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Outlook 2023



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Introduction: Turning point?

by Piers Hillier



Piers Hillier

Chief Investment Officer

Piers joined RLAM in January 2015 as Chief Investment Officer, with responsibility for managing and developing RLAM's investment capabilities. Piers has over 25 years of investment experience, including roles as Head of International Equities and a member of the Strategic Policy Group responsible for setting asset allocation for multi asset portfolios at Kames Capital. Prior to this, Piers was CIO and Head of Asset Allocation for LV= Asset Management and previously CIO European Equities for WestLB Asset Management. He also previously held the position of Head of European Equities at Deutsche Bank and Schroders. In his current role, Piers is a director of Royal London Asset Management Ltd, Royal London Unit Trust Management, a member of the RLAM Executive Committee, and chairs the RLAM Investment Committee. Piers holds a Bachelor's degree from the University of Bristol and Masters degree from the University of Oxford.

Writing an outlook for the year ahead might be viewed as an exercise in damage limitation: don't stick your neck out and go with the consensus. But Royal London Asset Management has never been a consensus asset manager. Last year, we highlighted three main concerns: geopolitical risk was probably not properly priced into markets; inflation was probably not transitory; and finally, asset prices were quite elevated while the conditions for a pullback had increased.

A simple prediction for 2023 would be that markets now do understand geopolitical risk properly, are fully aware of inflation and market falls mean that asset prices are better value. But markets are never quite that simple.

My basic belief for 2023 is that we see a degree of normalisation after a volatile 2022. I'm cognisant that economically things will, certainly from a data perspective, get worse before they get better. Markets have rallied in Q4 2022 in anticipation of a peak in the US interest rate cycle, but for example, if we saw an escalation in the war in Ukraine, further deterioration with China, or mismanagement of interest rate policy by the Fed, things would get worse before they get better. While all of these factors

are possible, markets, as discounting mechanisms, are already reflecting quite a lot of bad news: whilst credit spreads are not back to previous crisis peaks and we have not seen a significant increase in default rates, interest rate increases and spread widening mean that yields in many fixed income asset classes are the most attractive they have been since the Global Financial Crisis.

If this sounds dangerously like 'RLAM CIO predicts market turn', then I would say that calling turning points is difficult, and generally quite high risk — we've all seen the effect on 10-year investment returns if you missed the best 5/10 trading days. And we all recognise that markets do not move in a linear fashion.

Our job as investors of your capital is not to predict what will happen in 2023 – the events of the past three years alone have shown the futility of this (I didn't see many predicting a global pandemic, US insurrection and Russian invasion). Our job is to focus on the dozens of individual investment decisions we make each year on your behalf, and work on ways to tilt the odds in our favour, by marrying skilful investors with robust processes and strong support. Long-term investment success is based on identifying value and acquiring it, ensuring that we are getting the balance of risk and reward right for our clients. So what drives that risk / reward consideration for 2023?

Inflation is still top of the list

In economic terms, inflation has utterly dominated the agenda in 2022. First it was considered transitory, then simply a mathematical function of higher energy prices, but it is clearly more than that. Following a period of very low interest rates, quantitative easing (QE) and government intervention, it was naturally tempting to see the post-Covid period through the prism of the global financial crisis. That period also saw a large shock to economic growth, rates slashed by central banks, quantitative easing and massive government intervention, but little or no inflation. Of course, the main change this time is wages: after the GFC, wage growth was utterly anaemic; today it is not.

Writing this in the UK, on another strike day, I am all too aware that there is considerable upward pressure on wages. In every major economy in the west, public sector wage growth is constrained by a poor fiscal position, while private sector wage growth will struggle as profitability comes under pressure (more on that later): against this, workforces are facing significant cost of living increases and in some sectors, are looking at quite buoyant job markets.

“ More than ever bottom up, research led active and engaged investment management will be critical for success in 2023. ”

However, it is worth noting that energy and commodities have been a large part of the recent rise in inflation. With oil now some 20% off its peak of around \$110, London Metals Exchange inventories starting to rise and even grain exports easing, we have at least a partial fall in inflation already baked in.

Against this, we have had a strong deflationary trend pushing inflation lower for more than two decades – globalisation. Covid and Ukraine have showed us that the secure and free-flowing supply chains that are an essential foundation of that trend can no longer be counted on. For example, at the end of the third quarter, Ford had some 45,000 unfinished vehicles waiting on parts due to blockages in their global supply chain. Whilst it is too early to sound the death knell for globalisation we are already starting to see companies 're-onshoring' production to reduce reliance on global supply chains, this will add to domestic labour demand.

Two stages of asset price decline

Bear markets usually go through two distinct phases. First, a de-rating where we see multiples fall, leading to somewhat counter-intuitive moves as companies announce decent earnings yet see their share price fall. This phase now largely feels complete. The second, as economic activity slows, driven by a fall or rebasing of earnings. We started to see earnings misses in the second half of 2022, and with economic growth slowing, earnings pressures are likely to persist in 2023.

One of the most important aspects of 2023 will be how companies – and investors – cope with high inflation. We have been in a low inflation environment for most of the last two decades, and many of today's business leaders are facing this for the first time. Companies that have pricing power and strong cost control could see significant earnings increases thanks to inflation-boosted revenues. More easily said than done of course, but this is the challenge all companies are facing and it will be interesting to see who can weather this particular storm.

Traditionally, an economic slowdown is a time to unload cyclicals and buy quality defensive growth and that may prove to be a good principle for 2023. As ever, understanding the underlying companies and what drives their earnings will be important. However, given the inflationary back drop and the rise in interest rates, the ability to grow and convert earnings in to free cashflow will be a critical focus and this may provide investment opportunities across industries. Just as the liquidity tide has lifted many corporate 'boats' so, as it continues to go out in 2023, it will become clear who has sailed too close to the insolvency 'rocks'. More than ever bottom up, research led active and engaged investment management will be critical for success in 2023.

Building portfolios

A traditional and simple way to build a portfolio is to add a mix of equities and bonds. We think that investors wanting a true multi asset approach should also look at areas such as property and commodities but the reason that this approach has lasted as long as it has is because it often works. But not in 2022. The rise in bond yields not only dragged bond returns firmly into negative territory, but also those of equity markets – particularly the growth areas that are valued using long bond yields as a discount rate.

It's tempting to think that this means we need to look again at how to build portfolios. My own view is that we have to respect what happens in the bond and equity markets, and the interplay between them, but it is not a reason to rip up everything and start again.

Bond markets can obviously see more disruption, but yields are back at pre-GFC levels. Of course yields can go higher, but this is a much better starting level than we've seen in a decade. And with credit spreads wider, all-in yields are attractive and provide a better buffer for investors from default risk. For equity markets, the last couple of years have been as much about the change in the discount rate as corporate earnings and free cashflow generation. We believe that 2023 offers an excellent opportunity for bottom-up stock selection as the nuances of each business and their ability to manage and navigate the inflationary challenges they face need dedicated analysis rather than a macro-economic or cost of capital view.

An interesting lesson to take from 2022 was how quick and far markets can move. As a result, a strategy built on a point forecast is always subject to outlier events such as those seen this year. Looking to 2023, having a diverse asset allocation with a global lens should provide good opportunities to add value through tactical asset allocation. Given the themes I have noted, I believe it strengthens our underlying philosophy of being active managers and bottom up stock pickers: RLAM's investment teams will continue to make individual investment decisions that respect the macro backdrop, but do not defer to it.



Global equities: Where next?

by Peter Rutter



Peter Rutter

Head of Equities

Peter is Head of Equities at RLAM as well as the Global Equities team, and a Senior Portfolio Manager with over 19 years of experience. Prior to joining Royal London Asset Management, Peter was Head of Global Equities at Waverton Investment Management, where he worked alongside Will Kenney and James Clarke under the same team construct. Prior to this, Peter was a partner and global equities fund manager at IronBridge Capital Management for six years, where he co-managed the £3bn IronBridge Global Select equity strategy.

Previously, he worked in the Global Equities team at Deutsche Asset Management. Peter graduated from Christ's College, Cambridge University, with a starred double first-class degree in Geography, is a CFA Charterholder and a chartered management accountant (CGMA). Peter has also achieved the CFA Institute Certificate in ESG Investing.

What challenges did global stocks face in 2022?

Rising interest rates, bond yields, inflation and threats of a looming global recession have been significant challenges for stocks globally in 2022. This formidable set of headwinds has seen global equity markets post significant losses in US dollar terms.

With the 'transitory' inflation pressures of global supply chain disruption that first appeared in the aftermath of Covid being exacerbated and prolonged by the escalation of Russian aggression in Ukraine, an inevitable tightening of monetary policy globally in order to try and control this has resulted in interest rates rising sharply over the course of the year.

