Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Ethical Bond Fund

Quarterly update September 2023

Government bond markets were staggeringly volatile last quarter as bond yields (which run in the opposite direction to prices) soared to their highest levels in more than 15 years. US investors in particular seemed to get a big wake-up call that interest rates won't fall any time soon. This forced them to adjust quickly to a world of higher borrowing costs than they'd hoped and (as a result) less spending, which is bound to weigh on economic growth.

	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	2.02%	0.93%	9.55%	-11.39%	2.43%
IA UK Sterling Corporate Bond Sector	2.12%	-0.74%	7.28%	-13.68%	-1.93%

	30 Sep 22-30 Sep 23	30 Sep 21-30 Sep 22	30 Sep 20-30 Sep 21	30 Sep 19-30 Sep 20	30 Sep 18-30 Sep 19
Rathbone Ethical Bond Fund	9.55%	-22.77%	4.74%	5.67%	9.39%
IA UK Sterling Corporate Bond Sector	7.28%	-20.53%	1.26%	4.21%	9.02%

Source: FE Analytics; data to 30 September, I-class, mid price to mid price.

These figures refer to the past, which isn't a reliable indicator of future returns

Longer-term government bonds – those due to mature in 10 years or more, whose longer durations make them the most sensitive to interest rates–sold off most sharply. The 10-year US Treasury yield began the quarter at 3.84% and had surged to 4.58% by its end. It was racing towards 5% at the start of October, before falling back as investors rushed to buy up 'safe haven' government bonds following the onset of the conflict between terrorist group Hamas and Israel. The yield on 10-year UK government bonds (gilts) also spiked, rising from 4.39% at the start of the quarter to reach 4.50% at its end.

The timing of this sell-off might seem a bit surprising. It really picked up pace soon after the US Federal Reserve (Fed) and Bank of England (BoE) policymaking meetings in September at which they decided to pause on further interest rate hikes. And these, in turn, followed signs that inflation could now be flatlining as economic growth cools. These are all things that would usually be expected to drive government bond prices *up*, not down. But the Fed and BoE, along with the European Central Bank, signalled very strongly in September that while rates have likely peaked (or are almost there) for now, they'll stay close to their current highs for some time. Central banks have been sending out a 'higher for longer' message for ages, but it wasn't until September that bond investors really started to believe it.

Other things seem to have played a part in fuelling the sell-off. These included a flurry of new government debt issuance that inundated bond markets in September, pushing prices down, as well as worries about big foreign buyers of US government debt (principally China and Japan) selling Treasuries.

Why a steeper yield curve may spell trouble ahead

When central banks started hiking rates 18 months or so ago, it was short-dated bond yields that rose most. Longer-dated bond yields didn't increase nearly as much – probably because investors expected inflation and growth would eventually fall. As we explained last quarter, that's meant that the yield curves that plot the differences in yields investors demand in compensation for lending their money over various periods have 'inverted'. In other words, bonds maturing soon have been yielding more than those maturing further into the future so yield curves have been sloping down, rather than up. And inverted yield curves are one of the strongest warning signs that recessions may be looming.

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.

The spike in longer-dated bond yields last quarter has driven a very fast 'disinversion' (or steepening) in yield curves. Curve disinversions often happen because shorter-term yields start to fall faster than long-term ones — something that's known as a 'bull steepener' — because investors expect rates to get cut soon. But what's been happening is that longer-term bond yields have been increasing much more quickly than short-term ones. As investors have got more uncertain about the direction and level of rates in the long term, they've been demanding higher yields to take on greater duration (interest rate) risk. That's led to what's known as a 'bear steepening' of yield curves. And, while inverted yield curves have proved reliable indicators that recessions will happen at some point, they've also often disinverted just before they're about to start.

As has been the case for quite a while, economic data are sending some very confusing signals. Most big economies have been slowing and there are some nasty warning signs of things that might cause trouble ahead. Rates have jumped from virtually zero to roughly 5% in about 18 months. That's a phenomenally rapid rise and something we think is difficult for households and businesses simply to shrug off.

The big outlier is the strength of jobs markets. This is a huge worry for central banks because hot jobs markets raise the risk that inflation won't fall back further and might even start to reaccelerate. Annualised pay growth in the UK hit 7.8% in the three months to July — its highest ever three-month rate in records going back to 2001. And in the US, employment increased by the most in eight months in September, with non-farm payrolls numbers double expectations. Fed officials want to see the jobs market cooling because this will reduce pressure on businesses to raise pay, which can feed into higher prices.

Notwithstanding so-far resilient jobs markets, the speed at which yield curves have been steepening does seem to suggest that a sharper economic downturn is coming at some point. As investors have grown less confident about the prospect of a 'soft landing' for the economy, they've got more concerned about how higher borrowing costs and weaker demand could impact on some corporate borrowers. The iTraxx European Crossover Index, which measures the extra yield (or spread) that corporate debt offers relative to government bonds for taking on default risks, began the quarter at 400 basis points (bps). But it had widened to 426bps by its end.

Dialling down longer-dated credit...

We still believe that selected higher-quality (investment grade) corporate bonds offer decent compensation for any potential hit to returns from wider credit spreads and sensitivity to interest rate-swings. But we've been growing more cautious about the longer-term outlook for some corporate borrowers. As a result, we've been selling some of our longer-dated credit, for example some of our private equity group **3i 3.75% 2040** and offshore wind business **Orsted 5.375% 2042** bonds.

We also opted to sell some of our bonds that rank lower in companies' capital stacks (which means these debts would be paid back only after more senior borrowings were repaid if the companies were to default) when we got the opportunity to buy the same companies' bonds higher up their capital structures. For example, we sold some Spanish bank **Santander 1.5% Senior Non-Preferred 2026** and **1.75% Senior Unsecured 2027** bonds and bought some of its higher-ranked **4.75% Senior Preferred 2028** and **5.125% Senior Preferred 2030** bonds instead. Likewise, we sold some French bank **Credit Agricole 1.874% 2031 Subordinated Unsecured** bonds, but added to its higher-ranking **4.875% Senior Preferred 2029** bonds.

...but adding to long-dated government debt

We're pairing our exposure to credit with longer-dated government bonds (like Green Gilts) via a 'barbell' structure. (We added quite a bit to our holdings of the **UK Green Gilt 1.5% 2053** and **0.875% 2033** during the quarter.) In bond investing, a barbell combines significant weightings of short-dated bonds with significant weightings of much longer-dated ones. One end of our barbell tilts towards shorter-dated credit that's less sensitive to interest rate moves. The other end tilts towards longer-duration government bonds that usually outperform in a slowing-growth, falling-rate environment in which some corporate bonds could struggle. We think this tilt could give us a nice cushion against any volatility in credit markets if it looks like we're heading towards a harder economic landing and central banks are beginning to gear up for rate cuts. We discuss our barbell approach in more detail here.

How today's challenges could bring big opportunities for tomorrow

Overall, the lesson of the third quarter seems to be that bond markets will probably stay pretty volatile for a while. Investors may now accept that rates will stay higher for longer. But there's a lot of uncertainty about how high and for how long. And investors are demanding higher yields to compensate for that uncertainty. This is challenging for those trying to time exactly when government bond yields may peak. But it also opens up significant opportunities for longer-term investors to lock in yields at close to once-in-a-generation highs.

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

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