Royal London Fixed Income Funds

Fund Manager Commentary – October 2022

FOR PROFESSIONAL INVESTORS ONLY, NOT SUITABLE FOR RETAIL INVESTORS.

ROYAL LONDON
ASSET MANAGEMENT

Contents

Economic Developments

- The new Chancellor reversed a set of tax cuts, signalling a more stringent fiscal approach following September's poorly received mini-Budget. He also announced that the energy bill freeze will only run to April 2023, rather than for two years as previously intended. A shorter-than-usual selection process saw Rishi Sunak take over as Prime Minister. A full Autumn Statement will now be delivered on 17 November, and press reports indicate that further tax increases and spending cuts are likely.
- Expectations of the likely peak in UK interest rates fell over the month along with gilt yields. September, however, saw continued inflationary pressures with year-on-year inflation rising back to 10.1%, while core inflation rose to 6.5%. Wage growth again came in stronger than expected against a still-tight labour market as unemployment fell to 3.5%. However, October PMI business survey indicators signalled a deteriorating growth picture.
- US data remained firm but October business surveys indicated some worsening in outlook. Strong inflationary pressured remain evident and this prompted a 75bps hike in the Fed Funds rate in early November.
- Eurozone price pressures remained elevated with the German inflation rate surpassing that of the UK and the European Central Bank (ECB) again hiked rates by 75bps. Eurozone growth in the third quarter surprised on the upside, although business survey data pointed to an imminent contraction in private sector activity.

RLAM Credit Fund Performance

	1 month (%)	Rolling 12 Months (%)
RL Corporate Bond Fund Z Inc	**2.80**	**-18.39**
IA Sterling Corporate Bond Sector	3.74	-18.84
iBoxx Sterling Non-Gilts All Maturities Index	4.03	-19.11
RL Ethical Bond Fund Z Inc	**3.06**	**-18.84**
IA Sterling Strategic Bond Sector	1.12	-14.20
iBoxx Sterling Non-Gilts All Maturities Index	4.03	-19.11
RL Global Bond Opportunities Fund Z Inc	**-0.72**	**-10.45**
RL Investment Grade Short Dated Credit Fund Z Inc	**2.63**	**-9.35**
IA Sterling Corporate Bond Sector	3.74	-18.84
ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index	3.12	-8.21
RL Short Duration Credit Fund Z Inc	**1.85**	**-8.65**
IA Sterling Strategic Bond Sector	1.12	-14.20
ICE BofA ML 1-5 year Sterling Non-Gilt All Stocks Index	3.12	-8.21
RL Sterling Credit Fund Z Inc	**3.30**	**-18.99**
IA Sterling Corporate Bond Sector	3.74	-18.84
iBoxx Sterling Non-Gilts All Maturities Index	4.03	-19.11
RL Sterling Extra Yield Bond Fund A Inc	**0.39**	**-8.96**
RL Sterling Extra Yield Bond Fund B Inc	**0.35**	**-9.43**
RL Sterling Extra Yield Bond Fund Y Inc	**0.42**	**-8.56**
RL Sterling Extra Yield Bond Fund Z Inc	**0.41**	**-8.72**
IA Sterling Corporate Bond Sector	3.74	-18.84
IA Sterling High Yield Sector	1.93	-13.07
IA Sterling Strategic Bond Sector	1.12	-14.20

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.
SOURCE: RLAM AND FE, CORRECT AS OF 31 OCTOBER 2022. RETURNS QUOTED ARE NET OF FEES.
ALL IA SECTOR PERFORMANCE SHOWN IS FOR THE MEDIAN.
[1]PLEASE NOTE THAT THE BENCHMARK PRICING IS END-OF-DAY AND ENTAILS NO CURRENCY CONVERSION.

ROYAL LONDON ASSET MANAGEMENT

Credit Market Review

Market highlights – sterling investment grade credit

- After the volatility that hit the UK and European markets in late September, government bond markets were mixed in October as some order was restored and investors looked ahead to the central bank meetings early in November. Further interest rate rises at these meetings were priced into market levels although there was increasing expectation of a peak by the first half of 2023.
- The benchmark 10-year gilt yield decreased by 58 basis points (bps) to 3.52% over the month, with gilts returning 3.12% to investors (FTSE Actuaries) on an all-maturities basis. In comparison, sterling investment grade markets returned 4.03% (iBoxx). The average investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) narrowed by 14bps to 1.85%.
- Credit sector returns were positive across the board, but dispersions in return were wide. Healthcare, telecoms and retail were the strongest sectors, while subordinated financials (banks and insurance) also outperformed. Supranationals and covered bonds were the weakest sectors, with real estate and asset-backed securities also underperforming the broad market. Duration was positive as longer-dated bonds notably outperformed shorter-dated issues. The A and BBB ratings bands were the strongest, outperforming higher-rated issues: the sterling high yield index notably underperformed all the investment grade ratings bands.
- The LDI crisis and resultant selling of sterling investment grade credit caused exceptional market turmoil, so new issuance slipped to £1.0bn in October with only a handful of utility deals. Despite the sterling credit issues disrupting the market in the first part of the month, euro credit issuance was much healthier at €38bn – only slightly lower than for the comparable month in 2021. It was the second month in a row when non-financial supply outpaced financials.

Royal London Corporate Bond Fund

Portfolio commentary

- The fund underperformed its benchmark, the iBoxx Sterling Non-Gilts All Maturities Index, in October, but has marginally outperformed for the year to date.
- Bond yields fell sharply in October following the extreme volatility of the previous month. Performance was helped by the underweight in supranationals, which underperformed, and the overweight in subordinated banks and insurance. However, the structured sector lagged the October rally, reflecting its previous resilience and the reduced scope to bounce back. Overall, credit sector allocation was neutral with real estate and social housing also acting as a drag. The relative underperformance was mostly driven by negative stock selection, most noticeably in the structured sector. The fund's duration had a small positive effect, reflecting its long-duration position.
- New issuance activity was severely affected by the volatile market conditions. We participated in only two issues, both in the utility sector, buying bonds of **Northumbrian Water** and **Northern Ireland Electric**.
- Given the market conditions, secondary market activity was more limited. We took advantage of this to add to existing holdings, particularly in the subordinated financials (banks and insurance), social housing and structured sectors. Sales were limited and focused on bonds that had outperformed.

