# Royal London International Government Bond Fund

## Quarterly Report 30 September 2022

## Asset split

| | Fund (%) | Benchmark[1] (%) |
|---|---|---|
| Conventional credit bonds[2] | 0.0 | 0.0 |
| Index linked credit bonds | 0.0 | 0.0 |
| Sterling conventional gilts | 1.9 | 0.0 |
| Sterling index linked gilts | 0.0 | 0.0 |
| Foreign conventional sovereign | 91.8 | 100.0 |
| Foreign index linked sovereign | 6.3 | 0.0 |
| Derivatives | 0.0 | 0.0 |
| Other | 0.0 | 0.0 |

## Fund data

| | Fund | Benchmark[1] |
|---|---|---|
| Duration[3] | 6.7 years | 6.9 years |
| Gross redemption yield [4] | 2.98% | 3.07% |
| No. of stocks | 105 | 968 |
| Fund size | £616.4m | - |

*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 (%) |
|---|---|---|---|
| **Q3 2022** | **-2.39** | **-3.58** | **1.19** |
| Year-to-date | -9.68 | -11.78 | 2.10 |
| Rolling 12 months | -9.42 | -11.78 | 2.36 |
| 3 years p.a. | -2.36 | -3.60 | 1.24 |
| 5 years p.a. | 0.24 | -0.49 | 0.74 |
| 10 years p.a. | 1.56 | 1.21 | 0.35 |
| Since inception p.a. 0.11.2011 | 1.83 | 1.56 | 0.27 |

***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.***

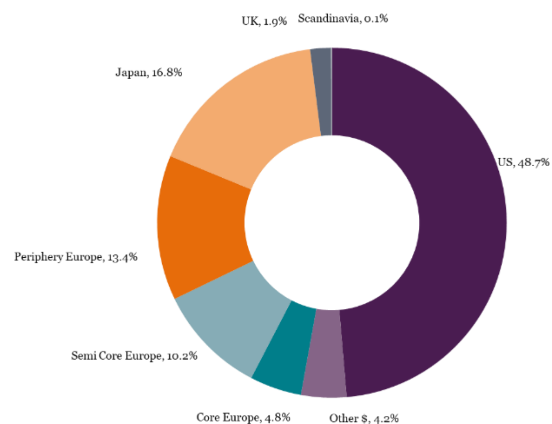
*All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment. The impact of fees reduces your return.*
*Source: RLAM, based on the M share 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.*

ROYAL LONDON
ASSET MANAGEMENT

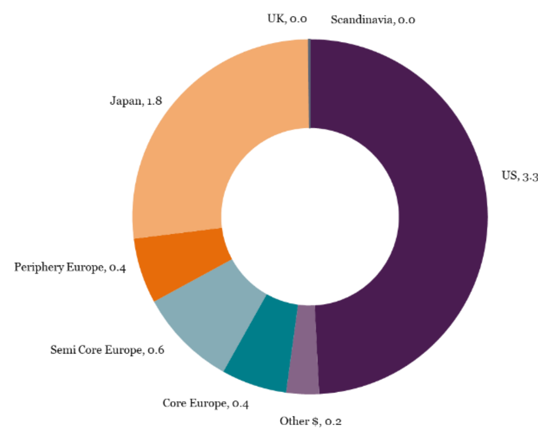
## Ten Largest Holdings

| | Weighting (%) |
|---|---|
| US Treasury 2.375% 2029 | 4.6 |
| Italy (govt Of) 0.95% 2023 | 4.6 |
| French (rep Of) 0% 2023 | 4.1 |
| Japan Govt 0.1% IL 2026 | 3.5 |
| US Treasury 0.75% 2026 | 3.2 |
| US Treasury 2.25% 2024 | 3.2 |
| US Treasury 0.375% 2024 | 2.9 |
| Italy Buoni Poliennali Del Teso 1.4% IL 2025 | 2.8 |
| US Treasury 0.625% 2026 | 2.5 |
| US Treasury 2.125% 2024 | 2.4 |
| **Total** | **33.6** |

