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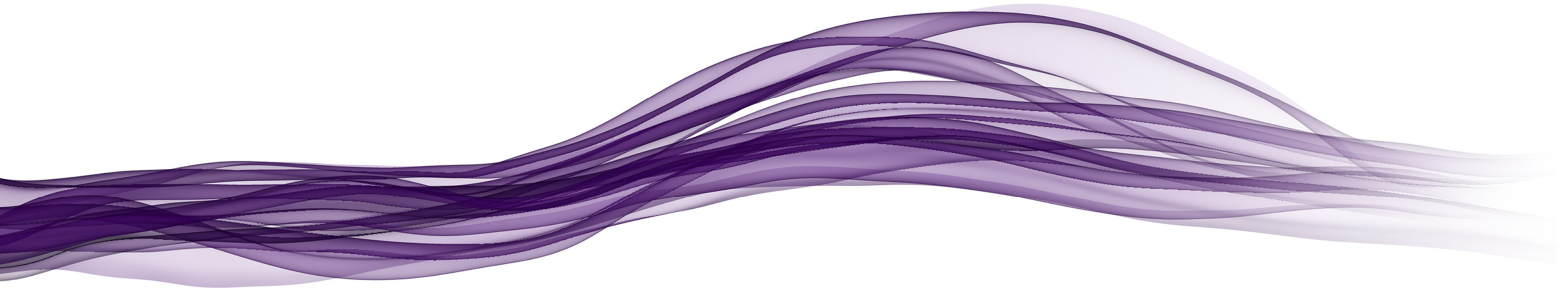

Liquidity strategies

Quarterly Overview

31 March 2024

ROYAL LONDON
ASSET MANAGEMENT

Overview

Market overview

A key theme to emerge during the quarter was indication of a more favourable global macro backdrop. Despite some mixed signals, the US economy remains resilient, while Europe and the UK show signs of gradually exiting their recessions. Activity in China also seems to be stabilising. At the same time, core central banks are still confident that the disinflation trend remains intact, despite some recent setbacks in inflation prints. Policymakers have often highlighted that they are in no rush to cut rates – with markets now generally pricing the start of the easing cycles to begin this summer. The Federal Reserve, European Central Bank and Bank of England all left interest rates unchanged over the quarter.

One major development over the quarter is that markets have recalibrated their pricing for expected central bank cuts over this year. At the end of last year, markets were pricing in an aggressive rate cutting cycle, but then swiftly move to temper those forecasts. This re-pricing contributed to negative returns for global government bond markets over the quarter. Despite the belief of many that it was the anticipation of a 'Fed-pivot' that contributed to the rally in equity markets in late 2023, equity markets proved to be immune to this bond market sell-off as global growth and business confidence showed signs of resilience and investors focused on the potential offered by AI.

UK government bonds produced negative returns due to rising yields, delivering a -1.62% return (FTSE Actuaries) over the first quarter with the benchmark 10-year gilt yield rising from 3.54% to 3.94%, with the bulk of this move seen in the first two weeks of January, then largely trading in a range between 4% and 4.2% for the rest of the quarter. The sterling investment grade credit market (iBoxx non-gilt index) returned 0.06% over the quarter, with the average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) tightening from 1.15% to 1.02% (iBoxx).

UK money market rates were generally flat during the quarter, with longer-dated rates generally falling slightly, reflecting changing market expectations – generally rising early in the period as the market realised that rate rises were further away than initially thought, and then falling late in the quarter as inflation fears receded and the market moved to price in rate rises earlier in the summer. SONIA started the quarter at 5.18%, and remained at this level throughout the quarter, with no changes to UK base rates from the Bank of England, while two-year gilts, often seen as a proxy for market expectations of BoE rates, ended slightly higher, from 3.98% at the end of 2023 to 4.18% at the end of March.

Performance and activity

After a period of rising interest rates, short-term money markets have essentially been flat for around six months. During that period, the consensus around when rates would finally peak and then when central banks would start to trim rates has swung from optimistic, to pessimistic, and back again. However, for our portfolios, this has been a period where we have benefited from activity in previous quarters where we built up portfolio yield, and yet have still been able to rotate maturing proceeds into equally attractive securities. The high level of carry in the portfolios has helped produce strong returns for the quarter.

For the Sterling Liquidity Fund, we still focus on short paper – reflecting the fund's objective. This has generally meant a focus on three-month maturities for much of the last few months. However, with long-dated bank issuance somewhat muted, and increased demand for short-term paper, the spreads on that paper over SONIA have decreased somewhat in recent months – from an average of around 45bps to nearer 20bps.