Investment outlook

- The announcement of the new Chancellor's plans was delayed from 31 October: a full Autumn Statement will now be delivered on 17 November with reports indicating that it will involve further tax increases and spending cuts. It is likely that there will continue to be a yield premium associated with UK government bonds following the reputational damage incurred in recent weeks. While inflation is expected to peak in coming months there remains considerable uncertainty about energy prices and wage pressures.
- Weaker GDP growth and recession in some areas will impact the corporate sector and we expect to see some increase in default rates. We will maintain focus on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.
- Despite this outlook, we believe that the current asset allocation in favour of sterling credit bonds is appropriate as the widening in credit spreads this year has taken valuations to very attractive levels, on both a relative basis compared to government bonds and in absolute terms. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. With 10-year gilts yielding over 3.5% and the credit spread at nearly 2%, the 'all-in yield' on sterling investment grade credit is at the most compelling level for years, particularly if inflation starts to fall as we expect. Although some further volatility is likely, our recent preference for short-dated credit bonds is gradually easing as we begin to take on more duration risk – albeit not at the ultra-long end of markets where all-in yields still look challenging.
- The fund has a material exposure to BBB bonds, but we believe that compensation for default risk remains most attractive in this rating band.

Key views within the fund

- Well diversified, with over 300 holdings, in order to improve overall portfolio liquidity and to reduce the effect on overall fund performance of any deterioration in the creditworthiness of an individual holding.
- A significant underweight in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- Duration in line with the benchmark.
- An overweight position in subordinated financial debt, where we believe yields are attractive.

- Orientated towards secured bonds in the asset-rich investment trust, property and social housing sectors, and towards structured bonds, which benefit from a claim on assets and cashflows.
- Environmental, social and governance (ESG) risk factors are fully integrated in the management of the portfolio. The WACI (weighted average carbon intensity) of the portfolio is below that of the index.

Shalin Shah
Senior Fund Manager

Matt Franklin
Fund Manager

Jonathan Platt
Head of Fixed Income

Royal London Ethical Bond Fund

Portfolio commentary

- Net of fees, the fund underperformed its benchmark, the iBoxx Sterling Non-Gilts All Maturities Index, in October, but has outperformed over one, three and five years.
- Bond yields fell sharply in October following the extreme volatility of the previous month. Performance was helped by the underweight in supranationals, which underperformed, and the overweight in subordinated banks and insurance. However, the structured sector lagged the October rally, reflecting its previous resilience and the reduced scope to bounce back. Overall, credit sector allocation was a small negative with real estate and social housing also acting as a drag. The relative underperformance was mostly driven by negative stock selection, most noticeably in the banks, structured, social housing, consumer services and general industrials sectors. The fund's duration had a positive effect, reflecting its moderately long-duration positioning compared to the benchmark.
- New issuance activity was severely affected by the volatile market conditions. We participated in only two issues, both in the utility sector, buying bonds of **Northumbrian Water** and **Northern Ireland Electric**.
- Given the volatile market conditions, secondary market activity was more limited. We took advantage of this to add to senior banks holdings, buying debt of **TP ICAP**, **BNP Paribas** and **3i**. Against these, we sold senior banks bonds of **Op Corporate Bank** and **DNB**, subordinated banks bonds of **HSBC**, senior insurance bonds of **New York Life** and covered bonds of **Clydesdale Bank**. Otherwise, we sold structured bonds of **Heathrow** and bought bonds of **Progress Health** that are secured against the new hospital in Peterborough, and bought social housing bonds of **Sunderland**, **Harbour Funding** and **Guinness Trust**.

Investment outlook

- The announcement of the new Chancellor's plans was delayed from 31 October: a full Autumn Statement will now be delivered on 17 November with reports indicating that it will involve further tax increases and spending cuts. It is likely that there will continue to be a yield premium associated with UK government bonds following the reputational damage incurred in recent weeks. While inflation is expected to peak in coming months there remains considerable uncertainty about energy prices and wage pressures.
- Weaker GDP growth and recession in some areas will impact the corporate sector and we expect to see some increase in default rates. We will maintain focus on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.
- Despite this outlook, we believe that the current asset allocation in favour of sterling credit bonds is appropriate as the widening in credit spreads this year has taken valuations to very attractive levels, on both a relative basis compared to government bonds and in absolute terms. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. With 10-year gilts yielding over 3.5% and the credit spread at nearly 2%, the 'all-in yield' on sterling investment grade credit is at the most compelling level for years, particularly if inflation starts to fall as we expect. Although some further volatility is likely, our recent preference for short-dated credit bonds is gradually easing as we begin to take on more duration risk – albeit not at the ultra-long end of markets where all-in yields still look challenging.
- The fund has a material exposure to BBB bonds, but we believe that compensation for default risk remains most attractive in this rating band.

Key views within the fund

- The fund is diversified in order to improve portfolio liquidity and to reduce the effect on overall performance of any deterioration in the creditworthiness of an individual holding.
- The fund has a significant underweight position in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- Duration broadly in line with the benchmark.

- The fund has an overweight position in subordinated financial debt, where we believe yields are attractive.
- The fund remains orientated towards secured bonds in the asset-rich property and social housing sectors, and towards structured bonds, which benefit from a claim on assets and cashflows.

CITYWIRE AA

Eric Holt
Senior Fund Manager

ROYAL LONDON
ASSET MANAGEMENT

Royal London Investment Grade Short Dated Credit

Portfolio commentary

- Net of fees, the fund underperformed its benchmark, the ICE BofAML 1-5yr Sterling Non-Gilt All Stocks Index, in October It has also underperformed over the rolling 12-month period, but strongly outperformed over three and five years.
- The overweight exposure to subordinated financial debt, substantial underweight in supranational bonds, and bias towards secured and structured issues remained the most noticeable features of sector positioning.
- Bond yields fell sharply in October following the extreme volatility of the previous month. Performance was helped by the underweight in supranationals, which underperformed, and the overweight in subordinated banks. However, the structured sector lagged the October rally, reflecting its previous resilience and the reduced scope to bounce back. Overall, credit sector allocation was slightly negative. The relative underperformance was mostly driven by negative stock selection, most noticeably in the banks, real estate, social housing and structured sectors. Duration had a small positive effect.
- New issuance activity was severely affected by the volatile market conditions. As a result, we didn't participate in any new issues in the month.
- We took advantage of the volatile market conditions in secondary markets to add to favoured sectors, particularly banks and insurance (both senior and subordinated debt) and structured. Sales were limited and mainly focused on bonds that had outperformed.

