on further policy moves until the growth consequences become more evident. The US yield curve (between 2- and 10-year maturity bonds) inverted during March, which many view as recession signal, which is possible given that US investors are positioned for eight further rate hikes this year, taking the Fed Funds target rate above 2.5% (from 0.50% at present). In the UK the picture is only marginally different: five further hikes and a rate of 2%. In the eurozone there has been a significant shift, with tightening now expected in the second half of the year. Although we expect a slowdown in medium term, we believe that market pricing may be too aggressive at present. However, we must highlight the uncertainty of any market forecasts at present, given the unpredictability of war in Ukraine.
- We expect yields to move higher through 2022 as central banks remain hawkish in the face of sustained inflationary pressure, due, in part at least, to the disruption arising from the conflict in the Ukraine – the fund will remain short duration as a result. Given the hawkish pivot from the ECB, the fund will also underweight periphery markets, instead moving overweight "cheaper" inflation markets where the breakeven (implies) inflation rate is below the central bank targets, namely Japan, or markets which remain reasonably priced in the ongoing inflationary environment, such as Australia.

Find out more

- 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.
- Fund managers and other in-house specialists regularly address the issues that they consider in managing their funds via blogs, articles, webinars and other mediums. Please visit the RLAM Digital Insight Hub, or the *Our Views* section of www.rlam.co.uk for further information.

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