

RATHBONE SICAV ETHICAL BOND FUND

MONTHLY UPDATE NOVEMBER 2024

Government bond markets have remained edgy as investors grapple with uncertainties associated with a Trump presidency in the US, plus Budget-related fall-outs this side of the pond.

Early in the month, Americans voted decisively to elect Donald Trump as president. The immediate response was a big wobble in US bond markets. Trump's policy agenda (widespread tax cuts, higher tariffs and restricted immigration) could add up to higher US inflation and interest rates – bad news for bond investors.

The 10-year US Treasury yield, the benchmark for US and global borrowing costs, began November at 4.28%, briefly spiked to around 4.45% after Trump's win and then fell back again to 4.18% by month-end. That retreat seems likely to be an acknowledgement that the Trump playbook suggests his bark can be worse than his bite. Some policy pledges may prove more negotiating tactics than concrete plans. And, of course, it's still some time before he even sets foot in the Oval Office (inauguration day is 20 January).

Most investors are confident that the US Federal Reserve (Fed) will cut rates again when it holds its final rate-setting meeting on 17-18 December. That would amount to one full percentage point in cuts from the Fed in 2024. After that, we're firmly in 'wait and see' mode. US inflation has been edging very slightly higher over the last couple of months, suggesting Fed policymakers will be cautious about pressing ahead with bold rate cuts.

Uncertainty about the inflation outlook, in part due to the potential policies of a second Trump presidency, is a good part of the reason why government bond yields have been popping higher. Another part is the expectation that the already ginormous US fiscal deficit (the gap between government expenses and revenues) could swell still further given Trump's promised tax cuts. The US government isn't alone in living beyond its means. Most major developed countries have struggled to rein in their fiscal deficits, especially since the pandemic. For a long while, big investors in government bonds haven't worried too much about countries piling up their borrowing. But that now seems to be changing as concerns grow that it could result in too much debt supply for bond markets to absorb.

As we explained last month, investors have got decidedly twitchy about just how much the Labour government plans to scale up its borrowing. Labour's first Budget on 30 October signalled it intends to borrow around an extra £30 billion per year over the next five years and to hike taxes by around £40 billion per year (mostly by increasing Employer National Insurance Contributions (NICs) and halving the threshold at which they kick in). On Budget day itself, the 10-year gilt (UK government bond) yield stood at 4.31%, but it had risen to well above 4.50% by the first half of November. The surge seems driven by worries about the big increase in government debt supply alongside fears that businesses might try to offset their higher costs by raising prices, forcing up inflation and ensuring the Bank of England (BoE) cuts rates less and

more slowly. By month-end, those fears had eased a bit and the 10-year gilt yield had dropped to 4.24%. But the Budget fall-out shows that investors are demanding extra compensation (via higher yields) when lending to governments that keep issuing more and more debt.

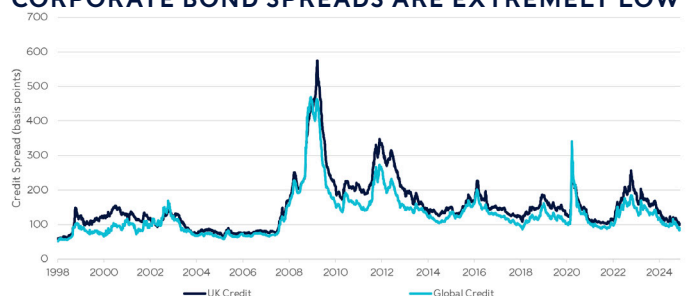
That was very much in evidence towards the end of the month when France got shoved into the hot seat. Ever since its inconclusive parliamentary polls over the summer, France has been stuck in a political gridlock. Parliament is divided into three fractious blocs, none of which enjoys a commanding majority. When Prime Minister Michel Barnier tried to force through an austerity Budget aimed at reining in France's mighty deficit, his opponents united to oust him. President Emmanuel Macron is now struggling to appoint another prime minister who might be able to forge some sort of consensus. In the meantime, investors have been voting with their feet. In late November, France's borrowing costs briefly surged above those of Greece – once deemed the Eurozone's riskiest borrower. Those costs have since come down a bit, but investors are still demanding a hefty risk premium to hold French debt rather than German Bunds. As a precautionary move, we trimmed some of our French bank bonds, including some **BPCE 2.5% 2032s**.

With fiscal concerns coming to the fore and complicating the interest rate outlook, we're trying to avoid taking big positions on duration (the direction of rates). We bought some longer-duration UK green sovereign bonds ('Green Gilts'), notably some **Green Gilt 1.5% 2053s**, early in the month when they looked particularly good value. But we trimmed them again towards month-end as we sought to get our duration exposure closer to neutral (i.e. more or less in line with that of peer group funds).

A tougher backdrop for UK borrowers?

Despite the volatility in government bond markets, credit spreads (the extra yield that corporate bonds offer over government debt to reflect their higher default risks) have kept grinding lower. The iTraxx European Crossover Index, which measures those spreads, began November at 314 basis points (bps) and had tightened to 299bps by its end. As we approach year-end, most measures of spread are at multi-decade lows. And when spreads get this tight, they can't tighten much more. But they can widen a lot if anything goes wrong.

CORPORATE BOND SPREADS ARE EXTREMELY LOW



Source: FactSet; data 1 January 1998 to 29 November

What happens from here largely depends on the economy. If it continues to chug along in decent health, then corporate bonds should continue to hold up well. But that could change if it looks like the economy is weakening.

We've got more worried about the economic outlook in the UK in the wake of the Budget. In particular, we worry that the increase in Employer NICs, alongside a higher national living wage, could force employers to cut back their workforces, driving up unemployment and thereby increasing the risk of a recession in the UK. Business leaders are warning that Budget "ripples will be felt across the wider economy".

Against this backdrop, we've been dialling down our exposure to some bond issuers that we think could struggle in more challenging economic conditions. For example, we sold some insurer **Phoenix 7.75% 2053** bonds. The firm's solvency ratio (the metric which measures an insurer's ability to withstand unexpected shocks given all the risks they're exposed to) isn't as strong as that of some of its peers. We also sold some investment firm **M&G 5.625% 2051** bonds.

Against this backdrop, we decided to buy more bonds with strong credit ratings and defensive characteristics (i.e. the bonds of issuers less likely to be impacted directly by a weaker economic backdrop). For example, we bought some **European Investment Bank (EIB) 5.625% 2032** bonds. The EIB is a super well-capitalised supranational development bank and it benefits from the highest possible credit rating. We also bought some **Co-Op Bank 5.579% 2028** bonds. Coventry Building Society is taking over Co-Op and we think this is likely to benefit the prices of Co-Op bonds.

Towards month-end, we got the disturbing news that the UK's social housing regulator had uncovered serious concerns about housing association Notting Hill Genesis' business planning and risk and control frameworks. The regulator concluded that these failings led to "poor outcomes" for the association's tenants. We sold our **Notting Hill Genesis 3.25% 2048s** and **3.75% 2032s**.

Twenty (twenty) vision?

Financial markets don't keep performing in the same way year after year. And adaptability is a critical component in the search for longevity. It's now 20 years since Bryn first began managing the Ethical Bond Fund.

As Bryn explains in [this webcast](#), over that period we've kept adapting to changing market conditions and to broader changes in the world at large. We firmly believe this approach will keep our fund fit for purpose over the next five, 10 and even 20 years!



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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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