Investment outlook

- The announcement of the new Chancellor's plans was delayed from 31 October: a full Autumn Statement will now be delivered on 17 November with reports indicating that it will involve further tax increases and spending cuts. It is likely that there will continue to be a yield premium associated with UK government bonds following the reputational damage incurred in recent weeks. While inflation is expected to peak in coming months there remains considerable uncertainty about energy prices and wage pressures.
- Weaker GDP growth and recession in some areas will impact the corporate sector and we expect to see some increase in default rates. We will maintain focus on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.
- Despite this outlook, we believe that the current asset allocation in favour of sterling credit bonds is appropriate as the widening in credit spreads this year has taken valuations to very attractive levels, on both a relative basis compared to government bonds and in absolute terms. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. With 5-year gilts yielding just over 3.5%, the additional credit spread available on shorter-dated bonds looks attractive, particularly if inflation starts to fall as we expect.

Key views within the fund

- The fund is diversified, with almost 300 holdings, in order to improve general portfolio liquidity and to reduce the effect on overall performance of any deterioration in the creditworthiness of an individual holding.
- It has a minimal weighting in supranational bonds, as we expect corporate debt to outperform over the medium term.
- Fund duration is marginally longer than the benchmark.
- It has an overweight position in subordinated financial debt, where we believe yields are attractive.
- The fund remains orientated towards structured debt, which benefits from a claim on assets and cashflows; secured issues in the asset-rich property and social housing sectors; and covered bonds (i.e. senior bank debt benefiting from a first claim on a specified over-collateralised pool of assets).

CITYWIRE AA

Paola Binns
Head of Sterling Credit

Royal London Short Duration Credit Fund

Portfolio commentary

- Net of fees, the fund underperformed its benchmark, the ICE BofAML 1-5yr Sterling Non-Gilt All Stocks Index, in October. It has also underperformed over the rolling 12-month period, but strongly outperformed over three and five years.
- The overweight exposure to subordinated financial debt, substantial underweight in supranational bonds, and bias towards secured and structured issues remained the most noticeable features of sector positioning.
- Bond yields fell sharply in October following the extreme volatility of the previous month. Performance was helped by the underweight in supranationals, which underperformed, and the overweight in subordinated banks and insurance. However, the structured sector lagged the October rally, reflecting its previous resilience and the reduced scope to bounce back. Overall, credit sector allocation was broadly neutral with real estate also acting as a drag. The relative underperformance was mostly driven by negative stock selection, most noticeably in the banks, structured, insurance and consumer services sectors. Duration also had a negative effect.
- New issuance activity was severely affected by the volatile market conditions. As a result, we didn't participate in any new issues in the month.
- We took advantage of the volatile market conditions in secondary markets to add to favoured sectors, particularly banks and insurance (both senior and subordinated debt) and structured. Sales were limited and mainly focused on bonds that had outperformed.

Investment outlook

- The announcement of the new Chancellor's plans was delayed from 31 October: a full Autumn Statement will now be delivered on 17 November with reports indicating that it will involve further tax increases and spending cuts. It is likely that there will continue to be a yield premium associated with UK government bonds following the reputational damage incurred in recent weeks. While inflation is expected to peak in coming months there remains considerable uncertainty about energy prices and wage pressures.
- Weaker GDP growth and recession in some areas will impact the corporate sector and we expect to see some increase in default rates. We will maintain focus on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.
- Despite this outlook, we believe that the current asset allocation in favour of sterling credit bonds is appropriate as the widening in credit spreads this year has taken valuations to very attractive levels, on both a relative basis compared to government bonds and in absolute terms. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. With 5-year gilts yielding just over 3.5%, the additional credit spread available on shorter-dated bonds looks attractive, particularly if inflation starts to fall as we expect.

Key views within the fund

- The fund is diversified, with more than 300 holdings, in order to improve overall portfolio liquidity and to reduce the effect on overall performance of any deterioration in the creditworthiness of an individual exposure.
- The fund has a significant underweight in supranational bonds, as we expect corporate debt to outperform over the medium term.
- The fund's duration is marginally shorter than that of the benchmark.
- The fund has an overweight position in subordinated financial debt, where we believe yields are attractive.
- The fund remains orientated towards secured bonds in the asset-rich investment trust, property and social housing sectors, and towards structured issues, which benefit from a claim on assets and cashflows.

Paola Binns
Head of Sterling Credit

Royal London Sterling Credit Fund

Portfolio commentary

- Net of fees, the fund underperformed its benchmark, the iBoxx Sterling Non-Gilts All Maturities Index, in October, but has performed in line with the index on a rolling 12-month basis. It has significantly outperformed the index and peer group on a 3-year and 5-year basis.
- The overweight exposure to subordinated financial debt, substantial underweight in supranational bonds, and bias towards secured and structured issues remained the most noticeable features of sector positioning.
- Bond yields fell sharply in October following the extreme volatility of the previous month. Performance was helped by the underweight in supranationals, which underperformed, and the overweight in subordinated banks and insurance. However, the structured sector lagged the October rally, reflecting its previous resilience and the reduced scope to bounce back. Overall, credit sector allocation was broadly neutral with real estate and social housing also acting as a drag. The relative underperformance was mostly driven by negative stock selection, most noticeably in the banks and structured sectors. Duration also had a negative effect.
- New issuance activity was severely affected by the volatile market conditions. We participated in only two issues, both in the utility sector, buying bonds of **Northumbrian Water** and **Northern Ireland Electric**.
- Given the market conditions, secondary market activity was more limited. We took advantage of this to add to existing holdings, particularly in the subordinated financials (banks and insurance), social housing and structured sectors. Sales were limited and focused on bonds that had outperformed.

Investment outlook

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- Despite this outlook, we believe that the current asset allocation in favour of sterling credit bonds is appropriate as the widening in credit spreads this year has taken valuations to very attractive levels, on both a relative basis compared to government bonds and in absolute terms. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. With 10-year gilts yielding over 3.5% and the credit spread at nearly 2%, the 'all-in yield' on sterling investment grade credit is at the most compelling level for years, particularly if inflation starts to fall as we expect.
- The fund has a material exposure to BBB bonds, but we believe that compensation for default risk remains most attractive in this rating band.

Key views within the fund

- Well diversified, with around 350 holdings, in order to improve overall portfolio liquidity and to reduce the effect on overall performance of any deterioration in the creditworthiness of an individual holding.
- A significant underweight in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- Duration marginally longer than the benchmark at month end.
- Orientated towards subordinated financial debt, where we believe yields are attractive.
- The fund remains orientated towards secured bonds in the asset-rich investment trust, property and social housing sectors, and structured bonds, which benefit from a claim on assets and cashflows.

