



RATHBONES

RATHBONE ETHICAL BOND FUND

QUARTERLY UPDATE MARCH 2024

US inflation ran hot and investors reined in their interest rate cut expectations in the first quarter, putting immense pressure on government bonds. But corporate bonds continued to rally.

At the beginning of the year, investors were confident that the US Federal Reserve (Fed) would deliver around six 0.25% rate cuts this year, perhaps starting as early as March. But persistently sticky inflation, alongside a roaring US jobs market, have forced them to rein those bets in big time.

The Fed came under a lot of fire for its insistence that the pressures that drove US inflation up to a peak of 9.1% in mid-2022 would prove “transitory”. It will be acutely aware that cutting rates too much and too soon this year might risk inflation getting stuck at an uncomfortably high level – or even reaccelerating. That would damage its credibility badly.

Hopes of early US rate cuts wane

Investors no longer see much chance of the Fed cutting rates any time soon. Most expect around two 0.25% cuts in the second half of 2024, though a fair few think the Fed might not cut at all this year. Because government bonds are the asset class most sensitive to rate moves, this reassessment has driven bond yields up significantly, forcing down their prices.

The benchmark 10-year US Treasury yield stood at 3.87% at the end of last year. By the end of the first quarter, it had soared to 4.21%. And it's kept moving higher in April on more evidence that US inflation is creeping higher. At the time of writing, the yield is around 4.65% – much higher than it was last summer when the Fed was still raising rates! UK 10-year yields have risen as well (from 3.54% to 3.98% during the quarter) and have continued rising in early April, hitting 4.35% as we write. The big variation is in shorter-term bonds, which tend to be a better barometer of expected changes in central bank interest rates. The gap between the yield of the two-year US Treasury and the two-year gilt is double what it was at the start of the year, because many expect the Bank of England (BoE) to cut rates well before the Fed. The BoE should be able to move earlier because the UK's economy is much weaker and inflation appears to be more under control this side of the Atlantic.

We felt that the rally in government bond prices at the start of the year was way too strong and that yields could well back up. But, equally, we didn't want to pare back our duration (interest rate) exposure too much because it's longer-duration government bonds that will rally most when rates do get cut.

The inflation and rate-cutting picture seems a bit clearer in the UK and Europe than it does in the US. Indeed, at the BoE's most recent rate-setting meeting, BoE Governor Andrew Bailey seemed positively itching to cut rates. He announced the UK's latest inflation data was “very encouraging and good news” and signalled that cuts were on the way. As their prices dipped over the quarter, we bought more long-dated UK government bonds, notably the **UK Green Gilt 0.875% 2033** and **1.5% 2053**.

While corporate bonds have kept rallying

Even though government bonds had a turbulent first quarter, corporate bond markets kept powering ahead. Credit investors grew increasingly confident that high interest rates aren't about to tip economies into harsh recessions that might result in a deluge of corporate defaults and downgrades.

With investors seeming to buy fully into a ‘soft landing’ for the global economy, the extra yield (or spread) that corporate debt offers over government bonds to compensate for default risks continued to narrow. The iTraxx European Crossover Index, which measures this spread, began the quarter at 310 basis points (bps), but had tightened to 297bps by its end. This has reversed so far in April as disappointments about the path of US rates (which are the global benchmark for borrowing costs), more trouble in the Middle East and a sell-off in Continental stock markets weighed on corporate bonds. At the time of writing, the spread had jumped to 343bps.

The outlook for economic growth certainly seems a bit more positive than it did at the beginning of the year, April credit spread wobbles aside. This has been particularly important in the UK and Europe, where things have been pretty dire for quite a while. There's more evidence each day that the UK and Europe are now emerging from last year's stagnation/mild recessions. Monthly GDP data showed that the UK grew again in February after an upwardly revised performance in January, so it's highly likely that the economy returned to growth in the first quarter as a whole. Yet UK inflation is expected to fall sharply again in the next set of monthly figures, with Ofgem's energy price cap falling this April. UK headline inflation could very soon be well *below* the BoE's 2% target, as food inflation also falls a lot further.

Performance review

	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	2.14%	9.47%	10.49%	-5.23%	8.11%
IA UK Sterling Corp. Bond Sector	0.35%	8.15%	7.35%	-6.60%	2.62%

	31 Mar 23- 31 Mar 24	31 Mar 22- 31 Mar 23	31 Mar 21- 31 Mar 22	31 Mar 20- 31 Mar 21	31 Mar 19- 31 Mar 20
Rathbone Ethical Bond Fund	10.49%	-10.12%	-4.56%	12.93%	1.00%
IA UK Sterling Corp. Bond Sector	7.35%	-9.14%	-4.25%	9.02%	0.78%

Source: FE Analytics; data to 31 March, I-class, mid price to mid price.

These figures refer to past performance, which isn't a reliable indicator of future returns.

Against this backdrop, we are finding plenty of attractive credit opportunities, particularly in shorter-dated investment grade (high-quality) corporate bonds. Many of these bonds' yields come close to those on offer from longer-term corporate bonds. This means they can deliver attractive carry (coupon income) alongside less credit and duration risk because of their shorter maturity (i.e. there's less time before maturity for rates to change and defaults to occur). During the quarter, for example, we bought some attractively priced asset manager **Abrdn 4.25% 2028** and some **Coventry Building Society 5.875% 2030** bonds. And we sold some of our longer-dated corporate bonds, including our life insurance and pensions group **Scottish Widows 7% 2043** and asset manager **Legal & General 5.5% 2064** bonds.

Over the last few years, one of the big attractions of bonds issued by banks and insurers has been the opportunities afforded to buy the 'legacy' bonds they issued to shore up their capital positions in the wake of the financial crisis. Many offered sizeable coupons and quite a few have been bought back by their issuers because the regulatory framework has changed and this legacy debt is being superseded. When issuers ask bondholders to 'tender' (sell back) this legacy debt, they can sweeten the deal by offering to buy it at premium prices. This gives us scope to lock in attractive price gains when we tender our legacy bonds. In February, we got a welcome double-whammy with tender offers at really attractive prices for two of these legacy bonds issued by French insurer AXA.

We got more good news in early March when Nationwide Building Society launched a bid to take over Virgin Money. We've been buying up **Virgin Money 4% 2026, 4% 2027 and 2.625% 2031** bonds for quite a while as we felt they offered good value. The takeover bid drove the prices of these bonds much higher so we decided to sell them.

Income yields are at multi-year highs

The stickiness of US inflation is a salutary reminder that financial markets and big economies rarely glide along entirely smoothly. There are likely to be plenty more bumps in the road towards lower inflation and lower rates.

But the yields now available on both interest-rate sensitive government debt and growth-oriented investment grade credit are a lot more attractive than they've been for many years. That huge reset means bond yields offer very decent buffers against any further volatility in bond prices, while also offering investors a way to achieve their long term return objectives through income yields alone.



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For more info on our fund, including factsheets, performance and fund manager views, please click [here](#).

If you require further clarification on this commentary, then please contact your adviser or Rathbones at the contact details below.

Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

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