For professional clients only, not suitable for retail clients.

Sustainable Credit 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.

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 falling yield environment was helpful for longer duration assets, with longer-dated bonds outperforming shorter-dated bonds.

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 underperformance compared to the gilt market is the result of the shorter duration of the credit market index. 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). Given the fall in yields, sectors with a greater proportion of long-dated bonds performed well, including utilities and social housing. Supranationals was the worst performing sector, while in financials, banks lagged slightly but insurance bonds modestly outperformed the market. Looking at maturities, longer-dated credit generally outperformed shorter-dated equivalents. By rating, the general positive tone of markets meant that lower rated A and BBB bonds produced stronger returns than AA and AAA debt.

Issuance was relatively low in the fourth quarter, reflecting usual seasonal patterns. For the year as a whole, sterling issuance was £63.9 billion, or £28 billion in net terms, compared with £51.5 billion and -£2.7 billion respectively in 2022.

Performance

This report covers Royal London's sterling credit-only funds Sustainable Managed Income and Sustainable Short Duration Corporate Bond fund, along with the credit-oriented mixed-asset fund Sustainable Managed Growth. As the Global Sustainable Credit Fund and European Sustainable Credit fund are not limited to sterling credit as with our other sustainable credit portfolios, these have separate reports and are not covered here.

Our credit-only fund Sustainable Managed Income and the credit exposure within our Sustainable Managed Growth strategy produced a positive absolute return for the quarter, thanks to the impact of falling gilt yields, narrower credit spreads and the income on the portfolios. On a relative basis, the portfolios performed broadly in line with the iBoxx Sterling Non-Gilt index.

The main positive driver of performance was our sector positioning, notably our underweight position in supranationals, which continued to lag the wider market having done so in the third quarter. Stock selection effects were mixed: we saw positive selection in insurance bonds, notably longer dated subordinated bonds from M&G and Legal & General, but this was outweighed by negative selection effects in structured bonds, which generally have a lower sensitivity to wider market moves.

In addition, our holding in Thames Water was also a detractor from performance over the quarter. We maintained exposure to Thames Water as part of a diversified portfolio, based on the attractiveness of the overall blended yield across holdings in operating company and holding company debt. Whilst structurally junior holding company debt underperformed and was downgraded, our larger exposure to the operating company debt was beneficial for performance over the quarter. We continue to believe that the sector remains attractively valued – largely based on our view that spreads in the sector overcompensate when compared to other regulated infrastructure assets such as UK electricity distribution.

Overview

Our sterling credit fixed income strategies are generally positive on the banking sector, particularly subordinated bonds. Whilst most banks will be well resourced to meet the needs of external ESG rating providers, and will look very attractive on a scope 1 and 2 emissions basis, we think there is no substitute for in-house primary sustainability analysis. Our more rigorous sustainable approach has led to more selective financials exposure than other funds, although with banks performing in line with the benchmark in the fourth quarter, this had little impact on performance.

The equity exposure within our mixed-asset fund Sustainable Managed Growth saw positive returns over the quarter. Generally supportive macroeconomic data, and more recently in December, the first signs of a pivot by the US Federal Reserve in terms of the interest rate narrative have meant that the fourth quarter has been one of the strongest for global equity markets for a long time. The best performing sectors in the quarter were information technology, real estate and industrials. The tech sector continues to benefit from the excitement around artificial intelligence (AI) and real estate is a sector that stands to benefit from falling interest rates. Industrials experienced a tailwind from a resilient macro backdrop combined with government stimulus towards infrastructure spending. The only sector that was negative in the quarter was energy, where we have zero exposure given our sustainable approach.

It was no surprise that the technology sector did well as this tends to be thought of as a long duration equity sector. Sage saw strong results in the quarter and was up 20% in the month of December. Dutch distributor of specialty chemicals IMCD had been facing headwinds due to its customers holding excess inventory and we saw evidence in the quarter that those inventory levels were now starting to normalise, benefitting the company's share price. A key detractor during the quarter was Rentokil, the global leader in pest control and hygiene, where its share price declined after it reported a surprising slowdown in growth in its US business.

Our credit-only fund **Sustainable Short Duration Corporate Bond** fund produced a positive absolute return for the quarter, thanks to the impact of falling gilt yields, narrower credit spreads and the income on the portfolios. On a relative basis, the fund outperformed its benchmark index.

The main positive driver of performance was our sector positioning, notably our underweight position in supranationals, which continued to lag the wider market having done so in the third quarter.

