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Government Bond strategies

Quarterly Overview

31 March 2024

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.

Data released in the first quarter confirmed that the UK experienced a technical recession in the second half of 2023 but painted a picture of stronger economic activity in the first quarter, with falling inflation and more signs of softening underlying domestic inflationary pressure. Fourth quarter GDP fell 0.3% quarter-on-quarter in real terms after falling 0.1% in the third quarter. Meanwhile, CPI inflation fell a bit further to 3.4% year-on-year in February from 3.9% for the November release. Core inflation fell to 4.5% year-on-year from 5.1% over the same period. By the end of the quarter (the January data release) regular pay growth figures were showing more sign of slowing, at 6.1% (3M/Y) for the 3-months to January (from 7.2% three-months earlier). Consistent with falling – but still above target – inflation, but with activity and labour market data relatively resilient, the Bank of England continued to keep rates on hold at 5.25%. The Budget saw the Chancellor present further tax cuts, adding net stimulus near term but with the projections for future years still implying sizeable real terms spending cuts for unprotected government departments.

Yields on 10-year gilts moved higher over the quarter with the vast majority of this move coming in the first three weeks of January, as the market unwound a large portion of December's strong rally. Since the middle of January, the market has broadly moved sideways, in what has been a relatively tight trading range; 10-year gilt yields, have, for much of the quarter, traded between 3.9% and 4.1%. The sell-off in early January was led by the front end of the curve, with five-year yields rising most, as markets reappraised both the timing of the first cut, and the number of cuts it expected from the BOE in 2024.By the end of the quarter the first cut was priced for June with three cuts in total for 2024, against forecasts of March and six cuts respectively at the start of the year. Central to this was the surprising resilience of both the UK and global economic data versus expectations.

Despite this broadly 'hawkish' narrative, there was significant interest in the Bank of England's March meeting. Going into the meeting the market had expected a split vote to keep rates on hold. And whilst that was the case, the lack of any members voting for a hike came as somewhat of a surprised, providing the market with a more dovish impulse.

Gilt supply has been a hot topic for some time, and this was no different during the first quarter. With March's budget out the way, and the remit for gilt supply now known to the market, attention can shift to what lies ahead. One key feature of the DMO's announcement was the reduction in the percentage of long gilts and linkers to be issued in fiscal year 2024, at the expensive of slightly higher issuance in short and medium maturity bonds. This was well predicted by the market, and thus had little impact on either the outright level of gilts or the shape of the curve.

Portfolio commentary

RL UK Government Bond Fund

The fund outperformed its benchmark during the first quarter, but delivered a negative absolute return. The fund started the period slightly short relative to the benchmark, but strategically extended duration towards the end of January, taking the fund slightly long relative to the benchmark. We continued to add duration in February getting to around 0.4 year long. We decided to add duration as yields rose, with our duration addition being focused in the 15-year part of the curve. Overall, our strategic duration stance added to performance during the quarter but only marginally, as the yields moved broadly sideways after the initially sell off in January.

One key aspect of all global bond markets during the quarter was the heightened intraday market volatility driven by macroeconomic data, persistent and high levels of bond supply, and positioning within markets. This has provided opportunities for active managers to tactically trade the market as yields have risen and fallen in relatively tight ranges, and the funds high actively duration trading was a key driver of performance.

During the fourth quarter, our long duration position had been predominantly expressed by a large overweight at the front-end of the curve, mainly in 5-year gilts. As the market rallied in December, we reduced this front-end overweight taking the fund more neutral 5-year maturity

ROYAL LONDON ASSET MANAGEMENT

Overview

gilts, but short overall relative to the benchmark. As yields rose during January we added duration back but mainly through buying 15-year and 30-year gilts.

In terms of curve, the fund is overweight 5-year maturity gilts and 15-year maturity gilts with a large underweight in 7 to 15 year maturity gilts. The fund is broadly neutral 30-year maturity gilts and longer, with the fund covering some of its underweight in the ultra-long end of the curve (50 year maturity) as that part of the curve steepened late in the quarter.

We ended the quarter with no cross-market positioning. We had retained a small residual position in Australia but took profit on the position during the quarter, selling 30-year Aussie bonds when yields were flat to 30-year maturity gilts.

The fund had a small inflation exposure through a holding in linker 2051s. We took profit on this at the start of February as index linked bonds outperformed and break-evens rose.

Finally, as credit spreads on corporate bonds tightened, we took the opportunity to sell out of long-dated credit positions in the fund – namely Oxford University, State of Jersey and Church Commissioners of England. Spreads on these bonds were at near all-time lows. A small portion of the fund is still invested in high-quality credit, but it is now focused in sub-5-year bonds.

RL Short Duration Gilt Fund

The fund was in line with its benchmark during the first quarter.The fund started the year slightly short relative to the benchmark but and added duration as the period went on, ending the quarter 0.2 of a year long relative to the benchmark. We decided to add duration as yields rose, with our duration coming from an increase in the holdings of 2029 gilts.

The fund's duration position remains focused in the five-year portion of the curve, but we continue to tactically trade around market volatility.We started adding duration when five-year yields hit the 4% mark – which was around the middle of February – and we did not see yields rise much further from that position.

The fund remains overweight in the two-to-three year part of the curve.

Our relative-value positioning retains a large overweight position in certain 2025 and 2027 bonds – which have seen strong performance versus neighbouring bonds so far this year.

During the period, the fund added 6-month UK Treasury bills, with the yield on them coming in 25-30bps higher than 5-year gilts.

The fund has no inflation exposure.

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. 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 move through 2024, central banks are likely to start reducing rates, but with yields below base rates in all markets, this is well priced.

In the UK, the market is now assuming base rates have peaked at 5.25%, with the first cut priced in for June 2024 and falling to a terminal level of around 3.5% by late-2026.

Supply will remain high for 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 could represent a headwind for gilts. However, when considering gilts in a global context, we believe the gilt market is somewhat priced for this, with the UK curve much steeper than both the US and German bonds.

Further Information

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