Quarterly insurance update

Q2 2025

ROYAL LONDON
ASSET MANAGEMENT

Summary

Welcome to the Quarter 2 2025 investment update designed for insurers and produced by Royal London Asset Management.

The first quarter of 2025 started with initial stability following a turbulent fourth quarter of 2024. As the quarter progressed, however, stability gave way to volatility, primarily due to elevated policy uncertainty in the US.

Within this quarterly update, we cover developments that will have long term effects on insurers' balance sheets - investment markets and themes.

1. Market update:

- Government bond markets saw heightened volatility over the quarter, amid ongoing political noise across Europe and the US.
- The sterling investment grade credit market returned 0.70% over the quarter, with the average sterling investment grade credit spread widening over the period from 0.85% to 0.95%.
- The result of all the uncertainty seen in the quarter was global equity indices succumbing to weakness, led by the US market, which posted a torrid quarter as technology stocks experienced a dramatic sell-off following news of a new competitor in the AI industry: China's DeepSeek.

2. Insurance investment themes:

For this quarter's publication we focus on Asset Backed Securities. One of Royal London Asset Managements' strategic priorities in developing a Private Assets capability is to provide clients with access to diversified asset classes, both in terms of risk and return profiles.

1. Market update

Overview

After initial stability, following a turbulent fourth quarter of 2024, the global economy saw modest growth and central banks eased monetary policy as inflation remained well below the peak levels of recent years. As the quarter progressed, however, stability gave way to volatility, primarily due to elevated policy uncertainty in the US, with President Donald Trump pivoting away from Europe; the spectre of aggressive tit-for-tat tariffs; and Europe's fiscal regime change, led by Germany looking to alter decades of fiscal policy stability and ramp up spending, principally in relation to defence.

The increasingly uncertain US policy backdrop and related disruptions to global trade seem likely to weigh on growth in the US and beyond. Fiscal stimulus may provide something of a shield in economies like the euro area and China. Gradual and careful rate cuts are likely in major economies (except in Japan), but the US inflation outlook is uncertain enough that US rate hikes can't be ruled out either.

The result of this was weakness in global equity indices as US tech stocks saw a dramatic sell-off following news of Chinese competitor, DeepSeek. European and UK stocks fared much better, posting positive total returns for the three months.

Most major central banks are running with interest rates slightly above neutral. If growth remains positive and inflation remains moderate, then central banks can continue to cut towards neutral. But stickier than expected inflation, substantial policy uncertainty, and rates being closer to neutral suggests that at least some slowing of the pace makes sense beyond just the US.

UK

After a quarter point cut in early February, in March, as expected, the Bank of England's (BoE) Monetary Policy Committee voted to keep rates on hold at 4.50%, with an 8-1 vote in favour of keeping rates steady. The bank continues to see a "gradual and careful approach to the further withdrawal of monetary policy restraint" as appropriate. The BoE has noted that not much in the domestic picture has changed for them. Although inflation has been a touch stronger than expected, they see domestic and wage pressures as moderating (but remaining elevated) and they still expect inflation to fall back after an expected rise in CPI in the coming months. But – as with other central banks – they are dealing with significant external sources of uncertainty. The minutes from March's meeting flagged increased trade uncertainty (due to tariff and geopolitical issues), a global rise in financial market volatility and Germany's fiscal plans.

Chancellor Rachel Reeves delivered her Spring Statement towards the end of the quarter, with the main headline being the country will need to spend less to meet fiscal rules. The Office of Budget Responsibility revised down their growth forecasts for this year by 1.0% (to 1.0%). They revised up their forecasts for bond yields. Neither of those things were good news for their forecasts for public finances. The Debt Management Office announced that this coming fiscal year will see a net financing requirement of £304bn, of which £299bn will be gilt sales. It would not be a surprise to see more fiscal tightening action from Reeves at the Budget in the Autumn. February CPI came in lower than expected at 2.8% year-on-year after 3.0% for January, with consensus for 3.0%, as did core at 3.5% year-on-year in February after 3.7% in January and consensus at 3.6%. January GDP was weaker than expected, but that follows the stronger than expected December print. GDP fell 0.1% month-on-month after rising 0.4% in December. Consensus expectations had been for a 0.1% month-on-month rise in January. Taking the last couple of months together, the data fits the picture of a flattish UK economy – as has been painted by recent PMI business surveys.

