RATHBONES

RATHBONE ETHICAL BOND FUND

MONTHLY UPDATE FEBRUARY 2025

The shortest month was far from short on drama. The big themes that had dominated bond markets since the start of the year (sticky inflation, fewer interest rate cuts and worries about fiscal deficits) were swept aside as investors started to worry about weaker economic growth, especially in the US.

The key trigger was US President Donald Trump's back-and-forth on tariffs and trade war escalation. The policies tumbling out of the White House almost daily exerted a heavy toll on investor confidence. Uneasiness was fuelled by the news that US economic growth had slowed at the end of last year, while inflation rose to 3% in January, its highest rate for six months. Investors began to fear the Trump platform might drive the US into stagflation, a nasty mix of sluggish growth and relentless inflation. That drove big sell-offs in US stocks: between mid-February and mid-March, the S&P 500 index had plunged by just over 10% (a drop of this size marks what's known as a full-blown 'market correction').

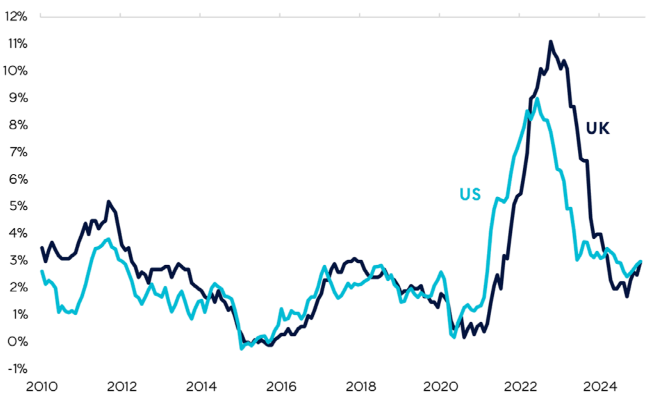
Government bonds rally amid tariff turmoil

As investors fled equities for 'safe haven' government bonds, US Treasuries found favour. That drove the 10-year US Treasury bond yield down from 4.54% to 4.20% (yields move in the opposite direction to bond prices). Here in the UK, the 10-year Gilt yield, which had soared to a high of 4.89% in mid-January, began February at 4.53% and dropped to 4.48% by its end.

Looking ahead, the hard economic data coming out of the US are nowhere near recessionary levels, but growth does seem to be slowing a bit. For bondholders, the main impact of the whole Trump shebang seems to be the extra uncertainty it's added to the outlook for US interest rates (the bedrock for global borrowing costs). US Federal Reserve (Fed) policymakers may get stuck between a rock and a hard place if tariffs and other policy broadsides stall growth and increase unemployment while stoking price pressures.

The Bank of England (BoE) seems in an even stickier spot. UK inflation is on the rise again just as growth seems on the verge of stalling completely.

INFLATION MAKES A COMEBACK



Source: Natural Statistics offices via LSEG to 31 January 2025

Households are glum, businesses are warning they may need to cut jobs and the government is under intense pressure to show its commitment to balancing its books. Big gilt investors have warned Chancellor Rachel Reeves she needs to build up more 'fiscal headroom' (money from the government's tax take to fulfil its spending ambitions without breaking its pledge to rein in borrowing over the next five years). The stakes are high for the chancellor ahead of the Spring Forecast on 26 March, which will include the UK fiscal watchdog's latest report card on the economy and tax receipts. If these rattle Gilt investors, they could demand higher yields to compensate them for their concerns about the health of the government's finances.

As we've explained above, the outlook for interest rates is pretty unclear right now. If price pressures stay on the up, that may constrain big central banks from cutting rates to support flagging economies. That means we don't want to overload our exposure to duration risk (sensitivity to the direction of rates). As a result, we're keeping our duration broadly neutral (i.e. roughly in line with that of peer group funds).

Germany lifts a foot off its debt brake

Meanwhile, Trump's more aggressive, transactional foreign policy has caused massive shifts in geopolitics this year. Certain immutable facts and alliances, built up over decades, have fractured almost overnight. The main one is NATO, the collective security pact that relies on its 32 members being adamant that any attack on one would trigger immediate retaliation by the rest. US equivocation on this point has badly damaged the alliance, perhaps irreparably. But Trump has done more than just put the sledgehammer to an ageing bulwark against the shadow of a Cold War superpower. He has also told the rest of the world, in no uncertain terms, that trade and security will be different from now on.