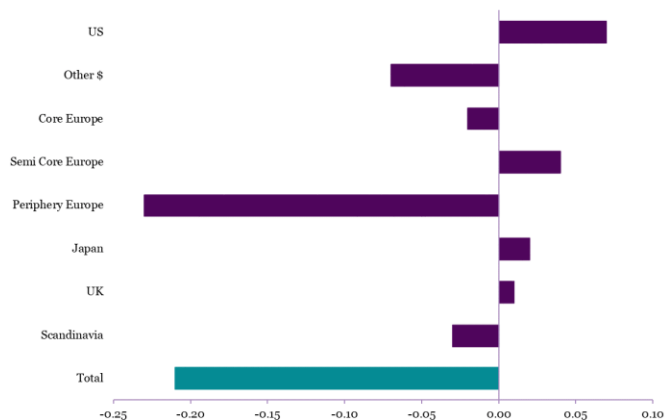
## Geographic split by percentage



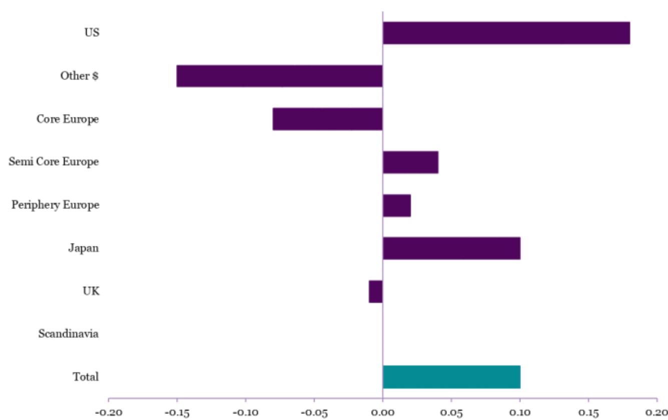

## Geographic split by duration




## Current position (by duration)

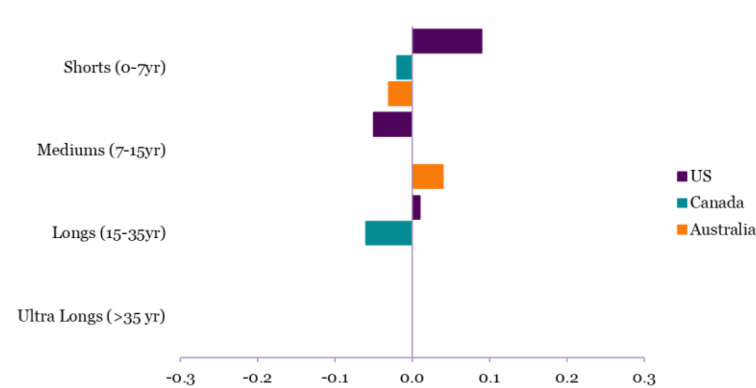



## Change on quarter by duration

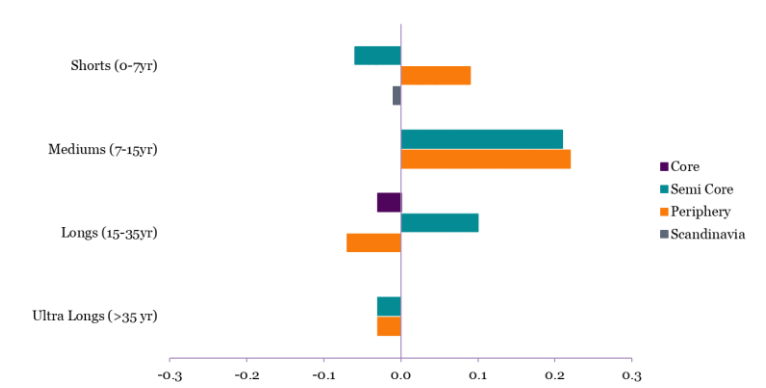


## Yield curve

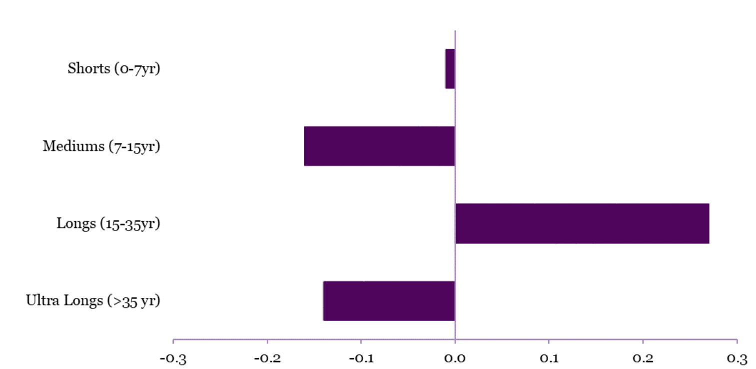
### Dollar bloc



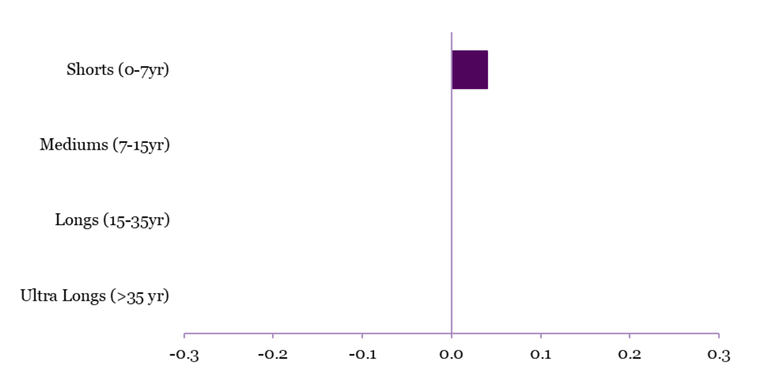

### Euro bloc



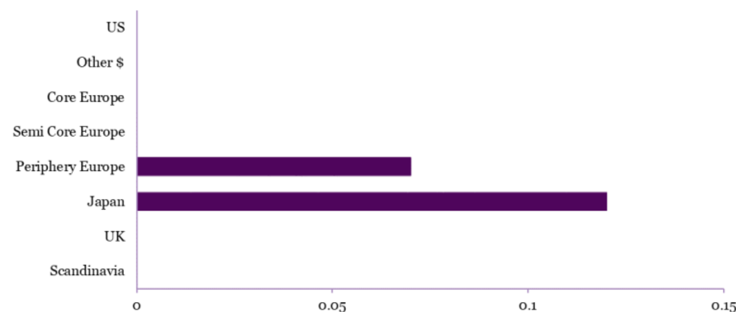

### Japan




### UK




## Inflation breakeven




## Market Overview

- 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 macroeconomic influences, along with growing fears of recession in the UK, Europe and the US. 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 which 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

Nordstream 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 US Federal Reserve (Fed) led the way, increasing rates by 1.50% over the quarter. Since March, the Fed has raised rates five times by an aggregate of 3% - its 0.75% increases in June, July and September were the biggest 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, ended its bond buying programme in July and increased rates by 0.75% (it's first increase in 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 also the worst performing major conventional government bond market over the quarter, delivering a return of -12.85% as the benchmark 10-year gilt yield rose by 186 basis points (bps) from 2.23% 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). In the UK, for example, gilts with five years to maturity or less provided negative returns of just -4.93%, whereas the 15 years or more to maturity segment returned -18.77%.
