Where is the value in sterling credit?

Paola Binns, Head of Credit describes where the opportunity set can be found in these volatile markets.

Increased geopolitical tensions and heightened macroeconomic uncertainty will always lead to reassessed investment assumptions and market volatility. Looking at the current situation, tariffs will likely hurt the consumer through price inflation and hamper GDP growth. Government bond yields and credit spreads have consequently been on the move.

What's the noise?

There is downside risk for the US economy as Donald Trump's administration embarks on a series of polarising and potentially harmful tariffs. There has been a notable shift in rhetoric from the US – in relation to its support for Ukraine and general alignment with Europe – which has set off alarm bells on the continent, resulting in potentially historic shifts in fiscal policy from Germany and other countries, in turn moving their government bond yields considerably higher.

Amidst this volatility, credit markets have behaved relatively calmly; whilst spreads have recently widened, this has been modest in absolute terms and the all-in yield of credit has led to renewed strong demand for the asset class.

It's important to remember that performance comes from long term investing and not being dragged by day-to-day market movements.

Can spreads tighten from here?

While sterling investment grade all-in yields are attractive, their make-up has changed; even including the most recent spread widening, spreads have tightened significantly over recent years and government bond yields have not fallen as many expected they would. The result has been that a larger component of the all-in credit yield is from government bond yields. And the recent volatility we have seen in fixed income markets has been driven by underlying government bond yields responding to geopolitics and macroeconomic uncertainties.

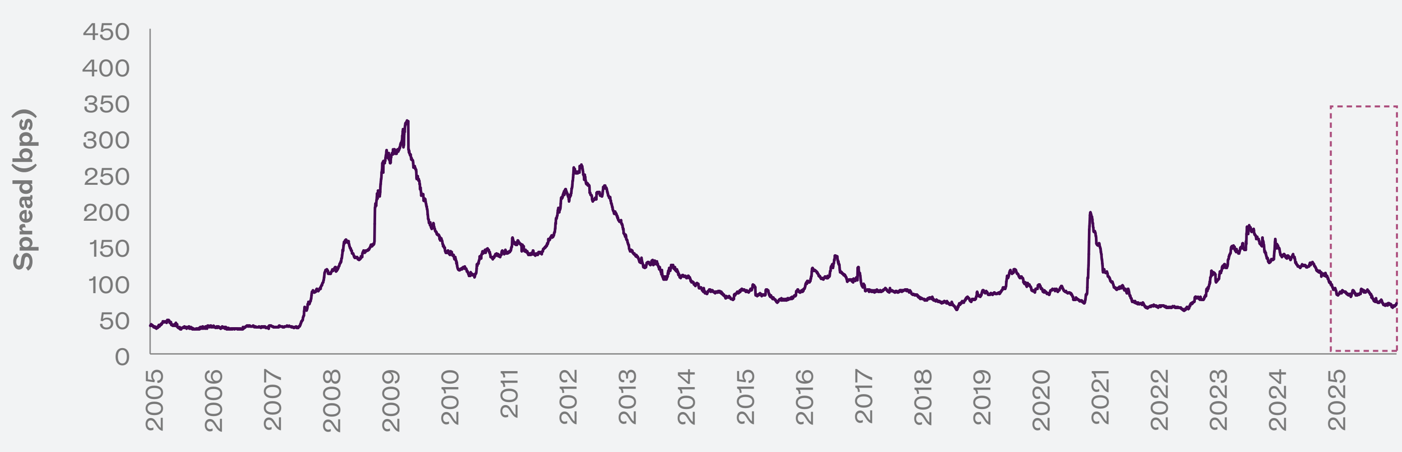
With spreads having recently reached levels previously not seen since 2007 – pre-financial crisis – it is reasonable to ask whether following the very recent widening, such tight spreads are achievable again. Indeed, it is also fair to ask why spreads have not moved even more significantly wider let alone already begin to tighten back from those levels.

The answer is that demand for the attractive yields from credit remains strong, with investors satisfied that, amidst higher geopolitical and macroeconomic uncertainty, fundamental credit risk is little changed.