CITYWIRE AA

Paola Binns
Senior Fund Manager

Royal London Sterling Extra Yield Bond Fund

Portfolio commentary

- In October, the fund posted returns of 0.38%, 0.35%, 0.42% and 0.41% for the A, B, Y and Z class shares, respectively. These bring 2022 year-to-date returns to -8.86%, -9.25%, -8.53% and -8.67%, respectively, for these share classes.
- From any longer-term perspective, sterling bond markets remained extraordinarily volatile in October, even if less so than in the market turmoil in the immediate aftermath of the Truss/Kwarteng UK 'mini-Budget'. The 30-year gilt traded in a price range of 42 to 60 in October, so up over 40% from the low point – corresponding to a fall in yield from above 5% to below 3.5%. In contrast, the price range of 30-year US treasuries in the month was 77 to 88, a yield range of 3.7% to 4.4%; while for 30-year German government bonds, the price range was 49 to 57, giving a yield range of 1.9% to 2.4%. Over the month as a whole, the broad gilt index posted a return of 3.30%, reflecting some recovery from returns below -8% in each of the two prior months. Meanwhile, US treasuries and EU government bonds posted returns of -1.39% and 1.18% in October, reflecting more the continuing inflation pressure and corresponding higher short-term interest rates.
- Sterling investment grade bonds posted an index return of 4.53% in October, as with gilts reflecting some recovery from the two prior months' sharp declines and benefitting from a narrowing of the average yield differential over reference gilts from 1.95% to 1.84%, still sharply up from 1.62% at the end of August. European sub-investment grade bonds and global sub-investment grade bonds, less influenced by moves in government bond yields, posted returns of 1.67% and 1.84%, respectively. Year-to-date returns of these four indices – UK gilts, sterling investment grade bonds, European sub-investment grade bonds and global sub-investment grade bonds – remain very subdued, at -23.88%, -19.05%, -14.02% and -14.52%, respectively.
- In another volatile month, the two areas of consistent strong returns in October were financials – with holdings of banks **Barclays**, **Nordea** and **Standard Chartered**, and of insurers **Aviva**, **M&G**, **Phoenix** and **Zurich**, each up over 5% in price in the month – and longer-dated structured bonds such as **Punch** (pubs operator), **Road Management Services** (PFI infrastructure bond) and **Tesco Property** (backed by operation assets and lease obligations of retailer Tesco) which posted similar price performance in the month. Elsewhere in the portfolio, performance was much more mixed. Within energy and energy services, holdings of **BP**, **Jacktel**, **Norwegian Energy** and **ShaMaran** posted positive returns, while investments in **Aggregated Micro Power**, **Harbour Energy** and **IOG** were down in value. Similarly in industrials, investments **Metal Resources** and lead recycling business **EB Holdings** were down in price, while **Copper Mountain** posted a strong positive return.
- Activity in the month comprised of increasing the size of some holdings at the markedly higher yields prevailing after the sharp market setback in August and September. These included property group **Peel Holdings**, utility **Thames Water** and publishing business **Daily Mail & General Trust**, together with insurance companies **Esure** and **QBE,** and **HSBC.** Unusually, long-dated bonds in the social housing sector were purchased for the fund, namely **Swan Housing** 2048 bonds. The business had been involved in merger discussions with Orbit in order to mitigate some challenges in their development programme from cost overruns and delays related to Covid, but these discussions were terminated. Despite larger entity Sanctuary stepping in to take over in the merger process, Standard & Poor's downgraded the bonds to BB from BBB, triggering selling of the bonds. These secured bonds were purchased at a price about 55 and a yield about 8% – and rose in value by more than 10% by month-end, albeit primarily as a result of recovery in the gilt market. New issue investments included energy sector businesses **Bluewater** and **Enquest**, in each case as a refinancing of bonds held in the fund, at yields of over 14% and 12% respectively and increasing both income and yield for the fund. Additionally, bonds of resources business **Nordic Rutile**, financing the development of their titanium and garnet (the latter used in industrial waterjet cutting and sanding) mining operations, were bought at issue at a yield of 15% – reflecting the high cost of issuing relatively small, unrated, non-benchmark bonds in recent volatile market conditions. Sales in the month included the repayment of the **Bluewater** and **Enquest** mentioned above, alongside sales of bonds of **Skipton Building Society** and **Virgin Money**, together with redemption of bonds of transport business **Swedish APT** and offshore support services company **DOF Subsea**. Activity in the month in short-dated gilts reflected short-term cash management.

Investment outlook

- The announcement of the new Chancellor's plans was delayed from 31 October: a full Autumn Statement will now be delivered on 17 November with reports indicating that it will involve further tax increases and spending cuts. It is likely that there will continue to be a yield premium associated with UK government bonds following the reputational damage incurred in recent weeks. While inflation is expected to peak in coming months there remains considerable uncertainty about energy prices and wage pressures.

- Weaker GDP growth and recession in some areas will impact the corporate sector and we expect to see some increase in default rates. We will maintain focus on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.
- Despite this outlook, we believe that the current asset allocation in favour of sterling credit bonds is appropriate as the widening in credit spreads this year has taken valuations to very attractive levels, on both a relative basis compared to government bonds and in absolute terms. Credit spreads discount a significant portion of bad news, and investors are being paid well to take credit over government bond risk. With 10-year gilts yielding over 3.5% and the credit spread at nearly 2%, the 'all-in yield' on sterling investment grade credit is at the most compelling level for years, particularly if inflation starts to fall as we expect. Although some further volatility is likely, our recent preference for short-dated credit bonds is gradually easing as we begin to take on more duration risk – albeit not at the ultra-long end of markets where all-in yields still look challenging.
- The fund has a material exposure to BBB bonds, but we believe that compensation for default risk remains most attractive in this rating band.

Key views within the fund

- The fund's objective is to achieve a high level of income by seeking attractive investments across a broad spectrum of fixed income opportunities, encompassing investment grade, sub-investment grade and unrated bonds.
- The fund mitigates stock-specific risk by holding a diversified portfolio of investments, so that no individual investment can in isolation have an undue impact on overall performance. In addition, where possible within the yield objective of the fund, investments are focused on bonds where risk is mitigated by structure or a claim on assets or cashflows.

