

## RATHBONE ETHICAL BOND FUND

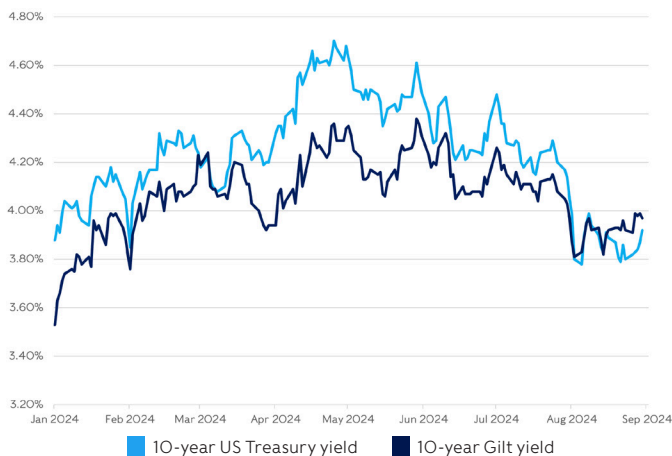
MONTHLY UPDATE AUGUST 2024

**Fears that the US economy might be slipping into a recession, alongside the unwinding of investments funded by a cheap yen, triggered an extreme, but short-lived, bout of panic in financial markets at the start of the month. As stock markets around the world tumbled, government bond yields also dropped and their prices rallied.**

By month-end, equities had basically recovered what they'd lost. But the volatility improved the backdrop for bonds. Many investors rushed to the safety of government bonds during the stock market meltdown and government debt was further supported by a fast, sizeable shift in expectations about how far and how fast the US Federal Reserve (Fed) will cut interest rates. By month-end, investors were expecting around 100 basis points (bps) in Fed cuts across its three remaining rate-setting meetings this year. That's about double the level they'd expected in late July and suggested a cut at every meeting, including one of 50bps.

Against this backdrop, the yield on the benchmark US 10-year Treasury fell from 4.03% at the start of the month to a panicked low of 3.78% on 5 August. By month-end it had backed up a bit to 3.91%. While the yields on US Treasuries fell to their lowest levels in more than a year, UK government bond (gilt) yields bucked the downward trend. In fact, the 10-year UK government bond (gilt) yield rose from 3.97% to 4.02% in August. That was because UK economic data was surprisingly strong, persuading investors that the Bank of England (BoE) would likely take its time cutting rates despite trimming them by 25bps at the start of the month.

### BONDS HOLD ON TO THEIR GAINS



Source: FactSet, Rathbones

### Recession risks

Early August's equity market upheaval was driven mainly by a couple of bad US economic data releases, including manufacturing and crucially jobs and payroll data. Tight Fed monetary policy in the form of high interest rates has reined in soaring prices without squeezing too much juice out of the economy. But it can't do that forever. Keeping rates too high for too long risks tipping the economy into a recession and triggering high unemployment. Unemployment is deemed a lagging indicator of economic downturns. By the time it's rising, a recession may already be under way. Investors have been getting edgy for a while that the US economy might be weakening so early August's bad jobs report really played into their fears.

They seem to have been extra-spooked by the simultaneous mass unwinding of lots of 'yen carry trades'. Those trades had involved global investors borrowing cheaply in yen and then ploughing the money into investments elsewhere to earn a nice easy 'carry'. When the Bank of Japan announced a surprise interest rate rise on 31 July, that drove up the value of the yen and triggered the unwinding of yen carry trades worth hundreds of billions of dollars.

Only a few days after US recession fears peaked, investors began to calm down. Equity markets bounced back quickly after the release of a contradictory jobs report (which showed jobless claims falling) and very positive services sector data, soon followed by the news that US inflation in July had dipped below 3% for the first time in more than three years. Evidence that the US economy wasn't about to keel over, alongside positive inflation data, bolstered investor confidence in a 'soft landing' for the US economy. That scenario is positive for 'risk assets' like stocks and corporate bonds. As a result, the iTraxx European Crossover Index, which measures credit spreads (the extra yields that corporate bonds offer over government debt to reflect their higher default risks), tightened after starting the month at 295bps and then briefly blowing out to above 340bps. By month-end, spreads had narrowed to 288bps.

