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Sustainable Credit 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 soggy 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.

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.

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. 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 1.48% to 1.38% (iBoxx). Banks and insurance bonds performed strongly in the quarter while senior insurance debt also enjoyed an impressive quarter. No sector saw negative returns, but real estate was broadly flat, and healthcare and transportation lagged other sectors. By rating, there was no standout performer in investment grade, with all bands posting returns between 1.8% and 2.5%. High yield bonds, however, saw a strong quarter, seeing returns of 3.7%. In duration terms, shorter-dated maturities performed significantly better than longer-dated equivalents.

Primary credit activity picked up after a particularly slow July. Sterling issuance was £11.2bn over the quarter, which was slightly behind the £11.5bn seen over the same time last year and significantly below the £17.4bn issued in the second quarter.

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.

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, with the impact of rising gilt yields mitigated by a narrowing in 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.

In terms of performance effects, the outperformance of short-dated bonds relative to long-term equivalents was a headwind for performance. However, this was offset by our sector allocation – in particular our overweight in banks and significant underweight in supranationals. Within banks, our subordinated bonds (lower in the capital structure than senior bonds) were the main contributor, whilst our real estate allocation also proved to be beneficial. Early repayment and calls continue to be supportive, with the redemption of 2024 bonds from Go-Ahead at a premium to market pricing.

Overview

Exposure to floating rate notes (FRNs), where interest payments are linked to cash rates, has increased in recent quarters. This helps dampen interest rate risk and has boosted income receipts. Our holding in student loan provider ICSL is an example of this, where income payments are linked to Sterling Overnight Interbank Average (SONIA) rate; income on these securities has risen significantly over the time, reflecting higher SONIA rates.

Activity

Primary activity was relatively low over the quarter. As well as the seasonal lull usually seen over the summer, higher yields has discouraged issuance. In recent years companies have brought capital raising forward to take advantage of low yields, and we would therefore expect issuance to remain somewhat lower in the next few quarters.

Financials remain the largest part of the market and dominated market issuance and our new issue activity during the quarter. We had a bias towards senior new issues over the period, reflecting the fact that we felt spreads in these areas were very attractive. Early in the period we added a new issue from Principality Building Society, these five-year senior bonds coming to market at a healthy credit spread, meaning a total yield in excess of 8%, also adding further to this bond later in the quarter in the secondary market as the spread remained very attractive. We also added a new senior issue from One Savings Bank, which priced with an attractive yield of 9.5%.

In the secured sector, we participated in a new issue from Last Mile Logistics – a commercial mortgage-backed security floating rate note backed by a portfolio of logistics assets across the UK with an attractive loan to value ratio and AAA rating.

In the secondary market we added selectively to subordinated bank and insurance debt – where yields still remain elevated following the rescue of Credit Suisse. However, underlying credit fundamentals mean that some of these bonds offer excellent value in our view, with legacy bonds from Legal & General the most recent examples, while we also added subordinated bonds from Close Brothers at a very attractive cash price, and the Co-Operative bank, where we added bonds with a 12.5% yield to call.

In the structured area, primary issuance has been very limited, but we continue to see secondary market availability. During the quarter we added PFI bonds from Derby Health, and bonds from Meadowhall Finance, secured on the Sheffield shopping centre with good loan-to-value paying a very attractive credit spread.

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.

Although the economic data remain very mixed, we still believe that higher rates will lead to a slowdown in the UK, impacting company earnings and leading to some increase in credit rating downgrades and default rates. We still favour sterling credit bonds over government debt as credit spreads remain at reasonably attractive levels. However, recent outperformance means that their relative attractiveness has reduced. 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.

The 'all-in yield' on sterling investment grade credit (government yield plus credit spread) remains attractive, particularly if inflation starts to fall as we expect. Our sterling credit exposure is generally achieved with a material yield premium to the market, which we feel will support performance both in absolute terms and relative to the market.

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.

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

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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