

# Rathbone High Quality Bond Fund

## Quarterly update March 2022

Alongside its devastating humanitarian impact, the war in Ukraine is triggering a chain of consequences that have reverberated across financial markets and significantly added to the uncertainties weighing on the global economy.

	3 months	6 months	1 year	31 Mar 21- 31 Mar 22	31 Mar 20- 31 Mar 21	Since Launch 16 Nov 18
<b>Rathbone High Quality Bond Fund</b>	-3.63%	-4.31%	-3.73%	-3.73%	4.23%	1.03%
Bank of England Base Rate + 0.5%	0.23%	0.39%	0.69%	0.69%	0.60%	3.01%

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

Source: FE Analytics; data to 31 March, I-class, mid price to mid price; performance is a combination of I-class units and S-class units where I-class was unavailable (I-class launched 23 July 2019).

There was a short-lived rush to buy 'safe haven' government bonds when the war first began. But overall, investors have been preoccupied by high, and rising, inflation.

Because inflation eats into bonds' fixed returns, government bond yields rose sharply during the quarter (bond yields and prices move in opposite directions). Indeed, the US Treasury market experienced one of its toughest quarters on record: the yield on 10-year US Treasuries began the quarter at 1.51% and had reached 2.35% by its end. The yield on 10-year gilts surged too, up from 0.97% at the start of the quarter to 1.61% by its end.

Adding to the pain for investors, 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 lower growth could make it harder for borrowers to repay their debts. The iTraxx European Crossover Index began the quarter at 242 basis points (bps) and had widened to 339bps by its end.

**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.**

## The inflation and growth outlook

Before Russia's invasion, the world's big central banks had made it clear they planned to wind down emergency monetary policies more quickly and aggressively than investors had initially expected to try to stem the rising tide of inflation driven by post-pandemic reopening. The Bank of England (BoE) was first to kick the process off, increasing rates in late 2021 and then again in February and March. Then the US Federal Reserve (Fed) lifted rates for the first time since 2018 in March. Markets are expecting at least seven further US rate rises this year. The BoE sounded a bit more cautious at its most recent policy-setting meeting, explaining it was worried about the growth outlook following the invasion of Ukraine. But BoE policymakers still believe that further rate hikes are warranted so UK rates are likely to rise further in the near term, especially if inflation continues to increase.

Central banks can address the demand-side drivers of inflation by trying to curb consumption by raising borrowing costs. But they can't do much when it comes to inflation caused by curtailed supplies of goods and services. The war in Ukraine triggered a supply-side shock because it threatens to cut Russian energy and other vital Russian and Ukrainian resources out of global supply chains. This sent energy prices on a truly wild ride. And the UN Food and Agriculture Organisation reported that global food prices hit a record high in March as the war hit global supplies of grains and vegetable oils. Because central bank policy can't counter the impact of these new waves of inflation, the war has increased the risk that inflation goes even higher still. At the same time, it's increased the chance that global growth disappoints as higher prices squeeze businesses and households.

## What's the US yield curve telling us?

At the start of the year, it seemed inconceivable that anyone would be worried about a looming recession. But even before the war began, economic growth was beginning to lose a bit of momentum and consumer and business confidence were dented by higher costs. The UK has been right in the eye of the storm given the huge cost of living squeeze exerted by April's whopping 54% increase in the cap on domestic energy prices and the simultaneous hike in national insurance contributions. Meanwhile, a closely watched recession indicator – the US Treasury yield curve – has flashed red on the other side of the pond. Typically, the yield on bonds increases with the time to maturity. That's because there's more time for things to go wrong before you get your money back, so you want a higher return for longer-dated bonds to compensate. A two-year bond should yield less than a 10-year bond. But, right at the end of quarter, the two-year US Treasury yield rose above that of 10-year Treasuries – or 'the curve inverted' – for the first time since 2019.