However, it's important not to be complacent: just because the credit market has provided us with positive performance over recent years, with any setbacks short-lived, one cannot assume this will continue indefinitely, and some caution is therefore required. The key aspect of our approach to active credit management is to make use of inefficiencies that provide attractive risk-adjusted return opportunities.

The determining factor for flows into credit markets, currently, is quite clear, and ties into our approach: income. Investors want income. It is also worth noting that based on future rate expectations, we think that 10-year gilts look a good entry point at current levels. So, although spreads are near to historically tight levels, we believe that the potential for strong returns built on income looks attractive. It is up to us to find the best ways to access it in portfolios.

Figure 1: Sterling investment grade market credit spread



Source: Royal London Asset Management as at 28 February 2025. Chart shows spread on the ICE BoA ML Non-Gilts All Maturities Index.

Where are the opportunities?

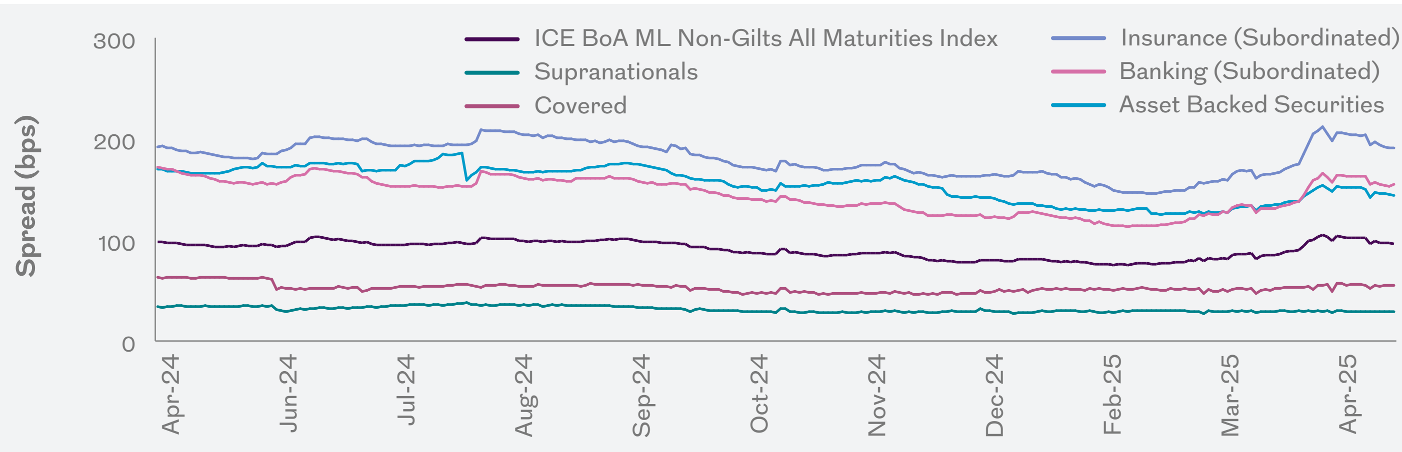
While global geopolitical and macroeconomic uncertainties are affecting global government bond markets in different ways, and despite where credit markets have reached in spread terms, sterling credit still offers attractive sources of value for those prepared to look carefully.

Our strategies continue to see value in financials – particularly subordinated debt, which offers good value and increased buying opportunities. The sector is also seeing continued issuance, keeping bonds attractively priced. It must be noted that this has slowed slightly in recent months, however.

We also maintain a high exposure to secured debt – representing a welcomingly diverse set of economic exposures with one critical commonality – a charge over assets. In an increasingly uncertain world, in an asset class with asymmetric risk and return profiles, the enhanced visibility and control from secured lending is hugely beneficial.

The ultimate attraction of secured bonds is that these enhancements remain under-appreciated and undervalued in a market that has largely developed as a conduit for unsecured finance. And such bonds have typically performed well in heightened volatility, seeing relatively modest spread movement. Even in times of volatility and uncertainty, portfolio managers have been reluctant to sell such assets to raise liquidity, and this has proven time after time to be a prudent approach.