USA

In the US, at its final meeting of the quarter, the Federal Reserve, as expected, kept rates on hold with the Fed Funds target range at 4.25-4.50%. With the Fed seeing the US economy as "strong overall", the central bank feels they are in a good place, and Chair Powell noted that they are in a position where the bank can cut or they can hold (perhaps notably not mentioning a possible hike) interest rates. Federal Open Market Committee (FOMC) participant forecasts still have two rate cuts in them for 2025. Broader Fed commentary continued to indicate that they are not in a hurry to cut rates. In a very uncertain environment, it makes sense to wait until things are clearer and "we'll be adapting as we go," said Powell.

US activity growth indicators have been mixed of late, with sentiment and survey indicators typically soft but worries about tariffs featuring in much of the commentary. The February US Employment Report didn't surprise by much but was a bit softer than expected overall. Non-farm payrolls rose 151K, so not far from consensus at 160K or the average increase of the past 12 months (168K). February's US CPI came in lower than expected at 0.2% month-on-month from 0.5%. Core was also 0.2% month-on-month after 0.4%. Both figures were a tenth less than expected and a bit more inflation target friendly. The data was likely somewhat reassuring, but with tariffs being implemented and likely to impact with a bit of a lag – alongside plenty of other US policy uncertainty – the most recent inflation data is unlikely to alter the Fed's thinking at this stage.

There are risks on all sides to the US outlook with President Trump bringing policy upheaval in multiple dimensions. To the extent that the surprisingly robust growth picture of the last couple of years was fiscal spending and immigration assisted, there are additional reasons to worry with the early targets for Trump's team including cutting Federal spending and immigration, alongside raising or threatening tariffs.

Europe

At its final meeting in the quarter, the European Central Bank cut rates 25bps, to 2.50% on the deposit rate, which was very much as expected. The ECB continues to describe the disinflation process as well on track and continues to "follow a data-dependent and meeting-by-meeting approach" without pre-committing to a particular path. They still see the skew of risks to growth as to the downside. Uncertainty was a recurring theme for the March press conference. ECB staff revised down their forecasts for euro area growth, but President Christine Lagarde admitted that staff had not had the chance to incorporate any effects of increased fiscal stimulus. She was clear that, should the additional defence spending/ infrastructure spending in Germany come through, that would be a positive for aggregate demand. In comments in late March, however, President Lagarde flagged ECB analysis suggesting that a 25% US tariff on EU imports would lower euro area GDP growth by about 0.3% or more if retaliatory measures follow.

Euro area growth petered out at the end of last year, with the focus now on three drivers of growth: the consumer – where (ongoing) rate cuts and positive real income growth are supportive; fiscal policy, where again things are looking positive; and, Trump and the external environment – where slower global trade, higher tariffs and greater trade policy uncertainty all have the potential to weigh on activity. CPI inflation surprised a little on the upside, but services inflation finally fell more significantly from the 3.9%-4.0% range it has been stuck in for a while.

Global and UK Government bonds

The first quarter was a turbulent period for government bond markets with a series of macro and political factors keeping investors occupied. The gilt market found itself caught between the US Treasury market and bund market, whose performance were dominated by US trade policy and announcements around Germany's fiscal policy.

Government bond markets also saw heightened volatility over the quarter, amid ongoing political noise across Europe and the US. In the US, 10-year treasury yields fell to 4.21% from 4.57%, while German 10-year bund yields rose to 2.70% from 2.36%. Benchmark 10-year gilt yields increased to 4.68% from 4.57%.

Against a backdrop of rising volatility, global index linked markets generally delivered a positive return for the quarter. Yield curves were generally steeper as short-dated real yields fell – most notably in the US. The UK was a notable outlier, seeing negative overall returns as further concerns over the UK's fiscal position and the collapse in demand from LDI buyers pushed yields higher, particularly at the long end of the curve.

Global Credit and High Yield

Global corporate bonds saw modest positive returns in local currency terms over the quarter. US dollar markets were the strongest performing, although this was largely due to the fall in US treasury yields, with spreads slightly wider over the period. Euro and sterling credit markets saw similar, much more modest gains, driven by different underlying factors: euro markets had the headwind of higher yields, but more than offset this with tighter spreads, while the sterling market shrugged off wider spreads helped by the impact of the high carry in the asset class.

