

Rathbone Strategic Bond Fund

Monthly update July 2022

Government bonds have rallied sharply on hopes that slower growth will cool red-hot inflation and persuade central banks to ease up on aggressive interest rate rises. But much uncertainty lies ahead in the notoriously volatile months of August and September.

Battered government bonds are back in favour as fears of a global recession mount. US 10-year Treasury yields (which run in the opposite direction to prices) have fallen by nearly 1% from the multi-year highs they hit in mid-June. The yield on 10-year US Treasuries began July at 3.02% and had fallen to 2.67% by month-end. UK government bond yields followed a similar trajectory. The yield on 10-year gilts fell from 2.24% to 1.87%.

Meanwhile, credit spreads – the extra yield (or spread) offered relative to government bonds for taking on default risks – have been extremely volatile. The iTraxx European Crossover Index began July at 580 basis points (bps), widened to almost 630bps by mid-month and then slumped back again to 529bps by its end.

Many people (including us!) are asking why credit spreads started to rally just when we got the news that the US economy had shrunk for a second successive quarter. US GDP fell by 0.9% on an annualised basis in the second quarter after shrinking by 1.6% in the first three months of the year. That's a milestone that many countries regard as showing that an economy has tipped into a recession. The US relies on additional data to make that call, but the US Q2 GDP release certainly points towards weakening growth that could test some borrowers' ability to repay their debts.

Perhaps the credit rally was down to the fact that more investors recognised that way too much bad news had been priced into higher quality (investment grade) corporate bonds ([as we explained last month](#)). That's because credit spreads have been so volatile ever since the current tightening cycle got under way, which is unusual. Spreads typically hold up when central banks begin tightening because that tends to happen when economies are in decent shape. At the same time, we worry that a fair bit of the credit rally is being driven by too much demand chasing too few bonds in a very illiquid period.

Light at the end of the Fed's tightening tunnel?

Despite investors' increasing hopes that the US Federal Reserve (Fed) in particular will soon dispense with rapid rate hikes, it feels too early to call the end of the Fed's current tightening cycle. Much depends on the path of inflation and we're yet to see clear evidence that the price level is starting to moderate in the US.

And inflationary pressures seem to be intensifying still further in both Europe and the UK, where volatile energy prices are stoking a cost-of-living crisis and boosting costs for industry and businesses, significantly raising the risks of a looming recession. Bank of England (BoE) Governor Andrew Bailey warns that UK inflation could hit 13% by December and also predicts that the UK economy will enter a lengthy recession by year-end. The BoE's grim outlook came as it stuck with its pledge to act "forcefully" to curb inflation and raised rates by 0.5 of a percentage point to 1.75% at its latest policy-setting meeting. This was the BoE's biggest rate increase in more than 25 years: it insisted it had to step up the pace of tightening to bring inflation under control to avert an even harsher economic downturn.

In the US the immediate economic outlook is more mixed. The housing market is clearly weakening and consumer confidence continues to fall. But evidence of a slowdown has yet to show up in US employment data, and real consumption (spending adjusted for inflation) and industrial production continue to grow, so the headline second quarter GDP number probably paints an overly gloomy picture of the state of the US economy.

But the Fed's steep interest rate rises do seem to be cooling US economic growth. The Q2 GDP data came in the day after the Fed raised rates by three-quarters of a percentage point for the second time in a row. The minutes of the Fed's June policy meeting show that getting inflation under control is still a top priority. But some investors started to detect signs that the Fed might be softening its stance on the pace and extent of future hikes. In particular, they seemed to seize on Fed Chair Jay Powell's comment in the post-hike press conference that he felt it would likely (but not definitely) become appropriate to slow down the pace of rate rises in future. Are these investors overinterpreting hints of Fed leniency and getting ahead of themselves by expecting fewer and smaller hikes plus rate cuts next year? A string of Fed officials have been quick to emphasise that the central bank isn't yet close to a pivot away from tightening and that expectations of rate cuts next year are premature.



What's the yield curve telling us?

The signal to bond markets is to not assume too low a peak in rates and to be prepared for plenty more tightening to come. And bond investors seem to be hearing that message loud and clear – at least when it comes to shorter-dated bonds that are most sensitive to changes in central bank interest rate expectations. Yields on two-year US Treasuries have been rising above those of 10-year Treasuries, a phenomenon known as a yield curve inversion. When yield curves invert, they typically spell trouble ahead for longer-term economic prospects. That's because while shorter-term yields reflect interest rate expectations, the 10-year yield moves in line with inflation and growth expectations. Yield curve inversion suggests that bond investors think Fed policy will stall economic growth. Inversions have preceded every US recession for the last 50 years.

Volatile markets and noisy data may well continue over the rest of the summer and into the autumn. We're braced for a bumpy few months ahead, particularly since thin trading volumes during the summer holiday season tend to exacerbate bond market volatility. Inflation is still high, rates have been rising quickly and uncertainty swirls.

Paring back emerging market debt

Against this highly uncertain backdrop for bond yields and prices, we haven't been rushing to buy lots of new bonds. Our focus during the month was to trim our exposure to emerging market (EM) debt. Aggressive Fed policy tightening has driven a big surge in the value of the dollar against other major global currencies. A strong dollar is particularly problematic for EM borrowers since much of their debt is denominated in dollars, meaning they must pay more in local currency terms to service and repay their borrowing.

During the month, we sold units in the **Legal & General Emerging Market Short Duration Bond**, **Eaton Vance Emerging Market Debt Opportunities** and the **Muzinich Emerging Market Short Duration Bond** funds. We added to our exposure to higher-yielding corporate bonds, buying units in the **Muzinich Americayield** fund, which is focused primarily on US high-yield bonds, and in the **Pareto Nordic Corporate Bond** fund, which invests in Nordic high-yield markets.



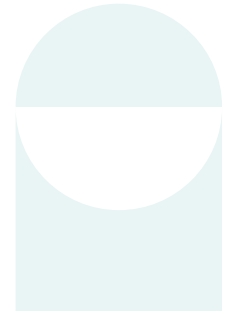
Bryn Jones
Fund Manager



Noelle Cazalis
Fund Manager



Stuart Chilvers
Assistant Fund Manager



Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. 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.