Figure 2: Sector credit spreads



Source: Royal London Asset Management as at 28 February 2025.

Finally, investors have not been sufficiently more rewarded by yield for taking longer maturity exposure, particularly given the greater sensitivity to volatility in longer term underlying government bond yields; short duration funds generate similarly attractive income but have been far more stable. In our view, this is not likely to change soon.

Portfolio approach

In a diversified portfolio, we believe that we can generate good levels of income by taking appropriate levels of risk but ensuring, where possible, mitigation of those risks. There continue to be plenty of opportunities for us to add value in this way.

While tariffs and sticky inflation continue to grab headlines, we don't see the UK at the forefront of these pressures. We feel these market conditions continue to offer good value with plenty of opportunities to invest in sterling corporate debt.

Volatility can create attractive buying opportunities for our portfolios. Active managers are in a position to capture the new issue premia and take advantage of market uncertainty and weakness as it arises. But equally if not more important are the benefits of deeply embedded long-term value.

RL Corporate Bond Fund

Fund size: £1,490.64m

Launch date: 29.03.1999

Fund Managers: Shalin Shah and Matt Franklin

Benchmark: Markit iBoxx GBP Non-Gilts All Maturities

Sector: IA Sterling Corporate Bond

RL Sterling Extra Yield Bond Fund

Fund size: £1,646.15m

Launch date: 11.04.2003

Fund Managers: Eric Holt and Rachid Semaoune

Benchmark: FTSE Actuaries British Government 15 years index

Sector: IA Sterling Strategic Bond

Analyst driven 55% Data coverage 45%

RL Sterling Credit Fund

Fund size: £2,410.85m

Launch date: 01.09.2008

Fund Managers: Paola Binns and Eric Holt

Benchmark: Markit iBoxx GBP Non-Gilts All Maturities

Sector: IA Sterling Corporate Bond

Analyst driven 55% Data coverage 45%

RL Ethical Bond Fund

Fund size: £1,160.57m

Launch date: 31.01.2007

Fund Managers: Eric Holt and Paola Binns

Benchmark: Markit iBoxx GBP Non-Gilts All Maturities

Sector: IA Sterling Strategic Bond

Analyst driven 100%

Source: Royal London Asset Management. Unless otherwise stated all data is as at 28 February 2025.

* Morningstar Awards 2025 (c). Morningstar, Inc. All Rights Reserved. Awarded to the Royal London Corporate Bond M Acc for Best GBP Bond Fund 2025, United Kingdom.

The Morningstar Silver ratings are specific to the RL Sterling Extra High Yield Fund A Acc and the RL Sterling Credit Fund M Acc. The Morningstar Bronze rating is specific to RL Ethical Bond Fund M Acc.

Investment Risk

The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Leverage risk: The fund employs leverage with the aim of increasing the fund's returns or yield, however it also increases costs and its risk to capital. In adverse market conditions the fund's losses can be magnified significantly.

Counterparty risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the fund to financial loss.

Emerging markets risk: Investing in emerging markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Liquidity risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Interest rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Exchange rate risk: Changes in currency exchange rates may affect the value of your investment.

