Royal London Index Linked Strategies

Quarterly Report 31 March 2022

Executive summary

- Russia's invasion of Ukraine in late February was met by a unified response from Western powers, enforcing far reaching economic sanctions. Although a sense of calm has returned to markets, the unpredictability of war means that this may not continue. The conflict has exacerbated inflationary pressures and rising commodity prices are driving a further squeeze on real disposable incomes. This is being compounded by higher interest rates, giving rise to concerns about future economic growth, nonetheless, central banks globally have maintained the hawkish pivot taken into the turn of the year. Government bonds have been badly impacted by the subsequent rise in interest rate expectations, and while inflation-linked government bonds markets delivered negative returns for the quarter, higher inflation has seen them outperform nominal bonds on a relative basis. Over the period, RLAM's index-linked funds performed as follows:

  RL Index Linked Fund: -6.38%, benchmark -5.50%

  RL Global Index Linked Fund: -2.93%, benchmark -3.10%

  RL Short Duration Global Index Linked Fund: 0.09%, benchmark -0.10%

- These figures (all M share classes, net of fees), are distorted by timing differences between the funds and their indices (with funds priced at midday and indices at close of business). On a like-for-like basis, the **Index Linked Fund** outperformed by 15 basis points (bps) in the quarter (returning -5.35%) and by 44bps over 12 months (+5.55%); the **Global Index Linked Fund** outperformed by 54bps for the quarter (-2.56%) and by 110bps over 12 months (+5.93%); and the **Short Duration Global Index Linked Fund** outperformed by 24bps for the quarter (+0.14%) and marginally underperformed over 12 months by 10bps for the year (+4.93%).

- For the most part, real yields rose during in the period, albeit with a few exceptions in Europe, where inflationary pressures are greater: US 10-year real yields rose the furthest, increasing by 61bps to -0.49%, while UK 10-year real yields rose by 21bps to -2.76%, and 10-year German real yields fell by 9bps to -2.19%. Although nominal yields rose significantly in Germany, the growth in inflation expectations was even greater, a result of the country's historic dependency on Russian gas. German 10-year breakeven (implied) inflation rates increased by 83bps in the quarter to 2.64%. Breakeven inflation rates rose across the board, but to a lesser extent in the US (+23bps) and in the UK (+41bps), leading inflation-linked markets to outperform nominal bonds markets: in the UK index-linked gilts returned -5.5% to investors on an all-maturities basis (FTSE Actuaries), while global inflation-linked government bonds returned -3.12% (Barclays Global IL).

- Duration was traded tactically between 0.4 years short and 0.2 years long during the period, and was the main contributor to performance. Towards the end of the quarter, we moved the long funds around -0.4 years short duration, selling ultra-long dated bonds following the announcement of a 2073 index-linked gilt syndication in April. The short fund was marginally long duration at the end of the quarter as yields in markets such as Australia moved into positive territory, discounting substantial moves higher in short-term rates.

- Cross market positions were mixed in the period. The funds' overweight Australia detracted in the period but we believe that is attractive position and will benefit performance in the medium term. All funds took profits in Japan into strength – Japanese inflation-linked bonds were the best performer globally in the first quarter. We also added to performance across the funds by tactically trading US and European positions around market volatility. Global funds took profits in Germany, Spain, and Italy after strong inflation led them to outperform globally on a relative basis, moving slightly short duration – we also moved short Italy on political concerns. The long funds were overweight the US at the close of the quarter. On curve, performance was mixed, but positive overall – all funds remained long the front end of the market as oil price rises pushed short-dated real yields to all-time lows.

Market overview

- Russia's invasion of Ukraine in late February was met by a unified response from Western powers, enforcing far reaching economic sanctions. Although a sense of calm has returned to markets, the unpredictability of war means that this may not continue.

- After the relatively benign impact of the Omicron variant of Covid-19, central banks globally maintained the hawkish pivot taken into the turn of the year, as they focused on tackling higher than expected inflation rates. Government bonds have been badly impacted by the subsequent rise in interest rate expectations, and while inflation-linked government bonds delivered negative returns for the quarter, they have outperformed nominal bonds on a relative basis, as inflation expectations continued to move higher.

