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Liquidity strategies

Quarterly overview

30 September 2023

Overview

Market overview

The third quarter was characterised by mixed data around the world, with central banks coming towards the end of their rate hiking path, but with cuts still seemingly a while away. The global economic picture is rosier now than it was at the start of the year, but global growth is spluttering again amid a disappointing bounce in China activity, slow-to-no growth in Europe and against a backdrop of restrictive monetary policy. The US still looks at risk of recession too, even if activity data to date has been fairly robust.

Inflation has fallen significantly and, although higher energy prices threaten a widespread revival in headline inflation, other factors – including a weak economic activity backdrop – should pull inflation lower still. With taming inflation still the priority for central banks, there is still a possibility of further rate hikes from the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE), but peak rates look to be near, with real rates now well into positive territory.

The outlook is still lacklustre in the UK. A technical recession is still assumed for the UK in the next 12 months, but a modest one. There are still risks from the housing sector and consumer spending has yet to respond fully to tighter monetary policy. GDP growth has been weak since late 2021 and PMI business surveys point to deterioration, falling into recessionary territory over the summer. Inflation should fall significantly at headline level, but domestically driven inflation continues to look strong, despite higher interest rates. The labour market is starting to look less tight and lead indicators of wage growth suggest some slowing ahead but so far, pay growth remains much too strong to be consistent with hitting a 2% inflation target.

UK government bonds struggled, being impacted by the higher-than-expected inflation print. Gilts delivered a -0.63% return (FTSE Actuaries) over the third quarter with the benchmark 10-year gilt yield rising to 4.44% from 4.39% but pulled back from a 4.75% high seen in mid-August. The sterling investment grade credit market (Non-gilt) returned 2.26% over the quarter, as the negative impact of higher government bond yields was offset by tighter credit spreads and the greater proportion of short-dated bonds (which performed well relatively to longer-dated equivalents) in credit indices.

UK money markets saw mixed impacts on rates as the BoE's single rate hike pushed very short-term rates higher, while the change in expectations weighed more on longer rates. SONIA started the quarter at 4.93%, rising to 5.18% after the BoE rate hike, while ICE Term SONIA three-month rates ended the quarter virtually unchanged at 5.29%, coming back from 5.45% in the middle of the quarter. Two-year gilts, often seen as a proxy for market expectations of BoE rates, fell from 5.26% to 4.66%. Reverse repo rates also increased over the quarter, ending at around 5.20% for high quality names.

Performance and activity

The third quarter was relatively quiet through July and August, with data releases still pointing towards further Bank of England (BoE) rate hikes towards an eventual peak around 6%. However, with the lower than expected August inflation print, and the US Federal Reserve's decision to pause rate hikes, it was little surprise to markets when the Bank of England left UK interest rates unchanged at 5.25%, the first 'hold' decision since November 2021. As a result, expectations of the peak in rates changes, pushing market rates in longer maturities lower – with one-year CD rates falling by around 10bps.

For a number of quarters, performance has been a trade-off of the positive impact of the carry built into our portfolios against the headwind of a rising yield environment. With yields generally flatter this quarter, performance has been relatively good for the period.

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 rates were going to roll over slightly, we did start adding selectively to four-month CDs later in the period – partly to lock in attractive rates ahead of the BoE decision to hold, but also to move maturities into 2024 and thus avoid tighter conditions going into year-end, similarly buying a small amount of six-month T-bills. At the margin, we also increase repo activity, as we were often able to achieve better rates on repo than overnight deposits.

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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 rates were going to roll over slightly, we did start adding selectively to four-month CDs later in the period – partly to lock in attractive rates ahead of the BoE decision to hold, but also to move maturities into 2024 and thus avoid tighter conditions going into year-end, similarly buying a small amount of six-month T-bills. At the margin, we also increase repo activity, as we were often able to achieve better rates on repo than overnight deposits. We also look for opportunities to add short-dated floating rate notes, examples including senior paper from Société Générale and covered bonds from Royal Bank of Canada at an attractive premium over SONIA.

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 Rabobank and NatWest. We also added a new issue three-year covered bond from Canadian bank Federation des Caisses Desjardins du Quebec. This was a relatively new issuer in this area, meaning pricing was attractive. We also added a short-dated senior new issue floating rate note from Royal Bank of Canada at an attractive premium to SONIA.

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. Activity was relatively low over the quarter. 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 Rabobank and NatWest. We also added a new issue three-year covered bond from Canadian bank Federation des Caisses Desjardins du Quebec. This was a relatively new issuer in this area, meaning pricing was attractive, also adding a new issue three-year covered bond from Deutsche Pfandbriefbank at an attractive premium to SONIA.

Outlook

Market attention is still focused on where the peak is for UK base rates, and how quickly we get there. The September pause in rates does not necessarily mean that we have seen the last rate hike for the current cycle – while the inflation rate is some 4% lower than its peak late last year, it is still over 4% above the BoE target.

Some further falls in CPI can be expected in the next few months as the domestic fuel price increases that came through in late 2022 fall out of the year-on-year comparison. We expect zero or one more hike in rates, depending on data and whether it appears that the rate increases to date are feeding through into weaker growth.

In terms of positioning over the next few months, we expect to continue to look for opportunities to extend maturities modestly where we are being paid an attractive yield premium – also acknowledging that this will help our money market exposure move beyond the traditional year-end squeeze on the use of overnight deposit. 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 40-50bps over SONIA.

For the strategies that can accept more credit and interest rate risk, we are being somewhat cautious – not on a view that credit risk is inherently bad, but because with yields at more attractive 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

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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. Notable publications in the third quarter include our annual Climate Report, as well as our annual Assessment of Value reports, available from the home page of www.rlam.com.

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