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Government Bond strategies

Quarterly Overview

31 December 2023

Overview

Market overview

Economic attention over the quarter has been on inflation. At the start of the quarter investors focussed on the persistence of large price increases and central bank messaging on rates being held higher for longer. Yet, as headline inflation fell, sentiment swung dramatically towards the end of the quarter, pushing markets to price in interest rate cuts in 2024. The Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE) all left rates unchanged over the quarter, maintaining official rates at multi-year highs. The Fed has now held rates unchanged at its last three meetings. There has however been a significant shift in messaging, with the US central bank now indicating that it expects to cut rates by 0.75% in 2024. The ECB has similarly kept rates steady at its two most recent meetings, but central bankers in the eurozone said that no rate cuts have yet been discussed.

In tune with the other major central banks, and potentially marking the high point in the UK interest rate cycle, the Bank of England left interest rates unchanged over the period. The Monetary Policy Committee continued to be split – at the December meeting three of the nine members were still voting for a rate hike. UK inflation has fallen significantly, with the annual inflation rate falling to 3.9% in November. This is the lowest rate of increase in over two years. However, this remains well above the BoE 2% target, with core and wage inflation significantly higher than the headline rate.

UK government bonds produced strong returns due to falling yields, delivering an 8.1% return (FTSE Actuaries) over the fourth quarter with the benchmark 10-year gilt yield falling from 4.44% to 3.54%. The falling yield environment was helpful for longer duration assets, with longer-dated bonds outperforming shorter-dated bonds in total return terms. However, when looking at changes in yields, five-year maturity bonds were the best performing area, and the curve steepened.

Data released in the UK in the fourth quarter painted a picture of sluggish economic activity, with falling inflation and more signs of softening underlying domestic inflationary pressure. Third quarter GDP fell 0.1% quarter-on-quarter after 0.0% quarter-on-quarter in the second quarter. PMI business survey data signalled some improvement in private sector activity though, with the composite PMI indicator rising back above the 50 ‘no growth’ level. Inflation fell, and tended to surprise on the downside at headline level versus expectations: Year-on-year CPI inflation fell from 6.7% for the August release to 3.9% for the November release, largely due to year on year base effects. Core inflation fell from 6.2% to 5.1% over the same period. By the end of the quarter (the October data release) regular pay growth figures were showing more sign of slowing, at 7.3% for the 3-months to October (from 7.9% three-months earlier). The Autumn Statement saw the Chancellor add more fiscal stimulus (tax cuts) than expected, spending the ‘windfall’ from the impact of high inflation on tax revenues.

Global government bond yields continued their upward path at the start of the quarter– a trend that began in mid-2020, reflecting market views that rising inflation would necessitate higher interest rates. With inflation starting to come down, expectations of rate cuts in 2024 meant that bond yields fell in November and December, ending the quarter lower than they started, and ending 2023 at roughly the same levels as they started.

The Fed kept rates on hold at 5.25-5.50% over the quarter against a still resilient labour market backdrop, but with inflation continuing to cool. As of the December meeting, the median forecast of voting regional bank governors had 75bp of cuts for 2024 with a further 100bp of cuts pencilled in for 2025. Over the quarter, CPI inflation fell from 3.7% year-on-year in August, to 3.1% in November. That is still above June 2023 levels, but core continued a more consistent drift lower over the period. The core PCE measure of inflation fell over the quarter and month-on-month was only 0.1% in November. Third quarter GDP recorded a strong 4.9% quarter-on-quarter annualised growth. More timely economic activity indicators were mixed over the fourth quarter. The House passed a spending package that pushed the effective next government spending deal/shutdown deadline into early 2024.

Over the fourth quarter, the ECB kept rates on hold. Going into the December meeting, various ECB speakers had already broached the topic of rate cuts, effectively opening the door for cuts in the second half of 2024 while pushing back on the chance of a near term cut. President Lagarde said that they did not discuss rate cuts in December and that “between hike and cut there is a whole plateau – a whole beach – of hold.” Euro area CPI fell to only 2.4% year-on-year in November from 5.2% in August. Core CPI fell sharply over the same period too to 3.6%. The euro area economy (GDP) shrank by 0.1% quarter-on-quarter in the third quarter after recording only 0.1% GDP growth in both the first quarter and the second quarter. Germany’s constitutional court put hurdles in the way of additional German government spending, ruling against the transfer of borrowing authorised during Covid to the Climate Fund (that decision was taken in 2021), in the name of protecting Germany’s constitutional debt brake.

