RATHBONES

RATHBONE STRATEGIC BOND FUND

QUARTERLY UPDATE JUNE 2024

Government bond markets stayed volatile in the second quarter, though their yields (which run in the opposite direction to their prices) swung less wildly than in the first three months of the year. Meanwhile, corporate bond spreads finished roughly flat after a rally in early May was offset by weakness driven by snap parliamentary elections in France towards the end of the quarter.

More-stubborn-than-expected inflation, especially in the first few months of this year, has kept investors very nervy about how deeply the world's big central banks will be able to cut interest rates by year-end. In the final few weeks of 2023, investors were expecting as many as five or six rate cuts from the US Federal Reserve (Fed) this year. But by the second quarter, they'd reined these expectations back hugely. They anticipated only a couple of cuts from both the Fed and the Bank of England (BoE) at best even as other central banks (most notably, the European Central Bank) got cautious rate-trimming under way.

After the surprise reacceleration in US inflation in the first quarter, it seems to have dipped decisively in the last three months. Here in the UK, April's inflation data (released in May) was a touch higher than expected, but the figure released in June finally dropped to the BoE's 2% target. That marked the first time it hit target in three years. Even more encouragingly, the data released in July shows it holding steady for two months in a row.. At the same time, there are signs on both sides of the Atlantic that the jobs market is cooling. That's important because too-hot employment has been fuelling wage growth, thereby exacerbating inflationary pressures.

Notwithstanding evidence that inflation might finally be crawling back into its box, investors have remained twitchy. That jumpiness has fed through to government bond prices. In the second quarter, the yields on benchmark US 10-year Treasuries traded in a wide-ish range, swinging fairly often and sometimes sizeably as they rose from 4.21% to 4.39%. Likewise, 10-year UK government bond (gilt) yields were volatile as they edged up from 3.98% to 4.18%.

Investor twitchiness on this side of the pond wasn't helped by the extra element of uncertainty injected by campaigning for earlier elections than people had expected in both the UK and France. Our polls here in the UK ended up proving largely shock-free, as explained here. But France's surprise elections rattled continental European bond markets towards quarter-end. Concerns that France's new government might step up public spending, further increasing the country's already mighty debt burden, sparked significant volatility in French government bonds (known as OATs) and also the credit spreads of French companies (particularly banks). We don't hold OATs, but we do hold French corporate bonds. As we explain in more detail below, we trimmed the latter ahead of the final round of voting on 7 July.

Adding to longer-dated gilts, selling Australian government debt

As we've grown more confident that the BoE is gingerly edging towards rate-cutting, we've been gradually increasing our duration (interest rate) exposure, principally by adding to our longer-dated government bonds. Over the quarter, we sold some of our shorter-duration gilts, like the **UK Treasury 0.5% 2029** and the **UK Treasury Index-linked 0.125% 2029** (whose coupons and capital repaid at maturity increase with inflation), and we bought some longer-dated **3.25% 2044, 4.25% 2040**, **1.50% 2053** and **0.5% 2061**.

Last November, we bought some **Australian Federal Government 3% 2033** bonds because we felt they offered good value. By the second quarter, Australian bond yields had fallen by more than UK government bonds, despite Australian inflation proving so painfully stubborn that the Reserve Bank of Australia has all but ruled out a rate cut this year. With prices higher and risks higher, we took the opportunity to take profit and reduce our holding.

Snapping up new issuance and high yield bonds

In stark contrast to the volatility in most big government bond markets in the year to date, credit spreads (the extra yields that corporate bonds offer over government debt to reflect their higher default risks) have been tightening more or less relentlessly, excepting a spike in April and another in June. That overall tightening reflects growing investor confidence that the global economy will manage to swerve a deep recession despite the big increase in borrowing costs over the last couple of years.

But towards the end of the second quarter, uncertainties over France's upcoming elections triggered this year's first meaningful credit spread wobble. As a result, the iTraxx European Crossover Index, which measures that spread, widened from 297 basis points (bps) to 321bps, This volatility was a short-term headwind for credit (especially continental European credit), but we didn't feel it signalled a meaningful worsening in the economic outlook that might risk a nasty deluge of corporate bond downgrades and defaults. Nevertheless, we felt it prudent to trim some of our more subordinated French bank debt that would be repaid only after higher-ranking, more senior borrowing if the issuing bank were to collapse. For example, we sold some of our subordinated French bank **Société Générale 8% and 4.75% perpetual AT1** bonds.

In the event, the French polls delivered political gridlock, with no single party or alliance of parties winning an outright majority. That gridlock means the chances of a massive government spending spree have more or less evaporated. By 8 July, the spread between German government bonds and OATs was about halfway between the highs reached right in the height of the chaos and where they were before the snap election was called. That reflects the challenges that France will face in reducing its government deficit with the current political impasse. European high-yield credit spreads — including those of French banks and other companies — snapped back sharply following month-end, trading at 288bps at the time of writing.

Performance review

	3 months	6 months	1 year	3 years	5 years
Rathbone Strategic Bond Fund	0.64%	2.61%	10.27%	-3.16%	7.40%
IA UK Sterling Strategic Bond Sector	0.48%	1.46%	8.84%	-2.45%	7.46%

	30 Jun 23-30 Jun 24	30 Jun 22-30 Jun 23	30 Jun 21-30 Jun 22	30 Jun 20-30 Jun 21	30 Jun 19-30 Jun 20
Rathbone Strategic Bond Fund	10.27%	-0.73%	-11.53%	7.86%	2.83%
IA UK Sterling Strategic Bond Sector	8.84%	-0.19%	-10.20%	6.13%	3.79%

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

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

Tight spreads mean that corporate bonds offer lower extra returns above government debt. But higher government bond yields mean that investors are still being compensated with historically very attractive yields for holding corporate debt. And that has been generating very strong investor appetite for credit.

Many companies have been responding to this demand and seeking to benefit from tighter spreads (which mean they can secure more attractive financing deals) by issuing new bonds. During the quarter, we bought several newly issued bonds, including some new **Pension Insurance Corporation (PIC) 6.875% 2034** and **Rothesay Life 7.019% 2034** bonds. (PIC and Rothesay are both specialist insurers that are benefiting from the boom in corporate pension schemes transferring their assets and liabilities over to such firms.) We also bought several high yield bonds over the quarter. These included some consumer credit group **NewDay 13.25% 2026s** and infrastructure services and construction company **Kier Group 9% 2029s**, and also some German autoparts supplier **Adler Pelzer 9.5% 2027s**.

In June, Coventry Building Society announced it was asking bondholders to 'tender' (sell back) its **6.875% perpetual AT1** bonds. We hold a sizeable chunk of these bonds. When issuers make tender offers, they can sweeten the deal by offering to buy back the bonds at premium prices. That's just what Coventry Building Society did this time around, giving us scope to lock in attractive price gains on the bonds by tendering them.

Paid to wait

It's not unusual for central banks to take their time in shifting from successive rate rises towards rate cuts. There can be a long lag in higher rates filtering through to impact consumers and businesses directly and slowing too-hot inflation. This time around, that lag seems to have been lengthier than many had expected, probably because of the lingering impact of exceptional spending and saving patterns triggered by the COVID-19 pandemic.

Many bonds now pay yields comfortably above inflation. That means a slower rate-cutting path isn't necessarily a bad thing: investors are being paid quite amply as they wait for cautious policymakers.

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Fund Manager

For more info on our fund, including factsheets, performance and fund manager views, please click here.

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