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## Quarterly Overview

## 30 June 2024

ROYAL LONDON
ASSET MANAGEMENT

# 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.

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. Of the major sectors, supranationals and banks produced positive returns, while insurance lagged.

## Performance and Activity – Sustainable Corporate Bond

Despite the slight negative returns for the wider sterling investment grade market, the fund 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 portfolio over the benchmark index was also helpful.

Within the banking sector, our exposure to subordinated bonds remained helpful. Lower tier 2 bonds from the likes of Close Brothers and Santander performed strongly, while our exposure across senior and subordinated bonds in Virgin Money and the Co-operative Bank also did well as the proposed takeovers by Nationwide and Coventry Building Society respectively continued to progress. Structured bonds were the other area of interest, with strong performance from student loan provider ICSL 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.

New issue activity provided numerous opportunities for the fund 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.

The secondary market was also a source of trades during the quarter. We took profits on senior OSB bonds after strong performance, and added Virgin Money AT1s, with the proposed takeover offering the opportunity to buy Nationwide risk at Virgin Money yields. We also took profits on Aviva bonds, switching in AXA for an attractive increase in credit spread.

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 a commercial mortgage-backed security from UK Logistics. The UK Logistics issue is backed by over 60 logistics properties, primarily in Greater Manchester but also including London and the Midlands.

# Overview

## Performance and Activity – Sustainable Short Duration Corporate Bond

Our credit-only fund Sustainable Short Duration Corporate Bond fund produced a positive absolute return for the quarter, broadly in line with the benchmark index. The main driver of positive performance was stock positioning – notably in the bank sector. 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 portfolio over the benchmark index was also helpful.

Within the banking sector, our exposure to AT1 bonds remained helpful as holdings in OSB, Santander and Lloyds Banking Group all performed well, while our exposure across senior and subordinated bonds in Virgin Money and the Co-operative Bank also did well as the proposed takeovers by Nationwide and Coventry Building Society respectively continued to progress.

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## Outlook

All issuers within our sustainable holdings offer a net benefit to society or show ESG leadership. As well as reducing risk, we seek out opportunities that are under-researched e.g., bonds that do not fall into mainstream indices or benchmarks and/or are unrated by ratings agencies. Importantly, the sustainable credit proposition provides access to critical sectors that most investors can't access via equity markets. Key themes in the funds include social housing, social & environmental infrastructure, community funding (regulated banks and building societies focused on SME and retail lending), financial inclusion & resilience (such as insurance products to support individuals through shocks) and the energy transition. On sustainability grounds, we have no exposure to bonds of oil & gas companies or extractive industries. We are also underweight in the general industrial and consumer goods sectors, and to a lesser extent in consumer services.

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

Please click on the links below for further information:

## Find out more

In an uncertain geopolitical and economic environment, we recognise the importance of keeping our clients updated on our current investment thinking.

Articles, videos, podcasts and webinars giving the latest views of our investment experts can be found in the Our Views section of www.rlam.com, including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams.

# Important information

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