



# RATHBONES

## RATHBONE ETHICAL BOND FUND

QUARTERLY UPDATE DECEMBER 2024

**This time last year, we were expecting a messy scramble as inflation and interest rates climbed down from their highs. Towards the end of 2024, the descent turned extra twisty as government bond yields (which move in the opposite direction to prices) spiked.**

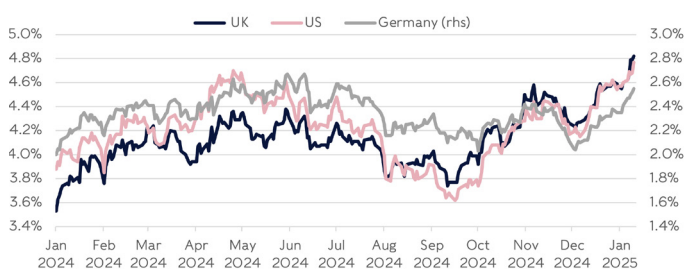
Ahead of the US Federal Reserve (Fed)'s jumbo 0.5% rate cut in September, many government bond yields had dropped to yearly lows. But since then, they've popped much higher. A lot of the selling pressure that's pushed yields up seems driven by nervousness that inflation is proving so sticky that it may not fall back to central banks' targets of around 2% anytime soon. That may force some central banks, especially the Fed, to stall further rate cutting.

The sell-off also seems to have been fuelled by increasing investor unease about global levels of government debt. Many countries already have huge fiscal deficits (gaps between government revenues from taxes and their public spending). And some big borrowers are planning to up their fiscal spending and may issue more sovereign debt to pay for it. Investors have got spooked by the prospect of a big glut in the supply of government debt. When the supply of anything exceeds the demand to buy it, its price will drop. That's making big gilt investors more price-sensitive and demanding a 'fiscal risk premium' (via higher yields) to compensate them for the risks involved in lending to heavy-borrowing governments. Pressure is most intense at the long end of the yield curve because of the extra uncertainties involved in lending very long-term.

The trend higher in yields gained extra impetus when Donald Trump won the US presidential election in November. His promises of lower taxes and higher tariffs seemed like a recipe for more government borrowing and higher US inflation. Against this backdrop, the 10-year US Treasury yield rose from 3.79% at the start of the period to 4.57% at its end. By early January, it had hit 4.79% – one full percentage point higher than at the start of October. That's a really massive move in the usually relatively staid Treasury market!

The US 10-year yield is the bedrock for global borrowing costs, regardless of where you live or invest. When it moves, virtually all other bond yields do too. You can see from the chart below that even the German government bond (bund) yield rose in 2024 and early 2025 even though Germany's national debt to GDP ratio is much lower than that of the US.

### UK 10-YEAR TREASURY YIELD SETS THE TREND FOR ALL



Source: FactSet; data to 10 January

### Gilt market turbulence

As we explain [here](#), the global bond storm blasted the gilt market in the New Year. The 10-year gilt yield, which had risen from 4.01% to 4.57% in the final quarter of 2024, soared to as high as 4.90% in the first half of January. At the time of writing, the severe pressure on gilts had eased a bit. But we're braced for further bouts of volatility. The steep increase in the government's borrowing costs risks deepening its fiscal hole. Some big gilt investors are reported to have warned the government it may need to hike taxes if it can't meet its key pledge to cover day-to-day spending from its tax take.

The gilt market turmoil was an uncomfortable start to 2025. But the rise in gilt yields since September does mean that longer-duration gilts in particular now offer a very generous yield. Even if the prices of long-dated gilts don't recover swiftly to their previous highs, they're offering very attractive 'carry' – the income you get from holding bonds even if their prices don't budge.

We were very active in managing our exposure to duration (sensitivity to rates) throughout 2024. We were underweight duration at the start of the year as we felt investors had priced in more rate cuts than central banks would likely deliver. As hopes of bold cuts were upended by strong US economic growth and sticky inflation, we added some duration back in spring and early summer. We then reduced it again after August's 'manic Monday' market meltdown over fears that an unexpected rise in US unemployment might signal a looming recession and kept paring it back in the run-up to the Fed's September rate cut.

In the final quarter, we added to duration once more as investors reined back their rate cut expectations. We did this by adding to our long-dated **Green Gilts 1.5% 2053s**, switching into them from shorter-dated **Green Gilt 0.875% 2033s**. At the close of the year, our duration was somewhere between broadly neutral (i.e. roughly in line with that of peer group funds) and slightly long versus our peers.