CITYWIRE A

Rachid Semaoune
Senior Fund Manager

CITYWIRE AA

Eric Holt
Senior Fund Manager

RLAM Government Bond Fund Performance

	1 month (%)	Rolling 12 Months (%)
RL Global Index Linked Bond Fund Z Inc	**1.20**	**-16.04**
IA Global Bonds Sector	1.19	-11.52
Barclays World Government Inflation-Linked Bond Index (hedged)	0.21	-16.86
RL Index Linked Bond Fund M Inc	**2.16**	**-31.54**
IA UK Index Linked Gilts Sector	2.26	-33.57
FTSE Actuaries UK Index-Linked All Stocks Index	-4.39	-32.23
RL Short Duration Gilt Fund Z Inc	**2.20**	**-3.80**
IA UK Gilts Sector	3.78	-22.59
FTSE Actuaries UK Conventional Gilts up to 5 Years Index	2.49	-4.51
RL Short Duration Global Index Linked Bond Fund Z Inc	**1.61**	**-4.42**
IA Global Bonds Sector	1.19	-11.52
RL Short Duration Global Index Linked Composite Benchmark[1,2]	1.66	-4.95
RL UK Government Bond Fund Z Inc	**4.01**	**-20.53**
IA UK Gilts Sector	3.78	-22.59
FTSE Actuaries UK Conventional Gilts All Stocks Index	3.12	-22.56

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ALL IA SECTOR PERFORMANCE SHOWN IS FOR THE MEDIAN.
1PLEASE NOTE THAT THE BENCHMARK IS PRICED END-OF-DAY.
2THE COMPOSITE BENCHMARK CONSISTS OF: 30% BLOOMBERG UK GOVERNMENT INFLATION LINKED BOND 1-10 YEAR INDEX, 70% BLOOMBERG WORLD GOVERNMENT INFLATION LINKED BOND (EX UK) 1-10 YEAR INDEX (GBP HEDGED).

Government Bond Market Review

Market highlights

- It was another volatile month in October, as gilts returned 3.12% to investors (FTSE Actuaries) on an all-maturities basis. The strong return was driven by the middle of the curve, which is a split from recent trends, with short-dated gilts typically doing the heavy lifting so far in 2022. The benchmark 10-year gilt closed the month at 3.52%, falling 58 basis points from 4.09% at the start of October, and pulled back from a high of 4.47% during the month.
- Front-end gilt yields fell, as investors kept a close eye on the UK government's continued attempts to unwind the proposals put forward at the maligned mini-Budget in September, and any secondary implications for monetary policy
- The new pairing in Downing Street of Prime Minister Rishi Sunak and Chancellor Jeremy Hunt looked to reassure markets that the UK was on a sustainable debt path – with the government indicating it will look to plug a £60 to £70 billion fiscal blackhole. Easing the pressure on short-term yields, market expectations for the Bank of England's (BoE) base rate lowered, as markets no longer fear the BoE will take rates above 6%, instead now pricing in about 4.5%.
- The European Central Bank (ECB) enacted its third successive rate hike, upping rates by 75 basis points – the largest in its history – taking base rates to 2%. Inflation in the eurozone remained stubbornly high, topping out at 9.9%, as the central bank looks to return inflation to its medium-term target of 2%.

Index linked bonds

- UK index-linked gilt returns were -4.39% on an all-maturities basis (FTSE Actuaries) in October, underperforming conventional gilts as breakeven (implied) inflation rates fell – the UK's 10-year breakeven rate fell by 46bps to 3.70%. The benchmark 10-year real yield fell by 14bps to -0.13%.
- The UK index-linked market underperformed the 0.25% return of the Barclays Global Index-linked Index. Real 10-year yields moved in similar directions, with 10-year real yields falling by 14bps to 1.53% in the US, and by 24bps to -0.22% in Germany – but breakevens rose by 36bps to 2.51% in the former and rose by 27bps to 2.36% in the latter.

Royal London Global Index Linked Bond Fund

Portfolio commentary

- Net of fund management fees, the fund returned 1.20% in October (M Inc share class), outperforming the benchmark returns of 0.21%, although this outperformance was due to timing differences between fund and benchmark. On an end of day basis, performance was broadly flat.
- After the volatility that hit the UK and European markets in late September, government bond markets were mixed in October as some order was restored and investors looked ahead to the central bank meetings early in November. Index-linked market performance was negative as the long end of the curve corrected following the rally seen in late September and early October after the Bank of England extended its gilt buying to include index linked bonds.
- Our short duration position was a modest positive after yields ended the month around 25bps higher – having been some 150bps higher before the reversal of government fiscal policy. We traded between 0.2 years short and 0.2 years long during the month, ending with a slight long position. However, yield curve positioning was negative given our flattening bias positive as curve steepened over the month. We reduced the scale of our overweight to 30-year linkers during the month, adding to the 15-year and 20-year areas that had underperformed. We also took our 2030 and 2035 positions from underweight back to neutral: these are old style eight-year lag bonds (phased out in 2005 for the now-standard three-month lag) and had underperformed as they were excluded from the Bank of England buyback programme.
- Cross-market activity was a modest positive over the month – although the spread on UK linkers relative to global equivalents was volatile, we were able to trade this tactically, notably adding 30-year US TIPS and 8-year Australian index linked bonds once spreads reverted to the levels seen before the mini-budget.

Investment outlook

- The UK has now unwound all of the mini-budget sell-off, as the changes of Chancellor and Prime Minister led to a government U-turn on fiscal policies and the risk of significantly higher base rates receded. However, markets remain very volatile and the new budget will be of key importance in November particularly for the course of monetary policy given persistently high inflation. The UK market has rallied on the assumption of a cut to the gilt issuance next year, but this ignores the fact that UK supply will still be at record levels post the financial crisis with quantitative tightening adding to market supply.
- The November budget will create a focal point for the market next month, but the DMO re-opening of the 2073 index linked gilt – the longest dated on the market – via syndication may also provide opportunities. In addition, there are two index events of note, as the 2027 linker drops out of the over five year index, while the 2022 linker is due to be redeemed and hence will drop out of the all-maturities index.
- Market volatility remains at elevated levels so we will continue to look for tactical opportunities, while generally sizing those positions smaller than normal to reflect that greater volatility. In our view, the UK market looks expensive again with real yields in the US now once again 170bps higher than the UK with Australia nearer 200bps. Following the budget we will look to increase cross market positions where attractive to the supply event and look for opportunities to sell longer dated breakevens.
- For 2023 we still expect base rates to rise as we see no early fall in breakevens and as such, we expect the heavy supply in the first quarter to push yields higher – back into positive territory – and hence the portfolio will retain a bias towards a short duration stance.

Key views within the fund

- The fund has a small long duration position on a tactical basis, with our bias still to be short given our view that yields will move higher over the next year.
- The fund holds a flattening bias via an underweight in 10-year bonds relative to 30-year bonds.
- The fund remains short the UK, with an overweight in global index linked markets, recently adding to the US, Australia, and France.

