



RATHBONE HIGH QUALITY BOND FUND

MONTHLY UPDATE OCTOBER 2024

Among all the types of investments, it's government bonds that are generally regarded as the steadiest Eddies. But their yields (which rise as their prices fall) have been very far from steady since mid-September.

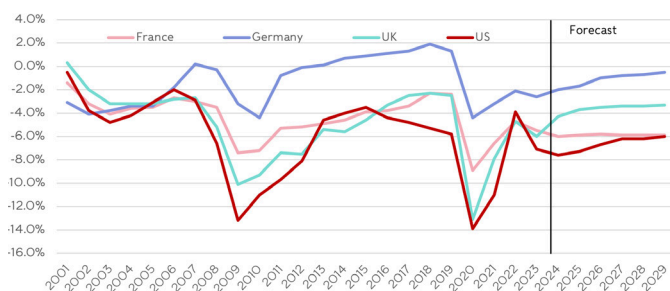
The yields on US, UK and many eurozone government bonds have all jumped significantly. The catalysts differ a bit from country to country. But, overall, these moves suggest investors are reining back expectations of a steady decline in long-term government bond yields.

Bond yields tend to fall alongside interest rates when central banks ease monetary policy. So it seems a bit strange that they've been rising as the US Federal Reserve (Fed), Bank of England (BoE) and European Central Bank (ECB) press ahead with interest rate cuts. But central banks control only short-term borrowing costs. They have less influence on the yields and prices of longer-dated government debt. Longer-term borrowing costs tend to be associated more with what investors think will happen to inflation and economic growth in the future than with what central banks are doing right now.

Rising levels of government debt seems to be driving the recent spike in longer-term government bond yields. As the chart below shows, most major developed countries are struggling to rein in their budget deficits (the gap between government expenses and revenues). And that's led to a glut in the supply of government debt. Supply and demand are key in determining bond prices, so all the extra supply is exerting downward pressure on prices. At the same time, investors worry that extra government spending funded by new debt issuance could reignite inflation, meaning central banks will cut rates less and more slowly.

SPENDTHRIFT GOVERNMENTS BECOME MORE OF A RISK

Government deficit/surplus as percentage of GDP



Source: IMF; data is general government net lending/borrowing and doesn't include Trump policies

Why are gilt yields rising as interest rates fall?

To focus on the UK, the 10-year UK government bond (gilt) yield was 4.01% at the start of the month and had risen to 4.45% by month-end. At the time of writing, it was just below 4.50%.

We think this spike was driven by three main catalysts:

1. Investors realised that the Labour government's first Budget on 30 October would bring more government borrowing. The big increase in how much the government plans to borrow raised the 'risk premium' on UK government debt – simply put, big investors in gilts demanded more interest in return for lending more. They also feared that all that extra spending might stoke inflation, forcing the BoE to rein in rate-cutting.
2. Like virtually all other nations' bonds, gilt yields take their cues from US Treasury yields. So the big rise in Treasury yields since mid-September explains at least part of the rise in gilt yields. The 10-year US Treasury yield soared by around three-quarters of a percentage point between mid-September and mid-November when it very nearly hit 4.50%. The surge seems initially to have been due to concerns that the next US President would ramp up government spending and/or cut taxes, spurring economic growth and fuelling inflation, while also swelling the supply of Treasuries. When Donald Trump won the Presidency, those concerns intensified given his promises of tax cuts, higher tariffs on imported goods and mass deportations that could raise labour costs. Investors concluded all that could add up to higher inflation and fewer Fed rate cuts. They also worried about a bigger budget deficit under Trump. You can find out more [here](#).
3. Finally, while very recent UK economic data has been a bit disappointing, things have been looking a bit brighter over the last few months. That encouraged investors to expect the BoE to cut rates at a measured pace, rather than hastily. Aggressive rate-cutting tends to happen only when central banks fear a recession is just around the corner.

