

Rathbone High Quality Bond Fund

Quarterly update June 2022

Bond markets stayed highly volatile as investors shifted from worrying primarily about inflation to worrying primarily about the risk of a global slowdown.

	3 months	6 months	1 year	30 Jun 21-30 Jun 22	Since Launch 16 Nov 18
Rathbone High Quality Bond Fund	-3.42%	-6.92%	-7.82%	1.44%	-2.42%
Bank of England Base Rate + 0.5%	0.36%	0.59%	0.90%	0.60%	3.38%

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

Source: FE Analytics; data to 30 June, 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).

For most of the quarter, concerns about inflation and higher interest rates (which eat into bonds' fixed returns) drove selling across global government bond markets. But towards quarter end investors began to expect the economy to slow rapidly, driving demand for the safety offered by government debt. The yield on 10-year US Treasuries began the quarter at 2.35% and then hit 3.48% in mid-June before falling back to 3.02% by quarter end.

UK government bond yields followed a similar trajectory. The yield on 10-year gilts rose from 1.61% at the start of April to peak at around 2.65% before falling back to 2.24% at the end of June.

Corporate bond markets were exceptionally turbulent. Credit spreads – the extra yield (or spread) offered relative to government bonds for taking on default risks – widened aggressively as investors began to anticipate an impending slowdown which would test borrowers' ability to repay their debts. The iTraxx European Crossover Index began the quarter at 339 basis points (bps) and had widened to 580bps by its end.

From fear of inflation to fear of recession

The biggest story in bond markets is the recent fall back in government bond yields. The simplest explanation is that investors' overriding concern is now the weaker growth outlook and the possibility that aggressive central bank rate rises intended to tame inflation will cool the economy far too much. Investors have started to think that central banks (particularly the US Federal Reserve (Fed)) will stop raising rates much sooner than they'd previously assumed. In fact, they're now

expecting the Fed to start cutting rates as early as next spring. Is this a jittery overreaction that reverses and sees bond yields start grinding higher again? Or could longer-term government bond yields now have peaked?

There's certainly been a bad run of numbers that (at the very least) add to the growing signs that growth is slowing. Higher food and energy prices as a result of the war in Ukraine are beginning to curb consumer spending. And manufacturing output is weakening. But the jobs market (particularly in the US) is still strong: red-hot labour demand stoked yet another month of big US job gains in June. These contradictory clues mean it's hard to know for sure where the economy is headed, how central banks will react and how all this will impact on financial markets. We're braced for bond markets to remain volatile over the summer.

An economic slowdown that develops into a full-blown global recession isn't currently the most likely scenario, in our opinion. But the UK and some European countries seem more likely to contract than the US.

We have pared back our exposure to bonds issued by a few lenders we felt could face particularly challenging prospects. For example, we sold some **Workspace Group 2.25% Senior 2028** bonds because we were concerned that the office leasing business could be vulnerable to tougher economic conditions in the UK. Workspace lets out offices and industrial spaces to small and medium-sized businesses in London on a flexible basis, which suggests it could quickly feel the impact of any weakening in demand. We also sold some German **Landesbank Baden-Württemberg 1.5% 2025** and **1.125% 2025** bonds as we

were worried about recent steep rises in gas prices in Europe after Russia cut supplies to several countries. Germany is hugely reliant on Russian gas. If Russia were to shut off the flow of energy to Europe entirely, this would inflict huge economic pain on Germany. Some 65% of Landesbank Baden-Wurttemberg's assets are located in Germany so it would come under pressure if a jump in energy prices stifled German growth.

Because bond markets have proved so turbulent this year, investors have been demanding cheaper prices and higher yields when borrowers issue new debt. As a result, many companies have reined in their borrowing plans, while a few have been forced to jettison new bond deals that have failed to attract enough investor interest. With far fewer new issuance opportunities on offer, we identified a couple we felt looked particularly attractive, notably US bank **Wells Fargo 3.473% 2028** and Finnish **OP Corporate Bank 3.375% 2026** senior bonds.

Moving from US dollar to Australian dollar bonds

US Treasury yields are markedly higher than gilt yields, so US credit investments can offer much more attractive yields than their UK counterparts. But it's been growing increasingly pricy to hedge out the currency risks associated with US dollar bonds: these hedging costs now wipe out a lot of the resulting yield boost. As a result, we've been paring back our exposure to US dollar-denominated bonds. Over the quarter, for example, we sold US dollar-denominated Australian bank **ANZ 1.25% 2026**, **Apple 1.2% 2028** and **Electricite de France 4.5% 2028** senior bonds.

Australian government bond yields, at roughly 4% for the 10-year, are also significantly higher than gilt yields and hedging out the currency risks associated with Australian dollar-denominated bonds is more cost-effective. Many global companies issue bonds in several different currencies to tap the widest possible investor base, enabling us to can buy bonds issued by UK and European companies that are denominated in Australian dollars. During the quarter, we bought French bank **BPCE 4.5% 2028** and UK bank **Lloyds 5.4% 2027** Australian dollar-denominated senior bonds, hedging the currency to protect ourselves from fluctuations in the exchange rate.

Are corporate bonds pricing in too much bad news?

Credit spreads could continue to widen for a while, but we think that corporate bond markets may now be pricing in too much bad news. The iTraxx European Crossover Index is now at the level it was back in April 2020 when fears of pandemic-driven global shutdowns were peaking. Credit spread levels are currently pricing in a five-year default rate for investment grade bonds that's significantly above any actual five-year default rate for investment grade bonds over the past 50 years. Moreover, the fundamentals of most of the businesses issuing investment-grade debt suggest that, overall, they're in very good shape. They aren't over-burdened with debt and their earnings are strong enough to comfortably meet the interest payments arising from that debt.

With the moves seen year-to-date, we think investors are getting very attractive compensation for the risk of lending to investment grade corporates. Your fund's conservative stance towards credit risk means that we are firmly focused on investment grade corporate bonds with the strongest credit ratings (AAA to A-).



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Fund Manager

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