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Sterling 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.

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.

Global government bond yields started the quarter continuing the rising trend that started in mid-2020. This reflected market views that rising inflation would necessitate even higher interest rates and the mantra of higher for longer. Yet, with inflation starting to come down, expectations of rate cuts in 2024 contributed to significant falls in bond yields fell in November and December.

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.

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). Given the fall in yields, sectors with a greater proportion of long-dated bonds performed well, including utilities and social housing. Supranationals was the worst performing sector, while in financials, banks lagged slightly but insurance bonds modestly outperformed the market.

Issuance was relatively low in the fourth quarter, reflecting usual seasonal patterns. For the year as a whole, sterling issuance was £63.9 billion, or £28 billion in net terms, compared with £51.5 billion and -£2.7 billion respectively in 2022.

Portfolio commentary

Please note, individual bonds may not appear in all sterling credit portfolios; however only those that are held more broadly across the range of funds are mentioned.

The fund saw a positive return in the period and was ahead of the iBoxx Sterling Non-Gilt index benchmark. The main driver of positive performance was our sector positioning, notably our underweight position in supranationals, which continued to lag the wider market having done so in the third quarter. Duration and curve positioning were positive – we were slightly long going into the quarter and the fall in yields and strong performance from longer-dated bonds therefore helped.

Stock selection effects were mixed: we saw positive selection in insurance bonds, notably longer dated subordinated bonds from Prudential and Legal & General, but negative selection effects in structured bonds, which generally have a lower sensitivity to wider market moves.In addition, our holding in Thames Water was also a detractor from performance over the quarter. We maintained exposure to Thames Water as part of a diversified portfolio, based on the attractiveness of the overall blended yield across holdings in operating company and holding company debt. Whilst structurally junior holding company debt underperformed and was downgraded, our larger exposure to the operating company debt was beneficial for performance over the quarter. We continue to believe that the sector remains attractively valued – largely based on our view that spreads in the sector overcompensate when compared to other regulated infrastructure assets such as UK electricity distribution.

Last quarter we highlighted an issue with our holding in HDL, where the principal was not repaid on maturity at the end of July. We are pleased to confirm that the bond was redeemed in full in November. We believe this is a good outcome as not only did holders receive full repayment, but also accrued interest at the coupon rate since the end of July. In our view, this demonstrates the power of covenants and how these can protect investors' interests in this sort of scenario. Naturally we prefer to avoid any default, but as we expressed in our initial update we had confidence in our position. It should be noted that, over time, the investment in HDL has been materially beneficial – despite the default.

Overview

Portfolio activity

Financials remain the largest part of the market with issuance in 2023 skewed similarly. We continued to find opportunities across the financial sector, adding a new senior issue from Barclays and Credit Agricole early in the period, also adding senior bonds from US insurers New York Life and Pacific Life, with the bonds ranking alongside policyholders in seniority. We are also happy to add subordinated bonds where we feel the risk/ reward profile is attractive, examples during the quarter including Aviva and defined benefit pension buy-in and buy-out specialist Pension Insurance Corporation. Finally we added an AT1 subordinated new issue from Close Brothers at a yield in excess of 11%. This market, having been very quiet since the Credit Suisse rescue, has been active with investors now confident that such debt will rank higher than equity holders in US dollar, euro and sterling markets.

We are selective in our exposure to utilities – often feeling that we can find better value elsewhere. However, the sector's regulated nature is attractive, and its more long-dated maturity profile means that it sits well with our philosophy of being long-term lenders. Southern Water is a regulated utility and we bought a new issue of senior operating company bonds during the quarter. We felt these were attractively priced – the company trades wider than the sector, but in our view has already been through a difficult period, during which it has reduced leverage. We also added a new 2040 issue from Thames Water. The bonds are at the operating company level and came at a very attractive spread.

Social housing remains a key area for our sterling credit strategies. During the quarter a new issue of 2041 bonds from Places for People. The company owns and manages 240,000 properties across the UK and the bonds came at an attractive spread premium to the market. We also added Saltaire Finance; the bonds were issued under the Affordable Homes Guarantee Scheme and will be used to fund the development of more than 1,500 homes across the North East, the East Midlands and the East of England. The bonds came to market at a tight spread – around 55bps over gilts – but we feel this is attractive given the UK Government guarantee.

There were noteworthy new issues in the structured sector as well. We added a new issue of Stark Financing, a commercial mortgage-backed security secured against 103 UK property assets, predominantly 'last mile' warehouse assets. The floating rate A notes we bought are rated AAA and have an attractive loan-to-value, also paying an attractive premium to SONIA. We also added a five-year new issue from the RAC, these bonds yielding over 8% and benefiting from security over the business.

In the secondary market we added selectively to subordinated bank and insurance debt – where yields still remain elevated. However, underlying credit fundamentals mean that some of these bonds offer excellent value, such as legacy bonds from Aviva and Legal & General. In other financials, we added bonds from global financial solutions provider Fidelity National Information Services. In the structured area we added a CMBS from Canary Wharf where we felt that the spread was very attractive for senior level risk bonds, and Meadowhall Finance, secured on the Sheffield shopping centre with a low loan-to-value.

Outlook

Inflation has come down significantly in 2023 but remains well above the Bank of England's target, and now does not have the 'easy' wins of base effects to push this lower. In our view, wage inflation is the key metric to watch: we believe that the Bank will find it hard to start cutting rates if wages continue to rise at 5-6% per annum. Although the economic data remain very mixed, we still believe that higher interest rates will contribute to a slowdown in the UK. This could well impact company earnings and lead to some increase in pressure on credit markets. However, consumer resilience has been greater than expected in both the UK and globally, which has helped support growth and prevent a recession. How this continues into 2024 could prove critical.

As we came into November 2023, we felt that the all-in yield on sterling investment grade credit was looking very attractive, having risen significantly since the start of the year. The falls in gilt yields since then have largely reversed those rises. Our sterling credit strategy focuses on three sources of return: gilt yields, market credit spreads, and the additional credit spread we generate over credit benchmarks. Whilst ten-year gilt yields of 3.5% are not as attractive as the 4.5% seen in October, we feel that the excess yield available on investment grade credit overcompensates for default risk. Further, the additional yield embedded in our credit strategies, over that available from credit benchmarks, gives us confidence in our ability to deliver long-term outperformance.

We expect supply to weigh on credit markets in the first quarter but believe that underlying fundamentals will limit spread widening. Our emphasis remains on building diversified portfolios, with a high relative exposure to asset backed and strongly covenanted bonds that offer an attractive yields. This strategy underpins the excess yield of the portfolio relative to its benchmark.

Although recent outperformance means that the relative attractiveness of sterling credit bonds has reduced, we still favour holding them compared to UK government debt as credit spreads remain at levels that more than compensate for the credit risk. Given the potential challenges in the outlook, we remain focused on identifying companies with strong balance sheets, favouring issues with security and downside protection, and ensuring that portfolios are diversified across issuers and sectors.

Further Information

Please click on the links below for further information:

- Stewardship and responsible investment at RLAM
- Responsible investment at RLAM
- Royal London Sterling credit ESG analysis
- Royal London voting and engagement
- 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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