When yield curves invert, they typically spell trouble ahead for longer-term economic prospects: that's because shorter-term two-year yields move with interest rate expectations, while the 10-year yield moves in line with inflation and growth expectations. Yield curve inversion seems to be telling us that investors think Fed efforts to tame inflation with rate rises will stall economic growth. Inversions have preceded every US recession for the last 50 years. Some think it's a less reliable warning sign nowadays and the downturns predicted by past inversions have often taken quite a while to arrive.

The question now is whether we agree with current market pricing. Markets imply that the current spike in inflation and interest rates will eventually subside and be followed – at some point – by an economic downturn. But there are huge uncertainties over how much further the current inflation shock has to run and how GDP growth will hold up.

## Adding to floating rate notes

Against a backdrop of rising rates and higher-than-average inflation, we added to our floating rate notes (FRNs). As their name implies, these bonds offer variable (floating) coupon rates that increase when rates rise and fall when rates drop. They are an attractive way to increase income as rates go up.

During the quarter, we bought **UK Municipal Bonds Agency 1.5097% Floating Rate Senior 2025** bonds. This agency issues bonds on behalf of local authorities in the UK, helping them invest in facilities and services with more attractive financing. Other FRNs included the **Bank of Montreal 2027** and **Santander UK 2026**.

## Recalibrating our corporate bonds

The outlook for corporate bonds has certainly got trickier over the last few months as worries about the risk of an economic downturn have grown. As a result, we pared back our exposure to bonds issued by a few lenders we felt could face particularly challenging prospects. We sold some Swiss bank **Credit Suisse 1.125% Senior 2025** bonds. The bank was left nursing big losses as a result of its funding of hedge fund Archegos Capital, which collapsed last year. It has repaired its balance sheet after writing off Archegos-related losses, but there's still a risk that the collapse could result in costly lawsuits which might dent its earnings over the next few years. We also sold some French energy utility **EDF 4.5% Senior 2028** bonds as we are concerned that the firm's profitability could be hurt by a requirement to sell power at below-market prices, as well as by its dwindling nuclear output.

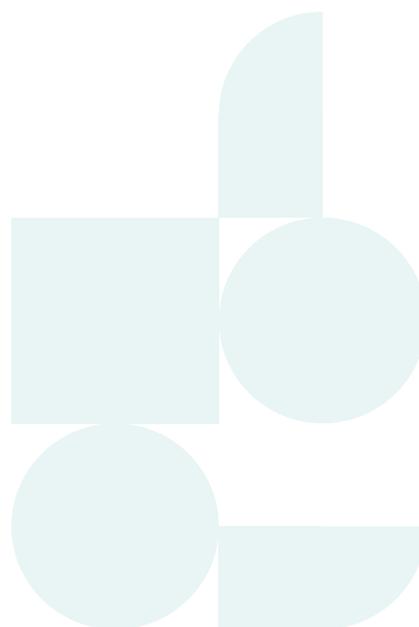
Notwithstanding Credit Suisse's specific challenges, we still favour bonds issued by select banks, insurers, building societies and investment firms. We think many of these businesses are likely to hold up well if life gets more difficult because they're well capitalised and manage their risk exposure carefully. Immediately after the war broke out, not many firms were issuing new bonds. Later in the quarter, issuance began to pick up again and we opted to buy some newly issued bonds from lenders that we believed offered good value, including Canadian bank **Toronto-Dominion 2.875% Senior 2027** and Norwegian lender **DNB's 2.625% Senior 2026** bonds.

### Focusing long term in short-term turbulence

When markets turn very volatile, as they did last quarter, it's easy to get panicked. We don't join short-term selling (or buying) stampedes just because that's what lots of other people are doing. We tune out market noise and instead stay focused on opportunities we believe will benefit our fund's long-term return and income. This can be painful in the short term. But we've learned that it's critical to stay disciplined and rational in turbulent times and to focus on long-term convictions rather than immediate uncertainties.



**Noelle Cazalis**  
Fund Manager



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