**Performance review**

	3 months	6 months	1 year	3 years	5 years
<b>Rathbone Ethical Bond Fund</b>	-0.45%	2.68%	5.07%	-4.25%	3.89%
IA UK Sterling Corp. Bond Sector	-0.33%	2.12%	2.57%	-5.83%	-0.46%

	31 Dec 23- 31 Dec 24	31 Dec 22- 31 Dec 23	31 Dec 21- 31 Dec 22	31 Dec 20- 31 Dec 21	31 Dec 19- 31 Dec 20
<b>Rathbone Ethical Bond Fund</b>	5.07%	10.08%	-17.21%	-0.41%	8.94%
IA UK Sterling Corp. Bond Sector	2.57%	9.42%	-16.10%	-1.92%	7.77%

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 bought the first-ever **Australian Federal Government Green Bond 4.25% 2034** in June because we felt it offered good value. Towards year-end, Australian government bond yields had drifted quite a bit lower than gilt yields, and their prices were correspondingly higher. We took this opportunity to take profits on these bonds and sold some to add to our higher-yielding Green Gilts.

**Is the UK economy in trouble?**

At the start of 2024, there was quite a bit of scepticism about whether corporate bond markets could keep powering ahead given the volatility in government bond (rates) markets. But, bar a few short-lived blow-outs in credit spreads over the summer (around the time of France's fractious elections and August's 'manic Monday'), they narrowed for most of 2024. The iTraxx European Crossover Index, which measures those spreads, hit a yearly low of around 290 basis points (bps) soon after Trump's election win, though spreads widened very slightly from 311bps to 314bps over the final quarter as a whole.

Going into year end, most measures of spreads were at multi-decade lows. When spreads get this tight, they can't tighten much more. But they can widen a lot if anything goes wrong.

What happens from here largely depends on the economy. So far, it's proved surprisingly resilient, especially in the US. If that continues, then corporate bonds should continue to hold up well. But the UK economy seems to have hit a rough patch.

Businesses have warned that the big tax rises announced in the Budget (mainly higher Employer National Insurance Contributions (NICs) and the lower threshold at which they kick in) will impact the wider economy. They've warned they could bring some combination of higher prices, reduced profits, lower wage increases or lower employment. All this seems to have put the brakes on UK economic growth. In mid-December, the Bank of England (BoE) announced that the economy was doing worse than it had expected and probably didn't grow at all in the fourth quarter of last year.

Against this backdrop, we slightly trimmed our exposure to credit risk in the final quarter and sold some bonds from issuers that we felt might be challenged in tougher economic circumstances. For example, we sold some UK insurance firm **Phoenix 7.75% 2053s, 5.87% 2029s** and **5.63% 2031s** because we had some concerns about the strength of its solvency ratio (the metric which measures an insurer's ability to withstand unexpected shocks given all the risks they're exposed to).

When credit spreads widen, those of bonds with weaker credit ratings and which mature a long way ahead tend to widen most. As a result, we added to our bonds with particularly strong credit ratings and defensive characteristics (i.e. the bonds of issuers less likely to be affected directly by tougher economic circumstances). For example, we bought some sterling-denominated **European Investment Bank (EIB) 5.63% 2032s, 0% 2028s** and **5% 2039s**. The EIB is a supranational – an institution established by the governments of two or more countries to pursue specific policy objectives. This government backing means the EIB benefits from the highest possible credit rating.

In addition, we're concentrating our credit risk exposure at the short-end to 'belly' (middle part) of the yield curve. Credit curves are 'inverted' at the long end (i.e. longer-term credit spreads are tighter than shorter-term ones) so we're paid less to own long-dated than shorter-dated credit. As we've mentioned above, we think limiting our credit spread duration should help mitigate the impact of any credit spread blow-outs.

We've also been adding to bonds that rank higher in companies' capital structures. Moving up the capital structure means you own bonds that are less subordinated – you're nearer the front of the queue to get paid back if the issuer were to run into trouble. And more senior, less subordinated debt tends to hold up better when credit spreads widen.

### Buckled up for a bumpy ride

We're still expecting global bond yields to edge lower this year, but it's likely to be a bumpy ride. We think the BoE will likely proceed cautiously in rate-cutting for now, but that could change if the cracks appearing in the UK economy start to suggest a more serious slowdown is looming.

In retrospect, we may have upped our duration a little bit early given the gilt market's New Year gyrations. But we're comfortable with our duration exposure looking ahead. If gilt yields across short to very long maturities dip below their current 4.5-5.5% level at some point, they could offer very decent capital gains.

In the meantime, gilts are paying very generous levels of income. And their juicy yields reinforce their ability to serve as a valuable counterweight if the prices of stocks and other 'risk assets' 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.

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.

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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