Paul Rayner
Head of Alpha Strategies

Gareth Hill
Fund Manager

Royal London Index Linked Bond Fund

Portfolio commentary

- Net of fund management fees, the fund returned 2.20% in October (M Acc share class), against benchmark returns of -4.39%. However, the comparison is distorted by the large moves seen in the benchmark on the last day of September. Across the two months as a whole (therefore eliminating the September month end distortion), the fund has outperformed by about 1%.
- After the volatility that hit the UK and European markets in late September, government bond markets were mixed in October as some order was restored and investors looked ahead to the central bank meetings early in November. Index-linked market performance was negative as the long end of the curve corrected following the rally seen in late September and early October after the Bank of England extended its gilt buying to include index linked bonds.
- On an underlying portfolio basis, the fund performed well over the month. Our short duration position was a modest positive after yields ended the month around 25bps higher – having been some 150bps higher before the reversal of government fiscal policy. We traded between 0.2 years short and 0.2 years long during the month, ending with a slight long position. Yield curve positioning was also helpful given our overweight at the front end of the curve as this steepened over the month. We reduced the scale of our overweight to 30-year linkers during the month, adding to the 15-year and 20-year areas that had underperformed. We also took our 2030 and 2035 positions from underweight back to neutral: these are old style eight-year lag bonds (phased out in 2005 for the now-standard three-month lag) and had underperformed as they were excluded from the Bank of England buyback programme.
- Cross-market activity was a modest positive over the month – although the spread on UK linkers relative to global equivalents was volatile, we were able to trade this tactically, notably adding 30-year US TIPS and 8-year Australian index linked bonds once spreads reverted to the levels seen before the mini-budget.
- Breakevens were also helpful. Prior to the 2051 auction, we sold breakevens at around 3.62, subsequently buying these back at the auction as breakevens cheapened. Credit was a small positive for performance given the move tighter in credit spreads.

Investment outlook

- The UK has now unwound all of the mini-budget sell-off, as the changes of Chancellor and Prime Minister led to a government U-turn on fiscal policies and the risk of significantly higher base rates receded. However, markets remain very volatile and the new budget will be of key importance in November particularly for the course of monetary policy given persistently high inflation. The UK market has rallied on the assumption of a cut to the gilt issuance next year, but this ignores the fact that UK supply will still be at record levels post the financial crisis with quantitative tightening adding to market supply.
- The November budget will create a focal point for the market next month, but the DMO re-opening of the 2073 index linked gilt – the longest dated on the market – via syndication may also provide opportunities. In addition, there are two index events of note, as the 2027 linker drops out of the over five year index, while the 2022 linker is due to be redeemed and hence will drop out of the all-maturities index.
- Market volatility remains at elevated levels so we will continue to look for tactical opportunities, while generally sizing those positions smaller than normal to reflect that greater volatility. In our view, the UK market looks expensive again with real yields in the US now once again 170bps higher than the UK with Australia nearer 200bps. Following the budget we will look to increase cross market positions where attractive to the supply event and look for opportunities to sell longer dated breakevens.
- For 2023 we still expect base rates to rise as we see no early fall in breakevens and as such, we expect the heavy supply in the first quarter to push yields higher – back into positive territory – and hence the portfolio will retain a bias towards a short duration stance.

Key views within the fund

- The fund has a small long duration position on a tactical basis, with our bias still to be short given our view that yields will move higher over the next year.
- The portfolio held a modest UK flattening bias via an underweight in 10- and 20-year bonds relative to 30-year bonds.
- The fund remains short the UK, with modest positions in global index linked markets, primarily Australia, France and the US.
- The portfolio has no breakevens although continues to find tactical opportunities in this area.
- The fund's exposure to highly rated sterling corporate bonds was maintained as we believe the attractive yields these offer more than compensate for the credit risk given our view that spreads discount a significant portion of bad news.

Paul Rayner
Head of Alpha Strategies

Ben Nicholl
Fund Manager

Royal London Short Duration Global Index Linked Bond Fund

Portfolio commentary

- Net of fund management fees, the fund returned 1.62% in October (M share class), performing in line with the benchmark returns of 1.66%. Although the fund looks broadly in line with benchmark, this is distorted by timing differences between fund and benchmark. On an end of day basis, fund performance was ahead of benchmark.
- After the volatility that hit the UK and European markets in late September, government bond markets were mixed in October as some order was restored and investors looked ahead to the central bank meetings early in November. Index-linked market performance was negative as the long end of the curve corrected following the rally seen in late September and early October after the Bank of England extended its gilt buying to include index linked bonds.
- On an underlying portfolio basis, the fund performed well over the month. Our short duration position was a modest positive after yields ended the month around 25bps higher – having been some 150bps higher before the reversal of government fiscal policy. We traded between 0.1 years short and 0.1 years long during the month, ending with a slight long position. Yield curve positioning was also helpful given our overweight at the front end of the curve as this steepened over the month.
- Cross-market activity was a modest positive over the month – although the spread on UK linkers relative to global equivalents was volatile, we were able to trade this tactically, notably adding 8-year Australian index linked bonds once spreads reverted to the levels seen before the mini-budget.

Investment outlook

- The UK has now unwound all of the mini-budget sell-off, as the changes of Chancellor and Prime Minister led to a government U-turn on fiscal policies and the risk of significantly higher base rates receded. However, markets remain very volatile and the new budget will be of key importance in November particularly for the course of monetary policy given persistently high inflation. The UK market has rallied on the assumption of a cut to the gilt issuance next year, but this ignores the fact that UK supply will still be at record levels post the financial crisis with quantitative tightening adding to market supply.
- The November budget will create a focal point for the market next month, but the DMO re-opening of the 2073 index linked gilt – the longest dated on the market – via syndication may also provide opportunities. In addition, there are two index events of note, as the 2027 linker drops out of the over five year index, while the 2022 linker is due to be redeemed and hence will drop out of the all-maturities index.
- Market volatility remains at elevated levels so we will continue to look for tactical opportunities, while generally sizing those positions smaller than normal to reflect that greater volatility. In our view, the UK market looks expensive again with real yields in the US now once again 170bps higher than the UK with Australia nearer 200bps. Following the budget we will look to increase cross market positions where attractive to the supply event and look for opportunities to sell longer dated breakevens.
- For 2023 we still expect base rates to rise as we see no early fall in breakevens and as such, we expect the heavy supply in the first quarter to push yields higher – back into positive territory – and hence the portfolio will retain a bias towards a short duration stance.