- War in Ukraine has exacerbated inflationary pressures. Rising commodity prices are driving up the cost of energy, food, and materials, leading to a further squeeze on real disposable incomes. This is being compounded by higher interest rates, giving rise to concerns about future economic growth. In the US, where the economy is better insulated from rising commodity prices (it is a net energy exporter) the Federal Reserve (the Fed) has doubled down on its hawkish stance on inflation – the Fed ended its quantitative easing (QE) programme at the end of March, as planned, and markets are now pricing eight rate hikes in 2022, including some 50bps hikes, taking the target rate to around 2.5%

by year end. In Europe, the European Central Bank (ECB) also ended its QE programme (the Pandemic Emergency Purchase Programme (PEPP)) at the end of March, and plans to accelerate the closure of the Asset Purchase Programme (APP), which is expected to end in the first half of the year. The ECB hinted at rate rises to follow, but was ambiguous on the timing – markets expect hikes to closely follow the closure of the APP, with an increase of 50bps by the end of the year.

- In the UK, Bank of England (BoE) Governor Bailey took a softer tone on policy tightening, citing concerns for the squeeze on disposable incomes and the potential impact on growth. The BoE increased the interest rate nonetheless – the UK base rate stood at 0.75% at the end of the reporting period, after consecutive 25bps hikes in February and March. The UK's Spring Budget Statement saw some measures to limit the impact of forthcoming tax rises, but only mitigated around one third of impact of rising costs on consumers. Nonetheless, markets are still pricing in seven rate hikes in the UK over the next twelve months, taking the base rate towards 2.5%.
- In the UK, the benchmark 10-year gilt yield rose from 0.97% to 1.61% in the quarter, a rise of 64bps. There was a respite in the upwards trend following the Russian invasion of Ukraine but concern about inflation and more hawkish central bank rhetoric meant that the fall in yields proved to be temporary. The same pattern was visible in the US and Germany, where yields rose throughout the period but temporarily dipped around the onset of war in Ukraine: in the US, the benchmark 10-year US treasury yield rose from 1.51% to 2.34% in the quarter, while the German 10-year bund yield rose from -0.14% to 0.55%. Overall, UK gilts returned -7.5% to investors on an all-maturities basis (ICE BoAML >1 Year), US treasuries returned -5.56%, and German bunds returned -5.11%.
- For the most part, real yields rose during in the period, albeit with a few exceptions in Europe, where inflationary pressures are greater: US 10-year real yields rose the furthest, increasing by 61bps to -0.49%, while UK 10-year real yields rose by 21bps to -2.76%, and 10-year German real yields fell by 9bps to -2.19%. Although nominal yields rose significantly in Germany, the growth in inflation expectations was even greater, a result of the country's historic dependency on Russian gas. inflation expectations we on Russian gas – German 10-year breakeven (implied) inflation rates increased by 83bps in the quarter to 2.64%. Breakeven inflation rates rose across the board, but to a lesser extent in the US (+23bps) and in the UK (+41bps), leading inflation-linked markets to outperform nominal bonds markets: in the UK index-linked gilts returned -5.5% to investors on an all-maturities basis (FTSE Actuaries), while global inflation-linked government bonds returned -3.12% (Barclays Global IL).
- Commodities had a very strong quarter due to supply concerns triggered by war. Brent Crude Oil rose by almost 40% to around $105 per barrel, having reached highs of $139 – gas prices also spiked to over $800 per therm before settling back closer to normal levels. Copper futures resumed their upward trend (+6.7%), while the gold spot price rose by 6.3% to around $1,930/oz.

