



## RATHBONE HIGH QUALITY BOND FUND

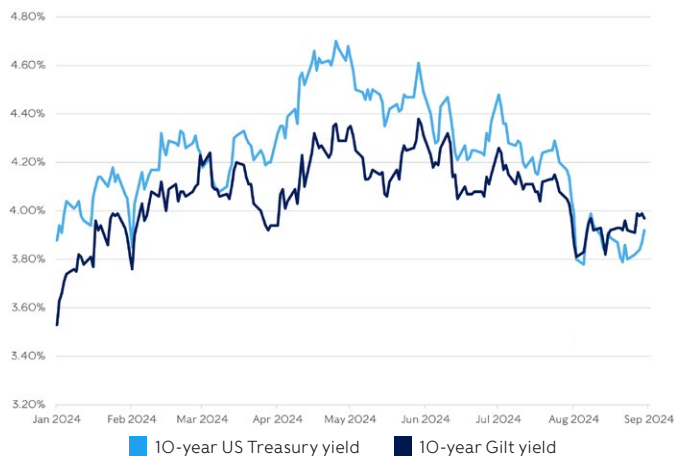
MONTHLY UPDATE AUGUST 2024

**Fears that the US economy might be slipping into a recession, alongside the unwinding of investments funded by a cheap yen, triggered an extreme, but short-lived, bout of panic in financial markets at the start of the month. As stock markets around the world tumbled, government bond yields also dropped and their prices rallied.**

By month-end, equities had basically recovered what they'd lost. But the volatility improved the backdrop for bonds. Many investors rushed to the safety of government bonds during the stock market meltdown and government debt was further supported by a fast, sizeable shift in expectations about how far and how fast the US Federal Reserve (Fed) will cut interest rates. By month-end, investors were expecting around 100 basis points (bps) in Fed cuts across its three remaining rate-setting meetings this year. That's about double the level they'd expected in late July and suggested a cut at every meeting, including one of 50bps.

Against this backdrop, the yield on the benchmark US 10-year Treasury fell from 4.03% at the start of the month to a panicked low of 3.78% on 5 August. By month-end it had backed up a bit to 3.91%. While the yields on US Treasuries fell to their lowest levels in more than a year, UK government bond (gilt) yields bucked the downward trend. In fact, the 10-year UK government bond (gilt) yield rose from 3.97% to 4.02% in August. That was because UK economic data was surprisingly strong, persuading investors that the Bank of England (BoE) would likely take its time cutting rates despite trimming them by 25bps at the start of the month.

### BONDS HOLD ON TO THEIR GAINS



Source: FactSet, Rathbones

### Recession risks

Early August's equity market upheaval was driven mainly by a couple of bad US economic data releases, including manufacturing and crucially jobs and payroll data. Tight Fed monetary policy in the form of high interest rates has reined in soaring prices without squeezing too much juice out of the economy. But it can't do that forever. Keeping rates too high for too long risks tipping the economy into a recession and triggering high unemployment. Unemployment is deemed a lagging indicator of economic downturns. By the time it's rising, a recession may already be under way. Investors have been getting edgy for a while that the US economy might be weakening so early August's bad jobs report really played into their fears.

They seem to have been extra-spooked by the simultaneous mass unwinding of lots of 'yen carry trades'. Those trades had involved global investors borrowing cheaply in yen and then ploughing the money into investments elsewhere to earn a nice easy 'carry'. When the Bank of Japan announced a surprise interest rate rise on 31 July, that drove up the value of the yen and triggered the unwinding of yen carry trades worth hundreds of billions of dollars.

Only a few days after US recession fears peaked, investors began to calm down. Equity markets bounced back quickly after the release of a contradictory jobs report (which showed jobless claims falling) and very positive services sector data, soon followed by the news that US inflation in July had dipped below 3% for the first time in more than three years. Evidence that the US economy wasn't about to keel over, alongside positive inflation data, bolstered investor confidence in a 'soft landing' for the US economy. That scenario is positive for 'risk assets' like stocks and corporate bonds. As a result, the ICE Bank of America Sterling Corporate Bond Index spread (the extra yield that corporate debt offers over government bonds for taking on default risks), which had started the month at 110bps and then briefly blew out to 121bps, ended the month at 115bps.

### How far will the Fed go?

At the annual central bankers' shindig in Jackson Hole (Wyoming) in late August, Fed chair Jerome Powell made it crystal clear that US rates would be cut in September. The Fed seemed to have concluded that the balance of risks had tilted towards monetary policy being too tight, rather than not tight enough. Although Powell officially declared that rate-cutting was about to start, he left all options open in terms of the scale and speed of Fed policy changes.

