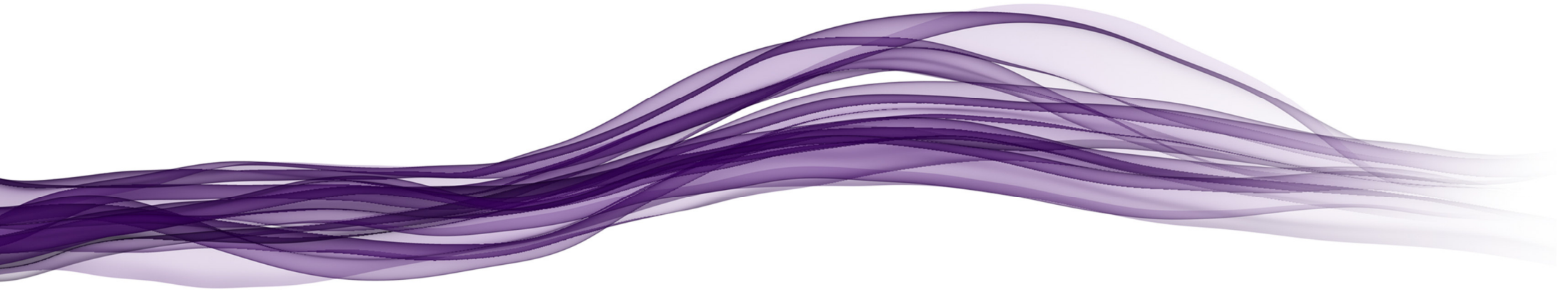


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High Yield and Multi Asset Credit strategies

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.

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 their December meeting, the median forecast of participants had 75bp of rate cuts in it 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 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, its lowest level in over two years. However, this remains well above the BoE 2% target, with core and wage inflation significantly higher than the headline rate.

Global government bond yields started the quarter continuing to rise – a trend that started 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. In the US, 10-year treasury yields fell from 4.57% to 3.88%, falling back from 15-year highs to reverse virtually all of the rise seen in the prior quarter, and ending the year only modestly higher despite rising for most of 2023. German 10-year bunds similarly saw material falls in the fourth quarter, falling from 2.84% to 2.01%, while the benchmark 10-year gilt yield fell from 4.44% to 3.54% (all local currency terms).

Global corporate bond markets saw a strong rally into year-end but this could limit performance from spreads in 2024. December continued in a similar vein to November with spreads and rates continuing their declines leading to another month of healthy returns – allowing 2023 to report double digit returns. Over the fourth quarter, the ICE BofAML US Corporate Index returned 7.91%, while in the euro zone and UK, the ICE BofAML Euro Corporate & Pfandbrief Index and iBoxx Sterling Non-Gilt indices returned 5.49% and 7.35% respectively.

In the high yield market, the ICE BofAML (BB-B) Global Non-Financial High Yield Index (sterling hedged) benchmark returned 6.47% in the quarter as spreads hit 400bps. At the end of the period, the index’s yield-to-worst stood at 7.05%, having fallen from 8.20% at the start of the year. In the broader-based high yield index, which includes CCC rated bonds, spreads tightened to 400bps, with a yield-to-worst of 7.7%. Over the course of 2023, high yield new issuance has totalled \$175bn up from \$106bn in 2022.

Overview

Portfolio commentary

RL Global High Yield:

The fund reported a strong return in the fourth quarter, performing broadly in line with the benchmark – while slightly ahead on a gross basis. It was a similar story over the year, with double digit returns for 2023.

The final couple months of 2023 saw very strong returns with a stunning magnitude of reversal in yields with spreads and rates substantially tighter. November ended up being the best month in 38 years for investment grade bonds, while it was simply the best month since last summer for the high yield market.

The fund's outperformance in the quarter was driven by idiosyncratic stock factors and our tendency to favour single B-rated bonds over BB. In particular, our holdings in media, services and telecommunications contributed to our outperformance versus the benchmark. Going forward, we will maintain a preference for B-rated bonds but are wary of sliding too far down the credit rating scale while yields remain high.

With the main uncertainty next year coming from rates, we are high on short duration bonds and carry – income matters in this yield environment. We continue to feel carry offered in high yield bonds will be our friend. The high yields seen in 2023 offer a buffer to absorb spread and default losses to keep total returns high in 2024.