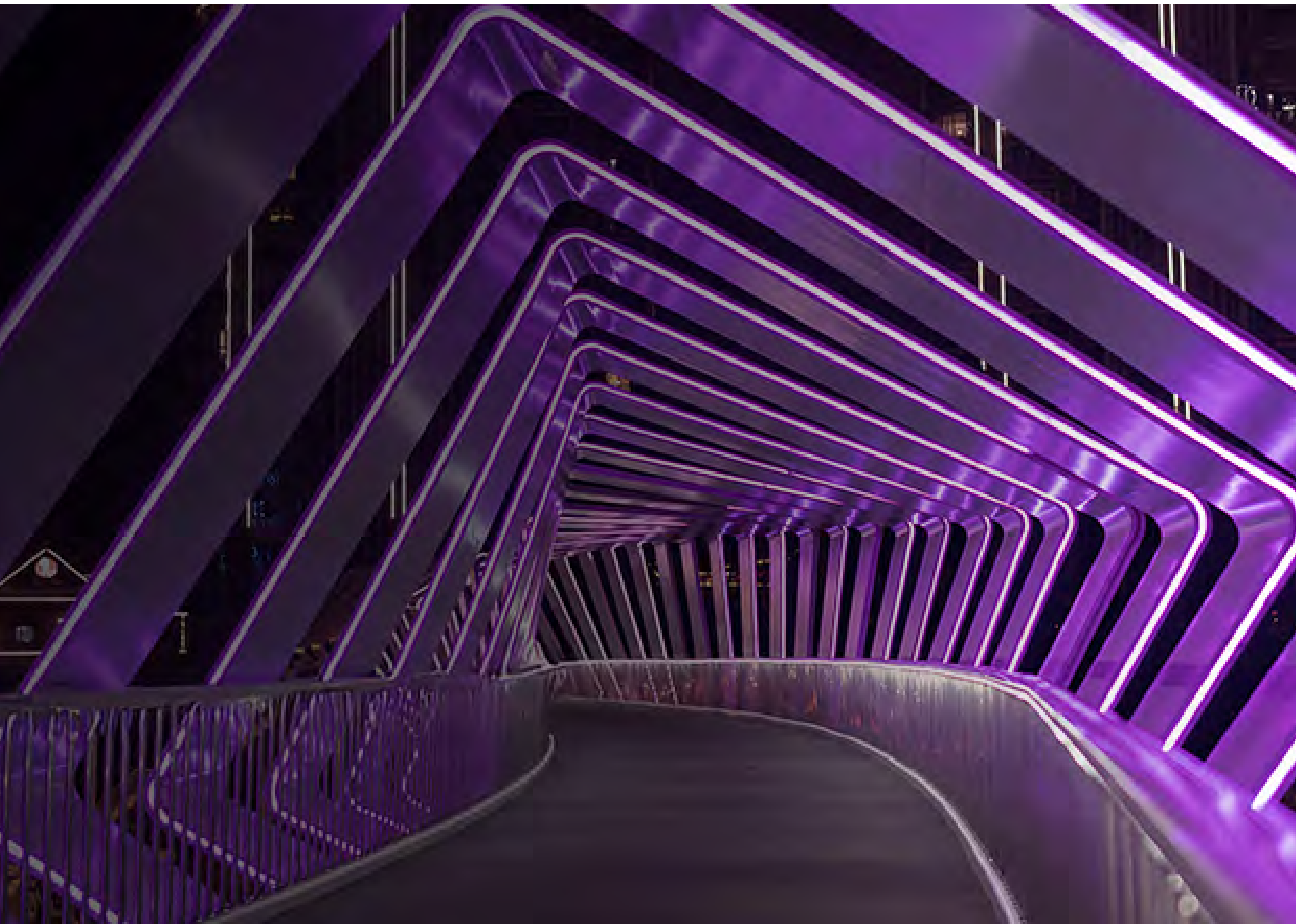
Efficient Portfolio Management (EPM) techniques: The fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the fund to increased price volatility.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Concentration risk: The price of funds that invest in a reduced number of holdings, sectors, or geographical areas may be more heavily affected by events that influence the stockmarket and therefore more volatile.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both fund losses and gains. The impact to the fund can be greater where they are used in an extensive or complex manner, where the fund could lose significantly more than the amount invested in derivatives.

Charges from Capital Risk: Charges are taken from the capital of the Fund. Whilst this increases the yield, it also has the effect of reducing the potential for capital growth.



Contact us

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Royal London Asset Management
80 Fenchurch Street,
London EC3M 4BY

For advisers and wealth managers
bdsupport@rlam.co.uk
+44 (0)20 3272 5950

For institutional client queries
institutional@rlam.co.uk
+44 (0)20 7506 6500

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