# Royal London UK Government Bond Fund

## Quarterly Report 31 December 2021

## Asset split

| | Fund (%) | Benchmark[1] (%) |
|---|---|---|
| Conventional credit bonds[2] | 1.4 | 0.0 |
| Index linked credit bonds | 0.0 | 0.0 |
| Sterling conventional gilts | 97.6 | 100.0 |
| Sterling index linked gilts | 0.0 | 0.0 |
| Foreign conventional sovereign | 0.0 | 0.0 |
| Foreign index linked sovereign | 0.9 | 0.0 |
| Derivatives | 0.0 | 0.0 |
| Other | 0.0 | 0.0 |

## Fund data

| | Fund | Benchmark[1] |
|---|---|---|
| Duration[3] | 11.7 years | 12.1 years |
| Gross redemption yield[4] | 0.94% | 0.90% |
| No. of stocks | 33 | 58 |
| Fund size | £911.9m | - |

*Source: RLAM, based on the Z share class. Launch date: 30.01.1990.*

*[1]Benchmark: FTSE® Actuaries All Stock Gilts Index.*

*[2]Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.*

*[3]Excluding cash*

*[4]The gross redemption yield is calculated on a weighted average basis*

*Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature.*

## Performance

| | Fund (%) | Benchmark[1] (%) | Relative (%) |
|---|---|---|---|
| **Q4 2021** | **1.99** | **2.42** | **-0.44** |
| Year-to-date | -4.68 | -5.16 | 0.47 |
| Rolling 12 months | -4.68 | -5.16 | 0.47 |
| 3 years p.a. | 3.74 | 3.16 | 0.59 |
| 5 years p.a. | 2.71 | 2.37 | 0.34 |
| 10 years p.a. | 3.60 | 3.41 | 0.19 |
| Since inception p.a. 30.04.2010 | 4.98 | 4.64 | 0.35 |

***Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.***

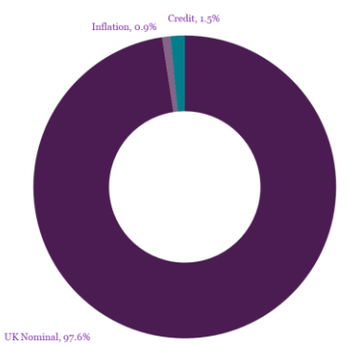
*All performance figures stated gross of fees and tax unless otherwise stated.*
*Source: RLAM, based on the Z share class.*
*[1]Benchmark: FTSE® Actuaries All Stock Gilts Index.*
*On 1 May 2012, the Royal London UK Government Bond Fund (Class B) was renamed the Royal London UK Government Bond Fund (Class Z). The Z share class was launched on 30 April 2010. All performance after this date is for the Z share class. All performance for periods prior to 30 April 2010 is for the Royal London UK Government Bond Fund (Class A).Therefore the performance shown in this table is a merged return which includes the historical 'A' share return for the periods to 30 April 2010, before the Z share existed. If you were invested in the fund prior to this, your investment was in the A shares. If you require separate performance solely for the Z shares since 30 April 2010, please contact your Client Account Manager.*
*Performance for the Royal London UK Government Bond Fund is based on pricing at noon, while index performance is based on pricing at close of business, preventing direct performance comparison. The significance of this timing discrepancy is likely to be greater for shorter measurement periods.*
*As of 6 April 2017, the UK Government announced that funds paying interest distributions will be required to pay those distributions gross of tax.*

## Ten Largest Holdings

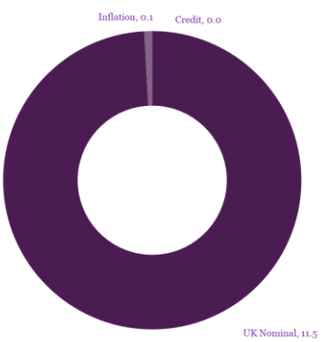
| | Weighting (%) |
|---|---|
| UK Treasury 0.125% 2024 | 17.6 |
| UK Treasury 0.375% 2026 | 13.5 |
| UK Treasury 0.625% 2035 | 8.4 |
| UK Treasury 1.25% 2051 | 5.4 |
| UK Treasury 1.75% 2057 | 5.4 |
| UK Treasury 4.25% 2032 | 5.1 |
| UK Treasury 1.75% 2037 | 4.3 |
| UK Treasury 0.125% 2023 | 3.6 |
| UK Treasury 0.25% 2031 | 3.0 |
| UK Treasury 0.875% 2046 | 2.7 |
| **Total** | **69.2** |

