RATHBONES

RATHBONE HIGH QUALITY BOND FUND

MONTHLY UPDATE JANUARY 2024

The stupendous bond market rally of the final months of 2023 stalled in January.

Investors realised that, given the strength of the US economy, they'd got overly optimistic about the chances of a US Federal Reserve (Fed) interest rate cut as early as March. Lots of data showed the US economy proving remarkably resilient in the face of rates at a 23-year high. US GDP growth is running at over 3% and the jobs market is still in rude health. January's blowout Nonfarm Payrolls report showed 353,000 more new jobs being added than lost: almost double the number expected and 20,000 higher than the previous month.

This strong economic data bolstered investor optimism about the chances of a 'soft landing', but also disappointed hopes of a 0.25% rate cut from the Fed in the first quarter. These hopes were well and truly dashed when Fed chair Jerome Powell explicitly pushed back on investor expectations on the timing of its first rate cut and said the Fed wouldn't hesitate to wait a bit before cutting.

As a result, investors pared back their expectations on the number of rate cuts likely this year. Back in December, they were expecting around six cuts in the UK and as many as seven in the US. They're now expecting around five in both the US and the UK. That ensured government bonds reversed some of last year's gains.

The US 10-year government bond price slumped, sending its yield, which had plunged to 3.87% over the fourth quarter, back up to 3.92% by the end of January. UK government bond (gilt) yields followed suit, with the 10-year gilt yield rising from 3.54% at year-end to 3.80%. Both benchmark yields were back above 4.0% by mid-February.

Expect a bumpy few months ahead

Last summer, the Bank of England (BoE) outlined two routes to taming inflation and getting it decisively down to its target of 2%. One looked like the super-steep Matterhorn in the Alps, and involved rates soaring quickly and then falling sharply. The second (which is the model the BoE favoured) was more like Cape Town's flat-topped Table Mountain, and involved rates peaking at a lower level and then plateauing for a considerable period before falling gently downwards.

We think rates' downward descent could be a bit bumpier and more akin to scrambling down from the Devil's Tower in Wyoming. Climbing the Tower, which features heavily in *Close Encounters of the Third Kind*, requires a special technique called 'crack climbing'. Instead of climbing features on the rock face, you need to wedge yourself into cracks between columns of rock to get up or down. The challenging route can involve getting jammed along the way before you carefully edge forwards.

We think core government bond yields are going to be lower later this year. But the path downward is unlikely to be smooth and we felt the year-end rally was a bit strong given the risk that yields might back up or get jammed like a climber on the Devil's Tower. Economic growth, job creation and wage growth, in the US in particular, continue to overshoot expectations. And while US inflation does seem to be on a downward trajectory, it's popped higher in recent months, to the surprise of most. All this suggests the route down from peak rates could well prove bumpy, with a fair bit of volatility along the way.

THE BUMPY TOPOGRAPHY OF DEVIL'S TOWER

Jumbo demand for credit

It's pretty unusual for corporate bond markets to power ahead when rates (government bond) markets are as volatile as they were in January. But credit prices kept on rising and there was plenty of investor appetite for the bumper supply of newly issued corporate bonds. January is traditionally a heavy month for supply, but 2024 set new records. In Europe alone, primary issuance had topped €300 billion a couple of days before month-end, beating last year's January total of €293bn, according to Bloomberg. Investors seem to be fully buying into the soft landing narrative being fed by the US economic juggernaut at the moment.

The headline strength of the US economy does suggest that things are set for a soft landing for much of this year. But how long that lasts before things get tougher is more debatable.

The ICE Bank of America Sterling Corporate Bond Index spread (the extra yield that corporate debt offers over government bonds for taking on default risks) began the month at 134 basis points (bps). It had tightened to 129bps by month-end.

We felt several of January's newly issued bonds offered attractive value. For example, we snapped up some new issuance from two French banking groups, buying some new **BPCE 4.875% 2030** and **Credit Agricole 5.375% 2029** bonds.

Given our view that investor expectations about the timing and number of rate cuts had gone a bit too far by year-end, we opted to pare back our exposure to more rate sensitive government bonds. For example, we sold some of our **UK Gilt 4.5% 2028** early in the month. We also trimmed some of our longer duration corporate bonds because, again, they're more sensitive to rate dynamics. An example was Swiss insurer **Zurich 5.125% 2052** bonds.

We switched some of our French co-operative bank **Banque Federative du Credit Mutuel 1.75% 2024** bonds for some **Yorkshire Building Society 3.5% 2026** bonds because the latter offered much more attractive spreads. Likewise, we sold some Norwegian bank **DNB 1.375% 2025** bonds and bought some Swedish bank **Skandinaviska Enskilda 5.5% 2026** bonds with more attractive spreads.

Resetting expectations on returns on cash

The two things that drive bond returns (rates and spreads) could well prove volatile in coming months.

But the yields on offer from both government and corporate bonds are much higher than they've been for many years. As we explain here, these juicy yields look particularly compelling considering that the once-tempting rates of return available on cash stand to fall fast as the Fed and other central banks are standing on the verge of cutting rates.

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