In the high yield market, the ICE BofAML (BB-B) Global Non-Financial High Yield Index (sterling hedged) benchmark returned 1.34% in the quarter with spreads at 312bps, widening from 269bps at the start of the quarter. At the end of the period, the index's yield-to-worst stood at 6.78% (6.64%), drifting higher since the fourth quarter on the back of rising yields and widening spreads. In the broader-based high yield index, which includes CCC rated bonds, spreads widened to 372bps from 324ps, with a yield-to-worst of 7.4%.

Credit

The sterling investment grade credit market returned 0.70% over the quarter, with the average sterling investment grade credit spread widening over the period from 0.85% to 0.95%. Most sectors saw positive returns, with the exceptions of utilities, consumer services and social housing. These exceptions were driven more by the greater exposure to long-dated bonds than issues with the sectors themselves.

Amidst this wider volatility, sterling credit markets have held up well so far, with the main attraction being the all-in yield this asset class continues to offer. While sterling investment grade all-in yields are attractive, their make-up has changed; a larger component of the yield is from government bond yields. The volatility we are seeing in fixed income markets is coming from government bond yields. However, credit spreads also remain susceptible to further weak macroeconomic news.

Equities

The result of all the uncertainty seen in the quarter was global equity indices succumbing to weakness, led by the US market, which posted a torrid quarter as technology stocks experienced a dramatic sell-off following news of a new competitor in the AI industry: China's DeepSeek.

From a sector perspective, most of the unwind has happened in AI-related growth names. These companies face slowing rates of growth, rising competition from China and were the most at risk from a downturn in sentiment, given how well loved these stocks have been over the past two years. Consumer discretionary stocks also suffered from concerns that stubborn inflation and declining growth prospects would hit spending.

European and UK stocks fared much better, posting positive total returns for the three months. In Asia, markets were negatively affected by concerns about the effects of US tariffs and a potential trade war. During the fourth quarter, the MSCI World Growth Index posted a loss of 8.71% while the MSCI World Value Index posted a gain of 3.87%.

Cash

The Bank of England rate cut in February was the focus for UK money market rates over the quarter. Having started the year at 4.70%, SONIA fell to 4.45% after the cut. Two-year gilts, often seen as a proxy for market expectations of BoE rates, started at 4.38%, fell through February ahead of and after the rate cut, and were then traded sideways for the rest of the quarter in a narrow range just under 4.25%, ending at 4.21%.

Money market rates fell in line with the Bank of England rate cut in February. Longer maturities have not moved substantially over the period – these were already pricing in modest rates in 2025 at the end of last year, and while the start of the Trump presidency has led to volatility for risk assets and policy expectations, it had little impact on UK economic data and therefore interest rate expectations over the quarter.

	Yield (%)*		Total 3 month return*	
	31 December 2024	31 March 2025		
Euro Treasuries†	2.72	2.90	-0.91% (GBP)	-1.31% (EUR)
UK Gilts†	4.80	4.87	0.55% (GBP)	
US Treasuries†	4.45	4.11	2.94% (GBP)	2.51% (EUR)

	Spread (bps)*		Total 3 month return*	
	31 December 2024	31 March 2025		
Global IG Corporates†	88	96	1.81% (GBP)	1.39% (EUR)
Euro IG Corporates†	98	91	0.17% (EUR)	
UK IG Corporates†	90	99	0.70% (GBP)	
Emerging Market Debt†	325	349	2.18% (GBP)	1.74% (EUR)
Global High Yield†	254	296	1.34% (GBP)	0.90% (EUR)

	Price index*		Total 3 month return*	
	31 December 2024	31 March 2025		
Global Equities†	22480.72	21421.85	-4.71% (GBP)	-5.86% (EUR)
Euro Equities†	4895.98	5248.39	7.20% (EUR)	
UK Equities†	4467.8	4623.62	4.51% (GBP)	
Emerging Market Equities†	684.5	683.61	-0.13% (GBP)	-1.33% (EUR)

	Index*	
	31 December 2024	31 March 2025
Volatility†	17.35	22.28

* Source: Bloomberg, IHS Markit.

