Royal London Cash Strategies

Quarterly Report 31 December 2021

Market overview

- Government bond and money markets were mixed in the fourth quarter, a period notable for its volatility. Markets grappled with the emergence of a new variant of Covid-19, Omicron, and experienced a surge in case numbers that led to increased restrictions on mobility across a number of countries. The quarter also saw very definite hawkish tilt from a number of central banks under pressure from persistently high global inflation data.
- In the US, messaging from the Federal Reserve (Fed) saw the removal of the term "transitory" from its inflation commentary. Fed Chair Powell gave very clear messaging regarding the likely future path of monetary policy, including a likely increase in the pace of the tapering (an increase in pace of quantitative easing (QE)), which in turn brought forward expectations of the first rate hike in the US.
- In Europe, the European Central Bank (ECB) met in December and announced what was perceived as a hawkish set of measures. It announced that the end of the Pandemic Emergency Purchase Programme (PEPP) in March 2022 will be accompanied by a doubling of its Asset Purchase Programme (APP) to €40 billion a month for the second quarter, reducing to €30bn and €20bn in the third and fourth quarters.
- In the UK, investors took meeting minutes from the September Monetary Policy Committee (MPC) meeting, and hawkish comments from Bank of England (BoE) Governor Bailley, as a signal that the base rates would rise in November. Having priced a November rate rise with near 100% certainty, markets were shocked by the MPC's decision to leave rates unchanged by 7-2 – this, alongside concerns around the Omicron variant, led yields lower. December saw the highest CPI (inflation) print since the early 90s of 5.1%, leaving the MPC with little choice but to raise base rates to 0.25%, prompting a rise in yields.
- In UK bond markets, the benchmark 10-year gilt yield fell from 1.02% to 0.97%, leading gilts to return 2.42% on an all-maturities basis (FTSE Actuaries). The apparent stability of the gilts market is misleading, however: having risen to 1.20% in late October, the 10-year gilt yield rallied to just 0.70% on 13 December (before the Bank of England raised the UK base rate), then ending the year at 0.97%. Credit market returns were more pedestrian than gilts for the fourth quarter – sterling investment grade credit returned 0.34%, as the average sterling investment grade credit spread (the average extra yield available from a corporate bond compared with government debt of equal maturity) widened from 0.87% to 0.98%. Sterling investment grade credit returned -3.09% for the year as a whole, outperforming gilts, with the credit spread tightening by one basis point to 0.98%.
- UK money markets therefore unsurprisingly saw yields rise as well. After some 20 months trading at or just over 0.05%, SONIA jumped to 0.19%, while three-month Libor rose from 0.08% at the start of the quarter to end 2021 at 0.48%. Similarly, the longer 12-month Libor cash rate jumped from 0.37% to 0.81%. Two-year gilts, often seen as a proxy for market expectations of BoE rates, rose from 0.41% at the end of September to end the year at 0.68%.

Performance and activity

- Our cash funds are standalone vehicles. However, we know that many clients use a combination of these as part of a cash laddering strategy – using short maturity funds for more immediate liquidity needs and using other strategies for cash needs beyond six months or so. The return profiles of these funds will differ, but all are underpinned by a common philosophy and process. We focus on creating diversified portfolios that with high credit quality in the underlying banks. These portfolios also screen out tobacco, fossil fuel and armaments, but also factoring in ESG considerations when considering the banks that make up the majority of the portfolios. In this way we believe we create portfolios that meet client needs.
- Funds with a much greater focus on near-term liquidity such as the Sterling Liquidity or Short Term Money Market Fund are invested almost entirely in classic money market instruments such as treasury bills and short dated certificates of deposit, occasionally adding very short-dated, highly rated covered bonds to add incremental yield and diversification.
- Money market exposure was generally a modest positive over the quarter. Although rising yields are a headwind for money market funds (as these yields often rise faster than a portfolio can rotate into those higher yielding securities), the fact that this happened towards the end of the period was helpful. For most of the quarter, we focused on short-dated paper and were able to pick up a small premium over SONIA without taking undue interest rate risk. As we moved into December, we typically slow purchases in CDs, reflecting our strategy of avoiding having too much maturing paper in this month when banks are generally looking to shrink balance sheets. The majority of our activity focused on three-month maturities, including names such as **Natixis**, **Danske Bank**, **National Australia Bank** and **Santander**.
- For the Short Term Money Market Fund, we also added a short-dated covered bonds in the secondary market when available. Purchases included Toronto Dominion Bank and Santander – both providing a small premium over SONIA, but also mitigating interest rate risk due to their floating rate structure.

