RATHBONE STRATEGIC 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 iTraxx European Crossover Index, which measures the extra yield (or spread) that corporate debt offers over government bonds for taking on default risks, began the fourth quarter at 426bps and had dropped significantly to 310bps by its end. This has partially unwound in early January, with the spread jumping to 340bps.

Another wild year – but better returns

Last year was a strong one for your fund, beating the average return of funds like ours and landing in the top quartile of the IA Sterling Strategic Bond sector. Yet it was anything but smooth sailing as markets have remained jittery and erratic.

Coming into 2023, the value of our portfolio was significantly less sensitive to changes in prevailing yields than our peers. This 'shorter-duration' positioning meant our bonds, generally, had less time before they matured and paid relatively more in coupons when compared with the capital received at maturity.

With central banks signalling that they would continue raising rates as 2023 progressed, we felt it was best to own less of those government bonds and highly rated longer-dated corporate bonds that have low chances of default and are highly sensitive to changes in yields. This was a bumpy choice in the first half of the year. First, several mid-sized US banks abruptly failed leading the Fed to tilt into crisis easing mode for a couple of months, sending bond yields diving. Yet yields steadily rose as central banks increased rates at a fair clip.

It also, broadly, meant we were taking more 'credit risk' than our rivals, i.e. owning more corporate bonds and those maybe at slightly higher risk of default. We felt the spreads on offer were high (and therefore attractive). Over the year, spreads ground lower, which was good for our fund.

Perhaps the biggest scare of the year was the spate of bank failures mentioned earlier. 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.

Performance review

	3 months	6 months	1 year	3 years	5 years
Rathbone Strategic Bond Fund	6.20%	7.46%	9.89%	-4.80%	8.97%
IA UK Sterling Strategic Bond Sector	6.73%	7.28%	7.83%	-3.3%	12.58%

	31 Dec 22-31 Dec 23	31 Dec 21-31 Dec 22	31 Dec 20-31 Dec 21	31 Dec 19-31 Dec 20	31 Dec 18-31 Dec 19
Rathbone Strategic Bond Fund	9.89%	-14.09%	0.84%	7.50%	6.47%
IA UK Sterling Strategic Bond Sector	7.83%	-11.01%	0.77%	6.55%	9.26%

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.

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 and which 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, it caused quite a stir.

While we held no bonds issued by Credit Suisse (or any of the failed US lenders), a lot of our portfolio is exposed to finance. This meant a bit of a short-term roller coaster as investors panicked about whether this kind of wipe-out could happen elsewhere. We believed that the risks weren't as systemic as many feared and, having re-read the bonds' paperwork, we used the opportunity to add to these sorts of bonds at very attractive prices. 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 prices duly rebounded. We then took profits in these bonds, keeping our holdings of these bonds at roughly the same proportion of the fund as before all the excitement.

We increased our duration slowly from early spring. We felt that the end of the hiking cycle was approaching and the last rate hike in a cycle has historically been the point after which long-dated gilts tend to start performing well. Yields kept rising right up till October, yet because we had relatively less duration risk than our peers, this worked out well for us. On the flipside, our corporate bonds tended to be, proportionally, shorter dated than those of our rivals. And so we didn't make as much from falling credit spreads. The two essentially offset each other, leaving us with performance roughly in line with our peers for the third quarter.

A strong finish

We traded gilts throughout the fourth quarter, buying more when yields rose and selling some of them when yields fell. To do this, we bought and sold the **UK Green Gilt 1.5% 2053** and **0.875% 2033** bonds. In hindsight, we reduced our gilts a bit too early as we didn't anticipate Powell being as dovish as he was at the 18 December press conference. With economic data, especially the jobs market, still relatively robust we had expected the Fed to err on the side of caution.

In November, we bought some **Australian 3% 2033** government bonds because we felt they offered good value. Australia's rates cycle is slightly lagging behind that in the US, UK and Europe, which means the bonds offer an attractive yield with the chance of capital gains if the Reserve Bank of Australia pivots to cutting interest rates in the future. Around the same time we bought several corporate bonds, including some French bank **Societe Generale 8.0%** perpetual bonds. As perpetual bonds, these don't have maturity dates, but they have a feature that allows their issuers to 'call' (redeem) them at specific dates. We think Societe Generale could call these bonds in September 2025 and, in the meantime, we like the very attractive yields they offer in compensation for this callability feature.

Despite the strong run for corporate bonds, we've grown more cautious about the longer-term outlook for some corporate borrowers. In October, for example, we trimmed some of our exposure to high yield, including some airline **Finnair 4.25% 2025** and Dutch cable company **Ziggo 4.875% 2030** bonds. We also sold some of our units in the **Chenavari Toro Income Fund**. It invests in asset-backed securities, bonds that are secured against a pool of assets, like credit card and mortgage loans, and we felt some of these sorts of asset might come under pressure in a recession.

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.

With yields much higher than in past years, we're trying not to hold too much cash in our fund because the amount of interest you lose from being out of the market can cause quite a drag on returns. Besides, there are plenty of quality bonds we can invest in, so we're not short of ideas.

BRYN JONES
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.