ROYAL LONDON INTERNATIONAL GOVERNMENT BOND FUND

Quarterly Report 30 September 2021

For professional clients only, not suitable for retail investors

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Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	0.0	0.0
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	2.5	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	79.2	100.0
Foreign index linked sovereign	18.3	0.0
Derivatives	0.0	0.0
Other	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration[3]	7.4 years	7.8 years
Gross redemption yield[4]	0.48%	0.55%
No. of stocks	104	948
Fund size	£462.2m	-

Source: RLAM, based on the M share class. Launch date: 01.11.2011.

[1]Benchmark: JPMorgan Traded World ex-UK Government Bond Index (£ Hedged).

[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 (%)
Q3 2021	**0.51**	**0.03**	**0.48**
Year-to-date	-1.47	-2.16	0.69
Rolling 12 months	-1.61	-2.21	0.60
3 years p.a.	4.01	3.70	0.30
5 years p.a.	1.83	1.54	0.29
Since inception p.a. 01.11.2011	3.04	3.01	0.03

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, subject to rounding.

Source: RLAM, based on the M share class.

[1]Benchmark: JPMorgan Traded World ex-UK Government Bond Index (£ Hedged).

Performance for the Royal London International 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 smaller for longer 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.

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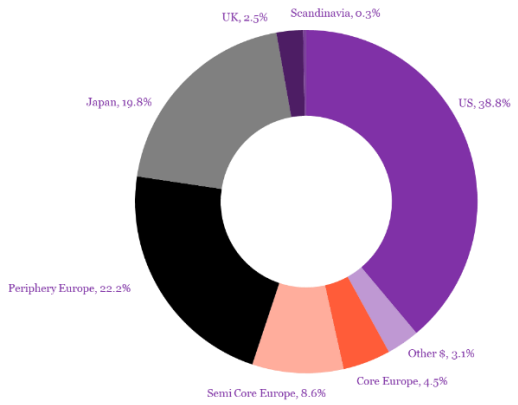
Ten largest holdings

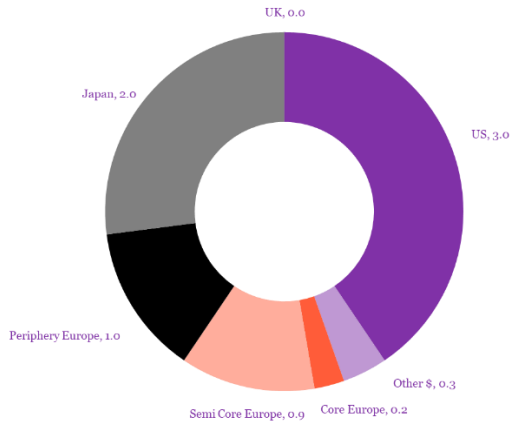
	Weighting (%)
US Treasury 0.625% 2026	4.7
BTP Italy 5% 2022	4.6
US Treasury 2.25% 2024	3.9
Italy Buoni Poliennali Del Tesoro 1% 2022	3.9
Buoni Poliennali Del Tes 2.35% IL 2024	3.6
US Treasury 0.125% 2026	3.1
Japan (govt Of) 0.1%IL 2026	3.1
Japan (govt Of) 10yr Issue 0.8% 2022	3.0
Japan (govt Of) 20yr Issue 0.4% 2039	2.6
France (gov) 0.1% Il 2025	2.6
Total	**35.0**

