Royal London High Yield & Multi Asset Credit Strategies

Quarterly Report 30 September 2022

Market overview

- The macroeconomic factors that disrupted financial markets in the first half of 2022 continued to dominate in the third quarter – higher-than-expected inflation and interest rate increases were the key influences, along with growing fears of a recession in the US, Europe and the UK. Inflation first surfaced in the aftermath of the Covid-19 pandemic, but was exacerbated by the Russian invasion of Ukraine in February and retaliatory sanctions that sharply increased the prices of oil & gas and other commodities. Although they have fallen back slightly, energy prices remain high and geopolitical events continue to affect sentiment as winter approaches. The apparent sabotage of the Nord Stream gas pipelines from Russia to Germany suggests that energy will remain a key pawn in relations between NATO countries and Russia.
- Central banks have responded to the continued strength of inflation by further tightening monetary policy and reiterating that they will do whatever it takes to suppress rising prices. The Federal Reserve (Fed) led the way, increasing rates by 1.50% over the quarter. It has raised rates five times since March by 3% in aggregate – the 0.75% increases in June, July and September were the biggest individual increases for nearly 30 years. Its commitment to do more has led markets to price in further hikes in 2022. The European Central Bank (ECB) has so far been slower to react, partly due to a more fragmented backdrop with a gap between Germany and 'peripheral' economies. However, it ended its bond-buying programme in July and increased rates by 0.75% (its first hike for 11 years and a bigger increase than the 0.50% expected by economists). A further increase of 0.75% followed in September with a clear commitment of further increases to follow. The Bank of England (BoE) increased rates by 1.00% over the quarter to 2.25%, taking its tally to six increases so far in 2022 and seven in this cycle.
- The UK gilt market was the worst performing major government bond market over the quarter, returning -12.85% as the benchmark 10-year gilt yield rose by 129 basis points (bps) to 4.09%. However, all major government bond markets were impacted as the ongoing interest rate rises and hawkish commentary from central banks drove bond yields higher globally (prices move inversely to yields): the 10-year US treasury yield rose by 82bps to 3.83%; and the 10-year German bund yield rose by 77bps to 2.11%. Longer-dated bonds performed worst in the period due to their greater sensitivity to interest rates (duration risk).
- Currency movements also had a notable impact in the quarter. The Fed's more aggressive approach to raising interest rates compared to other central banks pushed the dollar higher and it was again the strongest major currency: it appreciated by over 6% against the yen and euro, and over 8% against sterling. Sterling's weakness benefits sterling investors in overseas assets as it boosts the returns over the quarter. However, these movements will impact global trade over coming months, and dollar strength will also be a risk for emerging markets countries and companies that have borrowed in dollars.
- After a particularly difficult first half of 2022, in which the high yield market fell over 15%, with such generous 'all-in yields' and the boost for sterling investors in global high yield from currency movements, the third quarter was less challenging than it was for government bonds and sterling investment grade credit. The high yield spread actually tightened from 573bps to 540bps, although the weakness in the underlying treasury bonds increased the yield on our benchmark (the ICE BofAML (BB-B) Global Non-Financial High Yield Index) to 9.1%. Although high yield issuance picked up slightly in the third quarter having more-or-less dried up since January, the adverse market conditions continued to impair new issuance and largely confined activity to the dollar market.
- The yield on the broad high yield index (including CCC rated bonds) rose to 10% over the third quarter. At this level, around half the market could default over a five-year period and, assuming normal rates of recovery, investors would make more than the risk-free rate. However, having moved to a firmly defensive stance in March as inflation pushed up interest rates, we maintain a broadly cautious stance even though yields look particularly attractive. At these levels, there is no need to take unnecessary risks and there are still a number of challenges with the macroeconomic environment. Given the asymmetry of risks in credit investing, it doesn't pay to take excessive risks when heading into periods of more negative sentiment: we will keep our powder dry until there is more clarity about the overall outlook.
- By the end of 2022, monetary policy will be very tight and the global economy (as well as key areas such as housing) will be slowing sharply – as a result, we believe that there will definitely be a recession in the US, Europe and the UK (particularly with the impact of higher energy prices and possible rolling power cuts in the latter two economies). The outlook and timing may differ between regions, however, and there is still significant interest-rate risk in the US. Inflation remains embedded, and Fed Chair Powell has more freedom to act and put up rates as there is less political blowback, even with the mid-term elections approaching. In contrast, the UK feels more fragile and the BoE is more constrained by the specific dynamics of the UK housing market.

Portfolio commentary

RL Global High Yield:

- The fund underperformed its ICE BofAML (BB-B) Global Non-Financial High Yield Index benchmark. Regional weightings had a significant impact in the quarter with our overweight UK exposure and underweight US exposure detracting significantly.