With this rise, the present value of future company cash flows, upon which stocks are valued, painted a very different picture for many of the previous market leaders. As a result, traditional higher growth areas, such as technology stocks, saw sharp sell-offs over the course of the year and, as inflation pressures took hold, those companies with less pricing power also began to come under pressure.

What worked well in Global Equities in 2022?

As expected with hindsight, those sectors that tend to do well in rising inflationary periods were the best places to be over the year. Both energy and commodities sectors were especially strong during the year as prices rose on the back of strong demand for weaker supply.

Currency movements had a notable impact over the year with the Federal Reserve's early and more aggressive approach to raising interest rates pushing the US dollar higher against the world's other main currencies. For sterling investors in global overseas assets, this dollar strength provided a boost to returns over the year.

When researching and building portfolios of global equities we tend to look at the world through a proprietary Corporate Life Cycle classification lens. This is based on the belief that corporate returns on productive capital and growth tend to progress along a Life Cycle and every company can be located economically in one of five Life Cycle categories.

Over the course of 2022 we observed that those companies at the front end of the Life Cycle, which we term Accelerators and Compounders, came under significant pressure against the market backdrop. It is here that you would expect to find early-stage technology companies together with some larger, more established, traditional growth business which have been the market leaders for so long. In contrast, the later Life Cycle stages of Mature and Turnaround companies, where we tend to find much more representation of the traditional Value sectors, were much stronger overall performers than in previous years.

What were the biggest challenges when managing Global Portfolios in this market environment?

The volatility of 'style' and 'factor' performance in financial markets, which first started to pick up around six or seven years ago, increased significantly over the period. The deviations in performance between different types of stock and manager 'styles' over the period are strong evidence of this elevated risk.

This has made it increasingly challenging to build portfolios with absolute high stock specific risk, which is our traditional 'edge'. In response to this challenge, we have continued to spend much time and effort evolving our measurement of style and factor risks and also the tools we have at our disposal to build portfolios in these types of environments. We have for example continued to benefit this year from a proprietary toolset using over 20 fundamental risk factors which allows us to understand and balance top-down risk across our portfolios in multiple planes to ensure we remain in balance.

Are you positive on the outlook for equities in 2023?

The significant falls in equity markets along with the resilience of long-term wealth creation in equities means that stocks are likely more attractive now than 12 months ago which does provide some comfort in the face of a challenging and still uncertain outlook within which a pretty deep and prolonged recession seems to be priced in.

There are large swaths of the equity market that are likely to be relative beneficiaries should inflation moderate, in a way that cash and fixed income assets cannot be. The cyclical nature of parts of the equity market are also likely to rally in the event of a more moderate recession once the growth outlook improves.

It's never possible to predict the market for the next 12 months but current lower priced markets, areas of inflation protection and areas that have become particularly cheap all create pockets of opportunity that were not as evident at the beginning of the year.



What themes will be prominent next year?

The rate and magnitude of rising interest rates and bond yields have signalled a global recession as likely given how much consumer financing and disposable incomes are set to be squeezed. How deep, long and widespread this recession is will likely dominate analyst and earnings forecasts for the near term and there is much uncertainty around this. What happens next with the Chinese economy, Covid and geopolitical policy are issues that will all likely be front and centre to sentiment and moves within global equity markets.

We tend to avoid making any top-level sector or thematic predictions, as experience tells us that this can be very challenging. However, we can make observations based upon bottom-up insights and more long-term observations. We believe our approach of investing in a broad range of companies who are in control of their own fates, irrespective of market conditions is the right one. As well as looking for durable businesses, a willingness to look through short-term extremes of sentiment and buy stocks when they are out of favour, or take profits when sentiment becomes exuberant, should, in our view, deliver longer-term performance.

In this respect, for stock pickers like ourselves, the biggest challenge with global equity investing also provides its biggest opportunity: the fact that there are over 5000 investible stocks to choose from. We are advantaged in this approach at RLAM by our comprehensive data-layer and technology toolsets, built up over 20 years, which covers every stock in this broad universe and these form the basis for our comprehensive idea generation, research and stock selection.

In terms of portfolio positioning, we continue to invest broadly across this Life Cycle which, alongside our tight region and sector relative exposures, ensures that we continue to seek stock specific risk as our main performance driver.

We continue to be convinced in our belief that companies pursuing the right wealth creating strategy for their position in the Corporate Life Cycle will be very fruitful long-term opportunities for shareholders. Beyond that, and like 2022, we would note that relative valuation opportunities across the Life Cycle continue to be in abundance.

“A willingness to look through short-term extremes of sentiment and buy stocks when they are out of favour, or take profits when sentiment becomes exuberant, should, in our view, deliver longer-term performance.”



Sustainable investing: Take the long road

by Mike Fox



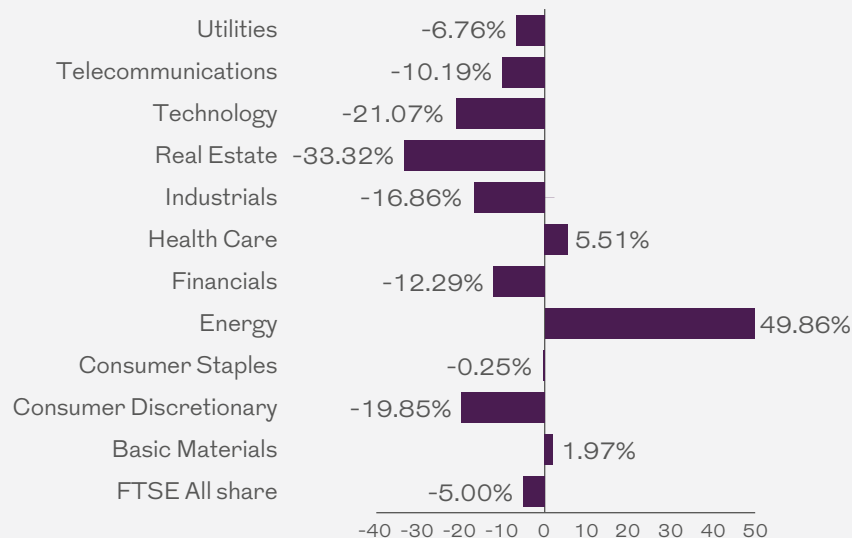
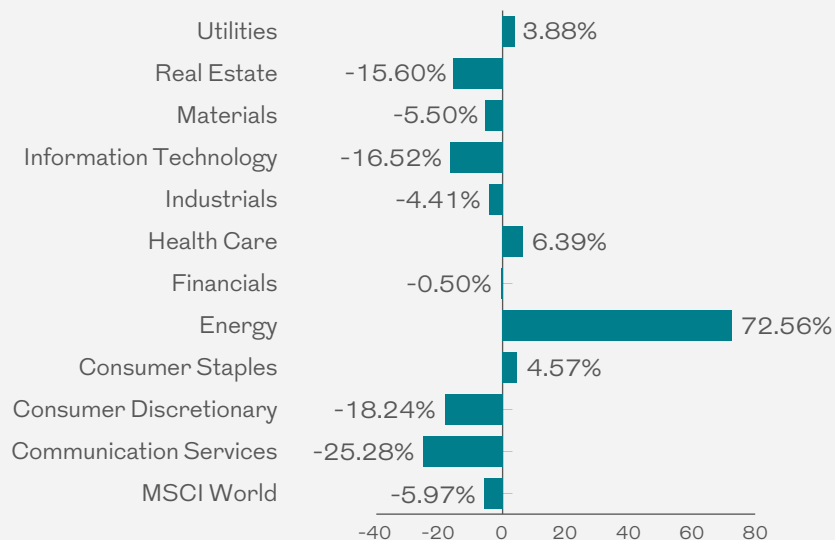
Mike Fox

Head of Sustainable Investments

Mike is Head of Sustainable Investments and co-fund manager of the Sustainable Leaders, World and Diversified trusts as well as the Global Sustainable Equity fund. He has managed the Sustainable Leaders Fund since November 2003. Prior to this, Mike worked as a Deputy fund manager at the Co-operative employee pension fund for two years and as an investment analyst covering the utility, support services and media sectors. Mike originally trained and qualified as a Chartered Accountant with Ernst & Young in Manchester. Mike has won five Fund Manager of the Year awards, in 2015, 2017, 2019, 2020 and 2021. Mike has spent the majority of his career assessing environmental, social and governance issues and how they influence investment decisions. He is a specialist in sustainable investing and one of the few fund managers in this area with such long tenure.

For anyone with a historical perspective of investment markets, 2022 will go down as one of the most historic and memorable. The scale and speed of change in key asset markets, such as equity and debt, has been at times breath taking. This in itself reflects a fundamental reassessment of the outlook for investment markets that was not captured or considered by outlooks a year ago.

