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Liquidity strategies

Quarterly Overview

31 December 2023

Overview

Market overview

Economic attention over the quarter has been on inflation. At the start of the quarter investors focussed on the persistence of large price increases and central bank messaging on rates being held higher for longer. Yet, as headline inflation fell, sentiment swung dramatically towards the end of the quarter, pushing markets to price in interest rate cuts in 2024. The Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) all left rates unchanged over the quarter, maintaining official rates at multi-year highs. The Fed has now held rates unchanged at its last three meetings. There has however been a significant shift in messaging, with the US central bank now indicating that it expects to cut rates by 0.75% in 2024. The ECB has similarly kept rates steady at its two most recent meetings, but central bankers in the eurozone said that no rate cuts have yet been discussed.

In tune with the other major central banks, and potentially marking the high point in the UK interest rate cycle, the Bank of England left interest rates unchanged over the period. The Monetary Policy Committee continued to be split – at the December meeting three of the nine members were still voting for a rate hike. UK inflation has fallen significantly, with the annual inflation rate falling to 3.9% in November. This is the lowest rate of increase in over two years. However, this remains well above the BoE 2% target, with core and wage inflation significantly higher than the headline rate.

Global government bond yields started the quarter continuing the rising trend that started in mid-2020. This reflected market views that rising inflation would necessitate even higher interest rates and the mantra of higher for longer. Yet, with inflation starting to come down, expectations of rate cuts in 2024 contributed to significant falls in bond yields fell in November and December. The fall in yields was such that yields along the length of the curve ended the quarter lower than they started, and closed 2023 at roughly the same levels as they started.

UK government bonds produced strong returns due to falling yields, delivering an 8.1% return (FTSE Actuaries) over the fourth quarter with the benchmark 10-year gilt yield falling from 4.44% to 3.54%. The sterling investment grade credit market (iBoxx non-gilt index) returned 7.35% over the quarter, helped by lower government bond yields and tighter credit spreads. The average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) tightened from 1.38% to 1.15% (iBoxx).

UK money market rates were generally flat during the quarter, with longer-dated rates generally falling slightly, reflecting changing market expectations – particularly after he lower-than-expected inflation print towards the end of the quarter. SONIA started the quarter at 5.18%, and remained at this level throughout the quarter, with no changes to UK base rates from the Bank of England. ICE Term SONIA three-month rates started the period at 5.29%, falling back marginally to 5.20% by the end of 2023, while two-year gilts, often seen as a proxy for market expectations of BoE rates, fell from 4.66% to 3.98%. Reverse repo rates were also steady over the quarter, at around 5.20% for high quality names.

Performance and activity

From the start of 2021 until the middle of 2023, short-dated yields have risen back to pre-financial crisis levels. While this has been a headwind for performance, it has also allowed us to add carry to portfolios. During the final months of the year, with yields flat or falling, that carry has been a key driver of performance across our liquidity and short-term fixed income portfolios.

For the Sterling Liquidity Fund, we still focus on short paper – reflecting the fund's objective. For most of this year that has meant a focus on three-month maturities. Given our view that we were close to the peak in rates, we added selectively to slightly longer paper early in the period, as we felt that we were being compensated for taking the additional duration risk. As the period progressed, we felt that the market had moved too far in its assumptions about the pace and timing of BoE rate cuts and with this impacting the yield on those longer maturity instruments, we reduced our buying in this area, preferring to focus on the higher yields in shorter (eg three and four month) paper. We also added UK treasury bills during the period, generally doing this at rates above SONIA. Examples of longer paper earlier the quarter included six-month CDs from Swedish bank SEB and Natixis, as well as floating rate CDs from Lloyds, ANZ and National Australian Bank, while later in the period we sold CDs with less than a month to maturity from Credit Agricole, Goldman Sachs and First Abu Dhabi bank, switching into three-month equivalents.

With the Short Term Money Market Fund, we still focus on short paper – reflecting the fund's objective. For most of this year that has meant a focus on three-month maturities. Given our view that we were close to the peak in rates, we added selectively to slightly longer paper early in the period, as we felt that we were being compensated for taking the additional duration risk. As the period progressed, we felt that the market had moved too far in its assumptions about the pace and timing of BoE rate cuts and with this impacting the yield on those longer maturity instruments, we reduced our buying in this area, preferring to focus on the higher yields in shorter (eg three and four month) paper. We also added UK treasury bills during the period, generally

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For the Short Term Fixed Income Fund, covered bonds still account for the majority of non-money market exposure. These were helpful for returns over quarter as these pay a premium over SONIA, while the modest duration we have in our traditional money market exposure was also helpful.

Given our view that rates were going to roll over slightly, we did start adding further to longer-dated CDs later in the period to lock in attractive rates ahead of the BoE decision to hold, examples including one-year CDs from First Abu Dhabi and DNB Bank. We also added a new issue three-year covered bonds from Skipton Building Society and DBS. Covered bond activity has picked up slightly in recent months, although with little yield pick-up for longer dated bonds, we have been happy to focus on the three-year area where we have been able to buy at around SONIA + 60bps, which we feel is an attractive level for such high quality assets with little interest rate exposure.

For the Short Term Fixed Income Enhanced Fund, performance over the quarter was positive in absolute terms – primarily due to the high yield built into the portfolio but also helped by the fall in yields later in the period. We also took advantage of volatility in the gilt market to trade five-year gilts around data and supply events, realising a small profit.

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Outlook

For most of the quarter, we felt there was a small chance that the BoE might have to raise rates one more time. The lower-than-expected inflation figures released in December appear to have removed that outside risk, despite three MPC members voting for a hike in the same month. While MPC member speeches since then have tried to convey a message that the Bank will be cautious in its approach to cutting rates, the market is now pricing in UK interest rates of around 4% by the end of 2024. We feel this is overly optimistic, as we believe that this would mean further sharp falls in inflation (which will now be harder given base effects) or a sharp deterioration in data indicating a sharp recession.

We do think that rates will start to come down next year, but our current base case is that there are fewer of these, and that cuts are not seen in the first half of next year. In terms of positioning over the next few months, we are less likely to add longer maturity paper given our view that rates available for those longer dates are lower than the fundamentals justify. In addition, we have added duration in recent months and are therefore happy to maintain this for now rather than look to extend further. Where appropriate for the strategy, we will also look at covered bond new issuance now that this is rising somewhat once again and where these can be added at around 60bps over SONIA.

For the strategies that can accept more credit and interest rate risk, we remain somewhat cautious – not on a view that credit risk is inherently bad, but because with yields still at attractive all-in levels generally and spreads somewhat compressed, we want to be much more targeted when adding short-term credit to ensure that the funds receive adequate additional premium for the risk taken.

Further Information

Please click on the links below for further information:

Stewardship and responsible investment at RLAM

Royal London Sterling credit ESG analysis

TCFD climate report

Find out more

Royal London Asset Management's Outlook 2024 document and podcasts are both available on our website. In this year's Outlook document, our fund managers assess the challenges and opportunities in their respective asset classes for 2024. With an environment of falling inflation and modest recession, the benefits or risk for equities or credit is not so clear cut and knowing your companies is key. We analyse the areas of concern and potential growth within this environment.

In our Outlook 2024 podcast, Piers Hillier, CIO, looks ahead to 2024 and discusses the issues he believes will be prominent over the next 12 months, and where the key investment risks and opportunities may lie.

Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams.

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