Key views within the fund

- The fund has a small long duration position on a tactical basis, with our bias still to be short given our view that yields will move higher over the next year.
- The fund remains short the UK, with an overweight in global index linked markets, recently adding to Australia and France

CITYWIRE +

Paul Rayner
Head of Alpha Strategies

CITYWIRE +

Gareth Hill
Fund Manager

Royal London Short Duration Gilt Fund

Portfolio commentary

- Gross of fund management fees, the fund returned 2.21% in October (M Acc share class), underperforming the benchmark returns of 2.49%.
- The fund's duration relative to the benchmark was -0.2 years short during the period, expressed via an underweight in 5-year gilts. We also had a curve steepening position, based on our overweight 2-year gilts versus an underweight in 5-year gilts, which added to performance over the month.
- Cross market exposure was mixed over the month. We added a position in very short-dated US treasuries, after these had underperformed equivalent gilts. However the spread continued to widen, and the trade detracted from performance.
- The fund held no exposure to UK inflation markets in the period.
- The fund's highly rated sterling credit holdings, focused on investment grade quality credits, had little performance impact in the period.

Investment outlook

- The perception of the third quarter was skewed by the market reaction to the mini-budget. Beyond this, we expect to see the trends of 2022 continuing for the rest of the year. Inflation is continuing to rise in the UK, reflecting higher raw material costs, energy price increases and tight labour markets. However, The Bank of England has been raising interest rates all year, and there are signs that this is starting to impact demand. It is likely inflation will peak at some point during Q4, but the key for central banks will be where inflation settles, and that remains a big unknown for markets.

Key views within the fund

- The portfolio's duration is shorter than the benchmark, including the impact of cash holdings on duration.
- The fund holds a small cross-market exposure in the US and will continue to look for opportunities to take such positions on a relative basis.
- The portfolio has allocations to high quality corporate bonds, which we expect to outperform gilts.
- The portfolio may look to tactically trade index-linked gilts to take advantage of mispricing opportunities, but had no exposure to UK inflation at the end of the month.

CITYWIRE AA

Craig Inches
Head of Rates and Cash

CITYWIRE AA

Ben Nicholl
Fund Manager

Royal London UK Government Bond Fund

Portfolio commentary

- Gross of fund management fees, the fund returned 4.01% in October (M Acc share class), outperforming the benchmark returns of 3.12%.
- The fund's relative duration short had little impact on performance over the month – we were generally only marginally short during the month as the market rebounded after September's sell-off.
- The fund's curve steepening bias was the main driver of returns in October. We had a long 30s / short 50s positioning and benefited as this section of the curve steepened over the month.
- Cross market exposure was a small negative over the month. We held a position in 30-year US treasuries, which underperformed equivalent gilts. However, we largely mitigated this effect through tactical trading of the position, reducing the scale of the position following gilt weakness early in the month, and then re-establishing the position following the Sunak / Hunt rally.
- The fund held no inflation exposure over the month.
- The fund's highly rated sterling credit holding had little impact on performance during the period.

Investment outlook

- The perception of the third quarter was skewed by the market reaction to the mini-budget. Beyond this, we expect to see the trends of 2022 continuing for the rest of the year. Inflation is continuing to rise in the UK, reflecting higher raw material costs, energy price increases and tight labour markets. However, The Bank of England has been raising interest rates all year, and there are signs that this is starting to impact demand. It is likely inflation will peak at some point during Q4, but the key for central banks will be where inflation settles, and that remains a big unknown for markets.

Key views within the fund

- The portfolio's duration is around -0.2 years short of the benchmark, including the impact of cash holdings on duration.
- The fund retains an exposure to steepening at the ultra long end of the curve.
- The fund has overseas exposure, mainly in dollar markets, and we continue to look for opportunities to take such positions on a relative basis.
- The portfolio has allocations to high quality corporate bonds which provide additional yield for the portfolio.

CITYWIRE AA

Craig Inches
Head of Rates and Cash

MORNINGSTAR Bronze

CITYWIRE AA

Ben Nicholl
Fund Manager

RLAM Global High Yield Fund Performance

	1 month (%)	Rolling 12 Months (%)
RL Global High Yield Bond Fund M Inc	**1.75**	**-16.28**
RL Global High Yield Bond Fund Z Inc	**1.78**	**-16.06**
IA Sterling High Yield Sector	1.93	-13.07
ICE BofA ML BB-B Global Non-Financial High Yield Constrained Index	1.96	-14.65
RL Short Duration Global High Yield Bond Fund A Inc	**2.52**	**-4.89**
RL Short Duration Global High Yield Bond Fund M Inc	**2.55**	**-4.51**
RL Short Duration Global High Yield Bond Fund Z Inc	**2.57**	**-4.39**
IA Sterling High Yield Sector	1.93	-13.07
Sterling Overnight Index Average Rate (SONIA)[1]	0.18	0.90

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SOURCE: RLAM AND FE, CORRECT AS OF 31 OCTOBER. RETURNS QUOTED ARE NET OF FEES.
ALL IA SECTOR PERFORMANCE SHOWN IS FOR THE MEDIAN.
[1] BENCHMARK: SONIA. PLEASE NOTE THAT THIS CHANGED FROM 3-MONTH LIBOR, EFFECTIVE 15 DECEMBER 2020, AND IS REFLECTED IN THE RETURNS SHOWN ABOVE.

Royal London Global High Yield Bond Fund

Portfolio commentary

- The fund (Z class) returned 1.78%, net of fees, in October, compared with 1.96% for the ICE BofA Merrill Lynch BB-B Global Non-Financial High Yield Constrained Index (100% GBP hedged). For the rolling 12-month period, the fund has returned -16.06% compared to -14.65% for the index.
- Global high yield spreads (BB-B index) were 62 basis points (bps) tighter on the month at 479bps and the government yield curve increased by 17bps, leading to a monthly return of +1.96%. Price and income returns were 1.54% and 0.50%, respectively. After the volatility that hit the UK and European markets in late September, government bond markets were mixed in October as some order was restored and investors looked ahead to the central bank meetings early in November. Further interest rate rises at these meetings were priced into market levels although there was increasing expectation of a peak by the first half of 2023.
- The high yield market is now yielding 8.57% (yield-to-worst) with duration of 4.2 years. The fund yield stood at 10.92%, excluding the impact of cash, and its duration (3.8 years) was lower than for the index.
- Returns from index sectors were nearly all positive for the month. The dispersion of returns was relatively narrow – with most sectors showing similar gains with the exception of real estate, which materially underperformed the wider market and delivered the only negative sector return. Other than emerging markets, all regions saw positive returns, with the UK otherwise outperforming the US and Europe. Single B rated credit outperformed BB rated, although the strongest part of the market was the CCC and below band. Longer-dated bonds outperformed their shorter-dated peers.
- The US default rate was unchanged in October at 0.01% – however, we expect an increase in defaults in the months to come as the global economy slows and particularly if the US slips into recession.
- As with prior months, new issuance was scarce, well below run-rate levels seen in 2020 and 2021.