At the start of 2022, a reasonable view would have been that inflation was indeed transitory, created by the supply chain bottle necks we saw in the wake of the pandemic, which in turn would have been expected to work through by the end of the year. What was unknowable at the time was the structural shift in energy and commodity markets that would be created by Russia invading Ukraine. This created a skewness to markets which is unprecedented, leading to energy being the only area of material positive returns this year within equity markets (figure 1).

Figure 1: Equity sector returns for first 10 months of 2022**Total Return - FTSE All Share****Total Return - MSCI World**

Source RLAM: FTSE All share and MSCI World indices sector returns
31 December 2021 to 31 October 2022.

Past performance is not a guide to future performance.

Sustained impact

Given how wrong outlooks were generally for 2022, what can we predict with certainty for sustainable investors in 2023? In our outlook for 2022 we suggested it could be a tougher year for sustainable strategies due in the main to higher valuations prevalent in longer duration growth stocks. This proved to be true – although valuations reset to a degree much greater than we expected due to inflation and interest rates both rising faster and further than anyone forecast.

We now feel that that much of this valuation reset has occurred and that even if inflation and interest expectations rise further, it is hard to envision a further shift as large as the one that has already occurred. It is also worth noting that we suggested that the drivers sitting behind the drive to a more sustainable society had reached critical mass and if anything were accelerating. This is certainly true, as from what we can see sustainability – in terms of investments, corporate behaviour and investor interest is booming.

Eyes on the prize

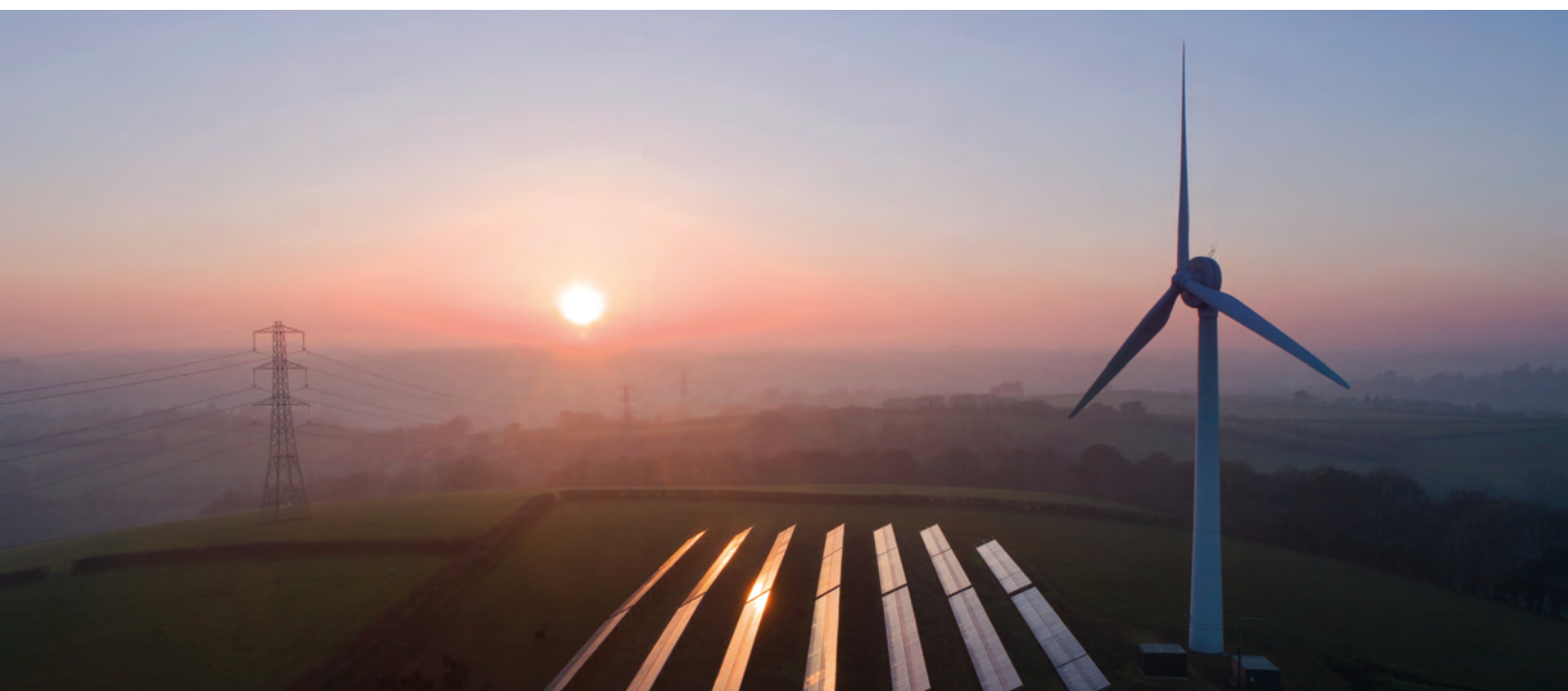
There are many descriptions or constructs used to describe the framework for sustainable investing. Cleaner, healthier, safer and more inclusive would be one we feel most affiliated to. Meeting the needs of today without compromising the needs of the future would be another. Both give direction to solving problems rather than creating them and having a positive role in society.

At times it can feel like we have more problems than we can ever solve as a society but, as in the pandemic, it is wrong to be short optimism and long pessimism. We see many of the most investable trends in their early stages. Digitisation, turning fatal diseases into chronic, and decarbonising society are all areas we expect to be talking about and investing in both 2023 and well beyond. Although coal and armaments may be a solution to current problems, they are unlikely to create the future path for society and investors.

Perhaps though the greatest lesson of 2022 is how unforecastable the future is. A year ago most investors would have had a sunny disposition, aided by markets at all-time highs and a global economy which was growing rapidly. If a year can create this much difference in the investment environment, the range of outcomes for the coming year is surely wide. A year from now will we be talking about inflation or deflation? Will we be talking about recession or recovery? Will we be talking about peace or war? All of these questions are fundamental to markets but largely unknowable.

To us it is more rational to invest by observable certainties than unobservable uncertainties. That the world will be more sustainable in the future than the past is really an assertion that solutions will overcome problems. And investing in sustainable funds is an assertion that companies providing solutions to problems will become more profitable, and those causing problems will become less so. Our outlook for 2023 therefore is a bifurcated one: uncertainty in the macro, certainty in the micro. Following the latter is the path we would recommend.

“ At times it can feel like we have more problems than we can ever solve as a society but, as in the pandemic, it is wrong to be short optimism and long pessimism. ”



Multi asset: Recessionary conditions good for bonds, but the equity bear market isn't over

by Trevor Greetham



Trevor Greetham

Head of Multi Asset

Trevor Greetham is an investment strategist and fund manager with 24 years of experience. Prior to joining Royal London Asset Management in 2015, Trevor was Asset Allocation Director for Fidelity Worldwide Investment, where he was responsible for implementing tactical investment decisions across a wide range of institutional and retail funds. From 1995 to 2005, Trevor was Director of Asset Allocation for Merrill Lynch, advising fund manager clients on their multi asset investment strategy. Trevor qualified as an actuary with UK life insurer Provident Mutual and has a Master of Arts in Mathematics from Cambridge University.

A relic of the 1970s, Stagflation, returned to haunt financial markets in 2022. Broad diversification was very beneficial, with inflation hedges like commodities surging and commercial property posting solid returns. For balanced funds investing only in stocks and bonds, there was nowhere to hide. Bonds suffered a once in a generation crash as central banks hiked rates to counter double-digit inflation, despite a slowdown in growth.

Higher bond yields, in turn, saw growth stocks de-rate with global equity markets seeing their worst year since 2008 in local currency terms. Much of this pain was offset for UK investors by a slide in sterling which raised the value of overseas assets – and this currency effect helps to explain why many bond-heavy 'low risk' portfolios saw much larger losses in 2022 than those with a higher equity exposure. We believe that inflation is set to drop as economies move into recession and this should benefit government bonds over 2023. Equity investors may need to be patient. The earnings recession is yet to start and, if history is any guide, we could see a second leg downwards in stocks which could be amplified for UK investors if dollar strength reverses.