- The index linked space was also volatile. Real yields swung wildly – in the UK, 30-year real yields started the quarter at -0.71%, reached a high of 1.92% on 27th September, and then rallied to end the quarter at 0.04%. These are extraordinary moves for a risk-free asset and reflected the combination of global pressures on inflation and interest rates, but exacerbated by the mini-budget and subsequent sacking of the Chancellor. Real yields on 10-year bonds showed a similar story – in the UK, yields moved within a range of nearly 2% over the quarter, while in the US and Germany, equivalent bonds moved in a range of 1%. UK 10-year breakevens rose by 47bps to 4.17% in the quarter, while US and German 10-year breakevens were calmer, the German 10-year breakeven rosing just 6bps to 2.09%, while the US equivalent fell 19bps to end at 2.15%.
- The price of Brent crude oil fell by 16.9%, but remains over $90 a barrel, and copper futures fell by another 8.0% in dollar terms on fears of a slowdown in China and global recession. Currency movements had a notable impact in the quarter, following the volatility in the first half of the year. The US Federal Reserve's more aggressive approach to raising interest rates compared to other central banks has pushed the dollar higher. It was again the strongest major currency: it appreciated by over 6% against the yen and euro, and over 8% against sterling. These movements will impact global trade over coming months, and dollar strength will also be a risk for any emerging markets countries and companies that have borrowed in dollars.

