**Rathbone Unit Trust Management**

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Look forward

# Rathbone Ethical Bond Fund

## Monthly update August 2022

Bond markets have been shaken by the forcefulness of central banks' commitments to keep raising interest rates to try to get inflation under control.

This dashed bond investors' hopes that the global rate-hiking cycle might be nearing a peak. As higher rates eat into bonds' fixed returns, government bond yields have been rising very sharply very fast (bond yields and prices move in opposite directions).

US 10-year Treasury yields began August at 2.67% and briefly dipped below 2.60% as bond investors grew more confident that central banks might start easing off the throttle as global growth slows. But this confidence was crushed as the US Federal Reserve (Fed) and other big central banks insisted loudly and repeatedly that they weren't about to back off from further rate rises any time soon. As a result, the 10-year US Treasury yield had soared to 3.20% by month-end, while 10-year UK government bond (gilt) yields rose even more stratospherically, rising from 1.87% to 2.83%.

The scale of the sell-off in gilts has been particularly significant, with the UK underperforming most other global government bond markets in August as it bore the brunt of big anxieties about the UK economic outlook as everyone waited for firm decision-making from a new prime minister. Shorter-dated gilts, which are most sensitive to interest rate expectations, came under the most intense selling pressure. In fact, two-year gilt yields rose by a whopping 130 basis points (bps) in August: the biggest rise on Bloomberg records dating back to 1992.

Credit spreads – the extra yield (or spread) offered relative to government bonds for taking on default risks – also surged. The iTraxx European Crossover Index began August at 510 bps and had widened to 591 bps by its end.

### A turning-point for bond markets

The big shift came when bond investors recognised that the world's largest central banks were placing more weight than before on bringing down inflation and prioritising this goal over supporting economic growth.

When Fed Chair Jay Powell addressed the central bank's annual summit in Jackson Hole towards the end of August, he delivered his most hawkish message to date. He pushed back hard on any hopes of a quick policy pivot, insisting that the Fed wouldn't back off from more hikes and must "keep at it until the job is done." Powell acknowledged that higher rates intended to crush inflation would probably drive economic growth lower "for a sustained period".

Like the Fed, the Bank of England (BoE) has made it crystal clear that a policy pivot away from rate hiking isn't on the cards. At its August meeting, it upped the pace of policy tightening as it forecast that a long recession would begin later this year. BoE Governor Andrew Bailey says there are "no ifs or buts" in his commitment to try to get inflation back down to the bank's 2% target (which is an awfully long way from the UK's current inflation rate of just below 10%). European Central Bank (ECB) delegates who attended Jackson Hole also vowed to act "forcefully" to curb price growth. The ECB recently hiked rates by 0.75 of a percentage point, its largest-ever hike since the launch of the euro back in 1999.

### The big energy squeeze

Central banks' hawkish drumbeat has got louder as inflationary pressures have proved painfully sticky. These pressures are most intense in the UK and Europe given the deepening energy crisis. Russia continues to severely limit gas exports to Europe. The announcement of an unscheduled maintenance shutdown of the Nord Stream 1 gas pipeline drove average gas prices to new all-time highs in August.

Policies like the UK's recently announced freeze on household and business energy bills should help cushion some of the blow. (Several other European countries are subsidising bills or capping how far they can rise.) But energy bills will still be high by past standards, they just won't hit the colossal levels they might have done otherwise. Recessions seem increasingly likely this winter given the growth-sapping impact of higher energy costs.

Consumers in the UK and Europe face sharp drops in their real income and purchasing power. And as businesses' costs have soared, some are even contemplating temporarily shutting down particularly energy-intensive operations that could struggle to recoup these higher costs.

The latest US inflation print was hotter than expected, but the economic outlook in the US looks better than on the other side of the Atlantic. The country is well insulated from the Russia energy shock, with wholesale gas prices there rising by much less than in the UK and Europe. The US jobs market is holding up well and American consumers benefit from decent savings buffers. Nevertheless, some cracks are appearing. Most significantly, the housing market is slowing. This matters a lot because the US housing market has a strong track of weakening *before* the broader economy so it's deemed a good predictor of future downturns.

### Adding to longer-dated bonds

We're braced for further market volatility. Inflation is still high, rates have been rising very significantly and uncertainty continues to swirl. As a result, we haven't been rushing to buy or sell lots of bonds.

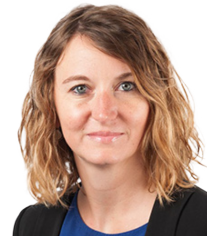
But we've been carefully paring back some of our shorter-dated bonds and adding to longer-duration ones that move more in line with inflation and growth expectations than changes in rate expectations. If we start to see inflation peaking and a broad growth slowdown, we believe it should be a better time to own longer-dated debt. During the month, we bought **Zurich Finance 5.125% 2052** and **UK 1.5% Green Gilt 2053** bonds.

### Dialling down more economically-sensitive bonds

Higher energy prices and borrowing costs bring extra challenges for corporate borrowers. This means we've been dialling down our exposure to bonds issued by companies that we felt were more exposed to the ups and downs of the business and economic cycle, particularly their short-dated debts. For example, we sold largest UK private residential landlord **Grainger 3% 2030** and private equity group **3i 5.75% 2030** bonds.

We also sold units in of one of our very few equity investments: the Ireland-listed **Greencoat Renewables** investment company. This investment has performed strongly but we felt it was time to sell. We bought the fund because it offered a strong income yield. The sharp rise in rates over the last few months means that we now have ample opportunities to buy attractive bonds offering similarly compelling yields.

**Bryn Jones**
Fund Manager



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8048.09.22