† See appendix for details on index used and returns quoted.

Past performance is not a guide to future performance. The value of investments and any income from may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

2. Insurance investment themes

Asset Backed Securities

For this quarters investment theme we focus on Asset Backed Securities (ABS). One of Royal London Asset Management's strategic priorities is to develop a Private Asset capability to provide clients with access to diversified asset classes, both in terms of risk and return profiles. We believe ABS is a well-established asset class, and our team has a proven track record in delivering performance.

High-quality alternative investments like ABS are rising in popularity as they have proven to be an incredibly resilient asset class over the years and through several different crises. The asset class offers benefits such as portfolio diversification, floating rate, high level of liquidity, lower volatility, and access to short to mid-term consumer assets, which would generally otherwise not be available to investors. Additionally, when compared to similarly rated corporate debt, Public ABS assets have lower risk and duration and benefit from a complexity premium pick-up.

Why invest in ABS with Royal London Asset Management?

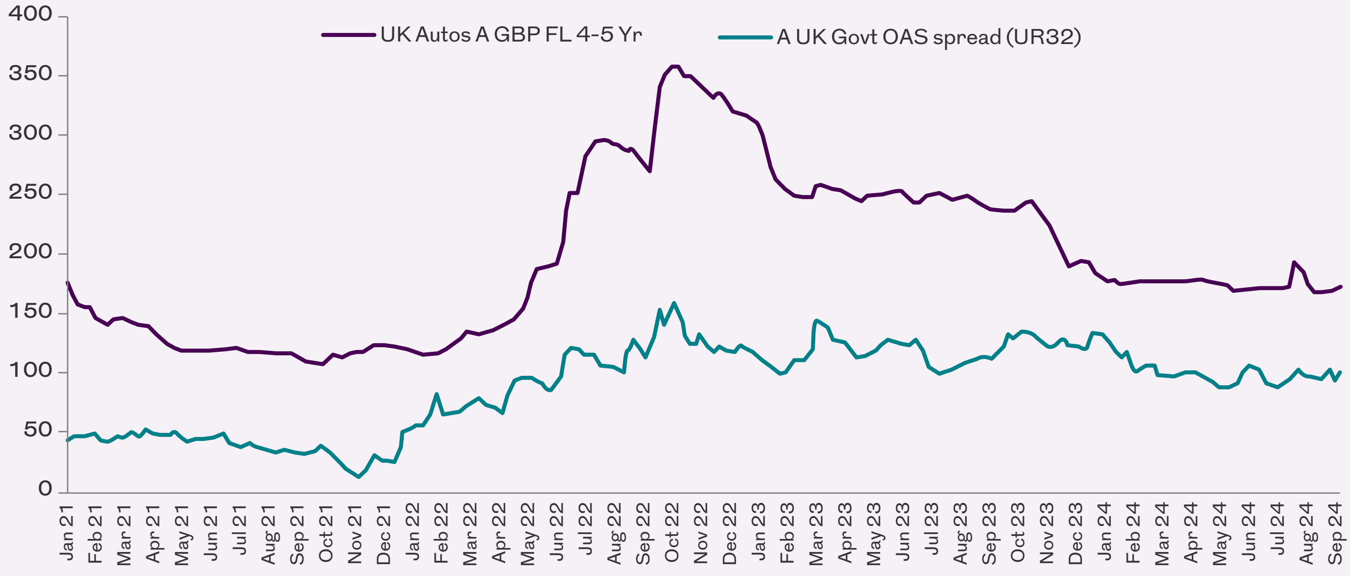
To ensure we fully understand the risks and rewards that exist in this specialist market, we have a highly experienced staff of seven people now working in securitised assets, with a further two more dedicated staff scheduled to join in 2025.

They in turn can draw on the resources of our well established and experienced Fixed Income, Property and Responsible Investment teams. The ABS team have successfully demonstrated their expertise in analysing and managing asset backed securities, based on their understanding of the legal structures of those assets, the origination processes of the underlying lenders and the value of any collateral, such as real estate. Additionally, the team are resourced with all relevant modelling tools, such as Intex, that enable the efficient analysis of this specialist asset class.

