Staying selective

Paola Binns
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Sterling credit

Last year we pointed out that, in our view, the all-in yield on sterling credit was very attractive. That remains the case now. Yield matters; the strong income element of credit yield is useful for many investors and can also act as a cushion against rising bond yields. That has been the case in 2024, where underlying UK government bond (gilt) yields saw a sell-off for the first few months of the year, rallied through the summer and then increased late on due to fears about increased issuance.

That higher credit yield (supported by income), as well as the credit market's shorter overall duration and a tightening of credit spreads over the year, meant that a negative return for gilts in 2024 (at the time of writing) didn't mean negative returns for credit investors.

We can say the same as we head into 2025. While the yield of the gilt market, as indicated by the FTSE Gilt All Stocks index – is around 4.5%, the iBOXX Sterling Non-Gilt index – the measure that we use as a benchmark for the UK sterling credit market – is yielding just under 5.5% as we head towards December. In addition, we aim to achieve an above-market yield – this has been a key element in our portfolios over many years and in our view helps underpin performance: of course, if yields rise dramatically then this 'buffer' can be overwhelmed, but that is not our core view today.

The underlying picture

If we pull back from the numbers, we look for lessons to learn and apply. Like many others, we underestimated the resilience of the US economy last year – that resilience and the impact on global markets meant that sovereign bond returns were negative as yields rose, but risk assets such as equities and credit did okay. Does that continue or reverse course in 2025?

The long-term picture for sovereigns is not good from a fundamental point of view. Budget deficits are still high and debt sustainability is an issue. In the short-term, issuance is only going higher, as governments that promise to cut deficits tend to lose elections: In the UK, we've seen the incoming government raise spending – partly funded by tax increases but also a big jump in gilt issuance. In the US, Trump has promised tax cuts, so we expect US treasury issuance to increase substantially.

> **Governments that promise to cut deficits tend to lose elections.**

Key drivers for 2025

Interest rates are always one of the first considerations for fixed income investors – are these going up or down? In one sense, both have advantages and disadvantages: rising rates do lead to more attractive yields, but create capital losses and more negatively impact investors with longer duration; falling interest rates, conversely, create capital gains for existing exposure, but mean that each maturing bond is replaced with a lower yielding one.

Rates expectations have swung violently over the course of the last 12 months. At the end of 2023, markets were optimistically predicting an avalanche of rate cuts – and then started 2024 by swinging to maximum pessimism. As we come towards the end of 2024, markets have just priced out a number of rate cuts, believing that higher deficits and government spending are more inflationary and hence central banks will be more cautious cutting rates. That feels about right.

However, with those higher inflation expectations, we'd expect to see less downward movement (or even further increases) in longer yields than the falls at the short end – so steeper yield curves. Short-dated credit has lower credit risk simply due to the shorter maturity, and steeper curves would help it outperform. We are not expecting any major move in UK credit spreads – we are not forecasting a recession that would push these wider, but nor do we see a buoyant economy that helps these tighten materially.

As we are not looking for major moves in yields or spreads, our focus remains on exploiting market efficiencies to enhance yields, supported by income, to produce better risk-adjusted returns over the long term. The UK market is undoubtedly a smaller proportion of global markets than it was 10 years ago – the popularity of US dollar and euro credit markets and the multi-currency funding/borrowing models used by the world's largest companies means that demand for sterling funding is not as great. However, certain sectors and types of companies will continue to look to sterling lenders such as the banking and insurance sectors that remain robust, and will likely dominate issuance. However, some other areas will also see robust sterling issuance: utilities are an obvious example – these need sterling funding and, while some do not like them, the government cannot afford to nationalise these. A more pragmatic regulatory regime and the continued involvement of sterling credit markets are key elements in a long-term solution. Social housing (see the sector focus on the next page) is another area that we expect to see more issuance and where funding needs to dovetail well with long-term investor objectives.

Staying selective

In fact, the main lesson I take from 2024 and into 2025 is about the power of diversification and selection. Even in a benign environment, bond returns are asymmetric: we have capped upside but have full exposure to a loss. So we retain a focus best described by opening lender position: we may have areas such as social housing or subordinated financials that we think are more interesting, but each bond has to earn its position in any portfolio. Diversification is the double-check on that – so that when we get things wrong (and every fund manager does) we mitigate the impact. These factors have underpinned our success in this market over the past 20 years or so, and will be the basis of our outlook both for next year and beyond.

> **"The main lesson I take from 2024 and into 2025 is about the power of diversification and selection."**

Sector focus: social housing

Martin Foden, Head of Sterling Credit Research

We have been lending to housing associations for over three decades, a period that has seen the sector develop from a bond backwater to become a material proportion of credit indices. Whilst the significance of the sector to credit investors has increased, so have the financial and societal challenges. Operating for a long time under a political ideology that favoured home ownership over social rent, as well as austerity over investment, and seeing heightened scrutiny over asset conditions post Grenfell, has squeezed the sector's balance sheet. Specific environmental laws bringing forward additional spending and rising interest rates have only added to the pressure. As a consequence, housing associations are being forced to prioritise balance sheet recovery and improvement of existing assets over development of new affordable housing.

Whilst 2025 is likely to see a continuation of these underlying dynamics, there are reasons to be positive. A new government, led by a party that has historically understood the importance of social housing, should herald more favourable policies – including longer-term rent visibility and additional grant funding. Both of which will help improve issuers' balance sheets whilst increasing resources to deliver much-needed homes. There are also early signs that certain housing associations have managed the challenges better than others and are starting to rebuild financial capacity. More broadly, clear attractions for bond investors remain, not least the critical societal impact that funding the management and delivery of social housing can deliver.

Building on our long-term experience, we will continue to support the sector, which is likely to have a renewed demand for bond funding in the coming years after a recent hiatus. However, our awareness of the increased risks will continue to see us diverting lending to those associations that have navigated recent challenges most effectively and offer an appropriate return for our clients.

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