Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Strategic Bond Fund

Monthly update January 2022

Big central banks are showing greater urgency in their shift towards tighter monetary policy as they harden their stance on inflation.

Investors have scrambled to adjust to the new policy regime, sending government debt prices tumbling as investors sold these bonds whose low fixed returns look unattractive when inflation and/or interest rates are higher. The yield on US 10-year Treasuries (which moves in the opposite direction to prices) shot higher: it began the month at 1.51% and ended it at 1.78%. The yield on 10-year gilts also surged, rising from 0.97% to 1.31%.

It was an exceptionally volatile month in credit markets. Credit spreads – the extra return above government bond yields for taking on default risks – widened significantly amid worries that the higher borrowing costs that tighter policy brings may hurt borrowers' ability to repay their debts. The iTraxx Crossover began the month at 242 basis points (bps) and had widened to 288 bps by its end.

Central banks harden their stance

This year has certainly got off to a tumultuous start. Investors have grown increasingly unnerved by the prospect of much more hawkish central bank policy than they'd expected and have rushed to try to price in aggressive interest rate-hiking and the reversal of big bond buying programmes. The US Federal Reserve (Fed) has opened the door to a rapid cycle of rate rises, with the first hike expected in March. The Bank of England (BoE) opted for a back-to-back 0.25% rate rise at the start of this month as expected; however, the revelation that four of the nine-strong committee wanted a 0.50% hike put the wind up many. Meanwhile BoE Governor Andrew Bailey's calls for workers not to ask for higher wages as they struggle to afford rising prices led to uncomfortable tabloid headlines about the "Plank of England"! The very same day that the BoE hiked, the European Central Bank signalled a hawkish policy pivot by refusing to rule out a rate rise this year.

Investors' big worry is that central bank efforts to bring down inflation will also slow demand, which, in turn, risks a policy-induced slowdown. This dynamic is causing the yield curve to flatten (the difference between yields of shorter and longer maturity bonds has decreased). In part, this is because investors seem to think tighter policy will prove too much to handle and central banks will be forced to cut rates again in the longer term. And it has increased strains in risk markets more broadly: many of the world's biggest equity markets had an awful January and their 'risk-off' mood has spilled over into corporate bond markets.

We expect yields to keep grinding higher for a while. But we think that investors are getting way ahead of themselves in terms of the number of rate hikes they're anticipating – Bank of America is expecting a whopping seven Fed hikes this year! In addition, growth is still powering ahead: US GDP grew by an annualised 6.9% in the last three months of 2021 despite the significant headwinds posed by Omicron, price inflation and supply-chain snarl-ups. And the jobs market is in rude health too. All this suggests that the global economy is not about to topple into a recession, forcing a big policy reversal.

Dialling down risk

High yield bonds tend to be less vulnerable to shifting rate dynamics than their investment grade counterparts. As part of our efforts to protect ourselves from the volatility in rates markets, we bought the **Munzinich Americayield** fund back in November. But we opted to sell the fund this month as we sought to pare back our exposure to riskier bonds with weaker credit fundamentals amid concerns that they may struggle as borrowing costs rise.

Because we think bond markets will stay volatile for a while, we're holding on to some of the cash we have raised from sales like these until rates and spreads settle down a bit. But we're putting some to work by buying bonds that we think offer particularly compelling opportunities.

We still like bonds issued by select banks, insurers, building societies and investment firms that we believe will hold up well if life gets more difficult because they're well capitalised and manage their risk exposure carefully. This month, we bought **Scotiabank Capital Trust 5.65% Tier 1 2056** bonds which offer a particularly attractive yield, as well as the **Co-Operative Bank Finance 9.5% Lower Tier 2 2029** bonds.

When credit spreads were tighter, we felt that some of the new bonds being issued looked overly expensive. Because prices fell as spreads widened, we bought some newly issued bonds that we felt offered good value. For example, we bought the **Lloyds Banking Group 2% 2028** bonds.

And finally...

The big bond market moves we've been seeing reflect investors' attempts to price in the impact of a new monetary policy regime before it's actually happened. We don't yet know exactly what policy makers are planning and how it will impact on financial markets or the 'real' economy (actual businesses and consumers).

For these reasons, we are continuing to favour investments in businesses and enterprises that look in good shape and which we expect to stay profitable and solvent.

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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 your original investment.

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