That's spurred much of Europe to promise to loosen the purse strings and invest heavily in infrastructure and its own defence. Most notably, German Chancellor-in-waiting Friedrich Merz has proposed amending the country's constitution and scrapping the country's debt brake to allow the creation of a 10-year €500bn infrastructure fund and permit essentially unlimited borrowing for defence budgets. If approved, this river of money could flow into a nation that's parched itself of infrastructure investment for years because of a commitment to straitened government finances. Germany's planned fiscal sea-change — along with EU-wide measures also in train — would amount to a complete change in direction for Europe, which has been saddled with underinvestment, anaemic economic growth and ultra-low interest rates relative to the rest of the world. Expectations of higher public spending that might ignite the region's growth prospects sent the 10-year German government bond yield (the benchmark for European borrowing costs) soaring from 2.39% to 2.80% in the first couple of weeks of March. It's hard to explain just how massive that move is! Over the longer term, we think a more dynamic German economy that grows more strongly and borrows more could open up exciting opportunities for bond investors.

Credit market wobbles

Corporate bond markets are sensitive to economic jitters, but held up pretty well in February. The iTraxx European Crossover Index, which measures credit spreads (the extra yield investors get for lending to companies versus 'risk-free' government bonds), widened only very slightly from 288 basis points (bps) to 289bps over the month. But spreads proved less resilient in March, blowing out to as wide as 315bps mid-month before then narrowing again.

That said, spreads are still a lot tighter than average and way below levels we've seen in previous growth scares. Back in late 2022, for example, spreads had widened to almost 640bps amid concerns that the higher interest rates intended to tame inflation would strangle growth. At their current tights, spreads don't suggest investors are expecting the kind of deluge of corporate downgrades and defaults that a recession might entail.

Nevertheless, the very uncertain outlook for growth and rates means we don't want to hold a lot of very long-dated credit. We think that would involve taking on too much extra credit risk: because long-dated credit matures in the distant future, there's more time for a healthy company to deteriorate, increasing the risk of default. Added to that, the business might be hurt by far-off changes in rates themselves, say by having to refinance at higher-than-expected rates of interest.

During the month, we sold some of our **0.875% 2033 Green Gilts** as their prices rallied, to buy corporate bonds that we felt offered attractive value. For example, we added to our **Co-Op Bank 11.75% 2034s**. Coventry Building Society is taking over Co-Op and we think this will boost the price of Co-Op's bonds. We also think there's a chance Co-Op might 'tender' (retire) these bonds early. When issuers make tender offers, they can sweeten the deal by offering to buy back the bonds in question for premium prices. We also added to our **Pension Insurance Corporation (PIC) 6.875% 2034s**. PIC is a specialist insurer that's benefiting from the boom in corporate pension schemes transferring their assets and liabilities to such firms. We view the bonds as attractively valued given the strength of PIC's business.

We also bought some newly issued bonds that we felt offered good value, including some , including some Premier Inn hotel chain owner **Whitbread 5.5% 2032s** and housing association **Places for People 5.375% 2032s**. We sold some bonds whose spreads we felt had got a bit too tight because they were edging very close to their maturity dates, including some specialist insurer **Rothesay Life 3.375% 2026s** and financial services firm **L&G 5.375% 2045s**. And we snapped up some banking group **Investec 9.125% 2033s** and wealth manager **Quilter 8.625% 2033 callable** bonds. We felt these bonds looked particularly attractively priced given our high conviction that the issuers will 'call' (pay them off) early, thereby shortening their expected maturity and, as a result, lowering their rate sensitivity.

A valuable hedge in volatile markets

The fast and furious sell-off in US stocks seems driven, in part, by concerns that US growth is fading as price pressures reignite. But the massive upheaval in global trade and alliances over the last few weeks suggest it's a bit early to know exactly where things are headed.

In the meantime, government bonds have proved their mettle as an effective offset to equity market volatility. The big reset in bond yields over recent years means there's now room for those yields to fall (and their prices to rise) if stock markets suddenly crater.

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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.

This product does not have a UK sustainable investment label because it does not have a specific sustainability objective; however, this product does apply environmental and social criteria as set out in the product's investment policy, including the non-financial objective, which can be found in the prospectus.

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