RATHBONES

RATHBONE HIGH QUALITY BOND FUND

QUARTERLY UPDATE DECEMBER 2023

After months of falling inflation and cooling economic data reduced bond yields, everyone expected the US central bank to warn of complacency and try to edge yields higher in December. Instead, US Federal Reserve (Fed) Chair Jay Powell all but declared victory on inflation and started to hint of interest rate cuts to come.

Added to this change of tone, the US government didn't issue as many bonds to pay for federal spending as everyone expected. Fourth-quarter issuance of US Treasuries was actually slightly lower than anticipated, reducing the supply.

Government bond yields promptly plummeted, delivering a nice Christmas present for investors as falling yields mean rising bond prices. Having started the fourth quarter at 4.58%, the benchmark 10-year US Treasury yield dropped to 3.87% by the end of the year. Because the yield had marched to a 16-year high in October in expectation of interest rates staying higher for longer, the fall over November and December was more than a full percentage point. UK government bond (gilt) yields followed suit, with the 10-year gilt yield dropping from 4.50% at the end of September to 3.54% by the end of the year. That's about as high-octane action as you're likely to see in bond markets!

Investors rate 2024 highly

Once the dust settled, bond prices and the market for locking in future interest rates show that investors now expect about the Fed to make six 25-basis-point (bps) cuts to its benchmark interest rate for overnight deposits. They would be spread throughout 2024, with the first anticipated in early spring. That's a huge shift. And it's mirrored in Europe and the UK, too: markets imply six 25bps cuts in the Europe and five in the UK.

Many bond investors (ourselves included) think these moves are a bit strong. Bond prices don't offer much leeway for any of the small disappointments that reality often serves up, and much of the gains were made at a time when few investors were actually trading. These 'illiquid' rallies can tend to reverse a bit when everyone gets back to the desk after a holiday season – and we've already seen that so far in 2024.

Despite the market following the US, it's important to note that while UK markets have followed the Fed's lead, the Bank of England (BoE) and the European Central Bank (ECB) haven't. They have so far retained their more severe rhetoric on interest rates. They are still worried about inflation and are yet to shift their attention from rate hikes to rate cuts. A chorus of commentators have lambasted their stances, yet that doesn't shift the reality. And if they reaffirm that hawkishness, expect UK and European bond markets to wobble.

Corporate bonds also had a strong quarter as the rally in government bond markets bled into confidence for the private sector as well. 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 fourth quarter at 158bps and had dropped significantly to 134bps by its end. This has partially unwound in early January, with the spread jumping to 140bps.

Changing gear on the plateau road

Because of our fund's lower-risk nature, we keep our portfolio significantly less sensitive to changes in prevailing yields than most bond funds. This 'shorter-duration' positioning means our bonds, generally, have less time before they mature and pay relatively more in coupons when compared with the capital received at maturity.

Yet as government bonds sold off early in the quarter, we added more duration (interest rate risk) to our fund at very cheap prices. We bought more of the **Gilt 4.5% 2028** and also several bonds issued by quasi-government organisations that are deemed exceptionally unlikely to default because of government backing. For example, we bought some **European Investment Bank (EIB) 0% 2028**, **Inter-American Development Bank (IDB) 4.75% 2029** and **KFW 4.875% 2028 bonds**. The EIB and IDB are both supranationals – institutions established by the governments of two or more countries to pursue specific policy objectives – while KFW is a German state-owned development bank. This government backing means the EIB, IDB and KFW all benefit from very high credit ratings: they have triple-A ratings, the highest rating possible. We then reduced our holdings of the **UK Treasury 1.625% 2028** and **4.5% 2028** bonds in December, taking profits after a big leg up in their prices (as yields fell).

Early in the quarter we bought newly issued **Coventry Building Society 7% 2027** bonds that we felt offered good value. This was vindicated as their credit spreads fell significantly (increasing the value of the bonds) when they started trading on the open market. We banked profits from the bonds by selling some of them in December because we felt their credit spreads were now a fairer reflection of the quality of the issuer. Added to this, there were rumours that the building society was thinking about buying the Co-op Bank. A big takeover often comes with extra debt and the risk of operational mistakes, which tend to hurt bond prices. We felt it was prudent to reduce our exposure to the bond because of this, along with the **Coventry Building Society 1% 2025**, which we also own.

Performance review

	3 months	6 months	1 year	3 years	Since Launch 16 Nov 18
Rathbone High Quality Bond Fund	4.17%	6.96%	7.61%	-3.54%	2.70%
Bank of England Base Rate + 0.5%	1.41%	2.81%	5.16%	7.86%	10.18%

	31 Dec 22-31 Dec 23	31 Dec 21-31 Dec 22	31 Sep 20-31 Dec 21	31 Dec 19-31 Dec 20
Rathbone High Quality Bond Fund	7.61%	-8.97%	-1.53%	2.93%
Bank of England Base Rate + 0.5%	5.16%	1.95%	0.61%	0.73%

Source: FE Analytics; data to 31 December, I-class, mid price to mid price.