*Source: RLAM. Figures in the table above exclude derivatives where held, subject to rounding*

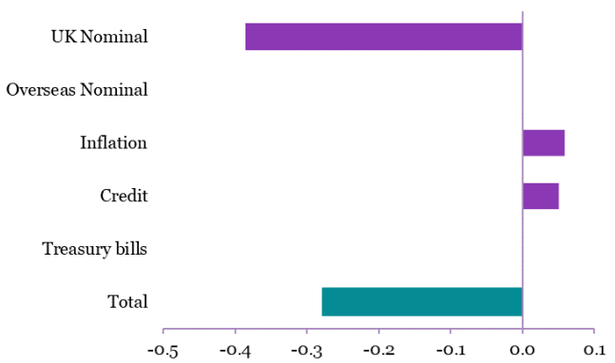
## Asset split by percentage



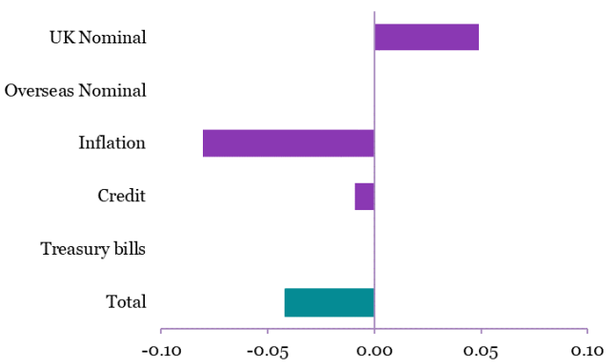

## Asset split by duration



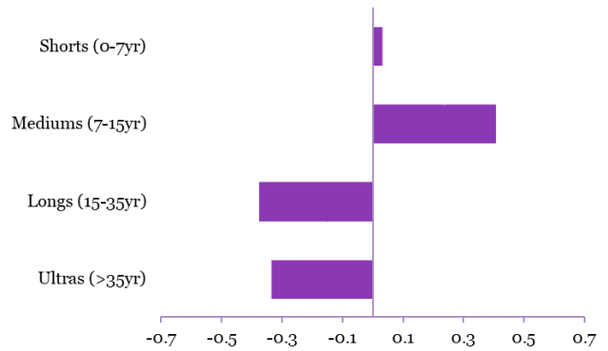

## Asset allocation relative to benchmark (duration)



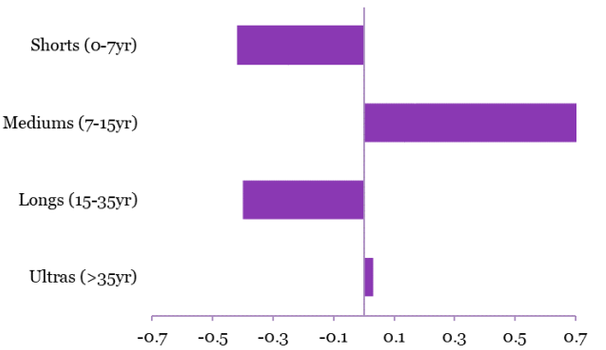

## Asset allocation change on the quarter (duration)



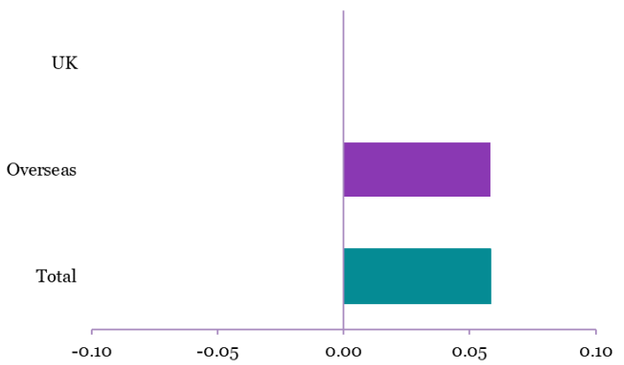
## Yield curve relative to benchmark (duration)



