Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone High Quality Bond Fund

Quarterly update September 2022

There have been plenty of outsized moves in financial markets during the last few years. But they pale in comparison with the turbulence that followed the UK's mini-budget in late September. UK bond markets were at the epicentre of the pain.

	3 months	6 months	1 year	3 years	Since Launch 16 Nov 18
Rathbone High Quality Bond Fund	-6.40%	-9.60%	-13.50%	-11.51%	-7.94%
Bank of England Base Rate + 0.5%	0.53%	0.89%	1.28%	2.80%	4.02%

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

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

Mini-budget mayhem

For most of the quarter, the biggest story in global bond markets was central banks' forceful pivot away from low interest rates as they sought to choke off stubbornly high inflation. US Federal Reserve (Fed) chair Jerome Powell made it abundantly clear that the Fed would hold its nerve and keep hiking rates despite signs of slowing economic growth. Bank of England (BoE) Governor Andrew Bailey said there were "no ifs or buts" in his commitment to get inflation under control despite forecasting that surging energy prices would probably drive the UK into a recession. This hawkish rhetoric drove bond yields, which run in the opposite direction to prices, up further since higher rates and high inflation eat into bond's fixed returns. The yield on 10-year US Treasuries stood at 3.02% at the start of the quarter, but had reached 3.83% by its end.

This steady, if relentless, sell-off in government debt turned frenetic in the UK in late September when Chancellor Kwasi Kwarteng unveiled his mini-budget. It aimed to kickstart economic growth with a massive package of help with energy bills, huge tax cuts and a raft of regulatory reforms. Its main aim was to inject significant extra spending power into an economy struggling with high inflation, without a corresponding increase in the supply of goods and services. If you give people more money to buy widgets, without increasing their supply, the result tends to be higher prices for widgets.

Injecting extra demand into an economy struggling with high inflation (UK inflation is hovering at around 10%) suggested the government was pulling in the opposite direction to the BoE. How could the government be loosening fiscal policy (taxes) as the BoE doggedly tightens monetary policy (interest rates)?

Investors feared the mini-budget could further inflame hot prices, forcing more aggressive and faster BoE rate rises than they'd previously expected. Investor confidence was further troubled by the government's failure to spell out how its proposals would be funded, or to provide the independent forecasts and analysis from the UK's taxation and public spending watchdog that would usually accompany a budget. Investors immediately demanded a higher premium for holding UK assets via a cheaper currency and lower government debt prices.

The value of sterling slumped to an all-time low versus the US dollar and UK government bond (gilt) yields ballooned. The yield on 10-gilts rose from 2.24% at the start of the quarter to hit an intra-day peak of 4.58% on 27 September, before retreating slightly to end the quarter at 4.10%. To put these price moves in context, the surge in yields to around 4.5% meant that gilt yields briefly rose above those of Greek government bonds.

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.

Gilt yields began sinking back down when the BoE was forced to intervene and start buying long-dated gilts whose yields were getting pummelled in the mayhem. A big slice of the UK pension sector — which dominates demand for long-term government debt — struggled to stay solvent as yields surged. To avert the potential collapse of some pension funds, the BoE stepped in with a promise to buy long-dated bonds on "whatever scale is necessary" to absorb these funds' forced selling.

The turbulence in gilt markets flowed through to corporate bond yields as well, with their spreads (the extra return over government bond yields to compensate for the risk of default) flying much higher. The iTraxx European Crossover Index, which measures spreads across a universe of higher-yielding European (including UK) corporate bonds, began July at 580 basis points (bps) and had widened to 639bps by its end. Unsurprisingly, sterling corporate bonds witnessed the most aggressive credit spread widening. In late September, average yields in sterling corporate bond markets were hovering at around 7%, up from around 5.5% before the mini-budget and around 2% last year.

Longer-term repercussions?

The worst short-term turmoil in UK financial markets now seems to have eased. BoE intervention averted a pensions meltdown and it's calmed gilt markets a bit. Following the end of the period the government reversed course, abandoning virtually all of its proposals and diluting its energy bill support package. This sent bond yields lower and sterling higher. Nevertheless, the turbulence has inflicted some longer-lasting scars. The BoE will still probably have to raise rates higher than forecast before the mini-budget was first announced. As this raises the cost of borrowing for banks and building societies offering mortgages, mortgage lenders have been withdrawing fixed-rate deals en masse to reprice them. The jump in mortgage rates will further squeeze household finances.