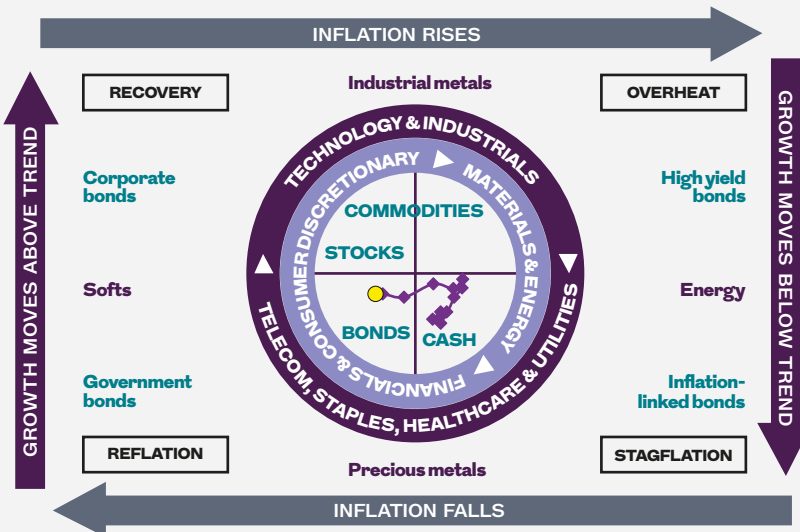
The move from low, stable inflation to high inflation was caused by the pandemic and the policy response to it. When Covid-19 hit in early 2020, governments asked people to stay at home to reduce transmission. Without further intervention, the Great Lockdown would have caused a collapse in consumer incomes and corporate cashflow, so it made total sense that monetary and fiscal policy was eased aggressively. The problem came in the recovery. Wartime levels of fiscal and monetary stimulus were left in the system far too long. Re-opening saw a rapid bounce back in activity into a supply-constrained world economy, with surging inflation the result.

Strong growth and rising inflation over 2021 would, in normal circumstances, have seen central banks raise interest rates but they were reluctant to remove stimulus in case another lockdown was necessary. As recently as December 2021, they were publishing ‘forward guidance’ suggesting they wouldn’t start raising interest rates until mid-2023. The thinking was that tighter policy was risky and the spike in inflation would be ‘transitory’. This view was shattered by Russia’s February 2022 invasion of Ukraine and the associated increase in energy prices, leaving central banks scrambling to raise interest rates.

Our Investment Clock, linking asset class returns to the stages of the global business cycle, spent most of 2022 in Stagflation, with growth slowing and inflation rising. This combination has historically been bad for both stocks and bonds, and 2022 was no exception (figure 1).

During the disinflationary four decades from 1980 to 2020, recessions were rare and central banks were generally on the side of investors, cutting interest rates in times of trouble. You have to go all the way back to 2000 (in the US) or 1990 (in the UK) to find a recession that was caused deliberately by central banks in an attempt to create spare capacity and bear down on inflation. This is what we see ahead.

Figure 1: The Investment Clock moving into Reflation



Source: RLAM. For illustrative purposes only. Trails shows monthly readings based on global growth and inflation indicators. Yellow dot is the current reading as at November 2022.

There is some good news. There are early signs that inflation may be peaking, with traded goods prices dropping and global supply chains opening up. This would move the Investment Clock from Stagflation to Reflation, the best stage of the cycle for government bonds. Falling real interest rates, lower inflation expectations and eventual central bank rate cuts are all positive for the asset class. We were strongly underweight bonds in early 2022 but we expect to move overweight tactically as inflation drops. We also expect to add to bond exposure in strategic asset allocation reviews. High allocations made little sense to us when yields were close to zero but at current levels prospective returns are much improved.

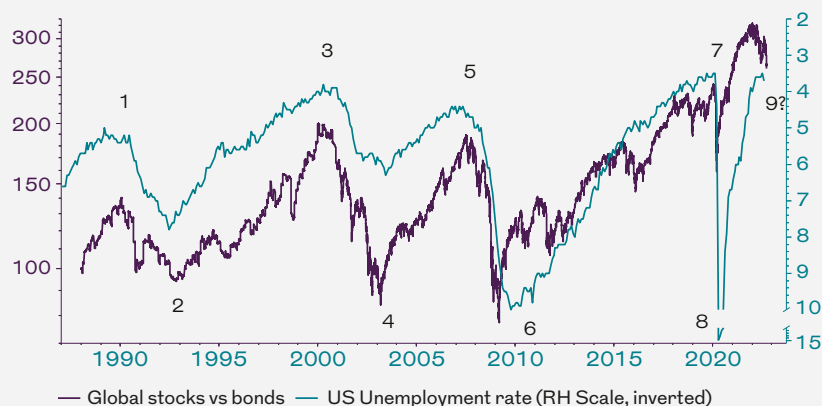
In the UK, the Sunak administration looks set to deliver spending cuts and tax rises just as rate hikes take effect, a deflationary mix that could make gilts particularly attractive. This makes us cautious about economically sensitive UK assets like commercial property, where we have moved underweight. Gilts went into a tailspin when the short-lived Truss/Kwarteng government announced a massive easing in fiscal policy. We are at risk of going to the other extreme with a new round of austerity. Lower gilt yields can signal policy credibility, but can also signal an over-tightening of policy. In our view, spending cuts should be back-end loaded or their scale reduced by credible policies that boost growth – fixing the trading relationship with the EU, for example.

While the prospects for bond markets are brightening, there is still some way to go before we can get bullish about equities or credit markets. The fall in stocks in 2022 can be explained by the sharp rise in bond yields, with interest rate sensitive growth sectors like technology hit hardest. While a turn downwards in bond yields may support a bear market rally, we don't think stocks have priced in a global recession. Analysts have only just begun to downgrade their earnings forecasts. A large drop in corporate earnings is ahead and history suggests it could result in a second leg of the bear market as well as a default cycle in credit markets.

In keeping with the Investment Clock approach, we believe equity bull and bear markets are closely linked to the economic cycle. To illustrate this, we plot the performance of global stocks versus global bonds against the US unemployment rate, shown inverted (figure 2).

- Bull markets usually start in the depths of recession, when unemployment rates are at their peak and about to fall – points 2, 4, 6 and 8 on the chart.
- Bear markets usually start at the end of an economic expansion when unemployment rates are at their lows and about to rise – points 1, 3, 5 and 7.

Figure 2: Global stocks vs Bonds and US unemployment rate (inverted, RHS)



Source: Refinitiv DataStream as at 31 October 2022.

It's hard to argue, looking at this chart, that the current bear market is over. In fact, it's hard to argue the bear market, as it relates to the coming recession, has even begun. We don't expect a new bull market to start until unemployment rates peak and that could be a year or more away. The last two central bank-induced recessions we associated with four- and three-year bear markets, respectively.

With such a high level of uncertainty about the future, general investment principles are more important than ever. This year has been difficult for passive multi asset funds investing in a simple mix of stocks and bonds. While inflation is likely to drop in a recession, structural

changes, from underinvestment in energy capacity to de-globalisation and populism, suggest it will keep coming back in the years to come. Broad diversification, including inflation hedges, will remain important, as will tactical asset allocation. Business cycles are likely to be shorter and more violent than they were in the disinflationary past and this will create opportunities for active managers.

“ We don't expect a new bull market to start until unemployment rates peak and that could be a year or more away. ”



Is there value in sterling credit?

by Paola Binns



Paola Binns

Head of Sterling Credit

Paola is responsible for the management of corporate bond portfolios. She brings some 20 years' experience in bond markets to RLAM, having joined in August 2007 from Credit Suisse Asset Management where she was responsible for managing sterling credit assets. Paola has developed a wide range of bond asset classes having held a number of roles specialising in European corporate bonds, government bonds and emerging market debt. Paola has a MA degree in History and Spanish Literature from Oxford University.

2022 was a terrible year for most fixed income investors. The causes are well known: rising inflation, higher bank rates, the impact of Covid and the Ukrainian war, ballooning government debt.

So, will 2023 be better? Our view is that the outlook for sterling credit is the best it has been for some time. There are several factors at play here. Most importantly, valuations are attractive and this has two component parts. Gilt yields have risen and now factor in a lot of monetary policy tightening whilst credit spreads are nearly 1% higher over the year.

A key question is whether the widening in credit spreads is justified. In our view there will be a pick-up in defaults over the next year. However, this will predominantly be a sub-investment grade event. We do not expect to see much change in investment grade defaults, reflecting the size and nature of these companies. Downgrades to sub-investment grade will be a threat to valuations but we believe that the current spread of 1.75% (figure 1) for non-gilt sterling bonds provides

more than adequate compensation. If we look at historic default rates and assume zero recovery from defaulted bonds, current spreads offer significant opportunities. Assuming a 20-year timeframe, investment grade investors require less than 30bps of excess yield to compensate for this risk. There is an argument that the nature of credit markets has changed, with a much higher weighting to the riskiest part of the investment grade universe (BBBs). However, when we look at this cohort over a 20-year timeframe, less than 50bps is required as compensation over government bonds.

Figure 1: Average investment grade sterling credit spread

Chart shows option-adjusted spread for the ICE BoA ML Non-Gilts All-Maturities index, Source: RLAM to 31 October 2022

There are challenges to face

The Autumn Statement in November confirmed that the supply of government bonds through the course of 2023 will be elevated and we believe that this will put upward pressure on yields. With over £200bn of gilt issuance to absorb there will be heightened competition for investors' attention. Quantitative tightening, which will see both gilts and sterling corporate bonds sold by the Bank of England, will add to this pressure. However, we do see scope for renewed interest in fixed income at these yield levels. Long-term investors will be attracted to current valuations and it is possible that pension funds that have benefitted from the move higher in government yields will look to increase their exposure to corporate debt as they de-risk. Similarly, we see room for asset allocators to increase weightings – which have generally drifted to low levels in recent years.