## Portfolio commentary

- The fund produced negative returns over the quarter, reflecting the backdrop of rising government bond yields, but performed strongly relative to its benchmark over the quarter, returning -2.39% gross of fees (M class) versus -3.58% benchmark returns (JP Morgan Traded World ex-UK Government Bond Index - hedged).
- Duration positioning was a material contributor to performance over the quarter. We have had a bias towards a short duration position for some time, and this has helped performance this year as well as during the quarter. We started the quarter around 0.3 years short, and ran the position throughout the period, taking some profits to end at 0.2 years short. The position was centred in Europe, particularly peripheral markets, reflecting our view that the ECB was lagging in terms of tightening monetary policy and that inflation was continuing to surprise on the upside, not least due to the greater dependence on Russian gas imports. The ECB was more hawkish than many expected following its June guidance where it suggested that it would start with a 25bps rate hike. The 50bps rate hike in July therefore caught the market by surprise, and yields jumped materially in Spain and Italy – underweight positions in these markets were helpful for returns, with Italy in particular being actively traded following the surprise election result. We also ran a small short position in the US, closing this at a profit late on as US yields hit around 4% across the curve.
- Inflation positioning was a small positive for the fund. We went into the third quarter holding breakeven positions in Japan, Australia, Italy and Germany. Our position in German five-year breakevens performed well in August, and we sold the position at a profit. Outside of Europe, we also exited our Australian position as breakevens remained stubbornly low and the RBA signalled a more dovish outlook. In Japan, inflation data began creeping higher, but remain well below those seen globally, a factor in the continued accommodative stance adopted by the BoJ. Notwithstanding this, the long-held position in short dated Japanese breakevens contributed positively to the performance of the fund over

the quarter, and we were happy to continue to hold the position at the end of the quarter. We also maintained our position in Italian short-dated breakevens.

- Curve positioning has little impact on performance over the quarter. We did not hold any significant positions over most of the quarter, believing that there were more attractive opportunities to add value elsewhere. Towards the end of the quarter, we added a Japanese flattening position based on our view that long Japanese yields looked very attractive, and that the Japanese curve is artificially steep due to the BoJ yield curve control policy, which caps 10-year yields at 25bps. We believe that continued yen weakness, global inflation and the trend of other central banks pushing rates higher will put the curve control policy under pressure.
- Cross market strategies were a small positive over the period. Within Europe, the fund has been running broadly neutral in both Core and Semi-core markets, with a corresponding underweight in Peripheral markets. This contributed positively to performance as peripheral markets underperformed as the ECB tightened policy. Within Core, the fund actively traded between Germany and the Netherlands and, within semi-core, between France and Belgium. This added positively to performance. In the Dollar bloc, the fund started the quarter overweight Australia vs the US, and exited the position towards the end of August as the spread tightened due to the contrasting dovish messaging from the RBA and continued hawkish signalling from the Fed. Towards the end the quarter the fund entered an underweight in Canada vs the US with the yield differential at multi-year highs, and whilst there may be something of a divergence between the messaging and outlook of the Fed vs the BoC (Bank of Canada), we believe that the spread between the two markets is too high.

## Outlook

- Much of the recent market talk has focused on central bank pivots, with the pace of rate hikes having to slow as tightening to date starts to have an effect, energy prices start to fall and the base effects begin to feed into inflation prints. Yields have increased dramatically over the course of the year and volatility remains elevated as the latest piece of data or central bank messaging has an unduly large impact on government bond yields. Against this backdrop, we have reduced our duration short, but still remain short, primarily in Peripheral Europe, as we believe that the ECB will have to continue tightening policy until there is a clear sign that they have got inflation back under control. The heightened volatility creates a good environment for active management and we continue to trade tactically to take advantage of any shorter term dislocations.

## Find out more

- We are experiencing unprecedented times in markets. Inflation is at multi-decade highs, energy prices are rising and the latest Bank of England announcement created further uncertainty. Following on from the unsettling fixed income and currency markets of late September, RLAM hosted a webinar for RLAM's Head of Fixed Income Jonathan Platt, and Craig Inches, Head of Rates and Cash to discuss the situation and how central banks and policymakers might react. Investors can listen again via the Our Views section of www.rlam.com, which also contains regular updates from Head of Fixed Income Jonathan Platt, Head of equities Peter Rutter, and Head of Sustainable Mike Fox.

## 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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