Adding to shorter-dated debt and selected financials

As we head into the final few months of 2022, the year to date has clearly proved bruising for bond investors. And the combination of more monetary policy tightening, persistent inflation and any number of unknowns could bring yet more pain.

Investing is always risky and bond prices may drop further as central banks hike rates up to levels that we haven't seen for many years. But, even though rates and prevailing yields are rising, if inflation starts to peak and falls back next year, we think that shorter-dated bonds should offer decent returns if we hold them until they mature. As a result, we added to our shorter-dated debt during the quarter, including **Anglian Water Services 6.875% 2023**, **HSBC 6.5% 2024** and **Scottish Widows 5.5% 2023** bonds.

High energy prices and steeper borrowing costs clearly bring extra pressures for corporate borrowers. As a result, we pared back our exposure to bonds issued by a few lenders we felt could face particularly challenging prospects. For example, we sold some **Electricite de France (EDF) 4.5% 2028** bonds. We expect EDF's credit rating to be further downgraded because its profitability prospects have been hobbled by the French government's requirement for it to sell power at below-market prices, as well as by its dwindling nuclear output. In July, the government announced it was going to fully nationalise EDF in a bid to shore up the business.

We also sold some more German **Landesbank Baden-Wurttemberg 1.125% 2025** bonds because of concerns about Germany's huge reliance on Russian gas. If Russia shuts 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.

Swiss banking group **Credit Suisse** attracted a lot of negative headlines during the quarter because of concerns about its financial stability. The bank has been nursing big losses as a result of its funding of hedge fund Archegos Capital, which collapsed last year. It's now repaired its balance sheet after writing off Archegos-related losses, but there's still a risk that the collapse could result in costly lawsuits which might dent its earnings over the next few years. We hold **Credit Suisse 1.125% 2025** bonds.

Despite the bank's significant governance and profitability challenges, its balance sheet is showing no signs of real stress and both its liquidity and capital positions remain comfortable. In early October, the bank announced a cash tender offer of $3 billion for its outstanding securities, including the ones we hold. We see the buyback announcement as a means to reassure investors that its liquidity is strong; this gives us some comfort. Nevertheless, there are big uncertainties over the bank's prospects: we expect to learn more about its restructuring plans towards the end of October.

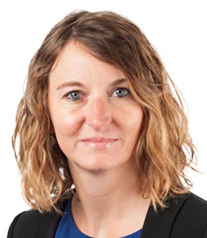
Notwithstanding Credit Suisse's specific problems, we still like bonds issued by select, well-capitalised banks, insurers and other financials that manage their risk exposure carefully. During the quarter, we snapped up some newly issued bonds that we felt offered good value, including **Banco Santander 4.75% 2028**, insurer **Hiscox 6% 2027**, Belgian banking and insurance group **KBC 5.5% 2028**, **Zurich Finance 5.125% 2052** and **Svenska Handelsbanken 4.88% 2032** bonds.

The income opportunity

In the wake of the extreme turbulence of the last quarter, it's important to remember that the surge in bond yields marks a significant shift in the income investing landscape that's largely prevailed since the global financial crisis. Higher bond yields present opportunities as well as risks. If these yields are compounded over decent periods of time, they can deliver attractive returns. Bonds offering attractive yields are positive for income-hungry investors, particularly since they may offer safer income streams than other asset classes because coupons must be paid and principal paid back before equity investors if a business fails. Equity dividends can suddenly get cut when equity markets run into trouble. There's much less risk of income-slashing when it comes to higher-quality bond investments.

At the same time, the turn in the rates cycle and the reversal of central bank bond-buying programmes introduced after the global financial crisis suggest that bond investments will start to offer a better safety net against equity market volatility. Ever since the financial crisis, low rates have contributed to most equity markets rising consistently, while central bank buying pushed bond prices up and their yields down. Now that rates are rising and buying programmes are being reversed, bonds and equities have been selling off at the same time.

We're now at the point where the yields on many important government bonds are firmly in positive territory (at least nominally). That means bond investors can once again earn an income for taking out an insurance policy on their equity portfolios on the assumption that the traditional lack of correlation between equity and bond prices will return as extraordinary policy supports keep on being removed.



Noelle Cazalis
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.

Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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