But we see value in several areas

Last year saw some significant sector de-ratings. This was most noticeable in banks and financial services, where relatively heavy supply, coupled with concerns about an uptick in bad loans – both commercial and residential – saw senior unsecured bond spreads widen by around 120bps in the case of sterling credit indices. We now see banks and insurance as two of the most attractive areas with yields, in some cases, higher than those recorded during the Global Financial Crisis.

Investors familiar with RLAM will know that we continue to favour asset backed and secured bonds. This reflects our view that we are over-compensated for risk when compared with unsecured debt. Recovery rates, typically, are materially higher on secured bonds and whilst liquidity tends to be lower, we feel it to be an attractive trade-off. Additionally, asset backed and secured bonds offer a material diversification, being less exposed to common economic factors that impact certain sectors, such as banks.

The economic background, globally and domestically, will be an important factor in returns from sterling credit in 2023. The UK has entered recession and it is likely that other major economies will follow. This will cap the upside on short-term rates. If we look at what is reflected in the sterling yield curve we can see that UK interest rates of 4.5%-4.75% are priced in for mid-2023 with a small reduction reflected for later in the year. This is a pattern repeated in the US, albeit with a higher peak. We think these profiles look reasonable. From a positioning viewpoint we think short duration strategies look good value, reflecting the government bond pricing and the significant credit spread premiums available. Further along the curve medium-dated credit has attractions, especially in some financial bonds, whilst we remain cautious at the longer end of the market where gilt yield curve inversion reduces the attractions of credit.

“The economic background, globally and domestically, will be an important factor in returns from sterling credit in 2023. The UK has entered recession and it is likely that other major economies will follow.”

High yield: When is the uncertainty?

by Azhar Hussain



Azhar Hussain

Head of Global Credit

Azhar has 20 years direct experience of investing in an array of strategies across the global fixed income and leveraged finance arenas. He trained as a chartered accountant with Deloitte before starting his investment career as a high yield credit analyst at Gulf International Bank in London. He subsequently became Head of Corporate Debt responsible for IG & HY absolute and relative return strategies. He left to join Insight as Head of HY & Leveraged Loans before joining RLAM initially as Head of Global High Yield where he has successfully launched strategies across the global credit spectrum. Azhar holds a BA in Economics & Law from SOAS, University of London and obtained a MSc in Behavioural Science from the London School of Economics in 2018.

Around a year ago, we confidently predicted that for high yield markets, it was 'Looking good for 2022 after August reboot'. With our global high yield benchmark index down around 15% for the year to the end of October, it quite clearly wasn't all good. Against that, global high yield has outperformed gilts and sterling credit as predicted, however; and emerging market debt has been the key area of weakness, delivering returns well below the US and European regions.

So, what did I get wrong? Like most people, I didn't foresee the Russian invasion of Ukraine and how it would supercharge inflation – the downstream impact on interest rates and risk of recession have been painful. Of course, unlike annual outlook predictions, fund managers are able to revisit their assumptions as new information emerges (albeit within a clear and consistent investment philosophy and process).

React and reposition

In the aftermath of Russia's aggression in late February, we shifted to a firmly defensive stance: the Federal Reserve's commitment to tackle inflation with faster and higher interest rate rises than previously indicated was already

apparent. However, the inflationary impact of the invasion and retaliatory sanctions on oil, gas and other commodity prices created a double whammy that completely changed the situation.

This was our position for the rest of the year. Even though sharp falls in underlying government bonds and far wider high yield credit spreads lead to particularly attractive yields, there was no need to be more bullish. Given the asymmetry of risks in credit investing, it doesn't pay to take excessive risks when heading into periods of more negative sentiment.

2023: pivot or stay put?

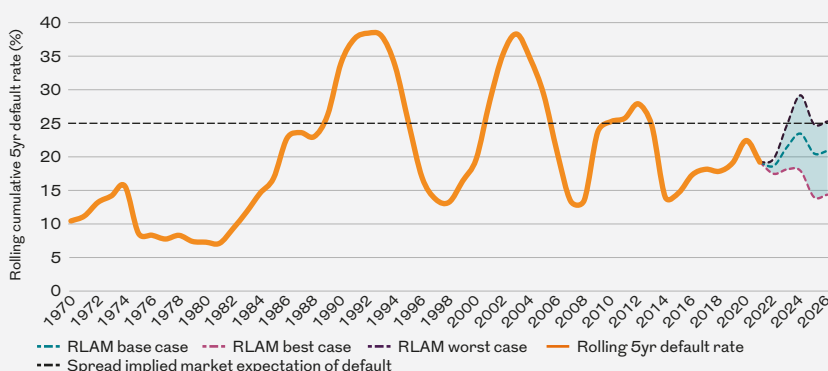
With yields now materially higher than this time 12 months ago, what are the prospects for the asset class and should we consider becoming more bullish? The big picture answer is pretty straightforward: in 2023, the high yield market will be all about the recession and the shape of the default cycle. This is the key dynamic for high yield markets at this point in the economic cycle.

With regard to the recession and defaults, after a moderate market panic in the autumn, markets calmed down somewhat and essentially started to price in a more benign environment – one that suggested that the peak of the rate cycle was near and that the recession would be relatively mild. The double-digit default forecasts we saw in September had turned into more modest 4-5% default predictions by December.

One factor that has to be considered more carefully is the risk-free rate. Until recently, around two-thirds of the total yield of the market was driven by the spreads on high yield bonds, with the risk-free element representing around one-third. With government bond yields now materially higher, that ratio is more of a 50:50. This isn't terrible in itself, but it does mean that government bond yield volatility will have a greater impact on the high yield market. And most investors are expecting more volatility in government bonds next year.

“In 2023, the high yield market will be all about the recession and the shape of the default cycle.”

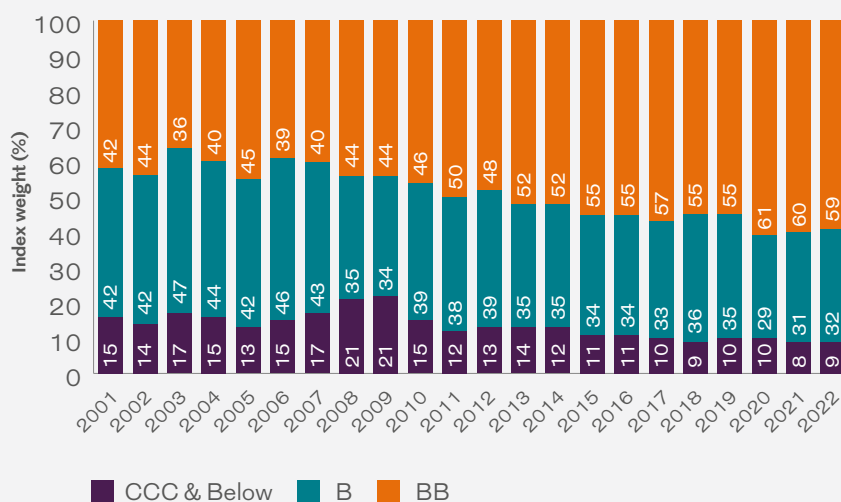
Figure 1: The default cycle has steadily evolved



Source: Moody's, BAML and RLAM as at 31 October 2022.

Past performance is not a guide to future performance.

Figure 2: High yield market composition



Source: ICE BofA Global High Yield Index (HW00) as at 31 October 2022.

Percentage figures are subject to rounding and so may not always equal 100.

The expectation that the peak of central bank action is within sight is also a concern for me. Perhaps central banks will be able to utterly crush the large uptick in inflation we've seen this year. I can see the combination of the year-on-year price effects and the impact of rate hikes already made bring inflation lower, perhaps a lot lower. But back to the 2% levels that most central banks target? I'm not so sure. I think there is material chance that the only way we see inflation back at the 2% is by means of far more hikes and / or a deeper recession than is currently priced into markets and that will be a question that both policy makers and markets will have to grapple with soon.

