

Rathbone Ethical Bond Fund

Monthly update May 2022

Bond markets remain highly volatile as investors ramp up their expectations that steep inflation will drive aggressive central bank interest rate rises.

For much of May, US government bonds rallied modestly following the fierce rise in yields in recent months (bond yields and prices move in opposite directions). The US Federal Reserve (Fed) stayed hawkish, with Fed chair Jerome Powell insisting that it would “keep pushing” up rates until inflation falls convincingly and warning this might involve moving “more aggressively.” But investors seemed more worried about the risks of a growth slowdown and this drove demand for the safety offered by government debt. US Treasury markets were choppy, but the yield on 10-year US Treasuries began the month at 2.94% and had retreated to 2.85% by its end.

By contrast, government bond yields in the UK and Europe rose still further, with fears about inflation and rate rises still at the fore. The yield on 10-year gilts rose from 1.92% at the start of May to reach 2.10% by month-end.

Corporate debt also stayed under pressure. Credit spreads – the extra yield (or spread) offered relative to government bonds for taking on default risks – widened further amid worries that high inflation (and weaker GDP growth) could make it harder for borrowers to repay their debts. The iTraxx European Crossover Index began the month at 428 basis points (bps) and had widened to 438bps by its end. As of mid-June, spreads had blown out further to 540bps.

Inflation persists...

Tentative hopes that the painful surge in inflation that began last year might now have peaked were dashed in early June when May's US consumer price index (CPI) print came in higher than expected. After slowing a bit in April, US inflation jumped to a new record of 8.6% in May – its highest rate since December 1981. Inflation continues to run red-hot in the UK and the eurozone too.

The persistence of high US inflation reinforced investor fears that tightening central bank monetary policy isn't about to change imminently. Since higher inflation and rates eat into bonds' fixed returns, this triggered sharp sell-offs in many government bond markets. The yield on 10-year US Treasuries had leaped to 3.39% by mid-June and 10-year gilt yields had risen to 2.52%.

It is hugely uncertain how much further the current inflation shock has to run and how GDP growth will hold up against a combination of higher prices and tighter financial conditions. Interest rates have been rising in earnest in the US and UK, with more to come in the next few months. The European Central Bank has signalled it will soon get in on the act and start to increase rates from July.

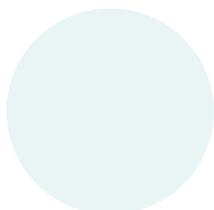
At the same time, higher prices are squeezing demand on several fronts. All this should eventually help to curb some price pressures, but it will also inflict a toll on global growth. The World Bank recently slashed its GDP forecast for 2022 to 2.9% from the 4.1% it had ventured in January, noting that it believes the world is entering a year or so of “feeble growth”. Against this complex (and highly volatile) backdrop, we're not making huge changes in the kinds of bonds we want to own. But we are staying as nimble as possible so that we can snap up opportunities quickly.

Trading green gilts, buying Australian dollar bonds

The UK's acute cost-of-living crisis suggests it could be particularly vulnerable to a growth slowdown. UK GDP fell for a second successive month in April and the OECD recently warned that it believes the UK will be the weakest economy in the G7 group of leading industrial nations next year.

This leaves the Bank of England (BoE) facing a particularly uncomfortable trade-off between tightening policy to combat inflation and staying more accommodative to try to avert a recession. As a result, the BoE policy outlook is far from clear, which we felt opened up some mispricing opportunities during the month.

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.



In the first half of the month, we sold the **Green Gilt 1.5% 2053** as investors rushed to safer assets amid recession fears, underpinning their prices. We then bought the **Green Gilt 7/8% 2033** when prices tumbled once more and we felt that gilts had probably sold off too much. We opted to sell some of these bonds again towards month-end when it became clear that gilt yields would rise further.

Australian government bond yields, at roughly 4% for the 10-year, are markedly higher than gilt yields so Australian state government debt and credit investments can offer much more attractive yields than their UK counterparts. Pricey currency hedging costs used to wipe out some of this yield boost, but it's now much cheaper for sterling investors like ourselves to lock in exchange rates ahead of time. Because of this we've been adding significantly to our Australian dollar exposure, hedged back to sterling. For example, we bought **New South Wales 2.5% 2032** and also **Queensland 1.25% 2031** state government bonds.

Because many global companies issue bonds in several different currencies to tap the widest possible investor base, we can buy bonds issued by UK and European companies that are denominated in Australian dollars. During the month, we bought French bank **BPCE's 4.5% 2028** Australian dollar-denominated senior bonds (again, hedging the currency).

We sold some more of our **Workspace Group 2.25% Senior 2028** bonds. Workspace 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.

A brave new bond world?

A lot of the things that have been driving bond markets for a long time are changing. Bond prices may fall further and yields increase more as the interest rate cycle turns and central banks hike rates higher than they have for many years. That presents challenges. But higher yields offer opportunities too.

If these higher yields are compounded over decent periods of time, they can deliver attractive returns. And of course bonds offering decent yields are positive for income-hungry investors, particularly since they may offer safer income streams than other asset classes because coupons must be paid and principal is paid back before equity investors if a business fails. Equity dividends can suddenly get cut when equity markets run into trouble. There's much less risk of income-slashing when it comes to higher-quality bond investments.

At the same time, the turn in the rates cycle and central bank reversal of quantitative easing (QE) bond-buying programmes introduced after the global financial crisis suggest that bond investments will start to offer a better safety net against equity market volatility. Ever since the credit crunch of 2008/09, low rates have contributed to most equity markets rising consistently, while QE pushed bond prices up and their yields down. Now that rates are rising and QE is being reversed, bonds and equities have been selling off at the same time.

We're now 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.



Bryn Jones
Fund Manager



Noelle Cazalis
Fund Manager



Stuart Chilvers
Assistant Fund Manager



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