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Government Bond strategies

Quarterly Overview

30 June 2024

Overview

Market overview

Financial markets have once again been dominated by macroeconomic data and the market's expectation of the direction for interest rates during the quarter. Although interest rates have remained largely unchanged in most countries, market pricing of when interest rate cuts might start, and by how much they might fall, is constantly changing. 2024 started with expectations that central banks would cut early, and cut often. However, as the year has progressed, those expectations have changed. Inflation has generally not come down quite as fast as hoped, with services inflation proving sticky, particularly in the UK, while growth has generally not been as weak as feared – particularly in the US. Interest rates were unchanged for the Federal Reserve and Bank of England, whilst the European Central Bank cut rates by 0.25% in June. Most central bank forecasters now only expect one or two cuts from each of these banks over the course of 2024 as a whole.

UK government bonds produced negative returns due to rising yields, delivering a -1.62% return (FTSE Actuaries) over the second quarter with the benchmark 10-year gilt yield rising from 3.94% to 4.18%. Yields rose for much of April then largely traded in a range between 4.0% and 4.4% for the rest of the quarter – a similar pattern to that seen in the first quarter. The sterling investment grade credit market (iBoxx non-gilt index) returned -0.13% over the quarter, with the average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) widening marginally from 1.02% to 1.03% (iBoxx).

Government yields rose in all the major markets. In the US, 10-year treasury yields rose from 4.21% to 4.40%, while German 10-year bunds similarly saw yields rise from 2.30% to 2.5%.

Data released in the UK in the second quarter confirmed that the country bounced out of technical recession in the Q1 and painted a picture of continued positive economic growth. The Bank of England kept rates at 5.25%, even though headline inflation dropped. This reflected concern about services inflation and pay growth, both of which remain elevated. The calling of UK general election, which has resulted in a change of government, had minor impact on sterling asset prices, reflecting a view that there would be little shift in economic policy.

The US Federal Reserve continued to keep rates on hold at 5.25-5.50% over the quarter against a still resilient labour market backdrop, and the relatively strong core CPI inflation seen over January to April. The May data (released in June) was more reassuring both from a CPI and core PCE perspective. As of their June meeting, the median forecast of participants changed from showing 75 basis points of rate cuts for 2024 to only 25bps of cuts.

The ECB lowered rates by 25bps in June, following good inflation progress and previous hints from ECB speakers. Further rate moves after June are less certain and depend on data. The European elections saw incumbent parties suffer a loss of support and prompted President Macron to call an early parliamentary election. This uncertainty saw French government bonds weaken in relation to German government debt.

Portfolio commentary

As the second quarter got underway, government bond markets were still forecasting that the major central banks would start to cut interest rates during the summer of 2024. By the end of the quarter that narrative had shifted somewhat, most notably for the Federal Reserve, where the first and only cut for 2024 is now expected late in the final quarter. The ECB, having boxed themselves into a corner, fully delivered on the markets expectation of a 0.25% reduction in base rates at their June meeting. Early in the quarter, the BoE also put a rate cut in play for its June meeting, but by the time the meeting arrived, economic data didn't support a move lower in rates, whilst the announcement of an election on the 4 July put pay to any remaining hopes of an interest cut in the UK.

Over the three-month period, 10-year gilt yields traded within a wide, but relatively well-defined trading range. Within that bond markets were notably volatile, particularly around economic data prints. That pattern held true in other markets such as the US and Europe where US treasuries and German bunds traded sideways,

In a similar story to yield moves, the curve did not see any dramatic shifts in the second quarter – with yields at the short-end and long-end trading in lockstep, and within a tight range.

As a result of the above, the strategic duration and curve positions within the fund added little to performance, with tactical activity more impactful.

The RL UK Government Bond Fund outperformed its benchmark during the second quarter, but delivered a negative absolute return.The volatile market conditions that prevailed for much of the quarter provided active investors with plenty of opportunities, particularly around economic data prints and bond supply (auctions and syndications). The tactical trading of our duration position was the primary driver for performance during the quarter.

During the period the fund added new strategic positions in overseas markets. Of note were new holdings in 30-year US TIPS, seven-year US treasury bonds and 30-year nominal Australian government bonds, which were bought early in the quarter. Overall, these positions were beneficial for the fund – particularly the two US positions as US bond markets outperformed UK gilts.

Overview

Our curve position did not change much in the quarter but we have increased our exposure to the 30-year portion of the curve as we bought 30 year maturity gilts when adding to our duration long.

The RL Short Duration Gilt Fund was broadly in line with its benchmark during the second quarter.The ongoing management of duration and tactical trading of market volatility was the key driver for performance during the quarter. With yields become highly sensitive to economic indicators, we were able to add to performance with active management of the position.

We retained our strategic curve position – remaining overweight in the two-to-three year part of the curve – as the UK curve was largely unchanged in the period. Our relative-value positioning retains a large overweight position in certain 2025 and 2027.

In cross-market trading, we have increased exposure in dollar markets, seeing value here. We bought US five-year maturity bonds in mid-April, before taking profit on these, firstly in May and then in June. We also added a new position in dollar markets, buying 2030 nominal Aussie government bonds.

Outlook

We believe that inflation will continue to drift lower in 2024, although it is likely to remain above target in most economies by the end of the year. Shallow recessions are possible but are unlikely to be deep enough at this stage to ease the excessive tightness seen in labour markets. As we move through 2024, central banks are likely to start reducing rates, but with yields below base rates in all markets, this is well priced.

In the UK, the market is now assuming base rates have peaked at 5.25%, with the first cut fully priced in for August 2024, and falling to a terminal level of around 3.5% by late-2026.

Supply will remain high for 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 could represent a headwind for gilts. However, when considering gilts in a global context, we believe the gilt market is somewhat priced for this, with the UK curve much steeper than both the US and German bonds.

Further Information

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TCFD climate report

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