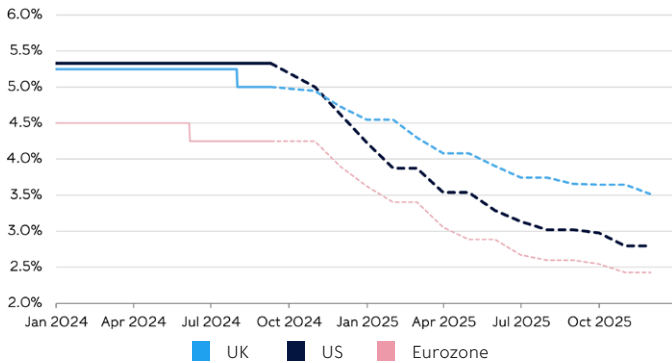
Some of the Fed's counterparts have, of course, already got cutting under way. BoE governor Andrew Bailey signalled at Jackson Hole that he was comfortable with more rate reductions after the BoE's initial cut at the start of the month. But he's been pretty cagey about the pace of cuts so it came as no big surprise that the BoE kept rates on hold at its September rate-setting meeting.

Now that August's market mayhem is behind us, we believe we're in a pretty positive environment for fixed income. Government bonds should be well supported by central banks' commitment to policy easing and we're not expecting credit spreads to blow out again without a big rise in defaults or downgrades (and that seems unlikely in a 'soft landing' scenario.) At the same time, we're seeing investor appetite for bonds gain extra momentum as investors have begun to prioritise recession protection over inflation protection. The negative correlation between stock and bond prices is reinforcing confidence in bonds' vital role in broad investment strategies by potentially providing a hedge against weak economic growth and mitigating stock market volatility.

That's creating a desire to own bonds for reasons of capital gain, as well as income accrual. At the same time, the yields currently available on both interest-rate sensitive government debt and growth-oriented investment grade credit are a lot more attractive than they've been for many years. That huge reset means bond yields offer very decent buffers against any further volatility in bond prices, while also offering investors a way to achieve their long term return objectives through income yields alone.

When interest rates start to get cut, longer-dated bonds rally most. We felt that the big shift in investor expectations about the scale and speed of cuts in August might have driven up the prices of longer-dated bonds a bit too much. As a result, we pared back our longer duration (more interest rate-sensitive) bonds selling some of our longest-dated bonds, including some **Inter-American Development Bank 4.75% 2029** bonds and some **UK Gilt 1.625% 2028s**. We also sold some NatWest 6.375% 2027 bonds to buy some **Bank of Montreal 5.125% 2028** bonds instead. When spreads temporarily widened early in the month, we took the opportunity to buy some Dutch bank **ING 3% 2026** bonds which we felt looked attractively valued. We also snapped up some newly issued US insurance firm **Massmutual 4.625% 2029** bonds that, likewise, we felt were attractively priced.

**AGRESSIVE RATE CUTS ARE PRICED IN FOR NEXT YEAR**



Source: DataStream, Rathbones the dashed lines are future rates implied by bond markets as of 31 August 2024

**STOP PRESS: The Fed's bumper rate cut**

As things turned out, I was out and about when the Fed announced a bumper 50bps rate cut on 18 August. Here are some initial thoughts:

**“This was a very exciting Fed meeting... we went into it with the most uncertainty about a rate decision in about 15 years. However, whilst the vast majority of the attention was on the size of the rate cut, we were just as interested to see the updated dot plot. Despite starting with a 50bps cut, it is worth noting that the median dot suggests another 50bps for the remainder of 2024, and another 100bps for 2025, while the Fed's estimate of the long-term neutral rate again shifted higher.**

**We think these forecasts show that while the Fed has started with a 50bps rate cut (which it had the flexibility to do, given the level of rates), we should not expect to see a rapid, deep rate cutting cycle without a deterioration in employment data. When we look at what is priced into markets, and assuming some curve normalisation as part of the rate-cutting cycle, we think it supports the case for relatively short-dated credit.”**

I'll be giving a more considered view on the Fed's cut (as well as the BoE's decision to keep rates on hold) and explaining what I think lies ahead for bond markets, in our upcoming In Conversation video which will be available at the end of September. (You can sign up [here](#).)



**STUART CHILVERS**  
Fund Manager

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