*YIELD-TO-WORST REFERS TO THE REDEMPTION DATE THAT PRODUCES THE LOWEST RETURN.

Investment outlook

- We turned more defensive in March to navigate the remainder of 2022, de-risking our funds by reducing duration and increasing security. While the near term is relatively unthreatening and yields are undoubtedly attractive, the outlook for interest rates and economic growth remains unclear heading into 2023 and we will retain a defensive mindset until the prognosis for inflation is clearer.
- Following three quarters of weakness in government bond markets and negative returns, the high yield market is now pricing in a severe recession and we believe therefore offers excellent value. With spreads at over 559bps at the end of October, the implied five-year cumulative default rate is 26%. 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. So, while defaults are currently at record lows, the high yield market is discounting a major recession and commensurate level of defaults.
- Yet this 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. We believe that the future default cycle is unlikely to be as negative as prior cycles because the market composition has improved: the highest risk CCC rating band now only represents 9% of the market, compared to 17% in 2007; meanwhile, the BB rated band now accounts for 60% of the market. In addition, following the bumper issuance of 2020 and 2021 (and the strength of the energy sector in 2021 and the first half of 2022), most issuers are in a stronger position than normal at this stage of a cycle and default and recovery expectations remain extremely benign.
- While these figures are compelling, we don't feel that a higher-risk strategy is necessary. With yields at current levels and appealing potential returns, we will be paid sufficiently for maintaining a lower-risk position 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. The way through difficult markets is to focus on those risks that you can control and know what you own. We will keep 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.

Key views within the fund

- The fund's objective is to achieve a combination of capital growth and income. The fund seeks to achieve its investment objective by outperforming its benchmark, the BofA Merrill Lynch BB-B Global Non-Financial High Yield Constrained index, 100% hedged to sterling, by 1% per annum over rolling three-year periods.
- The fund seeks to mitigate stock-specific risk by holding a diversified portfolio of investments, so that no individual investment can, in isolation, have an excessive adverse impact on overall fund performance. Currency risk associated with holdings of bonds is hedged through the use of forward currency transactions.
- We expect market volatility to continue due to market expectations surrounding Federal Reserve monetary policy. As such, we believe bonds with near-term catalysts, which mitigate market risk, are an important attribute underpinning investment performance over the medium term. We also expect ongoing volatility until there is a resolution of the conflict in Ukraine – this also has significant implications for the global economy, particularly if ongoing higher energy prices and supply chain disruption exacerbate a global economic slowdown.

Azhar Hussain
Head of Global Credit

Stephen Tapley
Global Credit Fund Manager

Royal London Short Duration Global High Yield Bond Fund

Portfolio commentary

- Net of fees, the fund (Z class) returned 2.57% in October, compared with 0.18% for SONIA.
- The fund's expected FX-adjusted yield decreased by 157 basis points to 8.39% with an expected duration of 1.77 years.
- Global high yield spreads (BB-B index) were 62 basis points (bps) tighter on the month at 479bps and the government yield curve increased by 17bps, leading to a monthly return of +1.96%. Price and income returns were 1.54% and 0.50%, respectively. After the volatility that hit the UK and European markets in late September, government bond markets were mixed in October as some order was restored and investors looked ahead to the central bank meetings early in November. Further interest rate rises at these meetings were priced into market levels although there was increasing expectation of a peak by the first half of 2023. The high yield market is now yielding 8.57% (yield-to-worst) with duration of 4.2 years.
- Returns from index sectors were nearly all positive for the month. The dispersion of returns was relatively narrow – with most sectors showing similar gains with the exception of real estate, which materially underperformed the wider market and delivered the only negative sector return. Other than emerging markets, all regions saw positive returns, with the UK otherwise outperforming the US and Europe. Single B rated credit outperformed BB rated, although the strongest part of the market was the CCC and below band. Longer-dated bonds outperformed their shorter-dated peers.
- The US default rate was unchanged in October at 0.01% – however, we expect an increase in defaults in the months to come as the global economy slows and particularly if the US slips into recession.
- As with prior months, new issuance was scarce, well below run-rate levels seen in 2020 and 2021.

Investment outlook

- The outlook for interest rates and economic growth remains unclear heading into 2023 and we will retain a defensive mindset until the prognosis for inflation is clearer.
- Following three quarters of weakness in government bond markets and negative returns, the high yield market is now pricing in a severe recession and we believe therefore offers excellent value. With spreads at over 559bps at the end of October, the implied five-year cumulative default rate is 26%. 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. So, while defaults are currently at record lows, the high yield market is discounting a major recession and commensurate level of defaults.
- Yet this 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. We believe that the future default cycle is unlikely to be as negative as prior cycles because the market composition has improved: the highest risk CCC rating band now only represents 9% of the market, compared to 17% in 2007; meanwhile, the BB rated band now accounts for 60% of the market. In addition, following the bumper issuance of 2020 and 2021 (and the strength of the energy sector in 2021 and the first half of 2022), most issuers are in a stronger position than normal at this stage of a cycle and default and recovery expectations remain extremely benign.
- For the RL Short Duration Global High Yield Fund, the current FX-adjusted expected yield is 8.39% at the end of October. All things being equal, an annual default rate of 14.0% (with 60% losses) would be required for an implied zero total return, at the current fund yield. This scenario is far in excess of both our own and market default expectations. It would equate to over a quarter of the fund defaulting over the next two years. It is worth recalling that the fund has never had any credit losses from defaults since inception.
- With yields at current levels and appealing potential returns, we will be paid sufficiently for maintaining a lower-risk position for at least another quarter until there is more clarity about the outlook. In keeping with the core focus of the strategy, we will keep 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 and we continue to favour companies with contracted revenues. With regards to geography, our global outlook provides diversification away from country-specific risks.

Key views within the fund

- The fund's objective is to provide income. The manager seeks to achieve this by outperforming the benchmark, SONIA, by 2% per annum over rolling three-year periods.
- The fund is diversified in order to improve overall portfolio liquidity and to reduce the effect on overall fund performance of any deterioration in the creditworthiness of an individual holding.

- We expect market volatility to continue due to market expectations surrounding Federal Reserve monetary policy. As such, we believe bonds with near-term catalysts, which mitigate market risk, are an important attribute underpinning investment performance over the medium term. We also expect ongoing volatility until there is a resolution of the conflict in Ukraine – this also has significant implications for the global economy, particularly if higher energy prices and supply chain disruption exacerbate a global economic slowdown.

Azhar Hussain
Head of Global Credit

Stephen Tapley
Global Credit Fund Manager

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