### How far will the Fed go?

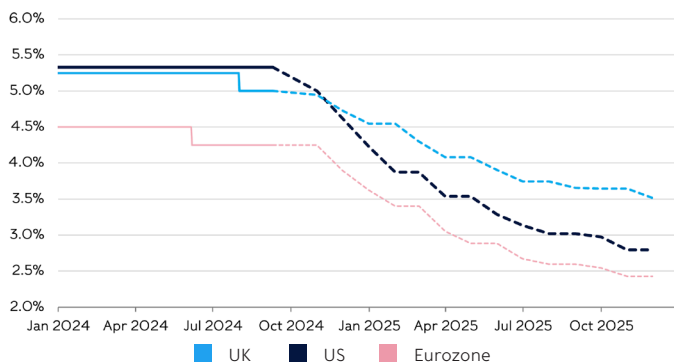
At the annual central bankers' shindig in Jackson Hole (Wyoming) in late August, Fed chair Jerome Powell made it crystal clear that US rates would be cut in September. The Fed seemed to have concluded that the balance of risks had tilted towards monetary policy being too tight, rather than not tight enough. Although Powell officially declared that rate-cutting was about to start, he left all options open in terms of the scale and speed of Fed policy changes.

Some of the Fed's counterparts have, of course, already got cutting under way. BoE governor Andrew Bailey signalled at Jackson Hole that he was comfortable with more rate reductions after the BoE's initial cut at the start of the month. But he's been pretty cagey about the pace of cuts so it came as no big surprise that the BoE kept rates on hold at its September rate-setting meeting.

Now that August's market mayhem is behind us, we believe we're in a pretty positive environment for fixed income. Government bonds should be well supported by central banks' commitment to policy easing and we're not expecting credit spreads to blow out again without a big rise in defaults or downgrades (and that seems unlikely in a 'soft landing' scenario.) At the same time, we're seeing investor appetite for bonds gain extra momentum as investors have begun to prioritise recession protection over inflation protection. The negative correlation between stock and bond prices is reinforcing confidence in bonds' vital role in broad investment strategies by potentially providing a hedge against weak economic growth and mitigating stock market volatility.

When interest rates start to get cut, longest-dated bonds rally most. We felt that the big shift in investor expectations about the scale and speed of cuts in August might have driven up the prices of very long-dated bonds a bit too much. As a result, we pared back our duration (interest rate) exposure slightly. We did this by selling some of our **UK Green Gilt 1.5% 2053s** to add to our shorter-dated **Green Gilt 0.875% 2033s** instead.

### AGGRESSIVE RATE CUTS ARE PRICED IN FOR NEXT YEAR



Source: DataStream, Rathbones the dashed lines are future rates implied by bond markets as of 31 August 2024

### Buying innovative bond supporting Amazon reforestation

In the first half of the month, we were delighted to be among the first investors to buy an innovative new **Amazon Reforestation-Linked Outcome bond 1.745% 2033** bond issued by the **International Bank for Reconstruction and Development** (the IBRD - the lending arm of the World Bank). We've got a lot to say about this bond. You can find out more [here](#).

We also bought some French insurer **AXA 4.45% perpetual** bonds. We think AXA could well ask bondholders to 'tender' (sell back) these bonds at some point. And when issuers make tender offers, they can sweeten the deal by offering to buy them back at premium prices. We also bought some **Co-Op Bank 11.75% 2034** bonds. Coventry Building Society is taking over Co-Op and we think this is likely to benefit the prices of Co-Op bonds. We sold some of our investment management firm **M&G 5.56% 2055** bonds as we felt they looked a touch expensive. We also sold some **BT 5.75% 2041** bonds. Broadcaster and telecoms services provider Sky has announced that it's going to stop using BT to deliver broadband services to its 5.7 million customers. We worried this could exert a lot of pressure on BT's Openreach business, while also highlighting the risk that BT could lose other big broadband customers.

### STOP PRESS: The Fed's bumper rate cut

As things turned out, we were both out and about when the Fed announced a bumper 50bps rate cut on 18 September. Here are some initial thoughts from Bryn:

**"This was a very exciting Fed meeting... we went into it with the most uncertainty about a rate decision in about 15 years. Inflation remains, people still have some savings, the US economy continues to grow at a decent rate, and – despite a recent uptick – unemployment is still low, but the Fed obviously felt it's time to cut by 50bps.**

**Generally, whenever rates go up, recessions do eventually occur, but the timing of those recessions can be anywhere between one year and several years after the first hike. The Fed does seem worried about the probability of this happening now. On the other hand, the cut could have been more a pre-emptive strike aimed at keeping the economy close to full employment.**

**Just as important as the cut itself is what the Fed told us about how it sees things from here. It's projecting that the Fed funds rate could end up somewhere between 2.9% and 4.1% next year. That's a massive range! It shows the uncertainty ahead for Fed rate-setters and all of us."**

We'll be giving a more considered view on the Fed's cut, and explaining what we think lies ahead for bond markets, in our upcoming In Conversation video which will be available at the end of September. (You can sign up [here](#).)



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For more info on our fund, including factsheets, performance and fund manager views, please click [here](#).

If you require further clarification on this commentary, then please contact your adviser or Rathbones at the contact details below.

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