Performance and activity

- Duration was traded tactically for the majority of the quarter around volatility created by war in Ukraine, as well as a number of supply events – duration ranged between 0.4 years short and 0.2 years long during the period, and was the main contributor to fund performance in the quarter. Towards the end of the quarter we moved the long funds around -0.4 years short duration, selling ultra-long dated bonds following the announcement of a 2073 index-linked gilt syndication in April. The short fund was marginally long duration at the end of the quarter as yields in markets such as Australia moved into positive territory, discounting substantial moves higher in short-term rates.
- All funds moved further overweight Australia over the quarter, as spreads to the UK reached 300bps – the position detracted in the period but we believe that this will benefit performance in the medium term. We also held a long position in Japan throughout the quarter, although this was reduced towards the end of the period as we took profits into strength: Japanese inflation-linked bonds were the best performer globally in the first quarter, as inflation continued to rise but nominal yields were pinned lower. Japanese inflation is still below the Bank of Japan's target, which announced further bond buying to defend its yield curve target, helping to anchor nominal yields at lower levels relative to global markets. All funds added to performance by tactically trading US and European positions around market volatility, and closed the period overweight France. Global funds took profits in Germany, Spain, and Italy after strong inflation led them to outperform globally on a relative basis, moving slightly short duration in these markets – we also moved short Italy on political concerns. The long funds were overweight in the US at the close of the quarter.
- Looking at curve positioning, all funds remained overweight at the short end of the markets, as oil price rises pushed short-dated real yields to all-time lows. The longer funds were generally underweight long maturity bonds, but entered a flattening 10s-30s position in March, when the curve reached its steepest levels post pandemic – this added to performance as the curve flattened on LDI demand into the end of the financial year. We sold ultra-long bonds into the end of the quarter, as we expect yields to rise in the run up to the UK's 2073 syndication in April. In the shorter fund we maintained a 5s-10s flattener in both the UK and US, as we expected more hawkish rhetoric would push real yields lower. Overall, curve positioning benefitted performance in the quarter.

- All funds traded gilts tactically around supply events in the quarter. We sold index-linked gilts into nominal gilts at the end of the period, with long-dated index-linked supply imminent.

Outlook

- There is considerable uncertainty about the year ahead. The war in Ukraine has worsened existing trends and has given central banks a real dilemma: tighten policy to address inflation or give some slack on further policy moves until the growth consequences become more evident. The US yield curve (between 2- and 10-year maturity bonds) inverted during March, which many view as recession signal.
- In the UK, investors are pricing in a move to a 2.5% base rate over twelve months and in the eurozone there has been a significant shift, with tightening now expected in the second half of the year. We still expect interest rates to rise gradually but by less than is currently priced into the market. We also expect the peak in inflation to come later in the year with RPI inflation expected to be higher than 10%. The rise in inflation expectations has steepened real curves, and we don't expect supply in the UK over the next financial year to impact market prices – the Office for Budget Responsibility announced £145 billion in supply to the gilt market this financial year, with inflation-linked bonds maintaining a 15% share of the entire UK government market.
- With breakeven rates remaining at elevated levels we anticipate increasing the gilt holdings within funds, particularly around the 2073 syndication. Cross market valuations are mixed with dollar markets offering better value after the strong performance of Europe and Japan in the first quarter. We anticipate adding to global positions prior to the syndication.
- With supply very much front loaded with an ultra-long syndication in April followed by two medium auctions for the remainder of the quarter, we envisage moving the funds towards a flattening curve bias post the syndication.

More on government bonds

- RLAM recognises that the Ukraine invasion is a human tragedy, and one that we hope is resolved swiftly. As stewards of our investors' assets, we are monitoring the situation closely, and of course are complying with all restrictions and sanctions issued by relevant authorities. RLAM has no exposure to Russian companies in our active funds. We had limited exposure (less than 0.1% of total assets) in our tilt and Emerging Market Tracker funds at the time of the invasion, but subsequently sold every holding we were permitted to. In our Emerging Market Tracker fund, we removed this in line with the MSCI index changes in early March.
- Fund managers and other in-house specialists regularly address the issues that they consider in managing their funds via blogs, articles, webinars and other mediums. Please visit the RLAM Digital Insight Hub, or the *Our Views* section of www.rlam.co.uk for further information.

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