Stock selection effects were mixed: we saw positive selection in insurance bonds, notably longer dated subordinated bonds from M&G and Legal & General, but this was outweighed by negative selection effects in structured bonds, which generally have a lower sensitivity to wider market moves.

In addition, our holding in Thames Water was also a detractor from performance over the quarter. We maintained exposure to Thames Water as part of a diversified portfolio, based on the attractiveness of the overall blended yield across holdings in operating company and holding company debt. Whilst structurally junior holding company debt underperformed and was downgraded, our larger exposure to the operating company debt was beneficial for performance over the quarter. We continue to believe that the sector remains attractively valued – largely based on our view that spreads in the sector overcompensate when compared to other regulated infrastructure assets such as UK electricity distribution.

Activity – Sustainable Managed Income

All issuers within our sustainable holdings offer a net benefit to society or show ESG leadership. As well as reducing risk, we seek out opportunities that are under-researched e.g., bonds that do not fall into mainstream indices or benchmarks and/or are unrated by ratings agencies. Importantly, the sustainable credit proposition provides access to critical sectors that most investors can't access via equity markets. Key themes in the funds include social housing, social & environmental infrastructure, community funding (regulated banks and building societies focused on SME and retail lending), financial inclusion & resilience (such as insurance products to support individuals through shocks) and the energy transition. On sustainability grounds, we have no exposure to bonds of oil & gas companies or extractive industries. We are also underweight in the general industrial and consumer goods sectors.

Financials remain the largest part of the market and continued to dominate market issuance during the quarter. We added senior bonds from New York Life, issued at the same level as policyholders, and subordinated new issues from Close Brothers, at a yield of over 11%, and defined benefit pension buy-in and buy-out specialist Pension Insurance Corporation.

There were noteworthy new issues in the structured sector. We added a new issue of Stark Financing, a commercial mortgage-backed security secured against 103 UK property assets, predominantly 'last mile' warehouse assets. The floating rate A notes we bought are rated AAA and have an attractive loan-to-value, also paying an attractive premium to SONIA. We also added a five-year new issue from the RAC, these bonds yielding over 8% and benefiting from security over the business.

Social housing remains a key element in the strategy. We think there is very strong sustainability case for this sector: it houses around six million of the most at need in England, and is building around one in every four new homes. During the quarter, we picked up a new issue of 2041 bonds from Places for People. The company owns and manages 240,000 properties across the UK and the bonds came at an attractive spread premium to the market.

Overview

These key areas were also visible in our secondary market activity. We added selectively to subordinated bank and insurance debt – where yields still remain elevated– buying HSBC and Admiral at attractive levels. The trust was also active in the water sector, where we sold Wessex Water, investing the proceeds in Yorkshire Water, adding to credit spread but also moving into a higher quality name. We also increased exposure to social housing provider Haven Funding, an older style bond with far stronger covenants than more recent sector issuance.

Activity – Sustainable Managed Growth

All issuers within our sustainable holdings offer a net benefit to society or show ESG leadership. As well as reducing risk, we seek out opportunities that are under-researched e.g., bonds that do not fall into mainstream indices or benchmarks and/or are unrated by ratings agencies. Importantly, the sustainable credit proposition provides access to critical sectors that most investors can't access via equity markets. Key themes in the funds include social housing, social & environmental infrastructure, community funding (regulated banks and building societies focused on SME and retail lending), financial inclusion & resilience (such as insurance products to support individuals through shocks) and the energy transition. On sustainability grounds, we have no exposure to bonds of oil & gas companies or extractive industries. We are also underweight in the general industrial and consumer goods sectors, and to a lesser extent in consumer services.

Financials remain the largest part of the market and continued to dominate market issuance during the quarter. We added subordinated new issues from Close Brothers at a yield of over 11% and defined benefit pension buy-in and buy-out specialist Pension Insurance Corporation.

Social housing remains a key element in the strategy. We think there is very strong sustainability case for this sector: it houses around six million of the most at need in England, and is building around one in every four new homes. During the quarter, we picked up a new issue of 2041 bonds from social housing provider Places for People. The company owns and manages 240,000 properties across the UK and the bonds came at an attractive spread premium to the market. We also continued to look at the structured sector, adding a five-year new issue from the RAC, these bonds yielding over 8% and benefiting from security over the business.