- The Cash Plus and Enhanced Cash Plus funds look to provide cash investors with returns over and above those on more traditional liquidity funds, by adding targeted exposure to non-money market instruments. Both use covered floating rate notes as part of this strategy, while the Enhanced Cash fund also adds limited exposure to very short-dated investment grade credit and secured bonds such as mortgage-backed securities. These all contain limited interest rate and credit risk. For core money market exposure, for most of the quarter, we focused predominantly on short-dated maturities, typically of around three months, looking for opportunities to extend beyond the calendar year end.
- For the Cash Plus fund, covered bonds still account for the majority of non-money market exposure. These aided performance over the quarter, partly due to the additional yield over SONIA these offer, but also due to the floating rate nature of these instruments that mitigates the impact of rising yields. Activity was relatively low in this area over the quarter, reflecting limited issuance and tight valuations. We've looked for preferred names yielding 25-30bps over SONIA and maturities of four to five years, finding several opportunities over the period, including a new issue of covered bonds from **DBS Bank**, as well as a five-year covered bond from **United Overseas Bank** in the secondary market. Otherwise activity was focused on CDs, where we added some 12-month paper from the likes of **Barclays**, **First Abu Dhabi Bank** and **Commonwealth Bank of Australia**, reflecting the higher yields available on this and the relatively hawkish interest rate profile being pricing in by the market.
- For the Enhanced Cash Fund, performance over the quarter was negative in absolute terms, as the yield pick-up we obtain from limited exposure to short-dated credit was more than offset by the interest rate risk embedded in these securities. However, performance for the year remains strong, and we believe that higher yields will ultimately benefit investors through higher returns.
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- Short-dated senior bank bonds remain the principal source of added yield. During the quarter we participated in new issues of four and three-year bonds from Industrial and Commercial Bank of China (ICBC)and DNB Bank, as well as a three-year senior floating rate bond from Bank of Nova Scotia, all of which offered an attractive yield premium.
- Outside of financials, we added a number of structured bonds. These all pay an attractive premium over gilts or SONIA, but also have a risk profile that we feel is well suited to this fund. Examples in the quarter included new issues from **Highways**, backed by motorway services assets, as well as **Frost**, secured on cold storage property in Yorkshire. Both are floating rate. We also completed secondary market purchases in **Westfield Stratford** and **Land Securities**.

Outlook

- The Office for Budget Responsibility forecasts CPI inflation to be around 4% through 2022 and markets are pricing two-year RPI at greater than 5%, significantly above the BoE CPI inflation target. And with wages rising, as well as a potentially tight labour market, investors are still searching for evidence to decipher whether current inflationary pressures are indeed transitory or not. As such the outlook for the gilt market remains uncertain, and we expect markets to continue hanging on every word from Bank of England commentators searching for signals regarding further interest rate rises.
- The market is 80% priced for a rate hike in February, taking the interest rate in the UK to 0.5%. With consumer price inflation above 5% (and still expected to peak higher), it would seem natural for the MPC to increase rates again. In total, the SONIA curve now suggests that there will be four rate increases in 2022. Rates have not been higher than 0.75% since 2009, and four rate increases suggests sticky inflation and /or an MPC resolutely focused on normalising rates. On balance, we think that the risk to that market forecast is on the downside, which is one reason we have been comfortable to buy one-year paper that effectively has those four rates reflected in the yield.
- A background of rising rates would be a difficult one for all cash and very short duration bond funds. Naturally with interest rates now having risen a little, and expectations of further increases already in prices, positioning around duration becomes more dynamic, rather than simply sitting as short as possible. Our strategy is to remain cautious, in keeping with the risk profile of our funds, ensuring that we continue to deliver on the security and liquidity expectations of the funds, looking for opportunities to mitigate the impact of rising yields on overall returns, while also taking advantage of market pricing in excessive rates to achieve additional yield.
- For exposure outside of these areas, our approach has always placed an emphasis on security and credit quality, both in the nature of assets we buy (such as covered bonds) but also in the way we assess credit quality, with our preference for bonds with security or covenants that we

feel offer a degree of protection to investors. A high proportion of the assets in our funds are exempt from bail-in, and we will continue to favour such assets given these provide our clients with greater security.

Find out more

- A record number of current and prospective clients and consultants joined us online for the 2021 RLAM Investment Series (our annual client conference) between 1 and 5 November 2021. Fund managers and other in-house specialists addressed the macroeconomic environment and prospects for different asset classes, and the issues that they consider in managing their funds. There were also sessions on responsible and sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. All the sessions are available to watch on demand – please visit the RLAM Digital Insight Hub
- You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2022 document, and regular updates on our investment thinking in the *Our Views* section of www.rlam.co.uk

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