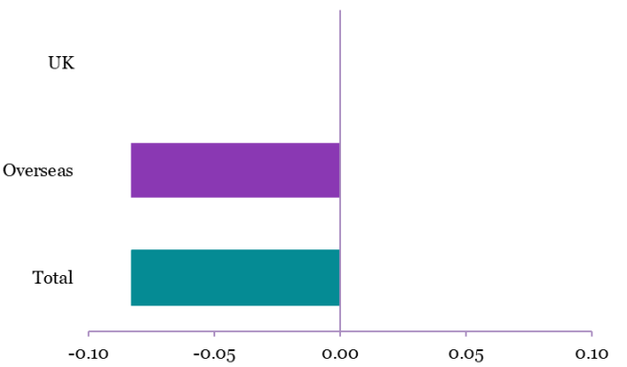

## Yield curve change on the quarter (duration)




## Inflation exposure (duration)




## Inflation exposure change on the quarter (duration)




## Market overview

- Global government bond 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. Regional government bond returns differed in the period: the UK provided positive returns to investors with the 10-year gilt yield falling by five basis points (bps); in Germany and the US, 10-year bund and treasury yields both crept higher – by 2bps – providing slightly negative returns.
- 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. The Fed's December policy announcements delivered on its messaging, causing US yields to rise during December, somewhat reversing the fall in yields in November in response to fears over Omicron.
- 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. Despite assurances of flexibility in the re-investment of maturing PEPP proceeds, the market viewed the policy as less supportive for peripheral European bonds – European yields rose into year-end as a result, and periphery market spreads widened versus German bonds.

- The UK market was particularly volatile in the final quarter of 2021: the five-year gilt yield, for example, began the period at 64bps, reached a peak of 85bps in November, and fell to a low of 53bps prior to the December MPC meeting, before closing the period at 82bps. Yields rose initially as 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.
- A mismatch in supply and demand dynamics in the fourth quarter accentuated the periods of volatility experienced in UK markets. Not only did the Bank of England not raise rates at the November meeting when the market fully expected a hike, the Bank decided to maintain its QE program at £875bn, rather than ending it early. This only accentuated seasonal trends and reduced market liquidity into year end, a time when market liquidity natural reduces as banks reduce balance sheets into year end. The impact of the Bank's QE program was reflected by the outright move in 50-year gilts – the 50-year gilt yields fell from 90bps in early November, reaching a low of 50bps in early December, before ending the year back at 90bps; at one point in early December the 50-year gilt yields traded with a lower yield than 5-year gilts, inverting the 5s 50s yield curve.

## Portfolio commentary

- The fund began the period -0.35 years short duration in the fourth quarter (FTSE Actuaries UK Conventional Gilts All Stocks Index), covering a small portion of is duration short during the period to close at -0.30 years short duration at the end of December – we expect yields to trend upwards through 2022 as monetary support unwinds. Strategic duration positioning had a mixed impact on performance, benefitting the fund in October and December when yields rose, but tempering performance during November as yields fell. The fund benefitted through tactically trading duration volatility at this period, trading between -0.40 years short and neutral during the quarter.
- Curve positioning also had a mixed impact on performance through the fourth quarter. The fund held a steepening bias throughout the period via a small position in 50-year gilts relative to 15-year gilts. The curve flattened through October and November, and into the beginning of December; the 50-year gilt yield fell from a peak of around 125bps in period to a low of 50bps in December, causing the 5s 505s curve to invert. We added to the steepening position as we approached the end of the BoE QE programme – this removed tightness from markets and led long-dated gilts yields higher on both an absolute and relative basis, causing curves to steepen and benefitting fund performance.
- Our cross-market positions benefitted performance in the period. After buying German index-linked government bonds in July at a yield of -1.45%, we sold them back into gilts in October at a yield of -2.39%, significantly outperforming gilts and therefore adding to fund performance. In addition, the fund maintained its exposure to Japanese index-linked bonds in the period, which has benefitted performance. We also added to returns through tactically trading across markets, buying Australia in October before selling in November, taking profits, and buying and selling US bonds versus UK gilts in December, also taking profits.
- The fund held no exposure to UK inflation in the quarter, wary that UK inflation markets were particularly buoyant in the fourth quarter on an absolute basis, but also relative to global inflation markets.
- The fund's highly rated sterling credit exposure had no significant impact on performance in the quarter. Credit spreads (the average extra yield available from corporate bonds compared with government debt of equal maturity) widened by 11bps to 0.98%. The fund's credit exposure remains focused in highly rated, covered, floating rate notes.

## 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. With this in mind, we will continue to employ a tactical investment approach in the fund, trading short-term market volatility to add to fund performance.
- 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. The committee previously announced that if rates were to reach 0.5% then they would stop the reinvestment of any maturing proceeds from QE. This would mean that the large maturity in March 2022 would not find its way back into the market. Markets have been very dependent on the huge demand that QE has provided over

the years – with a supply schedule that is likely to remain excessive over the next few years, the market may find it difficult to digest this deluge of gilt supply. Stubbornly high inflation, rising rates, and shortening pension fund demand could see significant pressure on longer dated yields in a world with no QE.

## 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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