The sterling investment grade credit market (iBoxx non-gilt index) returned 7.35% over the quarter, helped by lower government bond yields and tighter credit spreads. The underperformance compared to the gilt market is the result of the shorter duration of the credit market index. The average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) tightened from 1.38% to 1.15% (iBoxx).

Overview

Portfolio commentary

RL UK Government Bond Fund

The fund enjoyed a strong fourth quarter, outperforming its benchmark, which capped off an impressive year of outperformance. The two key factors during the final quarter of the year was our duration and curve positioning. Our strategic decision to take the fund long duration versus its benchmark was beneficial to performance but we have slowly reduced this position – taking profit as yields fell. However, in the final few days of the period, we took the fund slightly short versus the benchmark.

We started the quarter just short of a year long, but reduced this position gradually to the point we ended marginally short. The position was a significant contributor to performance over the quarter. Volatile markets have also provided ample opportunity to add value through tactically trading duration around the core strategic long duration position.

The curve in gilt markets steepened in the fourth quarter – which benefited the fund's curve steepening bias. We remain overweight the front end of the gilt curve via 5-6 year maturity gilts.

Gilt supply in 2024 is expected to be broadly similar to last year. In gross issuance terms the latest estimates show that around £1.5 trillion will be issued in the next five years – or around £120bn a year net when adjusting for redemptions. Supply is likely to be skewed towards short and medium maturities and away from long bonds and index linked gilts versus prior years, but not materially so. This tweak reflects declining demand for longer maturity gilt and index linked bonds. Nevertheless, the UK gilt market remains uniquely long-dated with a maturity of nearly thirteen years, compared with a global average of around nine years.

Our cross-market position was slightly negative for performance over the quarter as we had been overweight Aussie bonds which underperformed versus gilts. Although this was marginally detrimental to performance as yields on Australian bonds rose, we still view Australia as an attractive market to invest in at these yield levels, particularly in a global context.

RL Short Duration Gilt Fund

The short duration fund enjoyed a strong fourth quarter, outperforming its benchmark, which capped off a strong year of outperformance.

The majority of the fund's outperformance in the quarter came from its strategic long duration position, and its relative value positioning. The fund was long duration for the vast majority of the quarter, but in the waning days of the year moved into a neutral position – taking advantage of falling yields to take profits. The fund's strategic long position was the main driver of its outperformance throughout 2023.

Our relative value positioning also contributed to performance. The large overweight position in certain high coupon 2025 and 2027 maturity bonds drove this, as they materially outperformed surrounding bonds in yield terms. Late in the quarter, we opened a cross-market position – picking up a seven-year Aussie bond holding.

Outlook

We believe that inflation will continue to drift lower in 2024, although it is likely to remain above target in most economies by the end of the year, particularly so in the UK, which appears more at risk of inflation becoming more embedded and persistent, than other G10 economies. Shallow recessions are possible but are unlikely to be deep enough at this stage to ease the excessive tightness seen in labour markets. As we approach 2024, central banks are at peak rates, and markets are preparing themselves for cuts, starting in the first half of 2024.

In the UK, the market is now assuming base rates have peaked at 5.25%, with the first cut priced in for the first half 2024 and falling to a terminal level of around 3.25% by late-2026. At one point in early July the market was pricing peak rates closer to 6.5%. Government bond markets have moved a long way during the last few months, particularly in the UK where five-year gilts have fallen significantly from their summer peak.

Supply will be an issue for the market over the next few years, with around £200bn per annum forecast over each of the next five years. Alongside quantitative tightening (where the BoE is selling its gilt holdings back into the market), this will represent a headwind for gilts. However, when considering gilts in a global context, we believe the gilt market is somewhat priced for this.

Further Information

Please click on the links below for further information:

Stewardship and responsible investment at RLAM

TCFD climate report

Find out more

Royal London Asset Management's Outlook 2024 document and podcasts are both available on our website. In this year's Outlook document, our fund managers assess the challenges and opportunities in their respective asset classes for 2024. With an environment of falling inflation and modest recession, the benefits or risk for equities or credit is not so clear cut and knowing your companies is key. We analyse the areas of concern and potential growth within this environment.

In our Outlook 2024 podcast, Piers Hillier, CIO, looks ahead to 2024 and discusses the issues he believes will be prominent over the next 12 months, and where the key investment risks and opportunities may lie.

Articles, videos and webinars explaining our investment thinking can be found in the Our Views section of www.rlam.com, including regular updates from our Fixed Income, Global Equity, Sustainable and Multi Asset teams.

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