Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Strategic Bond Fund

Monthly update October 2022

The rout in UK government bond (gilt) and currency markets triggered by the tax-slashing mini-budget is thankfully over.

A gigantic gilt rally

Fall-out from the mini-budget continued early in the month, but new Chancellor Jeremy Hunt's massive policy U-turn in mid-October brought an end to the worst volatility. He scrapped virtually all the tax cuts outlined in the mini-budget and reined in some spending pledges, signalling that government fiscal policy (taxation and public sector borrowing) was no longer at cross-currents with Bank of England (BoE) monetary (interest rate) policy. This helped restore the credibility of key UK institutions and began to erode the uncertainty risk premium that had weighed so heavily on UK financial markets.

By month-end, the surge in UK gilt yields driven by the mini-budget had almost completely reversed (bond yields run in the opposite direction to prices) and gilts right across the maturity curve had rallied hugely. The yield on 10-gilts which stood at 4.10% at the start of October (after peaking above 4.50% in late September) backed down to 3.52% by month-end – only very slightly above where it was the day before the mini-budget. By contrast with this huge rally in gilts, US Treasuries continued to sell off. The yield on 10-year Treasuries began the month at 3.83% and hit 4.05% by its end.

Mixed messages?

With governments around the world struggling with a worsening cost-of-living crisis, big central banks have been doggedly raising interest rates this year as they try to get inflation under control (it's at or near 10% in many countries). Higher rates make it more expensive for consumers and companies to borrow money, thereby slowing consumption and easing pressure on prices.

The European Central Bank (ECB) hiked rates by a supersized 0.75% in late October and the US Federal Reserve (Fed) and BoE more recently implemented identical rises. But the central bank messaging that followed the rate hikes was less consistent. Fed Chair Jerome Powell acknowledged that smaller rate rises might be in the offing as the impact of earlier big hikes gradually feeds through. But he warned that the Fed still had "some ways to go" in taming inflation. As a result, the central bank may have to hike rates higher than the 4.6% peak level it envisaged back in September. The BoE sent a different message. It too said further rate rises were on the cards, but signalled that it might not increase rates as much as markets currently expect. For its part, the ECB was more in tune with the BoE's more dovish tone.

The new UK government headed by Prime Minister Rishi Sunak is warning that higher taxes and public sector spending cuts are on the way. Big fiscal belt-tightening may further slow consumption, helping to ensure the BoE won't need to tighten monetary policy as much as it had originally planned. And, of course, the economic outlook in the UK has been growing decidedly grimmer (in the topsy-turvy world of bond investing, bad news is often interpreted as good news since it can signal that inflation and expectations of rate rises – which are an anathema to fixed-income investors – may be cooling.)

A lot depends on what Chancellor Hunt and Prime Minister Sunak reveal in their Autumn Statement mid-month. But the BoE hasn't always done a great job on the communications front so we're cautious about expecting a big dovish BoE pivot away from rate hiking. Gilt markets may have rallied a bit too much and longer-dated gilt prices in particular could yet fall further (as their yields rise).

Credit makes a comeback

For most of this year, credit spreads – the extra yield (or spread) that corporate debt offers relative to government bonds for taking on default risks – have been widening aggressively as investors have worried about how higher borrowing costs and slowing economies could impact corporate borrowers. But spreads tightened a fair bit in October. The iTraxx European Crossover Index began the month at 591 basis points (bps) and had narrowed to 546bps by its end.

The spectre of a looming economic recession usually scares bond investors away from corporate debt. But we think there are plenty of reasons to be positive about the outlook for many corporate borrowers at the higher end of the credit-quality spectrum, particularly those whose businesses are less exposed to an economic slowdown. Lots of better quality corporate borrowers are in solid shape. They went through a tough time only a couple of years ago when the pandemic hit. The ones that got through the shutdown have been managing their businesses and finances pretty conservatively even when their profitability recovered in the reopening boom. This suggests to us that we probably aren't going to see a big spike in defaults from higher quality issuers.

Trading Gilts

We bought the **UK Treasury 1/8% 2023** and the **Green Gilt 1.5% 2053** when these bonds' yields ballooned as they were sideswiped by the gilt market rout.

A lot of the BoE heavy lifting on rates may now be behind us, but yields could still be pressured higher if sticky inflation drives more tightening. As gilt markets rallied along the curve, we felt that longer-dated gilts in particular might now be looking too expensive so we sold the long-dated **Green Gilt 1.5% 2053**.

Unlike some of the world's bigger central banks, the Reserve Bank of Australia (RBA) is already turning a bit more dovish and pivoting away from outsized rate hikes. It hiked rates by just 25 bps in October, a smaller hike than previous rate rises this year, and messaged that it recognises it's already increased rates substantially in a short period. We felt this suggested the RBA is nearing a peak in the current rate-hiking cycle. In order to lock in the attractive yield currently on offer from Australian state government debt, we bought **New South Wales 2.5% 2032** state government bonds.

Higher rates have been raising the cost of borrowing for banks and building societies offering mortgages and other loans, ensuring that this lending has become more expensive. Because we expect this to drive down mortgage and loan demand, we've been paring back our exposure to bonds issued by companies with direct exposure to the housing market and some business lending. In October, we sold the largest UK private residential landlord **Grainger 3% 2030** bonds and also **Blackstone Private Credit** investment firm **4.875% Senior 2026** bonds (Blackstone is huge lender to US and European corporates).

We also sold units in one of our very few equity investments, the Ireland-listed **Greencoat Renewables** investment company. This investment has performed strongly, but we've been selling out of it for several months now. We bought the fund because it offered a strong income yield. As rates have risen, we're finding ample opportunities to buy attractive bonds offering similarly compelling yields.

It's important to remember that the rise in bond yields, although painful at times, offers big opportunities for longer-term bond investors to reset their expectations on how returns might be generated over the next few years. Total returns stem from both price and income returns. Interest rate changes drive the two in opposite directions. Higher rates drive up bond yields, meaning prices fall. But, at the same time, rising yields imply a greater income return going forward. We see higher interest-paying bonds as providing a very rewarding buffer against price volatility.

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