Follow the risk

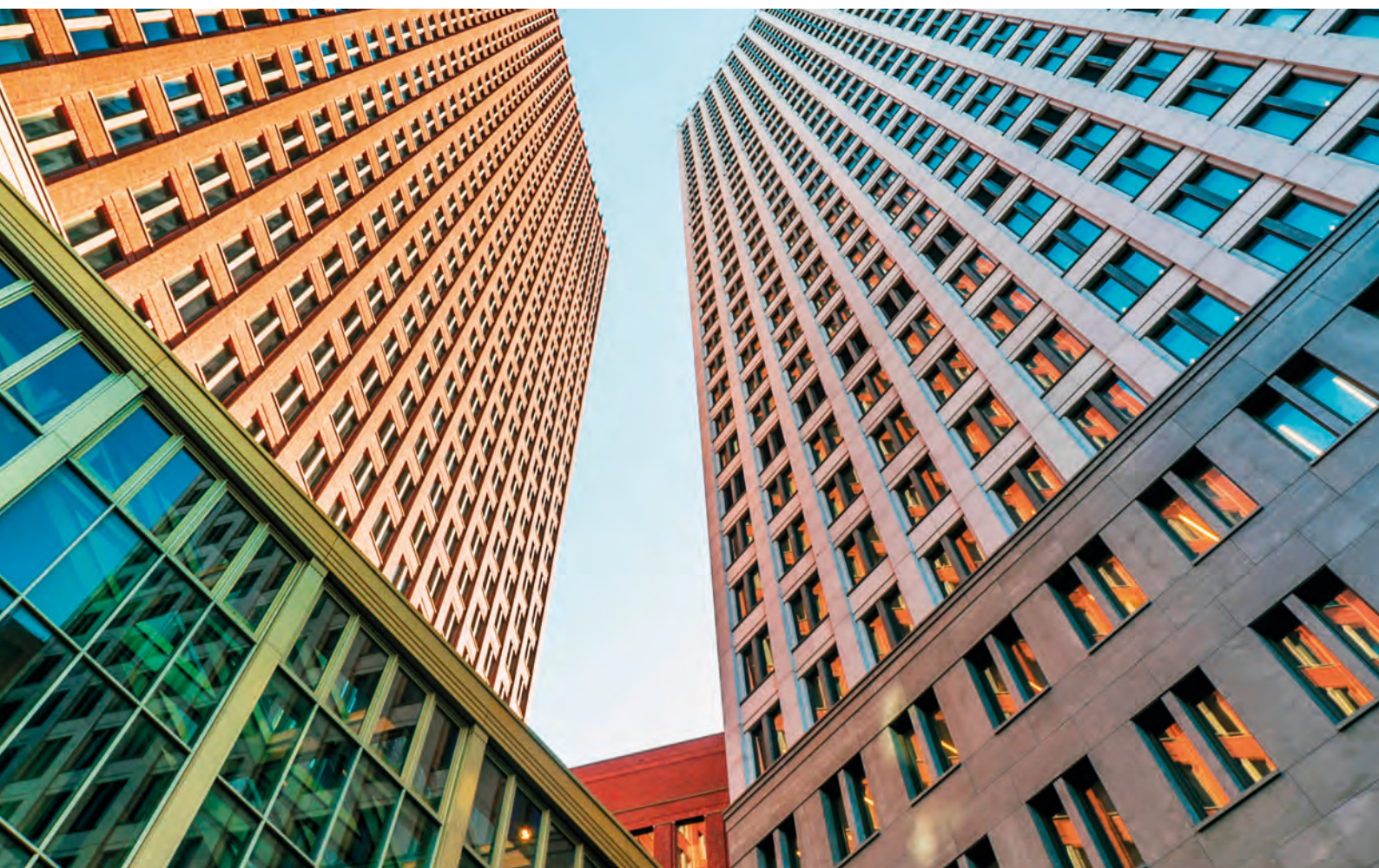
All of this sounds rather gloomy. But I continue to see opportunities for high

yield investors. The market as a whole was quite resolute in 2022 and many of the factors that drove that remain in place. The composition of the market is better than it was 20 years ago (figure 2), with around 9% of the market CCC rated, compared with double that a little over a decade ago while the proportion of higher quality BB bonds has increased materially. More importantly, the yield on this market is now around 8% – providing a buffer against further drawdowns and an attractive return if markets trade sideways over the year.

As ever in this market, there are higher and lower risk ways to gain exposure. Given our expectation that interest rates will remain volatile in 2023, many are still looking at short duration strategies to try to mitigate these effects. The recession also adds an element that we haven't seen in recent years. Unlike the

GFC, or even the pandemic, we expect negative effects to be much more issuer-specific, and therefore whether focusing on shorter or longer maturity issues, fully understanding that issuer and the quality of their financials will be a determining factor, rather than relying on third-party ratings or research. So above all, we think this is a year for targeted exposure, rather than taking a passive approach.

“ The market as a whole was quite resolute in 2022 and many of the factors that drove that remain in place. ”



Is there value in gilts and cash?

by Craig Inches



Craig Inches

Head of Rates and Cash

Craig Inches is Head of Rates and Cash at RLAM, responsible for the management and oversight of RLAM's rates and cash business. Craig works closely with Paul Rayner (Head of Alpha Strategies) and the rates team to manage a suite of solutions ranging from enhanced cash through sovereign and global bonds culminating in absolute return. Prior to RLAM, Craig was an Investment Director with Scottish Widows Investment Partnership, where he gained extensive cash and fixed income experience. Craig has an MSc in Investment Analysis from Stirling University, a BSc (Hons) in Actuarial Mathematics and Statistics from Heriot-Watt University and is an associate of the UK Society of Investment professionals.

In recent years, the prospects for gilts and other government bond markets have seemed somewhat dull, as the backdrop of historic low interest rates and quantitative easing meant the only sense of drama was how low yields could go. As a result, investors have viewed these assets as a dependable, risk-free, low-volatility, low yield asset. However, after 2022 – and notably for gilts, after the events in September – investors will be looking at these markets in a new light.

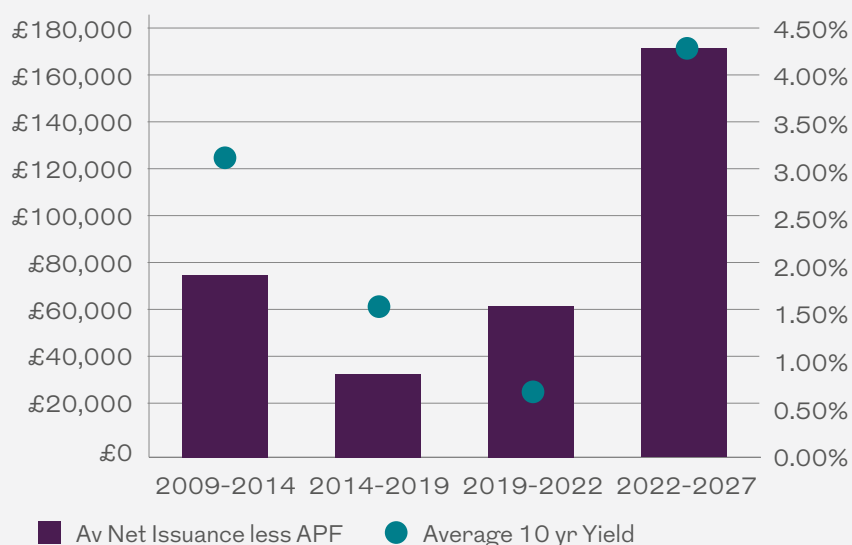
Of course, it had already been a challenging global environment, played out against a backdrop of persistently high inflation, war in Ukraine and escalating energy prices. For the UK though, the crunch came after then-Chancellor Kwasi Kwarteng's unfunded 'mini-budget' threw the gilt market into crisis. A fire sale followed, and gilt yields soared to levels not seen since the global financial crisis of 2008, while sterling fell to an all-time low. Only Bank of England (BoE) intervention – including committing to buy £65 billion of longer dated gilts – brought relief to the market, preventing a 'doom loop' that threatened the UK pension industry.

The clouds had already been gathering

While the mini-budget brought matters to a head, pressure had already been ratcheting up on the UK for some time. Although the BoE was the first major central bank to embark on a rate tightening cycle to combat inflation, its response overall proved painfully slow. As a consequence, the UK is expected to have persistently higher inflation – and for longer – than the rest of the G7 group. Domestic core inflation has picked up quite aggressively, partly due to weaker sterling feeding into core inflation. Back in 2021, the BoE considered UK inflation to be transitory – attributing it to higher food prices, higher energy prices (as a result of the Ukraine war) and ongoing but temporary supply chain challenges. But many of those supposedly transitory factors – deglobalisation, war, higher energy prices – look likely to remain with us for some time to come. Moreover, as core inflation keeps ticking up, that becomes problematic by leading to secondary wage effects feeding through.

The picture for gilt issuance doesn't look particularly pleasant either. Expectations are for net gilt issuance to increase from around £70 billion annually to anywhere between £160 - £200 billion per annum, but those estimates could be conservative. The sheer scale of net issuance will inevitably pull gilt yields higher – as it did in 2022 (see figure 1).

Figure 1: Gilt issuance and yields



Source: Bloomberg, ONS & Debt Management Office as at end October 2022.

