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Index linked strategies

Quarterly overview

30 September 2023

ROYAL LONDON ASSET MANAGEMENT

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.

In the US, the real economy has been surprisingly resilient in the face of tighter credit conditions. However, the fourth quarter looks set to see a few growth challenges, monetary policy is restrictive and employment growth has slowed. A number of recession indicators are still flashing. Business survey data paints a mixed picture, with PMIs consistent with flattish growth while ISM surveys look more upbeat. Employment gains have slowed on the non-farm payrolls data and job openings have fallen a long way from their highs consistent with a less tight labour market. Housing-related activity remain subdued.

The euro area economy may already be in mild recession and forecasts continue to pencil one in. Business surveys have deteriorated and look consistent with falling private sector output. Tighter monetary policy will still be feeding through to the real economy. Bank lending conditions have tightened and loan growth has slowed. High domestically driven inflation continues to point to the balance of risks being in the direction of further hikes.

Global government bond markets continued to see yields move higher – a trend that started in mid-2020, reflecting market views that rising inflation would necessitate higher interest rates and that the central banks and governments would ultimately have to withdraw the support measures put in place during the global financial crisis and then used further to help mitigate the economic impact of Covid. With the end of the rate rising cycle possibly in sight, but issuance expected to remain high, markets have become more volatile.

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. There was a marked difference in maturities, with short-dated bonds materially outperforming longer-dated bonds, as expectations that rates may be at a peak helped short-dated bonds start to anticipate cuts in late 2024, while longer-dated bonds remained weak due to concerns about the long-term inflation environment and significant gilt supply. In the US, 10-year treasury yields rose to 4.57% from 3.84%, hitting heights not seen in fifteen years, while in Germany the 10-year bund yield increased to 2.84% from 2.39%.

UK index-linked markets significantly underperformed on a global basis, returning -4.69% (FTSE Actuaries) in the third quarter. Real yields on UK 10-year bonds saw a rise over the period, ending the quarter at 0.60%, up from 0.52%. On longer-term bonds, 30-year real yields increased 53bps to 1.48%. Yields on US 10-year index-linked bonds increased to 2.23% from 1.61%, while its German counterpart saw yields rise to 0.45% from 0.07%.

Performance and activity

The trend of short-dated index linked bonds outperforming continued in the third quarter. Generally speaking, sub-10 year bonds delivered positive returns – the short end of the curve being supported by the belief that the peak in rates was near, as well as inflation being stickier than many had expected – the high spot inflation helping short-dated bonds provide high carry. Long-dated bonds performed poorly in most markets: markets can see a lot of supply coming down the line and demand remained weak for long-dated assets with LDI buyers notably quiet in both the UK and Europe. As a result, our all-maturities strategies generally saw negative absolute returns, while short0dated portfolios produced positive returns. Our funds performed broadly in line with benchmarks, with strong performance in July and August offset by a weaker September.

Overview

Duration was the main negative over the quarter. With yields haven risen in the early months of the year we felt that yields were at attractive levels and took our duration positioning long as we came into the summer. With yields rising further over the quarter, this was negative for relative returns.

Cross-market positioning again added value over the quarter. In the global funds, an underweight in peripheral bonds was the main positive with spreads widening. For the UK funds, we started the quarter with no non-UK exposure, and in global funds, with a neutral stance, both reflecting our view that the UK offered value after a long period of underperformance. We traded both US and France on a tactical basis over the quarter, adding short-dated France after these underperformed early in the quarter and subsequently taking profits. In the US, we were more active in longer-dated TIPS, with this helpful early in the quarter but negative late on as US real yields rose sharply to their highest levels since the financial crisis, with the short fund similarly affected after adding 10-year US TIPS.

Our inflation-linked strategies can move underweight inflation (selling linkers and buying conventionals) when market pricing presents opportunities. We traded syndications tactically but have a bias towards short inflation positioning as we felt that breakevens were higher than fundamentals justify, without hitting levels that justify an outright short position. One example during the quarter was the sale of 10-year breakevens ahead of the August auction of a 2033 index linked gilt, closing the position at a small profit.

Activity during the quarter continued to look for tactical opportunities to benefit from market issuance and ongoing volatility, but the main focus during the period was looking for opportunities to add to duration. Over the quarter we increased our long position selectively. This reflects our view that real yields globally are now looking more attractive, and that after a sustained multi-year your period where duration positioning has often been either short or very short, there is now value in locking in real yields at these levels.

This has driven increased exposure to markets such as the US or Australia – where positioning is less driven by a relative judgement of value vs the UK, but more by levels in these markets looking attractive on a fundamental basis now that these are at multi-year highs.

Curve positioning generally moved longer during the quarter. In the UK, there is no issuance in the 20-year part of the curve and hence we were more comfortable adding to exposure here. For the short fund, we moved to a neutral stance in five-year US and euro zone bonds, moving towards 10-year maturities, as we expect short-dated bonds to underperform later this if inflation starts to fall as expected.

Cross market activity has been relatively muted, given our focus on duration. We do think that Australian and US markets look attractive and also added France late in the quarter, but activity is likely to be driven by pockets of value in these markets rather than outright country views. In our global funds, we are underweight Japan where we expect real yields to rise if or when the Bank of Japan tightens monetary policy further.

Outlook

We expect the downward trend in inflation to continue through the rest of 2023, as energy and food price increases moderate and sluggish GDP weakens the labour market. Nonetheless, UK interest rates are likely to rise further as the BoE continues to focus on bringing inflation under control.

We believe that whilst inflation will fall sharply this year, its likely to remain well above target in most economies by the end of the year, and particularly so in the UK. Shallow recessions are possible but are unlikely to be deep enough at this stage to ease the excessive tightness seen in labour markets. As a result, base rates will continue to trend higher, albeit at a much slower pace than over the last 18 months and are unlikely to be cut anytime soon.

In the UK, the market is now expecting base rates to peak around 5.4% later this year, before being cut in late 2024, and falling to a terminal level of around 4.25% by mid-2027. At one point in early July the market was pricing peak rates closer to 6.5%.

Supply will be an issue for the market over the next few years, with around £200bn per annum forecast over each of the next five years. Alongside quantitative tightening (where the BoE is selling its gilt holdings back into the market), this will represent a headwind for gilts and we see similar impacts affecting other government bond markets.

Despite the impact of supply, with the peak of interest rates near and with real yields have risen considerably in recent months across most major government bond markets, we believe that yields are beginning to offer long-term value. At the margin, we are therefore looking for opportunities to add duration to portfolios, using market volatility or weakness as attractive entry points.

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