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Rathbones
Look forward

Rathbone SICAV Ethical 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-year 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.

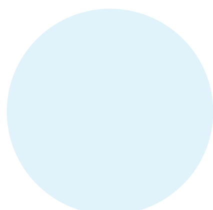
A looming economic recession might be expected to encourage investors to flock towards 'safe haven' government bonds. It might also be expected to scare them away from corporate bonds because of worries about the impact of higher borrowing costs and slowing economies on corporate borrowers. But, in fact, 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 new issues and investing in green energy

The revival in investor appetite for corporate bonds was clearly signalled when the new issue market roared back to life in November. There's been a long drought in the issuance of new corporate bonds because bond markets have been so volatile. The drought has been most acute in sterling-denominated credit because of the sell-offs triggered in response to former Prime Minister Liz Truss's 'mini-budget'. But the sterling new issue market seems to be back with a bang. We invested in several new bonds, including Spanish banking group **Santander 7.098% 2027** and French bank **Credit Agricole 5.75% 2027** bonds.

We also invested in wind farm **Gwynt y Môr 2.778% 2034** bonds. The wind farm, off the north Wales coast, comprises 160 wind turbine generators and is capable of generating enough energy to power around 400,000 homes (about 30% of all homes in Wales).



Trading Green Gilts

We don't invest in mainstream UK government gilts as the government is involved in some areas prohibited by our screening criteria. Instead, we focus on the UK's green sovereign bonds ('Green Gilts') as an ethical alternative.

Early in the month, we sold the **Green Gilt 1.5% 2053** and the **7/8% 2033** 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.

We decided to sell our French bank **BNP Paribas 2.875% 2029** bonds because of concerns about a lawsuit that alleges it is financially supporting new oil and gas projects. Several major Non-Governmental Organisations (NGOs), including Oxfam France, are taking legal action against the bank, based on a French Commercial Code requiring companies to identify risks of environmental damage (among other things) resulting from their operations. This could result in the first climate litigation case in the world to target a bank for its involvement in funding and investing in fossil fuels.

We also continued to sell 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 and hoping you have a very happy festive season.

Bryn Jones
Fund Manager

Noelle Cazalis
Fund Manager

Stuart Chilvers
Assistant 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.

This fund is actively managed. This is a marketing communication. Please refer to the prospectus of the UCITS and the KIID before making any final investment decisions.

Please note that the Rathbone Luxembourg SICAV may decide to terminate the agreements made for the marketing of the fund pursuant to Article 93a of Directive 2009/65/EC. For a summary of investor rights and guidelines regarding an individual or collective action for litigation on a financial product at European Union level and in the respective country of residence of the investor, please refer to the supplementary information document that can be found on rathbonefunds.com/international. The summary is available in English or an authorised language in the investor's country of residence.

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