Central banks are under scrutiny

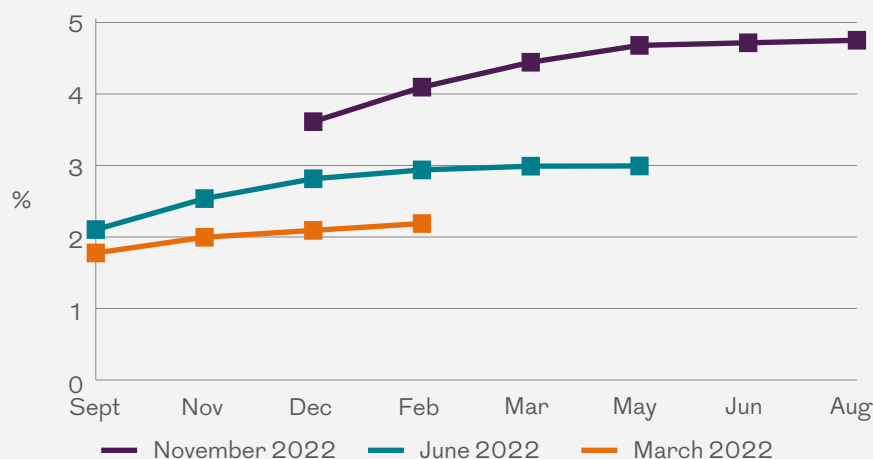
The BoE is not the only central bank under pressure. In the US, the Federal Reserve is trying to 'thread the needle' by engineering an environment where higher interest rates will dampen down the labour market, resulting in a mild recession at most. But should rate tightening lead to a deeper recession, we believe that the base effect plus declining demand would most probably push inflation back to the Fed's 2% target much quicker. This means that the US unemployment rate is potentially the most important metric to keep an eye on during 2023. As soon as the unemployment rate starts to go up, the Fed will be more inclined to ease off on rate hiking, as it should see a decline in second line wage effects, and therefore the demand side of the equation should also diminish.

Interest rate expectations have unsurprisingly shifted dramatically over the course of the year (figure 2). Between March and June, markets were expecting the BoE base rate to peak at around 2.0%. That peak forecast moved out to 6.0% in October, before settling back to nearer to 5.0% closer to the end of the year. Eurozone rates are expected to peak at 2.75% - 3.0%, while in the US, the peak is expected to be 4.75%.

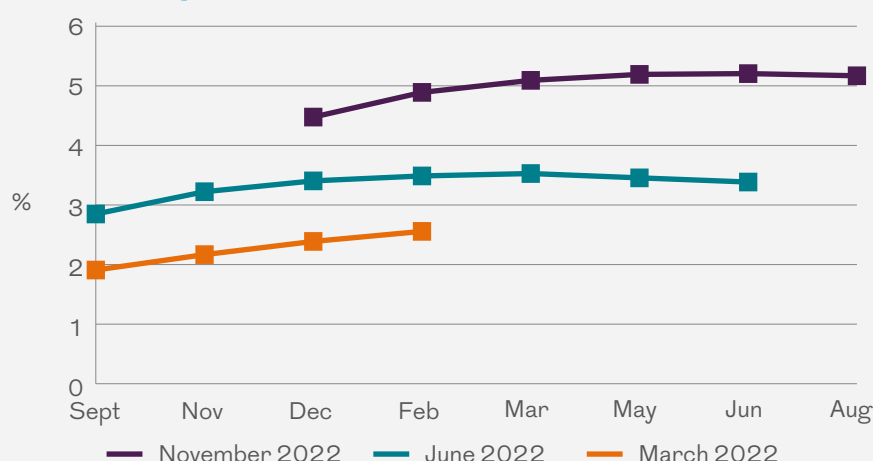
At RLAM, our central case is that we expect UK rates to peak at 4.5% in the mid-part of 2023, before falling back to around 3.75% in 2024. That is based on the assumption we'll see inflation peaking in early 2023, then drifting back towards 2.0% by the end of 2024. However, a stickier labour market could see rates going much higher, perhaps closer to 6.0%, before settling at 4.0%. In this scenario, there's a high probability that gilt yields could at some point in 2023 move back up to 4.8% - 5%, where they were following the mini-budget. The more optimistic – and less likely – scenario is that the peak for interest rates is much lower, as a result of inflation cooling off faster during 2023, which would result in a much lower yield curve profile.

Figure 2: Market expectations have shifted – particularly for the UK

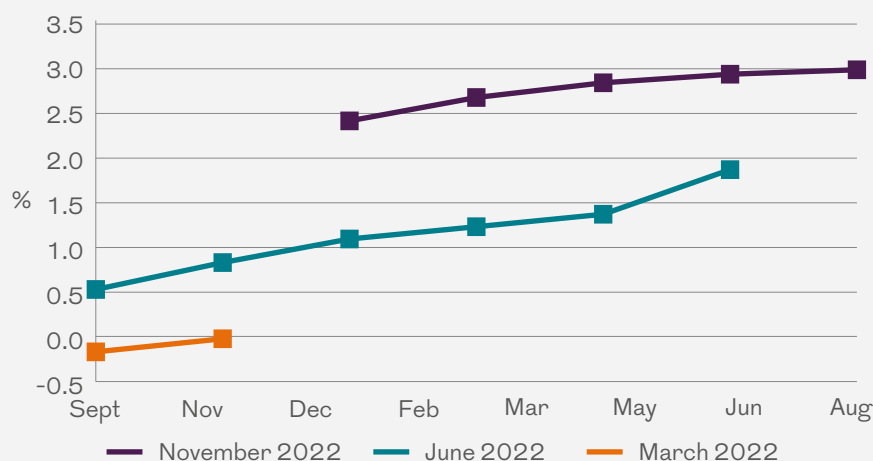
UK Rate Expectations



US Rate Expectations



EU Rate Expectations



Source: RLAM and MPC, as at 3 November 2022.

Money markets now offer a return

Looking at cash markets, throughout 2022 we saw strong investor demand for liquidity and short term fixed income strategies, and we expect this to continue throughout 2023. Liquidity is a basic building block for every investor, and everyone has short-term cash requirements – requirements that were demonstrated during the market disruption in October. The drive for these products comes from investors looking for assets with low or no capital downside, and therefore wanting to be in the shortest duration product possible. There has also been considerable demand for cash vehicles from asset allocators who have wanted to shift their positioning and move in favour of offerings with little or no interest rate sensitivity and very low credit sensitivity.

Do these assets still have a place in portfolios?

From an investor perspective, 2022 was clearly one to forget. At the time of writing, it looks like investors in gilt funds will experience asset value falls of over 20% over the year. With headline yields rising from around 1% to 4% over the year, there is of course potential for further increases: but while a yield increase from 4% to 5% hurts, it is a lot less painful than the move from 1% to 4%. For those already holding the asset class, the risk of further short-term capital mark to market losses may be outweighed by the more attractive yields on offer for the medium and long-term investor.

For those considering adding to exposure to gilts, we believe that a 10-year yield of 4.5% to 5% would be an attractive entry point, and despite pension fund deleveraging, we would expect to see strong buying at that level. And if UK real yields approach the 1.5% to 2% which are currently seen in the likes of the US, Australia or Canada, (compared to the current UK level around zero), we believe this would also be an attractive proposition. And last but not least, money market and short term fixed interest funds yielding between 3.5% and 5% will look attractive to many investors given their risk profile and low volatility nature.

Gilts have a critical role to play as an asset class and within investor portfolios, and we expect this to continue in a higher-yielding environment. From a structural perspective, there will always be a strong demand for longer-dated gilts, particularly from pension schemes looking to own physical assets, as well as from overseas buyers who see the available yields as attractive on a relative basis.

For many years, we felt gilt fund investors were not being fully compensated for the duration risk they were exposed to, and equally haven't been paid relative to other global government bond markets. As a result, over the last few years we've seen investors diversifying that risk through the use of short duration and / or global rates strategies. But at the levels mentioned above, we are seeing investors considering the opportunities available within all-maturity rather than short-duration strategies, increasing the rate sensitivity of their investments as they feel they are being better-compensated for the economic landscape we now find ourselves in.

The key to remember is that while gilts should be default free, they will probably not be volatility free. Thus it is important to look at the long-term fundamental value of the asset class. We expect this higher volatility environment to remain in place for the foreseeable future, given we are in a world of no QE and high debt issuance. This presents numerous relative value opportunities for active managers to capitalise on and more importantly help to mitigate capital drawdown.

