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Sterling Credit strategies

Quarterly Overview

30 June 2024

Overview

Market overview

Markets have once again been dominated by interest rates during the quarter, despite little or no movement in this area. 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 cut just once across the Federal Reserve, European Central Bank and Bank of England, with the ECB cutting rates 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.

Ahead of the US Presidential elections in November, snap parliamentary elections were called in the UK and France, providing reminders that voter dissatisfaction with the seeming consensus on economic policy and ongoing lack of consensus on longer-term issues such as climate change create an uncertain backdrop for businesses and consumers alike.

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. Euro area CPI went up from 2.4% to 2.6% year-on-year in May, which was unexpected, and services inflation rose above 4.0%. 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.

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. Inflation dropped back to the Bank of England's 2% target. The rate of change in the CPI basket fell from 3.4% year-on-year in February to 2.0% in May, helped by lower electricity and gas bills. 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.

Government yields generally rose over the quarter, particularly following poor US inflation data released in April with yields largely range-bound through May and June. 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 2.50%. Benchmark 10-year gilt yields rose from 3.94% to 4.18%.

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). Given the modest rise in yields, sectors with a greater proportion of long-dated bonds performed less well, including utilities and social housing.

Portfolio commentary

Despite the slight negative returns for the wider sterling investment grade market, our strategy saw a positive return in the period and therefore outperformed the benchmark. The main driver of positive performance was stock positioning – notably in the bank and structured sectors. This stock selection impact more than offset the negative effect of our underweight in supranationals, which performed well over the quarter. The additional carry built into the portfolios over the benchmark index was also helpful.

Within the banking sector, our exposure to subordinated bonds remained helpful. Subordinated bonds from the likes of Close Brothers and Santander performed strongly. Structured bonds were the other area of interest, with strong performance from student loan provider ICSL, real estate vehicle Canary Wharf and Telereal – secured on BT telephone exchanges.

Low exposure to the supranational sector was the main negative over the quarter, with this more defensive area performing well in a quarter where yields were slightly higher. We remain comfortable with the low weighting to this area given our belief that yields in the sector are poor value on a risk-adjusted basis compared to other parts of the market. Our bias towards insurance was also a drag on performance, lagging the wider market after a strong run. The market knows that there will be plenty of supply in this area as some business lines, like bulk annuities, required extra funding. This has caused higher initial yields and some changes in prices during the quarter. However, we still find the sector attractive and will maintain an overweight position.

News flow continues on the water sector as the regulator's draft decision on spending over the next five years was deferred as a result of the snap election being called. While the commentary on the sector remains febrile, there have been no real developments that require portfolio positioning to be changed, and we continue to support the funding of this critical sector.

Overview

Portfolio activity

New issue activity provided numerous opportunities for our sterling credit strategy over the quarter. Financials continued to dominate primary market activity and while we have a bias towards subordinated bonds, we found attractive issues at both senior and subordinated levels. We bought senior bonds from French banking group BPCE (which includes Banque Populaire, Caisse d'Epargne and Natixis brands) – although subordinated French bank bonds weakened slightly after President Macron called parliamentary elections, this had little impact on senior bonds. We also added AT1 bonds from Barclays and Coventry Building Society AT1s – both yielding over 9%. We also added a new tier 2 issue from asset manager Schroders, issued with a yield of over 6%.

In the insurance sector, we added a new issue from US insurer Protective Life. These bonds rank alongside policyholders, offering strong downside protection and were attractively priced at a yield of over 5%. We also purchased a subordinated bond from specialist UK insurer Pension Insurance Corporation, where we felt the high coupon looked attractive for the risk. In addition, we participated in a new sterling bond from UK bulk annuity provider Rothesay yielding 7%.

In the structured area, a key component of the portfolio, we continue to believe that the additional security and covenants are underpriced by the wider market. During the quarter, we added a new issue from Vantage Data Centers Jersey, a securitisation of real estate and tenant lease payments from two operating wholesale data centres in Newport. This deal offered a low to value (LTV) and pays an attractive credit spread. We also added Exmoor Funding, an RMBS secured on a portfolio of mortgages from specialist mortgage provider LiveMore, which focuses on lending to later life borrowers (50 to 90+ age group) – promoting financial inclusion for a segment of the UK population underserved by traditional high street lenders. We also added a new issue from UK Logistics – a commercial mortgage-backed security FRN, backed by a portfolio of logistics assets mainly in the Greater Manchester area with an attractive loan to value ratio and AAA rating. The assets, which are positioned in a close proximity to urban centres, allow SMEs to reduce their direct emissions as well as transportation costs thanks to being closer to end customers.

We continue to see value in utilities, with attractive spreads and supporting key infrastructure assets. In the primary market, we added a new hybrid from Centrica, while in the secondary market we added a subordinated bond issued by National Grid and increased our holding in Cadent. We continue to view National Grid as playing a fundamental role in the transition to a greener economy, demonstrated by the investments being made in the grid to meet the growing electricity demand. At the same time, our holding in Cadent recognises the role of gas as a “transition fuel” in the journey towards net zero, representing a lower emitting source of energy

than that of oil or coal to both industrial customers for generation as well as households for heating. We also take comfort in Cadent's continued investments to reduce leakage levels, evidenced by the reductions in absolute operational emissions achieved over the past three years.

Outlook

Last quarter we highlighted that we expected yields to remain sensitive to economic data, and unless there was a significant deterioration in underlying trends, we expected this to lead to range-bound yields. This is the scenario that unfolded over the quarter, with markets seeming to mark time until central banks – notably the Federal Reserve – start to cut rates. We expect a small fall in government bond yields in Q3.

Headline inflation is now significantly lower in the US, euro zone and UK compared to 2023. Base effects account for a material part of these falls. Beyond the headline figures, the likes of services inflation and wage growth remain higher than most central bankers would prefer. That said, we do expect to see more movement from central banks in the second half of the year, even if the quantum of those moves is less than many were forecasting earlier in the year.

Sterling investment grade yields are higher than they were at the start of the year, reflecting higher gilt yields and a small reduction in credit spread. We believe that the all-in yield on the market (using iBoxx), near 5.3% at the end of June, is attractive both in absolute terms but also relative to government bonds. Despite the contraction in credit spreads they continue to compensate investors for the risk of default.

We target – and achieve – a material yield premium over the market level in our sterling credit strategies. We mitigate the risks by maintaining highly diversified portfolios, with a bias towards bonds that offer greater security and downside protection. Our view remains that over the medium term our focus on delivering greater income than the benchmark will generate outperformance.

Further Information

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