These key areas were also visible in our secondary market activity. We added selectively to subordinated insurance debt – where yields still remain elevated– buying Admiral at attractive levels. The trust was also active in the water sector, where we sold Wessex Water, investing the proceeds in Yorkshire Water, adding to credit spread but also moving into a higher quality name.

Activity – Sustainable Short Duration Corporate Bond

All issuers within our sustainable holdings offer a net benefit to society or show ESG leadership. As well as reducing risk, we seek out opportunities that are under-researched e.g., bonds that do not fall into mainstream indices or benchmarks and/or are unrated by ratings agencies. Importantly, the sustainable credit proposition provides access to critical sectors that most investors can't access via equity markets. Key themes in the funds include social housing, social & environmental infrastructure, community funding (regulated banks and building societies focused on SME and retail lending), financial inclusion & resilience (such as insurance products to support individuals through shocks) and the energy transition. On sustainability grounds, we have no exposure to bonds of oil & gas companies or extractive industries. We are also underweight in the general industrial and consumer goods sectors, and to a lesser extent in consumer services.

Financials remain the largest part of the market and continued to dominate market issuance during the quarter. We added senior bonds from New York Life, issued at the same level as policyholders, and Coventry Building Society, as well as subordinated new issues from Close Brothers and defined benefit pension buy-in and buy-out specialist Pension Insurance Corporation, the former coming at a yield of over 11%.

There were noteworthy new issues in the structured sector. We added a new issue of Stark Financing, a commercial mortgage-backed security secured against 103 UK property assets, predominantly 'last mile' warehouse assets. The floating rate A notes we bought are rated AAA and have an attractive loan-to-value, also paying an attractive premium to SONIA. We also added a five-year new issue from the RAC, these bonds yielding over 8%.

In the secondary market we added selectively to subordinated bank and insurance debt – where yields still remain elevated– buying HSBC and Just Group at attractive levels. Outside of financials, we increased exposure to social housing provider Haven Funding, an older style bond with far stronger covenants than more recent sector issuance. We also added Bazalgette Finance, backed by the Thames 'super sewer' project, with strong sustainability characteristics and an attractive yield premium over the market for what we consider to be a low risk regulated asset. We also added rolling stock bonds from Eversholt Finance and Great Rolling Stock, which both offer strong security over key infrastructure assets and an attractive yield.

Overview

Outlook

Inflation has come down significantly in 2023 but remains well above the Bank of England's target, and now does not have the 'easy' wins of base effects to push this lower. In our view, wage inflation is the key metric to watch: we believe that the Bank will find it hard to start cutting rates if wages continue to rise at 5-6% per annum. Although the economic data remain very mixed, we still believe that higher interest rates will contribute to a slowdown in the UK. This could well impact company earnings and lead to some increase in pressure on credit markets. However, consumer resilience has been greater than expected in both the UK and globally, which has helped support growth and prevent a recession. How this continues into 2024 could prove critical.

As we came into November 2023, we felt that the all-in yield on sterling investment grade credit was looking very attractive, having risen significantly since the start of the year. The falls in gilt yields since then have largely reversed those rises. Our sterling credit strategy focuses on three sources of return: gilt yields, market credit spreads, and the additional credit spread we generate over credit benchmarks. Whilst ten-year gilt yields of 3.5% are not as attractive as the 4.5% seen in October, we feel that the excess yield available on investment grade credit overcompensates for default risk. Further, the additional yield embedded in our credit strategies, over that available from credit benchmarks, gives us confidence in our ability to deliver long-term outperformance.

We expect supply to weigh on credit markets in the first quarter but believe that underlying fundamentals will limit spread widening. Our emphasis remains on building diversified portfolios, with a high relative exposure to asset backed and strongly covenanted bonds that offer an attractive yields. This strategy underpins the excess yield of the portfolio relative to its benchmark.

Although recent outperformance means that the relative attractiveness of sterling credit bonds has reduced, we still favour holding them compared to UK government debt as credit spreads remain at levels that more than compensate for the credit risk. Given the potential challenges in the outlook, we remain focused on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.

Further Information

Please click on the links below for further information:

Stewardship and responsible investment at RLAM

Responsible investment at RLAM

Royal London Sterling credit ESG analysis

Royal London voting and engagement

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.

Important information

Important information

For professional clients only, not suitable for retail clients.

This is a financial promotion and is not investment advice.

Telephone calls may be recorded. For further information please see the Privacy Policy at www.rlam.com.

Issued in January 2024 by Royal London Asset Management Limited, 80 Fenchurch Street, London EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.