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

We sold some of our short-dated floating rate notes (FRNs), including Australian lender **Westpac Banking Group 2028** and UK lender **TSB Bank 2027**. As their name implies, these bonds offer variable (floating) coupon rates that increase when interest rates rise and fall when they drop. While we felt they were an effective way to boost income in a rising-rate environment, we felt they were looking less attractive now that central banks are keeping rates on hold.

Another wild year – but better returns

Last year was a strong one for your fund, beating our BoE Base Rate +0.5% benchmark comfortably, after a tough couple of years when rates rose and sent bond prices tumbling. Yet it was anything but smooth sailing as markets have remained jittery and erratic.

Perhaps the biggest scare of the year was the spate of bank failures. Many lenders had parked cash from depositors in government bonds with many years to maturity at very low yields. While these bonds are safe from default, their prices are highly sensitive to changes in the prevailing rate of interest (as we've already noted). So when yields started rising, the value of these bonds tanked. Theoretically, this shouldn't have been a problem as they were intended to be held till maturity and their values would recover as they approached the moment of repayment. However, a social media storm whipped up an old-fashioned bank run and several banks found themselves unable to come up with enough cash to redeem deposits.

These concerns spread across the Atlantic and hit Swiss mega bank and perennial underperformer Credit Suisse with a financial lightning bolt. It fell foul of a similar run of depositors, lost the confidence of everyone and had to be taken over by rival lender UBS in a weekend deal brokered by the Swiss National Bank that wiped out investors in Credit Suisse's AT1 securities. AT1s are bonds that rank very low down the hierarchy of creditors (therefore we don't own them) and which generally convert to equity when the bank or insurer that issued them gets into trouble. The trick is that the conversion instantly reduces the issuer's debts while also boosting its equity, helping to alleviate the crisis. These bonds are part of the European regulatory landscape, so are widespread in large European financial businesses – there's something like $250 billion of them outstanding. So when the $17bn of Credit Suisse AT1s were instantly zeroed as part of the deal (rather than being converted to equity), it caused quite a stir.

This meant a bit of a short-term roller coaster as investors panicked about whether this kind of wipe-out could happen elsewhere, with the falls spreading to other types of corporate bonds. The ECB and the BoE quickly made it clear that they would respect the hierarchy of creditors in AT1 bonds in any similar circumstances and bond prices duly rebounded.

The year ahead

As we enter 2024, the US economy is still growing strongly. As long as this is the case – and inflation remains above the 2% target – US Treasury markets will be jittery and volatile. And as long as these global benchmark bonds are jittery and volatile, other governments' bonds will be too, along with all the corporate bonds which base their prices on them.

Broadly, we're optimistic that interest rates have now likely peaked (which should be a good thing for bonds), but we think volatility within bond markets isn't going anywhere. We think it could stay greater than we've got used to for much of the past decade. However, with government bond yields now so much higher, the greater cash they throw off in coupons makes them more effective buffers against any further volatility in their prices.

While the global economy has proved more resilient than expected so far, we still think a lot of the full impact of super-aggressive central bank monetary policy tightening has yet to feed through fully. We're still wary about assuming that central banks will pull off a 'soft landing' for the global economy – the rare feat of taming inflation without triggering a serious economic downturn. A recession could drive higher quality (investment grade) credit spreads still wider, but we feel we are being compensated for this risk given the current yields on offer and we have increased our exposure to higher credit quality issuers to help protect us from this risk.

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.

Added to this, the biggest risk to bondholders is the loss of capital that happens when bond issuers can't make their interest payments or repay the principal they've borrowed on time. Historically, bond defaults are rare within investment grade credit. And if the economy does tip into a recession, investment grade credit could benefit from interest rate cuts (depending on inflation levels) because the coupons paid on outstanding bonds will be more attractive than what is available in the new, lower-rate environment.

STUART CHILVERS
Fund Manager

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.

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.

Rathbones Asset Management

8 Finsbury Circus
London EC2M 7AZ
+44 (0)20 7399 0000
Information line:
+44 (0)20 7399 0399
ram@rathbones.com
rathbonesam.com

Rathbones Asset Management Limited is authorised and regulated by the Financial Conduct Authority and a member of The Investment Association. A member of the Rathbones Group Plc. Registered office: 8 Finsbury Circus, London EC2M 7AZ Registered in England No. 02376568.

8755.01.24