- While at very low levels, there was still some new issuance in the period. However, we continued to be very selective, passing on companies with weak business models or poor fundamentals, and preferred to build up a cash buffer in the expectation of better quality new issues in the future.
- Over the quarter we reduced our off-benchmark exposure to term loans due to their strong year-to-date outperformance in names such as **Refresco**, **Carnival**, **Tekni-plex** and **Voyage Care**. We also sold our entire position in **Pemex** after adoption of a new stricter ESGC (environmental, social, governance and cultural) policy. We used the July rally to reduce our **Altice USA** exposure as the bonds rallied on asset sale rumours. We mainly used the cash raised to fund currency hedges, which were a use of cash after the strong dollar rally in the period.
- At quarter end, the yield on the fund was 10.86% (11.18% on an FX-adjusted basis), excluding the impact of cash, with a duration of 3.84 years, compared to the yield-to-worst* on the benchmark, which ended the quarter at 9.00%.

Short Duration Global High Yield:

- The fund performed strongly over the quarter relative to its all-maturities peer group and matched its Sterling Overnight Index Average Rate (SONIA) benchmark. The performance compared to other high yield funds was due to the shorter duration than its peers and its overweight position in the US.
- We took a cautious approach for the quarter, in keeping with this defensive strategy. Our focus was on keeping duration short by not reinvesting proceeds from redemptions, thus building up cash balances through this period of volatility.
- We still find the global high yield curve technically very interesting and the front end notably cheap. Over the course of the third quarter, we lost some names to redemptions (**Arqiva**, **IGT** and **Refresco**), reduced position sizing (**Community Health**, **iHeartMedia**, **Multi-Color Corporation** and **Level 3**) and exited our **Altice France** bonds on the grounds of extension risk. We utilised some of our cash to fund currency hedges and ended the quarter with a significant cash balance due to our defensive stance of not reinvesting proceeds during periods of volatility.
- At quarter end, the expected yield on the fund was 9.75% (9.96% on an FX-adjusted basis), excluding the impact of cash, with an expected maturity of 2.06 years, compared to the yield-to-worst* on the broader high yield market, which ended the quarter at 9.00%.

Multi Asset Credit:

- The fund underperformed its Sterling Overnight Index Average Rate (SONIA) benchmark due to the weakness in global bond markets, but outperformed its peer group (Lipper Global Bond GBP). It was flat versus its 50/50 Global High Yield/Loans reference index over the quarter, with strong gains in July and August that reversed in September.
- The fund's allocations to loans and collateralised loan obligations (CLOs) drove volatility, with these buckets performing strongly in the first two months of the quarter before reversing in September. As credit markets weakened in September, CLOs in particular underperformed materially due to technical pressure across ABS markets. As market sentiment and the outlook for the economy softened, we reduced the exposure to lower-rated credit in favour of higher quality B and BB credits. Asset class-wise, exposure to senior secured and short duration high yield was also increased with the aim of mitigating the impact of an economic slowdown and rising credit concerns.
- European credit also underperformed against the US and the fund's oversized exposure here led to underperformance. This was partially mitigated by its US credit holdings, which performed better on a relative basis, while low exposure to emerging markets enabled the fund to avoid the credit market sell-off in China and the wider Asia region. Exposure to CLOs negatively impacted performance this quarter as inflation concerns led to uncertainty about economic growth. CLO market technicals also hurt performance, including the negligible new issuance in the asset class.
- While at very low levels (particularly compared to expectations), there was still some new issuance in the period. However, we continued to be very selective, passing on companies with weak business models or poor fundamentals, and preferred to build up a cash buffer in the expectation of better quality new issues in the future.
- Over the quarter we reduced our loan exposure, selling names such as **Adevinta**, **Medline** and **Sivantos** and reducing **APX Group**, **Mauser Packaging Solutions**, **BB Hotels** and **Univision** – replacing these with low cash-priced, high quality BB bonds (**Ashtead**, **Ball**, **Broadcom**, **Centene**, **Catalent**, **Charter Communications**, **T-Mobile USA** and **United Rentals**).

- At quarter end, the yield on the fund was 9.87% (10.81% on an FX-adjusted basis), excluding the impact of cash, with a duration of 2.24 years.

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 619bps at the end of September, the implied five-year cumulative default rate is 31%. 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.

Outlook – Short Duration Global High Yield:

- 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.
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- For the RL Short Duration Global High Yield Fund, the current FX-adjusted expected yield is 9.96% at the end of September. All things being equal, an annual default rate of 16.6% (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 a third of the fund defaulting over the next two years, or half of the fund defaulting over the next three 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 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.

Find out more

- We are experiencing unprecedented challenges in financial markets and the global economy with unsustainable energy prices, inflation at a multi-decade high and rising interest rates. Following the turbulence in fixed income and currency markets in late September, we hosted a webinar for Jonathan and our Head of Rates and Cash Craig Inches to discuss how the current situation and how central banks and policymakers might react. You can listen back to the webinar via the *Our Views* section of rlam.com.

Additional information

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

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