For professional clients only, not suitable for retail clients.

Sustainable Credit 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.

Government yields rose in all the major markets. UK government bonds produced a return of -1.62% (FTSE Actuaries) over the first quarter, with the benchmark 10-year gilt yield rising from 3.54% to 3.94%. The bulk of this move occurred in the first two weeks of January, before largely trading in a range between 4% and 4.2% for the rest of the quarter. The rising yield environment helped short-dated bonds to outperform their longer-dated equivalents.

In contrast to the losses in the government bond market, the sterling investment grade credit market (iBoxx non-gilt index) returned 0.06% over the quarter, with the effect of higher yields mitigated by tighter credit spreads and the higher carry in this area. The shorter duration of the credit market index also helped offset some of the government market headwind. 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 1.15% to 1.02% (iBoxx). Given the rise in yields, sectors with a greater proportion of long-dated bonds performed poorly, including utilities and social housing. Of the major sectors, supranationals was the worst performing sector, while in financials, the banks and insurance sectors performed well.

Performance and Activity – Sustainable Corporate Bond

Our credit-only fund Sustainable Corporate Bond 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 the combination of our sector allocation and stock positioning. At a sector level, our underweight position in supranationals and overweight in both insurance and structured were the main positives as supranationals continued to lag the wider market, having also underperformed in the second half of 2023. Stock selection in insurance and bank bonds also contributed strongly. These positive contributions from bank and insurance stocks were broad-based. Our bias towards subordinated bonds was helpful, particularly AT1s which continued to outperform the wider market. Our exposure to structured bonds was also positive, despite the negative impact of our holding in Thames Water.

Thames Water shareholders had previously announced an intention to inject £750m of equity into the utility by March 2025, with £500m of this anticipated by March 2024. In late March, and following discussions with OfWat, the necessary conditions for that initial injection had not been met. This has been negatively received by credit markets – as was the S&P downgrade to BBB- after the end of the quarter. We continue to believe that liquidity in the operating company remains satisfactory and that the business can continue to fund itself and serve its customers. Equally, until regulatory clarity is received, we expect newsflow to be negative. However, we believe that valuations remain attractive on a fundamental basis, given the strength of protection afforded via the regulated asset base and an expectation that a regulatory determination in June will allow the company to gain shareholder support and avoid a scenario in which taxpayer money is required to support the company. We believe that the risk in the business remains political in nature, as higher returns to incentivise the significant investment that is required to enhance the network will require price rises for consumers. Nationalisation or a change in the regulatory regime would create wider ramifications for the funding of UK infrastructure and impose significant liabilities on UK taxpayers.

Alongside the announcement by Thames Water, Thames Kemble (the holding company for Thames Water) announced that it will not be able to meet the maturity on its £190m April 2024 loan and at the start of April, formally announced a default on the £400m 4.625% 2026 bonds. Whilst significant risks have already been reflected in Holdco bond pricing, the news weighed further on this bond. Our bias remains in the safest part of the capital structure – operating company debt that is closest to the assets – position sizing has reflected the differing risks and holdings remain part of a very diversified portfolio of lending decisions.

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New issue activity remained a key focus over the quarter. A notable trend has been the reduction in the new issue premia (the additional yield required to sell new bonds) and at times, book building sizes have looked extraordinary – suggesting huge latent demand. This has led to some caution on our part – we still believe that credit spreads more than compensate credit investors for the risk of default, but are equally aware that demand in certain parts of the market can lead to less favourable pricing.

Financials continued to dominate primary market activity during the quarter. Here we added a senior issue for UK mortgage specialist OSB at a yield of over 8.5%. Other notable purchases included Abrdn in the secondary market at a yield to call of over 11% and subordinated short-dated bonds from mutual Nationwide yielding over 6%.

Exposure to structured bonds remains a cornerstone of our process and portfolios. Issuance has been somewhat low in recent months, but there were opportunities in the sector during the quarter. Examples included Land Securities and a rare new issue from Telereal – the latter secured on BT telephone exchanges.

Demand from annuity buyers has continued to support longer-dated high quality bonds. In a number of areas, this has pushed spreads to levels that we feel were unattractive, and we took advantage of the higher demand for these bonds to take profits and recycle into more attractive areas. Our exposure to social housing was an example of this. Here we took profits on Housing & Care 21, after spreads had tightened to materially lower levels than the wider market. These monies were initially recycled into gilts to maintain duration, but then reinvested into more attractive opportunities in both new issue and secondary market, including a new issue from BPHA, who manage almost 20,000 homes across to Oxford to Cambridge corridor and we feel have strong EPC performance – indicating strong energy efficiency across their portfolio, at an above market average yield. We also took profits on Notting Hill Genesis, again after strong performance, reinvesting in A2Dominion, enhancing credit spread by around 80bps.

