

Rathbone High Quality Bond Fund

Quarterly update December 2022

Global bond markets have been through a very painful correction as investors came to terms with much, much higher interest rates than anyone expected at the start of 2022. It looks like 2023 will be a bad year for the economy, but a better one for bond markets.

	3 months	6 months	1 year	3 years	Since Launch 16 Nov 18
Rathbone High Quality Bond Fund	4.49%	-2.20%	-8.97%	-7.74%	-4.57%
Bank of England Base Rate + 0.5%	0.82%	1.35%	1.95%	3.32%	4.77%

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

Source: FE Analytics; data to 31 December, 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).

How high will rates peak?

For most of 2022, global bond markets bore the brunt of one of the most aggressive rate-rising cycles on record as the world's biggest central banks quickly hiked rates in a bid to tame sky-high inflation. High rates and higher inflation erode the value of bonds' fixed returns so global bond markets sold off very sharply (sending yields, which run in the opposite direction to bond prices, soaring to their highest levels in many years).

Central banks made it very clear that they'd keep hiking rates until the prices of goods and services stopped rising too fast, even if that meant engineering an economic slowdown and higher unemployment. Towards year-end, there was strong evidence that soaring goods prices, especially food and energy, were falling back fast. At the same time, it looked like recessions were looming for swathes of the global economy. The UK and the Eurozone already seem in the midst of a downturn, largely because they're at the epicentre of the energy crisis caused by the Ukraine war. The US is holding up better, but it too seems destined to slip into recession at some point as the economic handbrake exerted by the higher borrowing costs resulting from central bank rate rises start feeding through to households and businesses.

With inflation decelerating and growth slowing, bond investors grew more confident that policymakers were approaching the point where they'd call time on rate rises. As a result, government bond prices began to rally and yields to drift downward. The yield on 10-year UK government bonds (gilts) stood at 4.10% at the start of October, falling to 3.67% by year-end. The yield on 10-year Treasuries began the quarter at 3.83%, rose above 4.2% in late October and then fell back to 3.88% by year-end.

Further rate rises are likely as policymakers keep battling inflation. The US Federal Reserve (Fed) is particularly insistent that it's in no hurry to stop hiking. But the Fed, the Bank of England and the European Central Bank all opted for 0.50% rate increases in December, instead of the larger jumps they'd favoured for much of 2022. In his press conference following the December hike, Fed chair Jerome Powell again emphasised that US rates might peak at a higher level than it had previously indicated, with Fed policymakers now forecasting rates would max out at just more than 5% in 2023. That new forecast still implies that US rates aren't that far from peaking as they indicate that only about 0.50% to 0.75% of further tightening may be necessary. That certainly seems to be what bond investors now expect: they're pricing in that rates will peak just below 5% in the US, around 4.5% in the UK and near 3.5% in the Eurozone. And they're already turning their attention to what happens after rates peak.

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.

Whether rates then stay unchanged for quite a while or start to fall back relatively quickly is shaping up to be one of the most important questions for 2023. It will have a big impact on how bond markets behave. But, given the huge shift in investor expectations about where rates were heading in 2022, the scope for further big shocks has diminished significantly, provided that inflation keeps on cooling. That's a big difference versus the start of 2022 and suggests to us that 2023 is shaping up to be a better year for bonds.

A "sea change" in fixed income?

While government debt enjoyed a good end to 2022, so too did corporate bonds. Indeed, the belief that central banks may be nearing the end of aggressive hiking has injected new life into corporate bonds. Credit spreads – the extra yield (or spread) that corporate debt offers relative to government bonds for taking on default risks – tightened significantly after blowing out earlier in the year. The iTraxx European Crossover Index, which measures this spread, began the quarter at 639 basis points (bps) and had narrowed to 474bps by its end.

Lots of corporate borrowers at the higher end of the credit quality spectrum are in solid shape. They went through a tough time only a couple of years ago when the pandemic hit. The ones that got through the shutdown have been managing their businesses and finances pretty conservatively even when their profitability recovered in the reopening boom. This suggests to us that we probably aren't going to see a big spike in defaults from higher-quality borrowers even if the broader economic backdrop gets worse.

The big surge in yields and spreads in 2022 (they're still much wider than they were at the start of last year despite the recent tightening noted above) means that investing in corporate bonds at the higher end of the credit-quality spectrum can lock in very decent yields, while being very amply compensated for any default risks. Broad indices of sterling investment grade credit now yield well over 5%, compared with just over 2% at the start of 2022 and 3.4% on average since 2010. For the first time in years, credit seems to offer a way to achieve long-term return objectives through income alone. And there's always the potential for attractive price returns when rates do eventually start to fall. Celebrated investor Howard Marks, who founded Oaktree Capital Management, is calling this a "sea change" in the relative appeal of credit, saying that its potential for "solid returns" means he believes investors no longer need to rely as much on "riskier instruments", in other words, equities, to achieve their "overall return targets".

Corporate bond prices have risen in the last few months given growing investor appetite for credit, but they're still a lot more appealing than they were at the start of 2022 and, on average, over the past couple of decades (both in absolute terms and relative to government bonds and relative to equities).

We've continued to find attractively priced corporate bonds. During the quarter, for example, we bought Canadian **Toronto-Dominion Bank 2.875% 2027** and **HSBC 1.75% 2027** bonds, which we felt looked inexpensive.

Investment grade credit prices have historically nearly always been much less volatile than equities, holding up well when equities falter as a result of tougher economic conditions. In particular, investment grade credit performance has tended to improve when rate hiking cycles come to an end. We're not at that point yet, but we might well get there in the first half of 2023. And, of course, now that corporate bond yields are much juicier, they provide a more solid buffer against any price volatility.

Adding to floating rate notes

Against a backdrop of rising rates, 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. We view FRNs as an attractive way to increase income in a rising-rate environment. Over the quarter, we invested in **Nationwide Building Society 1.03% 2031**, **Barclays Bank 4.25% 2027**, **JPMorgan Chase 5.378% 2028** and **Clydesdale Bank 4.062% 2026** FRNs.

Dialling down property exposure

Higher rates have been raising the cost of borrowing for banks and building societies offering mortgages and other loans, ensuring that this lending has become more expensive. Because we expect this to drive down mortgage and loan demand, we've been paring back our holdings of bonds issued by companies with direct exposure to the property market, particularly its most cyclical parts, like commercial real estate. In November, for example, we sold property developer **Places for People 3.625% 2028** and real estate investment company **Realty Income 1.85% 2027** bonds.

Swiss banking group Credit Suisse attracted a lot of negative headlines in 2022 because of concerns about its financial stability. The bank nursed big losses as a result of its funding of hedge fund Archegos Capital, which collapsed in 2021. It's repaired its balance sheet after writing off Archegos-related losses and in late October it announced a radical overhaul of its business intended to turn its fortunes around. Our **Credit Suisse 1.125% 2025** bonds performed well on the back of the restructuring news; we felt it was a good time to exit our holding and sold our bonds in early November.



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