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

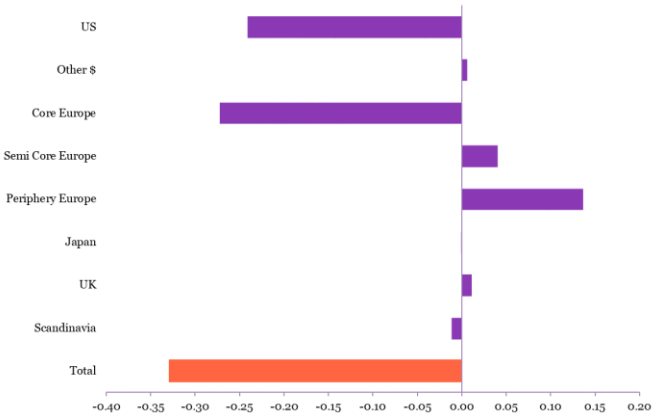
Geographic split by percentage



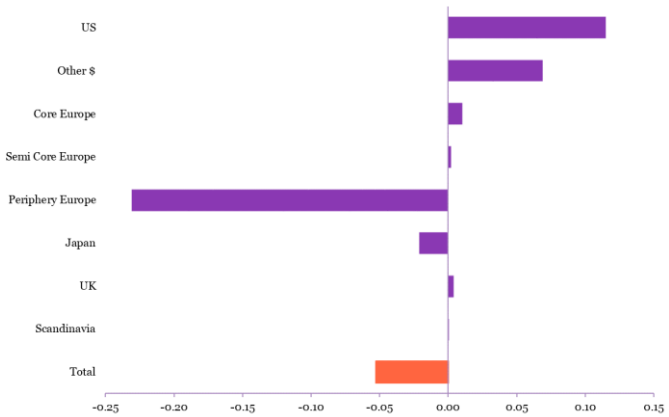
Geographic split by duration



Current position (by duration)



Change on the quarter by duration



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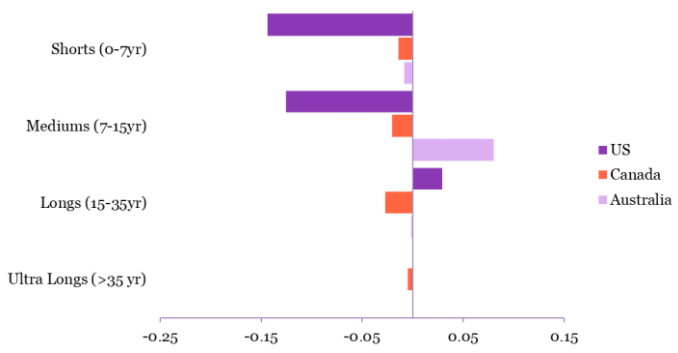
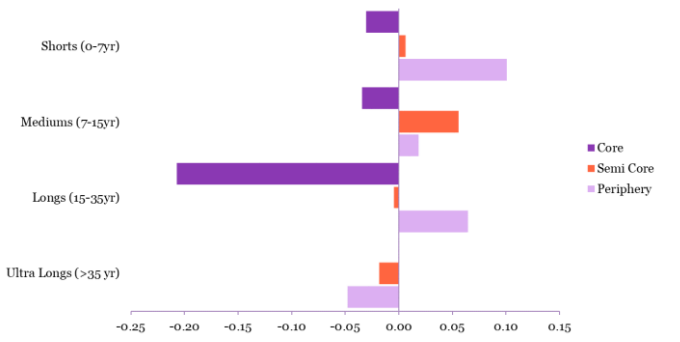
Yield Curve