Despite the intense volatility in government bond markets over the last couple of months, credit spreads (the extra yield that corporate bonds offer over government debt to reflect their higher default risks) have continued to tighten. Over the month as a whole, the ICE Bank of America Sterling Corporate Bond Index, which measures credit spreads, narrowed from 115 basis points (bps) to 107 bps. And it tightened to as low as 99bps in mid-November when Trump's victory drove a big rally in US stocks, probably driven in large part by hopes of another round of corporate tax cuts. (Corporate bonds usually don't quite match the performance of equities when the latter is on a bull run, though they tend to hold up better when investors rein in their appetite for riskier assets.)

Overall, we think credit spreads are looking fairly tight, although we're still finding attractive pockets of value. And investor demand for corporate bonds remains very strong. That should help limit the extent of any sell-offs in credit, as long as we avoid a nasty recession that brings lots of corporate downgrades and defaults.

Balancing on the yield curve

Bonds that mature in a long time are usually expected to yield more than those maturing sooner. Investors expect to be paid more interest for taking on the extra risks involved in lending for longer (it's more difficult to predict what inflation and economic growth will look like in many years than nearer term). That means the yield curve which measures the interest payable on government debt across lots of different timeframes usually slopes upward. But the big rise in long-term yields over the last couple of months has resulted in a super-flat curve, i.e. you're paid virtually the same yield to borrow for 10 years as you are for one.

Given big central banks' commitment to policy easing, we don't think it's necessarily going to stay as flat as it's been recently. And if the yield curve normalises in the way we expect, short-term bond yields will fall more than longer-term ones from here – what's known in the trade as a 'bull steepening'.

As a result, we've been selectively extending our duration (interest rate risk) exposure and buying some slightly longer-dated bonds that mature in about five years' time. This is known as the 'belly of the curve' and it's where we think we'll get the most capital gains from falling yields: short-dated enough that their yields fall by a sizeable amount, but long-dated enough that the price gain is significant as well. For example, in October, we snapped up some newly-issued Dutch bank **ING 4.875% 2029s**, **Royal Bank of Canada 4.875% 2030s** and **Co-operative Rabobank 4.875% 2029s**. We funded these purchases by selling some shorter-dated bonds we felt were now looking a bit pricey, including some **Bank of Montreal 5.125% 2028s**, **NatWest 6.375% 2027s** and US insurance firm **Massmutual 1.375% 2026s**. In addition, we sold some of our Spanish bank **Santander 4.875% 2028s** to buy some of its longer-dated **5.375% 2031s**. As well as giving us more duration exposure, the latter also offers a more attractive credit spread than the 2028s.

Buying eurozone bonds

Among the big central banks, we think the ECB could be the most persistent on the rate-cutting front. Inflation isn't proving quite as sticky in the eurozone as it is in either the US or the UK and, across the region as whole, growth is painfully anaemic.

In addition, we think there's a risk that the Trump administration's mooted universal tariffs on imports to the US could hit Europe particularly hard. The region is highly export-dependent and the US is its biggest market. The risk of that kind of growth hit could encourage the ECB to cut rates more often than the Fed or the BoE. That would exert meaningful downward pressure on the yields of short-dated eurozone government debt and also on the value of the euro.

We've been increasing our exposure to bonds likely to benefit from such trends. For example, in October we bought some euro-denominated **Coventry Building Society 3.125% 2029s** and **Nationwide Building Society 2.25% 2029s**.

We funded these purchases by selling some sterling-denominated **East Japan Railway 1.162% 2028s** that we felt looked a bit pricey and some sterling French bank **BFCM (Banque Fédérative du Crédit Mutuel) 5% 2029s**. While we're pretty positive on the outlook for some eurozone banks, French banks are a bit of an exception. France hasn't made much progress in resolving the political uncertainty that resulted from its inconclusive summer elections. If political risks flare up again, we worry that they could drive French banks' credit spreads wider so we opted to trim our exposure slightly with the BFCM sale.

Seeking stability in shorter-dated credit

As we've explained above, bond markets have been very volatile over the last couple of months. That volatility has been most intense at the long end of rates markets. With government borrowing unlikely to slow and big uncertainties about the outlook for inflation and economic growth, those gyrations seem unlikely to go away soon. Our focus on high quality short-dated credit means we can buy bonds offering attractive yields without taking on a lot of duration risk that might imply exposure to the greater price swings that come with volatility in rates.



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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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