“ Gilts have a critical role to play as an asset class and within investor portfolios, and we expect this to continue in a higher-yielding environment. ”



Quality is key in real estate markets

by Kevin McCauley



Kevin McCauley

Head of Strategy
and Property Research

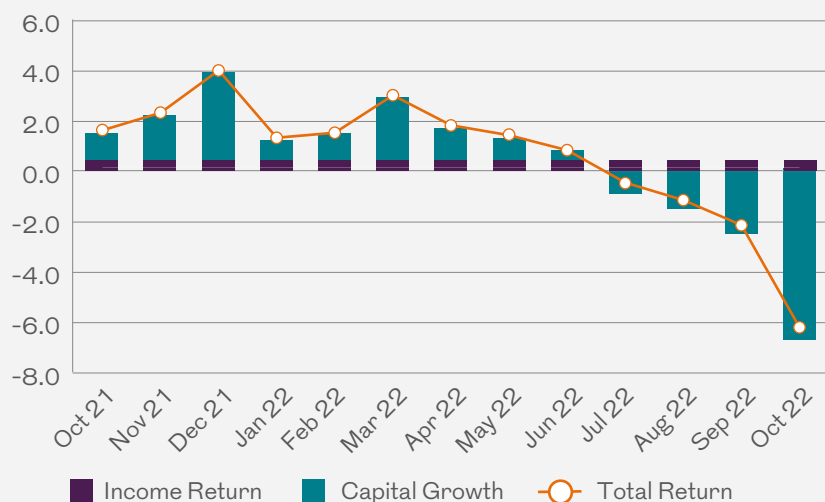
As Head of Strategy and Research, Kevin works with the RLAM Property team to enhance the strategic initiatives for the continued growth of the property business. Kevin spent 15 years at CBRE initially as head of London and South East Office Research and eventually head of UK Commercial Research. He also spent two periods as acting head of UK Research. More recently, he was head of Client Strategy and Strategic Projects. Throughout his career at CBRE, Kevin advised clients on single asset and portfolio strategy and wider strategic decisions. Kevin has also become a leading authority in real estate life science and technology sectors. His clients have included British Land, Landsec, Canary Wharf Group, The Crown Estate, CPPIB, CBREIM and Blackstone.

Investment markets in general have weakened quite significantly during 2022, as investors have grown increasingly concerned about the global economic slowdown, and by the deteriorating economic outlook for the UK.

The real estate market is no exception. A heightened level of uncertainty and pessimism has been affecting the price that investors are willing to pay for UK properties across the board, albeit with some sectors more heavily affected than others. As a result, investment volumes have dropped and pricing has moved out quite considerably.

The sectors most affected by this shift in investor sentiment are those that performed best some 6-12 months ago. According to MSCI, industrial values have fallen by 16.6% since June compared with 7.7% and 8.1% falls for offices and retail respectively. In the case of retail, it still hadn't recovered from its drawn-out retrenchment over the last decade, particularly during the pandemic. While the residential property sector has remained relatively resilient, there's been a noticeable deterioration in sentiment since September.

Overall, occupational markets have remained remarkably resilient, particularly for high quality or prime stock, and we're still seeing rental growth with pockets of strong growth in logistics where the fundamentals remain strong.

Figure 1: Property: MSCI UK Monthly Index – Monthly total returns (%)

Source: MSCI UK Monthly Index – as at October 2022

Past performance is not a reliable indicator of future results.

Conditions to get worse before they get better

As we look ahead into 2023, our expectation is that investment sentiment toward property will remain weak. We are continuing to see relatively low levels of investment volumes, which suggests to us that pricing has further to fall. This is being reflected in valuations with yields seeing some large outward increases in October. Compounding this negative investor sentiment will be weaker occupational demand as a domestic and global recession fully takes hold and job losses start coming through. We are already seeing some early signs of weaker occupational demand which will lead to rental falls although we expect prime assets to show more resilience.

To borrow a football analogy, we see 2023 as a year of two halves. The first half should see a continuation of those sentiment-based trends experienced over the last few months, as investors draw back further. However, we expect to see some form of stabilisation in values as we move towards the latter part of the year or the early part of 2024.

Quality focus remains paramount...

There are several themes within property markets that will help lead this recovery phase, where we expect to see increased demand for new, high quality space, against a backdrop of limited supply of such space. For example, the demand for good quality office space will continue to gather momentum. Post-pandemic, employers have sought to encourage their workforce back to the office by improving the office environment in a process that has been described as 'magnetising the workplace'. This has involved giving employees a higher quality space to work in, making space more flexible and adaptable, enhancing wellness features such as light, air and opportunities for activity, and improving internal connectivity within a building. These outcomes are best delivered through a new or refurbished building.

The growing importance of ESG and commitment to net zero carbon targets are translating through to the demand for higher quality and efficient space. For office occupiers, their choice of building is closely aligned

with their ESG strategy and is a crucial consideration when seeking to recruit and retain staff. Occupiers now expect buildings to be able to satisfy their firm's corporate responsibility strategies and demonstrate their sustainability and environmental credentials from an operational perspective. This theme is playing out across all sectors and is best satisfied through high quality prime buildings. Investors are similarly focused on investing responsibly with investment decisions guided by ESG global benchmarks such as GRESB. This is partially being reflected in premium pricing as investors look to 'future-proof' new investments. This is only likely to become more critical as we move through the current cycle.

...as do themes driving growth in some areas

Urbanisation remains another core theme. We believe that major UK cities, including Manchester, Birmingham and Bristol, as well as London, will continue to see their economies outperform relative to the rest of the UK. Agglomeration effects – whereby clusters of business activity and people thrive due to proximity to one another – are one of the main drivers of productivity and economic growth. The competitive advantages of these knowledge hubs will persist and serve as one of the key drivers of outperformance of large cities over the rest of the UK.

Another positive trend in the UK is the sustained focus on life sciences, most notably in mature markets like Oxford and Cambridge, but also more recently in London. UK cities have a very strong life sciences asset base in terms of research hospitals, universities and research institutions, as well as the availability of highly educated staff. Increasingly, UK life sciences – thanks in part to a hugely 'successful' pandemic – are benefitting from venture capital funding that is helping to fund and drive research and innovation.

The dynamics of the life sciences sector are compelling, both from an investment and an occupational perspective, and we see this being reinforced throughout 2023 and beyond.

Another enduring theme – part-cyclical and part-secular – is healthcare. The UK population is not just growing, it is also ageing. People living longer is putting further stress onto existing health provision, and there is a notable lack of quality fit-for-purpose housing and care facilities for the elderly. We believe healthcare presents a huge repositioning opportunity.

As mentioned, the retail sector has experienced significant consolidation and repricing for much of the past decade. Should 2023 be dominated by recession, we expect the sector to continue to be buffeted by economic headwinds, leading to some modest falls in values and further adjustments in rents. That said, while much of 2023 is likely to be a period of reconsolidation, we expect to see good value further out once the sector eventually stabilises.

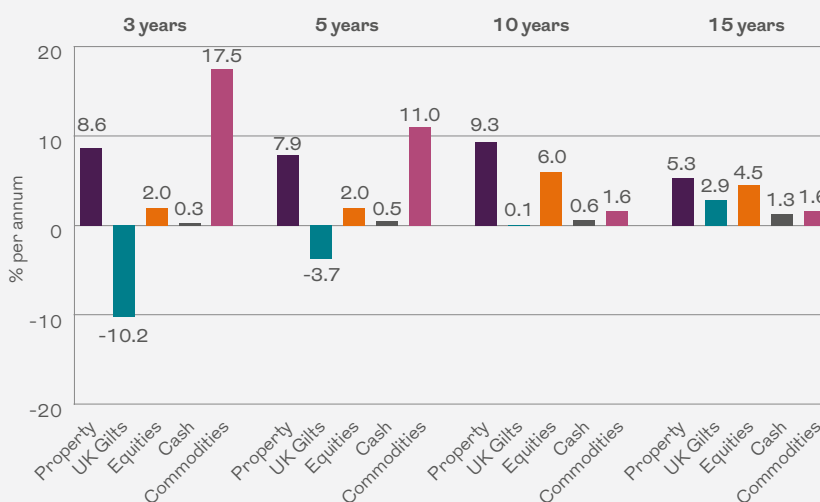
Focus on the long term

During periods of economic uncertainty, we like to remind property investors to think beyond the cycle. While capital values will fall over the next few months, there are long-term, investible trends that investors can look to capitalise on. Greater demand for higher quality, attractive and sustainably built spaces

will increasingly drive occupational decisions especially for office occupiers and determine where investors choose to place their money. Many logistic and industrial companies (and retailers with a strong multi-channel approach) should continue to enjoy the structural advantages presented by e-commerce, while the life sciences and healthcare sectors will benefit from longer-term secular trends. These factors give us greater optimism for the latter half of 2023 and the beginning of 2024.

“ While much of 2023 is likely to be a period of reconsolidation, we expect to see good value further out once the sector eventually stabilises. ”

Figure 2: Multi asset historic returns (% pa)



Source: Property from MSCI UK Monthly, August 2022 and UK Gilts (FTSE A All Stocks Gilt), Equities (UK FTSE All Share Index TR), Cash (IBA Libor 1w), and Commodity (Bloomberg Commodity Index GBP) from Refinitiv DataStream 10th October 2022.

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