Pockets of value can still be found, but it has meant that at the margin, we have increased purchases of treasury bills – not only do these offer excellent liquidity, but the yield on these is now only slightly lower than equivalent CDs but without the credit risk. Similarly we have increased repo and overnight exposure, reflecting that the yield premium on other instruments has decreased and these two routes offer greater liquidity and lower credit risk.

Where we have added CDs, we have preferred to add names with modest yield premium to SONIA but also strong credit, ESG and governance characteristics, rather than chase yield at the expense of quality. Examples during the quarter included Bank of Montreal, KBC and Credit Agricole.

With the Short Term Money Market Fund, we had the same focus as the Sterling Liquidity fund with a focus on short paper reflecting the fund's objective, and a focus on three-month maturities. In addition, there is the same increase in purchases of treasury bills and overnight exposure.

Where we have added CDs, we have preferred to add names with modest yield premium to SONIA but also strong credit, ESG and governance characteristics, rather than chase yield at the expense of quality. Examples during the quarter included BNP Paribas, KBC and Credit Agricole. We also looked to add short-dated covered bonds where these fitted into the fund's liquidity and maturity needs, examples including covereds with less than a year to maturity from Bank of Nova Scotia and Societe General.

Overview

For the Short Term Fixed Income Fund, covered bonds still account for the majority of non-money market exposure. These were helpful for returns over quarter as these pay a premium over SONIA, while the carry built into the portfolio was also helpful.

Given the volatility in longer rates and the relatively muted issuance, we have focused on short-dated treasury bills and CDs, preferring to add names with modest yield premium to SONIA but also strong credit, ESG and governance characteristics, rather than chase yield at the expense of quality. Examples during the quarter included BNP Paribas and Credit Agricole. Within covered exposure, we were happy to take profits on a number of holdings close to maturity where spreads had tightened significantly, including Toronto Dominion, Bank of Nova Scotia and National Australia Bank, but adding new issues of covereds where these had an attractive premium over SONIA, with examples including three-year Toronto Dominion and Santander, as well as five-year bonds from Leeds Building Society.

For the Short Term Fixed Income Enhanced Fund, performance over the quarter was positive in absolute terms – primarily due to the high yield built into the portfolio. Moves in yields were broadly neutral for the fund, although tactical trading of duration and tightening credit spreads also helped performance.

Aside from overnight deposits, we continued to look at tactical opportunities in five-year gilts to take advantage of market volatility, with gilts largely range-bound for much of the quarter. Within the portfolio, we were happy to take profits on a number of holdings close to maturity where spreads had tightened significantly, including CDs from Toronto Dominion and Commonwealth Bank of Australia, but adding new issues of covereds where these had an attractive premium over SONIA, with examples including five-year bonds from Coventry Building Society and Leeds Building Society. We also added subordinated bank bonds from KBC, as well as PMF, a securitisation of prime buy-to-let mortgages granted to borrowers with no adverse credit, rental income verification, and high LTVs, which came at around 100bps over SONIA.

Outlook

The story of the first quarter was one of the market interpreting short-term economic data releases through the prism of what might be a catalyst for the Bank of England cutting interest rates. Although the UK technically saw a recession in the second half of 2023, the economic outlook is little changed from last year: growth is low, inflation is falling, but elements of that – notably services and wages – are still above levels that suggest a clear return to the 2% inflation target.

Towards the end of the first quarter, market pricing of the first UK rate cut moved from August to June, reflecting an unexpected shift in the voting split on the MPC to 8-1 (eight voting for no change, one voting for a cut). Our own view is that while June is possible, we feel that August is more likely. From a domestic point of view, it allows more time for the Bank to digest spring economic data, and coincides with the August Quarterly Inflation report – historically the Bank has preferred to time rate moves with this release. In addition, in a global context, we think that many central banks will be cautious about being the first to cut – with many having half an eye on the Federal Reserve, where we feel the direction of travel in terms of growth and inflation is more obviously favourable for a rate-cutting move.

Current cash rates remain above the level of inflation, offering investors positive real yields, but a lot has happened in the past quarter and markets have at times, been unpredictable. However, it is exactly this level of market unpredictability which we believe offers opportunities for active managers. Our liquidity and short-term fixed income strategies are positioned somewhat cautiously. At the margin, we prefer treasury bills to CDs given the tight spreads on CDs at present and with credit generally priced for a favourable economic environment, we are happy to hold short-dated credit where appropriate for the strategy, but this exposure is generally towards the lower end of historical ranges.

Further Information

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