

# Rathbone Ethical Bond Fund

## Monthly update April 2022

Government bonds – the asset class most sensitive to interest rates – are reacting forcefully as central banks press ahead with plans to raise rates quickly.

Higher inflation and rates eat into bonds' fixed returns, ensuring that government bond yields rose sharply very fast (bond yields and prices move in opposite directions). The yield on 10-year US Treasuries began the month at 2.35% and had soared to 2.94% by its end (it sailed just above 3% in early May, its highest level in more than three years). The yield on 10-year gilts surged too, up from 1.61% at the start of April to reach 1.92% by month-end.

Corporate debt also came under intense pressure. Credit spreads – the extra yield (or spread) offered relative to government bonds for taking on default risks – widened significantly amid worries that higher inflation (and weaker GDP growth) could make it harder for borrowers to repay their debts. The iTraxx European Crossover Index began the month at 339 basis points (bps) and had widened to 428bps by its end.

### Can growth hold up?

The shift back to higher rates is proving messy as central banks continue to pivot hastily towards tighter monetary policy as they try to tame inflation. Bonds have been selling off since the beginning of the year as inflation has surged to its highest level in decades in many countries. But the sell-off is proving both erratic and volatile as investors try to second-guess when inflation might peak, how much (and how quickly) central banks will tighten and, increasingly, how global growth will hold up against a combination of higher rates and high inflation.

Central banks can address inflation driven by strong demand by trying to curb consumption via higher borrowing costs. But they can't directly counter the impact of new waves of inflation driven by in significant part by supply shocks from COVID-19, the war in Ukraine and new COVID lockdowns in China, which have spread to Beijing and Shanghai.

As investors brace for higher rates, rising costs are exerting a toll on demand, weighing on growth forecasts. This raises big questions about how far the US Federal Reserve (Fed) and other central banks will be able to lift rates without overburdening the economy and triggering a recession.

The UK seems more at risk from uncomfortable pressures than most. The Bank of England (BoE) thinks that headline inflation will keep on increasing until the final few months of this year as it expects the energy cap that dictates our household fuel bills will rise again. When it raised rates for the fourth consecutive time in early May, it warned that a recession could be looming as the UK experiences a painful cost-of living squeeze.

### Treading cautiously in turbulent markets

Bond prices suggest that the current spike in inflation (and rates) will eventually subside and be followed – at some point – by an economic downturn. For the first time in eight months, US inflation moderated in April, rising by 8.3% compared with March's 8.5% increase. Nevertheless, there are huge uncertainties over how much further the current inflation shock has to run and how GDP growth will hold up. Against this backdrop, we're not making big changes to the kinds of bonds we want to own.

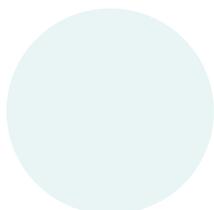
We don't invest in mainstream UK government gilts as the government is involved in some areas prohibited by our screening criteria. Instead, we focus on the UK's green sovereign bonds ('Green Gilts') as an ethical alternative. Given the very acute cost-of living squeeze in the UK, we think the BoE faces a particularly uncomfortable (and intensifying) trade-off between tightening policy to combat inflation and staying more accommodative to try to avert a recession.

We felt markets might be pricing in more BoE hikes this year than it will deliver and that gilts had probably sold off too much. As a result, we bought the **Green Gilt 1.5% 2053** in mid-April. When these bonds rallied later in the month, we sold them again.

The prices of some French bonds came under pressure ahead of the final round of France's presidential elections on 24 April amid fears that far-right populist (and less business-friendly) candidate Marine Le Pen might win. We felt that incumbent President Emmanuel Macron would secure a second term so we took advantage of the price dip ahead of the polls and bought French bank **BPCE 2.5% Lower Tier 2 2032** bonds.

We sold some of our **Workspace Group 2.25% Senior 2028** bonds. The group lets out offices and industrial spaces to small and medium-sized businesses in London on a flexible basis. We felt it could be vulnerable to more challenging economic conditions, particularly since it's paid out a lot of cash to take over one of its competitors.

We bought newly issued **Yorkshire Building Society 8.5% 2030** bonds, which we felt offered good value.



## Are bonds becoming a better buffer against equity market volatility?

Ever since the global financial crisis, low rates have contributed to most equity markets rising consistently, while central bank quantitative easing (QE) bond-buying programmes pushed bond prices up and their yields down. Now that rates are rising and central banks are reversing QE as they tighten policy, bonds and equities have been selling off at the same time.

We're getting to the point where the yields on many important government bonds are now in positive territory (at least nominally). That means bond investors can once again earn an income for taking out an insurance policy on their equity portfolios on the assumption that the traditional lack of correlation between equity and bond prices will return as extraordinary policy supports are removed.



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