The performance of the fund gives us confidence going into next year but sluggish growth, in both the US and Europe, tight lending standards, and rates uncertainty could put pressure on spreads broadly. However, we still see the default cycle being extended into 2025, leading us to believe spreads will fall in a range of 340 to 450 for next year. We are confident in finding insulation to protect ourselves from the structurally weakest parts of the market.

We feel we are getting rewarded for our current yield and do not feel the need to take on incremental risk with the current carry being offered in the high yield market. Our focus will remain on targeting solid names with good financials that have levers to pull in any potential economic fallout.

We think the tailwind risks of a much harsher recession than the shallow one currently predicted is hard to foresee as the credit market will be reacting to the recession, unlike its role in 2008 where it was a leading indicator as the root of the crisis. While we are comfortable with what we feel is a benign economic environment, we do accept there is increased idiosyncratic risk now than there was 12 months ago.

Short Duration Global High Yield:

The fund saw strong outperformance versus SONIA in the fourth quarter, adding to its stellar outperformance over 2023.

We continued on the more cautious approach adopted earlier in the year, in keeping with a defensive strategy, with the fund having no exposure to CCC rated bonds at all. Our focus is on keeping duration short by reinvesting shorter than the final maturity of the fund's assets.

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The low default rates being seen are indicative of a high yield market that is more robust than in the past. The CCC portion of the market is now a relatively small portion of the market, with issuers now typically larger and in better financial standing. The higher rated portion of the market has proven to be more resilient than given credit for and companies are exercising sound corporate judgement by looking to sell assets and refinance while liquidity is available. Liquidity and flexibility mean that defaults are being deferred and the most recent data also shows how issuers in distress are not defaulting.

Companies are using a resilient market to refinance, and push any 'maturity wall' concerns into 2025 and beyond. This was highlighted by Pilgrim's Pride redeeming their 2027 maturity bond during October – which illustrates how some companies are addressing their capital structure early in a prudent manner. Royal Caribbean Cruises, International Game Technology and Outfront Media all redeemed their short duration bonds during November.

Multi Asset Credit:

The fund saw strong outperformance versus SONIA in the fourth quarter, adding to its outperformance over 2023.

The benefit of the loan book in the portfolio includes the high carry, the short interest rate duration risk and convexity (as most high quality loans trade below par) so there is optionality on a refinancing in a defensive instrument.

Overview

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Outlook

Our focus will remain on the Fed. With inflation expected to fall back towards the long-term target, the levels that the Fed is happy with and when it then begins to lower rates will be the key factor for the upcoming year. The resiliency of the economy has led to the narrative that interest rates will now stay 'higher-for-longer'. With monetary policy lags appearing longer than they used to be there is some recognition by central banks that policy tightening needs time to work and that the impacts of policy tightening are still feeding through. This is causing spreads to tighten as investors are now convinced the fallout won't be coming until late 2024 or early 2025.

Current default rates are very low at around 2-3% and while we expect this to track to 3%-5% over the course of next year. These levels would be entirely normal in an historic context, but the nature of the economic backdrop and strong company balance sheets means we expect default rates to grinding higher over this period, instead of sharply spiking. Even if default rates creep higher than our target range we don't see this as particularly worrying as it won't change the fundamentals of the high yield market and will only come about from Fed monetary policy, which has been priced into corporate valuations, instead of, as of yet, unknown increased economic hardship.

With this in mind, we believe 2024 should play out similarly to 2023: maturity wall concerns being overplayed; companies holding high liquidity; private debt markets eating the bottom cohort of public markets; public markets remaining open, with solid issuance levels. As long as public markets stay open, any maturity wall concerns will be swept away. And, as long as private markets are taking away the weakest parts of public markets, defaults should stay low.

In our view, the way through difficult markets is to focus on those risks that you can control and know what you own. We will keep spread duration low and focus on the quality of issuers' financials, rather than relying on third-party ratings: at a sectoral level, cashflows are the key factor, meaning we need to know about on- and off-balance sheet leverage. We prefer not to wait for defaults as the recovery process can take time: however, should they occur, the key is to have an adequate solvency cushion.

Further Information

Please click on the links below for further information:



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.

Important information

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