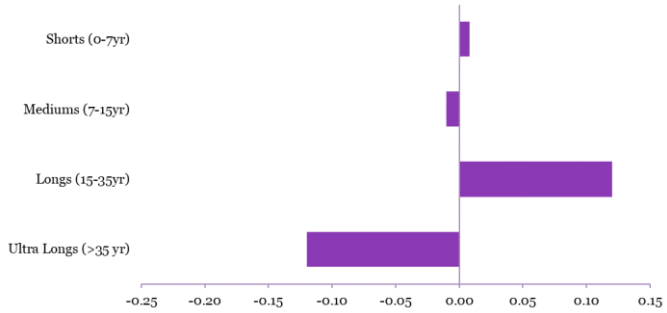
Dollar bloc



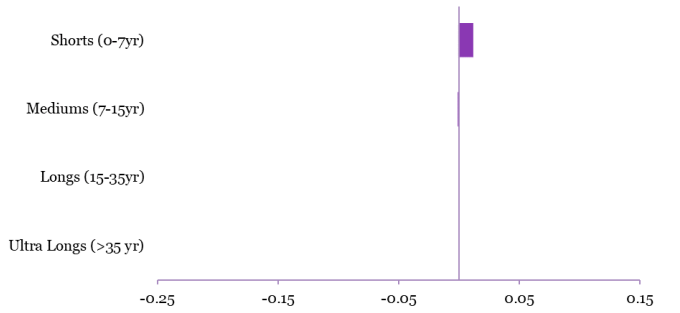
Euro bloc



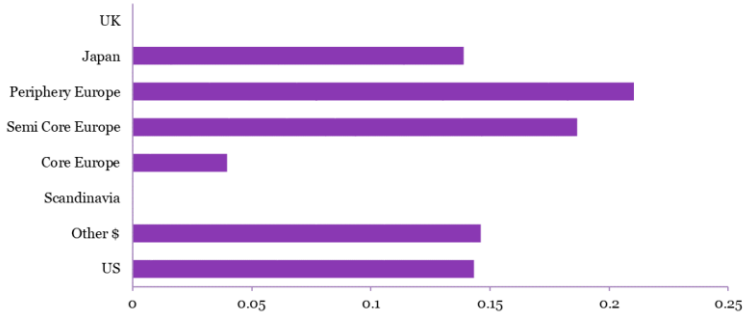
Japan



UK



Inflation breakeven



Market overview

- Global government bond markets posted negative returns in the third quarter, however, yields in the US and core European markets were broadly unchanged, closing the period only marginally higher. In the UK and selected European periphery markets, government bond yields rose much more significantly – the 10-year UK gilt yield rose by 20 basis points (bps) over the period. However, the third quarter was a tale of two halves, as the fast-changing characteristics of the Covid economy drove global yields downwards at the beginning of the quarter, and upwards towards the end of the quarter. The major factors driving yield movements were rising Covid-19 case rates, inflation proving more persistent than had been expected – a result of the ongoing global supply chain difficulties, and the increasing hawkishness of monetary policy makers.

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- In July, global government yields edged downwards: although global economic data was strong, it fell short of increasingly high market expectations; furthermore, a global rise in Covid-19 case numbers, and the prospect of a third wave of the virus, dented market confidence in a sustained period of economic strength.
- Financial markets were traditionally quieter in August, as global central banks continued to neutralise the impact of what little supply there was. The ECB scaled back its PEPP purchases to reflect this seasonality, however, yields crept higher overall as commentary from the US Federal Reserve (Fed) in particular prepared markets for the imminent roll back of quantitative easing (QE) programmes.
- Towards the end of the quarter yields were driven higher still as global monetary policy makers took a definitively more hawkish stance. The Fed made substantial changes to its economic forecasts, revising its growth outlook and increasing inflation expectations and Chair Jerome Powell suggested it could "easily move ahead" with plans to taper its $120bn monthly asset purchases programme as early as November. The Federal Open Market Committee (FOMC) also revised its interest rate path, signalling three potential interest rate rises of 25bps during 2022.
- Real yields fell to all-time lows in the third quarter and real curves steepened aggressively as spot inflation prints continued to come in higher than expected. Real yields on the shortest dated bonds globally fell between 70 and 180 basis points. In the UK, short dated-breakeven inflation peaked at close to 7% as natural gas prices surged. Furthermore, 5-year inflation-linked gilt yields fell by 37bps across the third quarter, while yields for the 10- and 30-year bonds fell by 13bps and 5bps respectively. The UK's 10-year breakeven inflation rate rose by 33bps to 3.8% in the quarter. In the US, the 10-year TIPS yield fell by 1 basis point, while the 10-year breakeven rose by 4bps to 2.38%.
- The UK issued its inaugural green gilt in September, a 12-year maturity bond, although it provided no specific detail on the use of proceeds or the source of income used for coupon repayments. Without a directly comparable bond, it will be more difficult to compare the performance of green gilts versus traditional gilts. In Germany, green bunds are issued alongside a traditional bund to allow for comparison of performance; the 10-year green bund "greenium" is currently 6bps.

