

Rathbone Ethical Bond Fund

Monthly update January 2023

Bond markets continue to recover from last year's shocks. Inflation fell and growth slowed in the first month of 2023, making many bond investors more confident that central banks were getting closer to halting aggressive interest rate hikes.

As a result, government bond prices rallied as their yields (which run in the opposite direction to their prices) drifted downwards. The yield on 10-year UK government bonds (gilts) fell from 3.67% at the start of the month to 3.33% by its end. Likewise, the yield on 10-year US treasuries fell from 3.88% to 3.51% in January.

As it's become clear that the economic handbrake exerted by last year's rate hikes is slowing spending and investment, many bond investors entered the new year expecting that central banks would decide sooner rather than later that their rate-hiking job is done for now. That's why they bought up government bonds whose prices should rise if rates rise less than markets currently expect. These bonds' prices will go up a lot more if central banks reverse course and begin to *cut* rates.

The world's big central banks are all committed to more rate rises until inflation is well and truly licked. So investor expectations of an imminent pause in hikes, let alone rate cuts, seemed premature.

A long, bumpy ride to lower inflation

Inflation may have been falling steadily, but it's still above 6% in the US, at 8.5% in Europe and above 10% in the UK, so much higher than central banks' 2% target. Central bankers' task in driving inflation down decisively and for good is made more difficult by a very tight labour market and high wage inflation. January's job figures showed an astounding 517,000 new jobs had been added in the US during the month, almost three times what had been expected. US wage growth has slowed a bit recently, but it's still higher than the US Federal Reserve (Fed) would like.

Despite their big January bounce, government bond prices have subsequently faltered again as stronger-than-expected economic data (particularly the very strong jobs data) made it clear that central banks would keep hiking for a while.

Following month-end, 10-year gilt yields briefly dipped below 3.05% before racing back to around 3.51% in just a couple of weeks. The 10-year US treasury yield retraced too, and was trading at around 3.75% by mid-February. These big moves show just how uncertain bond investors are about the outlook for inflation, rates and economic growth later this year.

Driving inflation down decisively requires reducing demand for labour by slowing the economy. But the jobs market is showing few signs of cooling. The unemployment rate is at a more than 50-year low in the US and is also unusually low in the UK and in Europe. Surging job creation, alongside strong wage gains, fuel concerns that the economy could still be running too hot, risking higher prices for longer. So jobs market resilience in particular has kept driving investors to price in a higher peak in rates than they'd previously anticipated. This trend may well continue until we start to see clear evidence of a weakened jobs market that persuades central banks that they can pivot to pausing rate hikes.

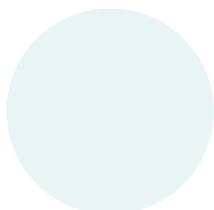
The impact on global demand from a newly reopened China is a further complication in central bank efforts to tame inflation. If China's reopening suddenly injects a lot of extra demand into the global economy, this could risk a fresh surge in the inflation rate.

Given this challenging backdrop, it's no surprise that Fed chair Jerome Powell recently warned that getting (and keeping) inflation down will probably be a lengthy and "bumpy" process. He also stressed that "we think we're going to need to do further rate increases... and to hold policy at a restrictive level for a period of time."

Groundhog Day for yields and spreads?

All this suggests that government bond markets could well get stuck in a Groundhog Day time loop for quite a while, with prices intermittently rallying a bit and then backtracking again as investors wait for a definitive sign that rates and yields are peaking.

While government debt enjoyed a good start to 2023, so too did corporate bonds. The growing belief that central banks are probably nearing the end of the current rate-hiking cycle, together with signs that the global economy is slowing but isn't falling off a cliff, drove strong demand for corporate bonds.



Credit spreads – the extra yield (or spread) that corporate debt offers relative to government bonds for taking on default risks – tightened further, boosting corporate bond prices. The iTraxx European Crossover Index, which measures this spread, began January at 474 basis points (bps) and had narrowed to 414bps by its end. Just as bond yields could well tread water for a while, we think credit spreads may get stuck in a tightish range until we get more clarity on where inflation and central bank monetary (interest rate) policy are headed and the extent to which the global economy is slowing.

If yields and spreads do get trapped in months of Groundhog Days, it's important to remember that total returns from bond investments come from both their income and price returns. Instead of focusing only on bonds' shorter-term capital return potential (i.e. the returns from price gains alone), it's worth thinking about how the big rise in bond yields over the last year now offers opportunities to secure decent returns from income alone. Look ahead a bit and imagine when hiking ends and inflation is no longer as high.

It feels like there's a good chance that bonds might end up quite a bit more expensive at that point than they are today. **And anyone who'd invested in bonds at current prices and yields would have locked in a nice juicy income yield as a buffer to protect themselves from any volatility in these bonds' capital values along the way.**

Buying new issues, selling Australian bonds

We've been underweight duration for a while because we're positioned for further rate rises given the persistence of inflationary pressures. As was clearly illustrated last year, the prices of bonds with higher interest rate sensitivity (duration) will fall the most as rates keep rising.

Early in the month, we added to some longer-dated UK government debt, including the **Green Gilt 1.5% 2053** and the **Green Gilt 0.875% 2033**, when we felt these bonds' prices looked particularly cheap. We sold them again when their prices rose.

Because we think we'll be looking to increase our duration later this year as the prices of shorter-dated bonds fall to levels where they may stall or reverse, we snapped up some particularly attractive new longer-dated bonds from a couple of high-quality issuers (the values of bonds with longer lives are more sensitive to changes in prevailing interest rates). We invested in some new **National Grid 5.72% 2043** bonds and also some new **4.875% 2043** social bonds issued by **Motability Operations** (which runs the Motability Scheme that aims to help people with disabilities to lease cars, scooters and powered wheelchairs).

While inflation has been falling back in the US, the UK and Europe, it remains on the rise in Australia. As a result, its central bank – the Reserve Bank of Australia – seems to be reversing the more dovish tone it favoured towards the end of last year and is stressing that it's going to keep rate hikes coming. This direction of travel suggests the yields on offer from Australian debt will rise, making the Australian bonds we currently hold look less attractive. As a result, we sold some **New South Wales 2.5% 2032** state government bonds and **Australia and New Zealand Banking Group 1.809% 2031** bonds.



Bryn Jones
Fund Manager

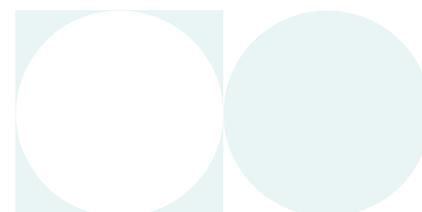


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