We believe that fundamental mispricing in ABS markets is driven by market frictions (the confluence of structural complexity, regulatory constraints and nuanced credit risk dynamics) that create risk and return opportunities, independent of market cycles or technical factors, which can be captured through a disciplined application of investment capabilities (investment skill, proven market experience and differentiated access to investment opportunities).

Due to the combination of complexity, regulatory and credit risk premia, returns in the ABS market exhibit strong risk-adjusted returns versus the standard corporate credit and financials debt. This is entirely consistent with Royal London Asset Management's longstanding process of using our resources to find unrecognised value in credit markets.

Figure 1. The appeal of ABS: Example showing securitised spreads versus corporate spreads



Source: RLAM, for illustrative purposes only.

Why consider Asset Backed Securities?

ABS offer a higher yield for the equivalent risk compared to corporate or government bonds (see figure 1). One factor in this higher yield is the 'complexity premium' that ABS offers, due to the specialisms required to understand both the underlying assets and how they operate within each securitisation. It is also worth noting that historical performance has shown that ABS have a very low default rate, through several economic cycles.

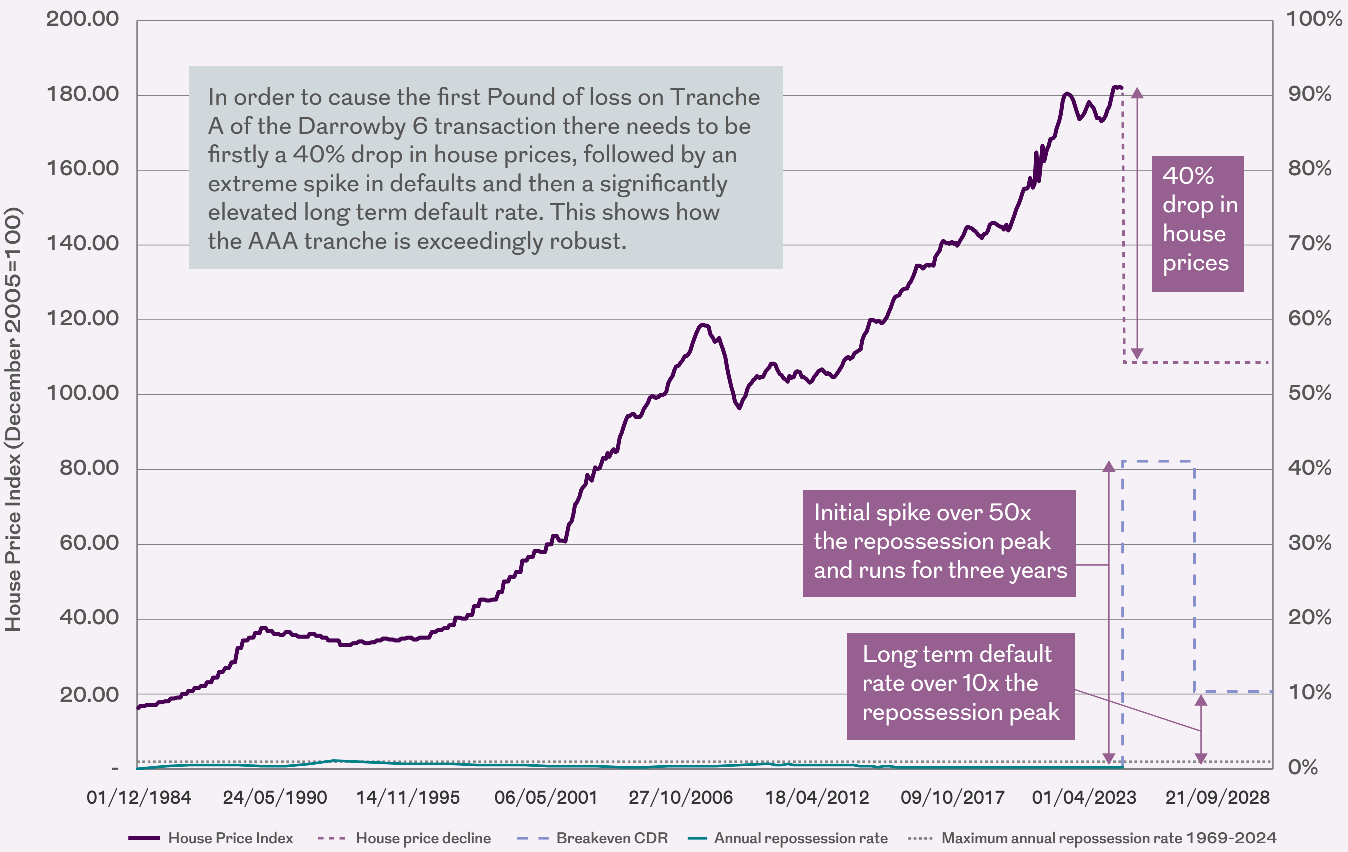
Almost all UK and European ABS are floating rate, which means they have near zero interest rate risk thus making them less volatile in an uncertain interest rate environment than traditional fixed income.