Portfolio commentary

- The fund performed strongly over the quarter, returning 0.51% gross of fees (M class) versus 0.03% benchmark returns (JP Morgan Traded World ex-UK Government Bond Index - hedged). However, the fund and the benchmark are priced at different times – on a like-for-like basis, the fund outperformed by 32 basis points.
- Cross-market strategies were the most significant contributor to outperformance in the quarter, as all positions added value. We trimmed exposure to periphery markets in the period, as we anticipate that spreads will widen as the end of the Pandemic Emergency Purchase Programme (PEPP) approaches in March 2022. The programme has provided disproportionate support to periphery markets during the pandemic, and while it is likely that the ECB will provide an interim solution to prevent a cliff edge in periphery government bond markets, periphery spreads are no longer at levels which justify large positions. We still held a small long position in Portugal and in Italian inflation-linked bonds at the end of the quarter, but we moved underweight Spanish markets. Our strongest conviction cross-market positions at the end of September were short US and Germany, and long France.
- We bought the UK's inaugural green gilt issuance in the quarter, hedged through the sale of gilt futures to remove exposure to the UK market as we sought only to gain exposure to the green bond premium, or 'greenium'. The bond provided an approximate greenium of 2bps in the secondary market, less than that of comparable European sovereign green bonds, but evidence suggests that the greenium does increase over time, and we continue to hold the bond. We also participated in a Spanish green bond issuance in the period, which benefitted the fund.
- The fund's strategic duration positioning began and ended the quarter at 0.3 years short relative to the benchmark, although we moved as far as 0.5 years short in July as global markets rallied. Duration was a slight positive for performance: although global government bond yields fell in July, they rose in September to end the period marginally higher for the quarter.
- Inflation-linked positions in the US, Japan, Australia and Europe – particularly France and Italy – benefitted fund performance in the quarter; inflation markets outperformed in the period, as central banks remain supportive of markets, and labour shortages, supply shortages and rises in commodity prices add to inflationary pressures. Italian breakeven (implied) inflation rates rose significantly over the quarter, with 10- and 30-year prices up by 29 and 25bps respectively. Even Japanese inflation which has long been low and stagnant has started to benefit from the global reflation trend with inflation prices rising to around 40bps from lows of around 0-10bps at the end of April.

Outlook

- Central bank support is beginning to wane, and markets are changing focus to the potential for tapering and rises in base rates. Central banks globally, highlighted plans of further rollbacks of QE in September, causing government bond yields to

rise globally in the third quarter. However, investors are still searching for evidence to decipher whether current inflationary pressures are indeed transitory. We believe that inflation may be less transitory and will last for longer than monetary policy makers currently suggest, although it is unlikely to persist over an extended period. We do not expect interest rates to rise for a while yet in Europe, most likely not until 2023, as the region has more recovery to sustain in comparison to the UK, for example, where rates will likely rise sooner. As such, we will continue to favour global inflation markets.

- Gilt yields have moved a lot in the third quarter and are probably more fairly priced at present. In Europe there is more space for rises. Although the ECB try to smooth out rises by replacing PEPP, with 10-year bund yields still negative, there is certainly scope for a rise in yields. QE will remain the key policy tool in Europe, and we expect the roll back in support to impact spreads in periphery markets, which were disproportionately supported by the PEPP. Into 2022, when governments globally begin to issue in the first quarter, combined with less QE, we could see yields rise globally as net supply once again turns positive.
- While coronavirus concerns will remain critical through 2021, more traditional political risks will also come into play with the French election on the horizon. We anticipate potential market uncertainty around this event, though we do not anticipate a repeat of 2017, which saw French yields rise dramatically on fears of a Euro-sceptic government, headed by Marine Le Pen.
- Join us online for the 2021 RLAM Investment Series (our annual client conference) between 1st and 5th November. A range of our fund managers and other in-house specialists will address the macroeconomic environment and prospects for different asset classes, and the issues they are considering in positioning their funds. There will also be sessions on responsible and sustainable investing, addressing the latest developments in these fast-changing areas and considering their possible evolution. For more details and to register, please visit rlam.co.uk.

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