We remain cautious around utilities as valuations are generally not as appealing as other areas of the market. However, during the quarter, we felt that valuations in the gas sector, an area we had reduced in recent years, had improved significantly, with credit spreads materially wider than those in the regulated electricity sector. As a result, we were happy to purchase a new issue from the UK's largest gas distribution network Cadent.

Performance and Activity – Sustainable Short Duration Corporate Bond

Our credit-only fund Sustainable Short Duration Corporate Bond fund produced a positive absolute return for the quarter, thanks to the impact of narrower credit spreads and the income in the portfolio more than offsetting the impact of rising government bond yields. On a relative basis, the fund outperformed its benchmark index.

The main driver of positive performance was the combination of our sector allocation and stock positioning. At a sector level, our underweight position in supranationals and overweight in both insurance and structured were the main positives as supranationals continued to lag the wider market, having also underperformed in the second half of 2023. Stock selection in insurance and bank bonds also contributed strongly. These positive contributions from bank and insurance stocks were broad-based. Our bias towards subordinated bonds was helpful, particularly AT1s which continued to outperform the wider market. Our exposure to structured bonds was also positive, despite the negative impact of our holding in Thames Water.

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Financials continued to dominate primary market activity during the quarter. Here we added senior bonds from Metropolitan Life, these bonds ranking alongside policyholders in seniority, in addition we participated in a senior new issue for UK mortgage specialist OSB at a yield of over 8.5%. Other notable purchases included Abrdn in the secondary market at a yield to call of over 11% and subordinated short-dated bonds from Nationwide and Legal & General.

Exposure to structured bonds remains a cornerstone of our process and portfolios. Issuance has been somewhat low in recent months, but there were opportunities in the sector during the quarter. Examples included Land Securities and a rare new issue from Telereal – the latter secured on BT telephone exchanges.

Relative value trades are always of interest to for the fund, looking for opportunities to add incremental yield or reduce risk, or both. An example during the quarter was taking profits on Notting Hill Genesis, after strong performance, reinvesting in fellow social housing provider A2Dominion, enhancing credit spread by around 80bps, or a trade slightly shorter in Yorkshire Building Society, where we sold 2028 bonds into 2027s from the same issuer for a small increase in yield.

Outlook

The rally in bond yields seen late last year, prompted by hopes that falling inflation would lead to relatively rapid and numerous interest rate cuts, was largely unwound in the first two weeks of 2024. This reflects the change in interest rate expectations and the sensitivity of markets to incoming economic data. Looking at market pricing, UK base rates are projected to be around 4.5% at the end of 2024, this is in contrast to the 12-month outlook, where markets were projecting rates below 4%. We expect yields to remain sensitive to economic data, and unless there is a significant deterioration in underlying trends, we expect this to lead to range bound-yields and the opportunity to add/trim duration as markets react to individual data points.

Headline inflation is expected to reach the 2% Bank of England target level in the next few months. However, we are mindful that underlying pressures in the labour market and parts of the services sector mean that headline inflation figures may be somewhat misleading. In addition, data since the start of the year suggests that the UK is growing again – albeit slowly. This trend can be seen in the US and euro zone as well. Overall, the global tone is that rate cuts are not going to come through as quickly as anticipated and that the neutral level may be a bit higher than previously thought.

With bond yields generally higher than they were at the start of the year, and interest rate cuts now closer, we believe that overall government bond yields look attractive. Credit spreads have come in further – and are now looking somewhat tight in longer-dated bonds – but continue to compensate credit investors for the risk of default. From a credit spread perspective we continue to find better value in shorter-dated credit bonds, but with absolute yields at attractive levels we prefer to be broadly neutral in overall duration positioning, with a bias to extend on further rises in yields.

All issuers within our sustainable holdings offer a net benefit to society or show ESG leadership. As well as reducing risk, we seek out opportunities that are under-researched e.g., bonds that do not fall into mainstream indices or benchmarks and/or are unrated by ratings agencies. Importantly, the sustainable credit proposition provides access to critical sectors that most investors can't access via equity markets. Key themes in the funds include social housing, social & environmental infrastructure, community funding (regulated banks and building societies focused on SME and retail lending), financial inclusion & resilience (such as insurance products to support individuals through shocks) and the energy transition. On sustainability grounds, we have no exposure to bonds of oil & gas companies or extractive industries. We are also underweight in the general industrial and consumer goods sectors, and to a lesser extent in consumer services.

We target – and achieve – a material yield premium over the market level in our sterling credit strategies. We mitigate the risks by maintaining highly diversified portfolios, with a bias towards bonds that offer greater security and downside protection. Our view remains that over the medium term our focus on delivering greater income than the benchmark will generate outperformance.

ROYAL LONDON ASSET MANAGEMENT

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