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Craig Inches is Head of Rates and Cash at RLAM, responsible for the management and oversight of RLAM's rates and cash business. Craig works closely with Paul Rayner (Head of Alpha Strategies) and the rates team to manage a suite of solutions ranging from enhanced cash through sovereign and global bonds culminating in absolute return. Prior to RLAM, Craig was an Investment Director with Scottish Widows Investment Partnership, where he gained extensive cash and fixed income experience. Craig has an MSc in Investment Analysis from Stirling University, a BSc (Hons) in Actuarial Mathematics and Statistics from Heriot-Watt University and is an associate of the UK Society of Investment professionals.

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Is this the year to decrease interest rate risk?

The recovery and inflation trades were the dominant themes of 2021 – a tough environment for global government bonds which provided negative absolute returns for the year, as yields trended upwards from low levels. However, with inflation expectations growing and nominal yields on the rise, real yields reached all-time lows. This saw global index-linked government bond funds perform very strongly and significantly outperform traditional government bonds last year. Looking into 2022, we expect nominal yields to continue creeping higher, as central banks begin to remove support from markets. We also expect buoyant global inflation markets to cool somewhat, pulling real yields higher from their all-time lows.

Waning monetary policy support will see yields trend upwards

Nominal yields are likely to rise in 2022 as central banks begin to remove monetary support, including rolling back vast quantitative easing (QE) programmes that have been in place since the beginning of the pandemic, and rising interest rates from record low levels. Most global government bond markets are well priced for rate rises at the short end at present – i.e. bonds between 0 and 10-years in maturity – so we expect the most significant yield rises to come from longer-maturity bonds, causing curves to steepen globally.

In the UK, quantitative easing ended in December, and the Bank of England (BoE) increased interest rates to 0.25%. However, the big debate is when rates will reach 0.5% – at this point the BoE will no-longer reinvest the proceeds of maturing bonds purchased as part of QE. The first of these bonds matures in March, so a move to increase rates to 0.5% at any point next year would be a strong tightening signal to the market. And considering that we will see the greatest net issuance of gilts in 2022 for over ten years, there is potential for softness in the gilt market next year.

The US is running a little behind the UK with the Federal Reserve (Fed) only beginning to taper QE in November 2021 and planning to remain supportive into 2022. Nonetheless, government bond yields are higher in the US than in the UK, as investors are more confident that the US market can reach a 2% Fed Funds rate sooner, likely towards the end of 2023. This is due to the US being the only major market to have generated a cycle of rate increases post the Global Financial Crisis. In comparison, the UK bank rate has stayed below 1% ever since. With US treasuries probably more fairly priced than UK gilts we feel there is less room for upwards movement in US yields, although a little movement is probable – we expect the US to perform well versus the UK on a cross-market basis.

In Europe, the European Central Bank (ECB) is not expected to raise interest rates until late in 2023, but the Pandemic Emergency Purchasing Programme (PEPP) is coming to a close in March. In December, the ECB extended the reinvestment period of maturing PEPP bonds until 2024, and announced an increase in purchasing power of the Asset Purchase Programme (APP) for the second and third quarters of 2022. We believe European periphery markets in particular are set for less monetary support this year, as many of these markets garner limited support from the APP. Government bond yields in periphery markets such as Greece, Italy and Spain all rose towards the end of 2021 in anticipation of less support, and we expect yields to continue to rise. The ECB maintained throughout 2021 that high levels of inflation are transitory – we believe that any upside surprises in inflation that bring forward tapering by the ECB could lead to a material repricing of longer-dated EU bonds.

Diversify and shed interest rate risk to protect from capital losses

At present, global inflation prints are still running high, and although the BoE has moved, other major global central banks are yet to raise rates having sustained their view throughout 2021 that inflationary pressures are transitory, and not persistent. Although central banks will likely want to remain supportive of markets during periods of coronavirus-related stress – highlighted by the global reaction to the emergence of the

Omicron variant – they will have to act if inflation looks set to become persistent. This saw Fed Chair Powell drop the transitory tag on inflation in November last year and signal that the tapering of asset purchases will be brought forward from June to March this year. It also raised the potential of an earlier than expected US rate rise.

The key metric we are monitoring to this end is wage inflation – particularly increased real average earnings. With labour markets already tight and with strong growth in real average earnings during 2021 compared to historical standards – especially in the US and the UK – bumper pay rises through the first quarter of 2022 could see increases to real average earnings surpass the rate of inflation. At this point, we believe central banks would be forced to guard against inflation and raise interest rates.

While any funds that correctly predict the nature of inflation and timing of interest rate rises will reap rewards, markets can read signals incorrectly – we need only look back to November last year, when as alluded to earlier, gilt markets were surprised after hawkish comments by BoE Governor Bailey in September did not bear fruit to a rate rise. With this in mind, we believe investors should consider steps now to protect themselves from capital losses, for example by moving to shorter duration investment products and by diversifying globally.

Moving into short duration funds is an effective way to shed exposure to interest rate risk, and short-dated funds have outperformed in 2021 as a result. Global diversification, on the other hand, can help to shield portfolios from concentrated risk in specific markets. This is particularly pertinent for gilt investors, as the UK may experience incremental increases in interest rates through 2022. Moving from UK to globally focussed funds will provide access to markets that we expect to outperform the UK on a cross-market basis during 2022. Furthermore, global funds are usually shorter in duration, as the UK has one of the longest debt profiles in the world.

For investors expecting inflation to be more persistent, and therefore wanting to retain some element of inflation protection via index-linked funds in 2022, we stress that index-linked funds are also real yield funds and so also carry an element of interest rate risk. For these fund strategies, and for the same reasons, we believe that short duration and global diversification is best. However, considering the extremely strong performance of short-dated global index-linked funds relative to traditional short-dated global government bond funds in 2021, we would not expect the same level of strength and outperformance in 2022. All inflation markets have performed strongly in 2021 and we expect to see inflation expectations drift lower around the second and third quarter of 2022, with base effects beginning to roll off from April onwards.

Investment risks

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