Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Strategic Bond Fund

Monthly update November 2022

Bond investors are starting to look beyond inflation and the level at which interest rates peak and to grow more positive about the outlook for bond markets.

For almost all of 2022, bond markets have been bearing the brunt of one of the quickest and most aggressive interest rate-rising cycles on record. The US Federal Reserve (Fed), the Bank of England (BoE) and the European Central Bank have all pressed ahead with successive super-sized rate increases after being wrongfooted by spiking inflationary pressures last year. The Fed, for example, has increased rates by a pretty staggering 4.50% this year. Higher rates and high inflation erode the value of bonds' fixed returns so most global bond markets have experienced very big sell-offs (sending yields, which run in the opposite direction to bond prices, soaring to their highest levels in many years.)

Bond markets bounce

But government bond markets rallied sharply in November. The yield on 10-gilts, which stood at 3.52% at the start of November, had backed down to 3.16% by month-end. Likewise, the yield on 10-year Treasuries began the month at 4.05% and had tumbled to 3.61% by its end.

There are two key reasons why bond markets have begun to recover. First, inflation in the US seems to have peaked and is now cooling. Secondly, the inflation slowdown eases pressure on policymakers to keep hiking as forcefully. Central banks have signalled that rate rises will keep coming in 2023, but they've also hinted they may get smaller and less frequent. And in mid-December, the Fed ended many months of 0.75% rate rises and hiked by 0.50%.

The Catch 22 of less awful inflation, of course, is that it's the result of demand falling away. Normally, successive rate rises are in response to growth being too strong. At the moment, growth is weak and getting weaker, while the impact of higher borrowing and other costs still hasn't fed through fully to households and companies.

A looming economic recession might be expected to encourage investors to flock towards 'safe haven' government bonds. It might also be expected to scare them away from corporate bonds because of worries about the impact of higher borrowing costs and slowing economies on corporate borrowers. But, in fact, credit spreads — the extra yield (or spread) that corporate debt offers relative to government bonds for taking on default risks — have been tightening dramatically. The iTraxx European Crossover Index, which measures this spread, began the month at 546 basis points (bps) and had narrowed to 464bps by its end.

The big surge in yields and spreads this year (they are still much wider than when the year began, despite the recent tightening noted above) means that investing in corporate bonds at the higher end of the credit-quality spectrum can lock in very decent yields, while being very amply compensated for any default risks. For the first time in years, credit potentially offers a way to achieve long-term return objectives through income alone. And there's always the potential for attractive price returns when rates do eventually start to fall.

Buying higher-yielding bond funds

Given the revival in investor appetite for corporate bonds, we added to our holdings in several higher-yielding bond funds during November. These included the **Pareto Nordic Corporate Bond** fund, which — as its name suggests — invests in a portfolio of diverse Nordic corporate bonds offering an attractive combination of high yields and low duration. We also invested in the **Muzinich Asia Credit Opportunities** fund. We feel that China's recent relaxation of some of its stringent COVID-19 restrictions paves the way towards the country's reopening, which would prove positive for many corporates operating in wider Asia.

Trading Gilts and trimming exposure to UK housing

Early in the month, we sold the **UK Treasury 1 1/2% 2047** and the **UK green sovereign bond ('Green Gilt') 1.5% 2053** because we felt their prices might have risen too much. That's because we suspect bond investors may have grown over-confident about the prospect of an imminent BoE pivot away from rate-tightening. Although the UK's inflation rate fell back to 10.7% in October, it's still higher than in the US or in the eurozone as a whole. And even if it's now passed its peak, high inflation may linger longer in the UK than elsewhere. Chancellor Jeremy Hunt's curtailing of the provision of two years of government support for energy bills raises the risk that much higher bills could see inflation spike again in April when the current price cap ends. If UK inflation fails to fade and the BoE ends up tightening more forcefully than bond investors currently expect, UK government debt yields could once again be pressured higher.

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 in the UK, we've been paring back our holdings of bonds issued by companies with direct exposure to the domestic housing market. In November, we continued to sell the largest UK private residential landlord **Grainger 3.375% 2028** bonds and also sold property manager **Places for People 3.625% 2028** bonds.

In addition, we sold more 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.

This has been quite a year! Thank you for your support during 2022. We hope you have a very happy festive season.

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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 what you originally invested.

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