Through ABS, investors can seek to diversify their portfolios away from traditional corporate risk and benefit from enhanced risk-adjusted returns. Investors would not normally be able to access exposure to the underlying consumer or private lending assets if they were not securitised as an ABS bond.

Due to the granularity of ABS and their capital structures, investors can choose an investment risk and return profile which suits to their appetite. Assets range from AAA to B, and even unrated. Investors can also tailor which asset class they want, such as mortgages, auto loans and credit cards, and in which geographical jurisdiction they wish to invest.

For investors seeking to invest in the most senior tranches of the securitised market, the downside risk mitigation potential is significant. In figure 2 we examine the AAA tranche of a UK residential mortgage-backed security (RMBS). The chart shows that house prices could fall immediately by 40%, and never recover, at the same time as defaults going to many multiples of their worst ever experience before investors suffered any loss.

Figure 2. Strong investor protections
Example showing the robustness of AAA UK RMBS: Darrowby No 6 PLC Tranche A



Source: RLAM, for illustrative purposes only. As at December 2024. Past performance is not a guide to future performance.

A key to the asset class is also the potential for enhanced downside risk mitigation. As the underlying assets of ABS transactions sit within a separate legal entity, they are protected from a lender's failure. Investors do not need to consider or assess a bank's often opaque balance sheet but can rather concentrate on understanding their lending criteria and underwriting process. Historically, ABS have a very low default rate, through several economic cycles. (Source S&P, weighted average of European RMBS one-year default rates, 1988-2023, AAA – 0.06%, AA – 0.01%, A – 0.01%, BBB – 0.06%)

Frequent reporting of the underlying assets is provided by the issuers, which allows investors to view the performance of the collateral pool and manage their portfolios accordingly. Robust analysis of the underlying loans allows experienced and well-resourced investors to exit potentially deteriorating securities.

