**Rathbone Unit Trust Management**

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Rathbones
Look forward

# Rathbone Ethical Bond Fund

## Monthly update July 2022

Government bonds have rallied sharply on hopes that slower growth will cool red-hot inflation and persuade central banks to ease up on aggressive interest rate rises. But much uncertainty lies ahead in the notoriously volatile months of August and September.

Battered government bonds are back in favour as fears of a global recession mount. US 10-year Treasury yields (which run in the opposite direction to prices) have fallen by nearly 1% from the multi-year highs they hit in mid-June. The yield on 10-year US Treasuries began July at 3.02% and had fallen to 2.67% by month-end. UK government bond yields followed a similar trajectory. The yield on 10-year gilts fell from 2.24% to 1.87%.

Meanwhile, credit spreads — the extra yield (or spread) offered relative to government bonds for taking on default risks — have been extremely volatile. The iTraxx European Crossover Index began July at 580 basis points (bps), widened to almost 630bps by mid-month and then slumped back to 529bps by its end.

Many people (including us!) are asking why credit spreads started to rally just when we got the news that the US economy had shrunk for a second successive quarter. US GDP fell by 0.9% on an annualised basis in the second quarter after shrinking by 1.6% in the first three months of the year. That's a milestone that many countries regard as showing that an economy has tipped into a recession. The US relies on additional data to make that call, but the US Q2 GDP release certainly points towards weakening growth that could test some borrowers' ability to repay their debts.

Perhaps the credit rally was down to the fact that more investors recognised that way too much bad news had been priced into higher quality (investment grade) corporate bonds, (as we explained last month.) That's because credit spreads have been so exceptionally volatile ever since the current tightening cycle got under way, which is unusual. Spreads typically hold up when central banks begin tightening because that tends to happen when economies are in decent shape. At the same time, we worry that a fair bit of the credit rally is being driven by too much demand chasing too few bonds in a very illiquid period.

**Light at the end of the Fed's tightening tunnel?**

Despite investors' increasing hopes that the US Federal Reserve (Fed) will soon dispense with rapid rate hikes, it feels too early to call the end of the current tightening cycle. Much depends on the path of inflation and we're yet to see clear evidence that the price level is starting to moderate in the US.

And inflationary pressures seem to be intensifying still further in both Europe and the UK, where volatile energy prices are stoking a cost-of-living crisis and boosting costs for industry and businesses, significantly raising the risks of a looming recession. Bank of England (BoE) Governor Andrew Bailey warns that UK inflation could hit 13% by December and also predicts that the UK economy will enter a lengthy recession by year-end. The BoE's grim outlook came as it stuck with its pledge to act "forcefully" to curb inflation and raised rates by 0.5 of a percentage point to 1.75% at its latest policy-setting meeting. This was the BoE's biggest rate increase in more than 25 years: it insisted it had to step up the pace of tightening to bring inflation under control to avert an even harsher economic downturn.

In the US the immediate economic outlook is more mixed. The housing market is clearly weakening and consumer confidence continues to fall. But evidence of a slowdown has yet to show up in US employment data, and real consumption (spending adjusted for inflation) and industrial production continue to grow, so the headline Q2 GDP number probably paints an overly gloomy picture of the state of the US economy.

But the Fed's steep interest rate rises do seem to be cooling US economic growth. The Q2 GDP data came in the day after the Fed raised rates by three-quarters of a percentage point for the second time in a row. The minutes of the Fed's June policy meeting show that getting inflation under control is still a top priority. But some investors started to detect signs that the Fed might be softening its stance on the pace and extent of future hikes. In particular, they seemed to seize on Fed Chair Jay Powell's comment in the post-hike press conference that he felt it would likely (but not definitely) become appropriate to slow down the pace of rate rises in future. Are these investors overinterpreting hints of Fed leniency and getting ahead of themselves by expecting fewer and smaller hikes plus rate *cuts* next year? A string of Fed officials have been quick to emphasise that the central bank isn't yet close to a pivot away from tightening and that expectations of rate cuts next year are premature.

### What's the yield curve telling us?

The signal to bond markets is to not assume too low a peak in rates and to be prepared for plenty more tightening to come. And bond investors seem to be hearing that message loud and clear — at least when it comes to shorter-dated bonds that are most sensitive to changes in central bank interest rate expectations. Yields on two-year US Treasuries have been rising above those of 10-year Treasuries, a phenomenon known as a yield curve inversion. When yield curves invert, they typically spell trouble ahead for longer-term economic prospects. That's because while shorter-term yields reflect interest rate expectations, the 10-year yield moves in line with inflation and growth expectations. Yield curve inversion suggests bond investors think Fed policy will stall economic growth. Inversions have preceded every US recession for the last 50 years.

Volatile markets and noisy data may well continue over the rest of the summer and into the autumn. We're braced for a bumpy few months ahead, particularly since thin trading volumes during the summer holiday season tend to exacerbate bond market volatility. Inflation is still high, rates have been rising quickly and uncertainty swirls.

### Moving out of US dollar bonds

Against this highly uncertain backdrop for bond yields and prices, we haven't been rushing to buy lots of new bonds. Our focus during the month was to trim our exposure to dollar-denominated securities. US Treasury yields are markedly higher than gilt yields, so American credit investments can offer much more attractive yields than their UK counterparts. But it's been growing increasingly pricy to hedge out the currency risks associated with dollar bonds given the growing strength of the greenback: these hedging costs now wipe out a lot of the resulting yield boost. As a result, we've been paring back our exposure. In July, for example, we sold dollar-denominated **Legal & General 5.25% Subordinated 2047** and **Abrdn 4.25% Level 2 2048** bonds and also global datacentre specialist **Equinix 3.2% 2029** senior dollar bonds. We like the Equinix story: it's growing very profitably as many businesses continue to ramp up investment in their digital infrastructure, so we bought some of its euro-denominated **Equinix 1% Senior 2033** bonds. We also bought some life insurer **Just Group 5% Perpetual-2070** bonds which we felt looked attractively valued.

### What price energy security?

Abstract warnings about the climate emergency have certainly started becoming all too real over the last month or so as scorching temperatures hit the UK and mainland Europe, while millions of American suffer under record-breaking heatwaves. The prospect of more extreme weather suggests that countries around the world will need to adapt to the effects of climate change if they want to build resilience and prevent critical infrastructure from failing when temperatures leap.

Energy security is a particularly pressing concern given the big increase in volatility in international energy markets in the wake of Russia's invasion of Ukraine. This volatility and the UK's recent extreme heatwave forced the UK to buy energy at a 5,000% (yes, 5,000%!) premium in late July to ensure security of supply. Increased demand for energy across Europe to cope with extreme temperatures plus a bottleneck in the grid forced the National Grid's Electricity System Operator (ESO) to buy electricity from Belgium at more than 5,000% the typical price. ESO only bought a tiny amount of power at this sky-high price (just enough to supply a few houses in south-east London). But the incident highlights the urgent need to replace existing power supplies with clean and flexible alternatives that don't leave consumers at the mercies of international energy markets. It reinforces our long-standing commitment to investing in renewable energy sources (including wind, solar and hydro power) that deliver environmental benefits while also boosting national security of supply.

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