The team

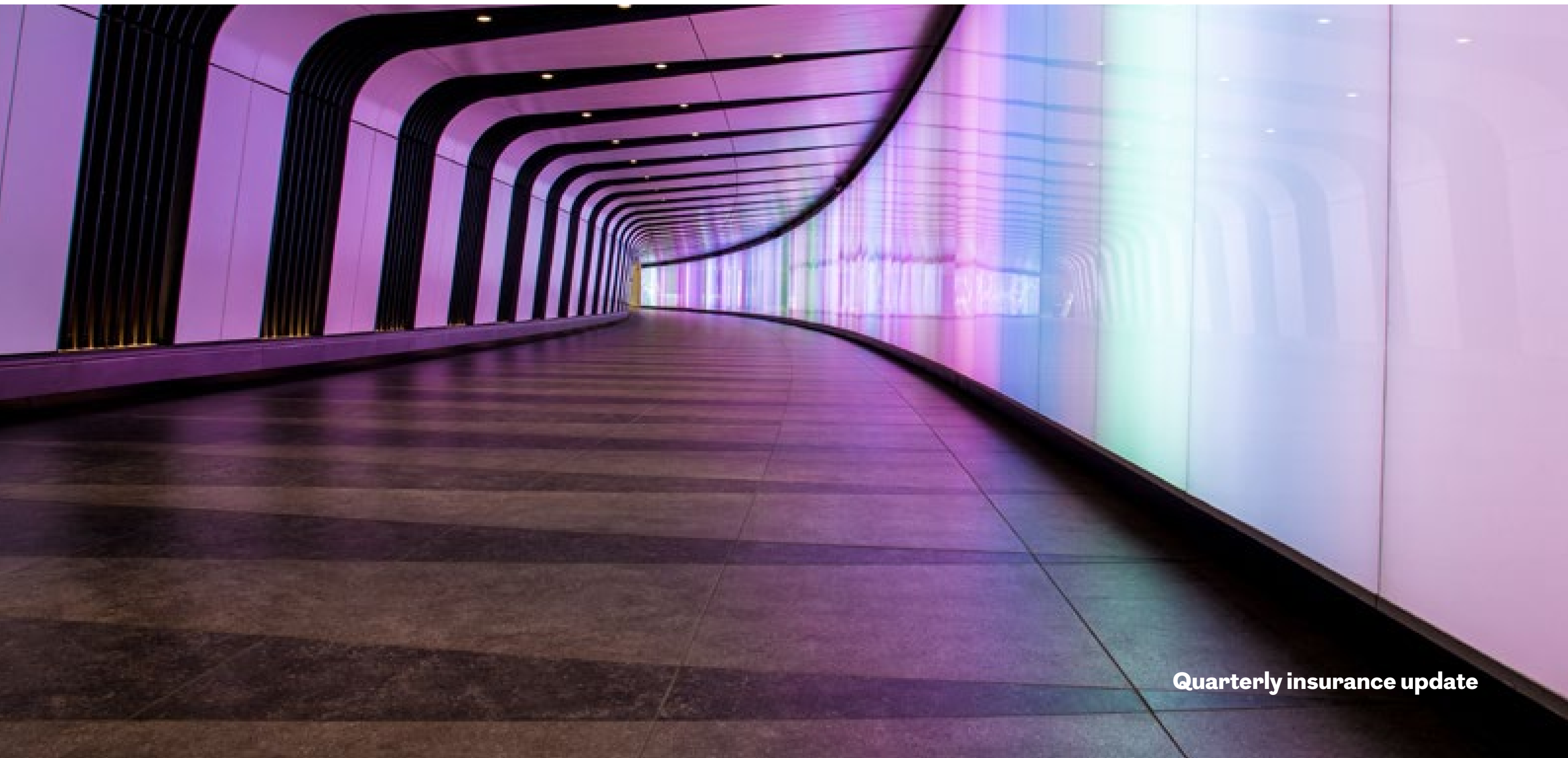
An established, specialist ABS team, who have worked together for over 10 years, have joined our proven, credit management team which has a history of producing outstanding risk-adjusted returns for our clients. We use our resources to follow a research driven process to fully understand all of the complexities of the assets and maintain portfolios of high quality securities at the right price. As at 31 December 2024, 92% of our fixed income funds were outperforming their benchmarks over a three year period, on an equal weighted basis.

The team has extensive experience of not only investing in the securitised structures, but also of underwriting the sorts of assets that form the underlying loans in these pools. Our team has seen the full spectrum of behaviours on display during the market cycles in consumer, financial and corporate credit. This means that they understand the nature of the end borrowers in these vehicles, and therefore not just the asset's price, but its true worth.

Appendix

Fixed Income	Index Used	Returns Quoted
Euro Treasuries	Bloomberg Barclays Euro Treasury Index	EUR Hedged
US Treasuries	Bloomberg Barclays US Treasury Index	EUR Hedged
Euro IG Corporates	ICE BofA Euro Corporate & Pfandbrief Index	EUR Unhedged
Global IG Corporates	Bloomberg Barclays Global Aggregate Corporate Index	EUR Hedged
EMD	JPM GBI-EM Global Diversified Index	EUR Hedged
Global High Yield	ICE BofA BB-B Global Non-Financial High Yield Constrained Index	EUR Hedged
Equities		
Euro Equities	Euro Stoxx 50 Index	EUR unhedged
Global Equities	MSCI World Net Total Return GBP Index	EUR unhedged
EM Equities	MSCI Emerging Markets Net Total Return GBP Index	EUR unhedged
Volatility:		
Volatility	Cboe Volatility Index (VIX)	

Source: Bloomberg, IHS Markit



Important information

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

ABS investment risks

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.

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.

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

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.

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.

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.

Important information

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