



# RATHBONES

## RATHBONE HIGH QUALITY BOND FUND

MONTHLY UPDATE NOVEMBER 2024

### **Government bond markets have remained edgy as investors grapple with uncertainties associated with a Trump presidency in the US, plus Budget-related fall-outs this side of the pond.**

Early in the month, Americans voted decisively to elect Donald Trump as president. The immediate response was a big wobble in US bond markets. Trump's policy agenda (widespread tax cuts, higher tariffs and restricted immigration) could add up to higher US inflation and interest rates – bad news for bond investors.

The 10-year US Treasury yield, the benchmark for US and global borrowing costs, began November at 4.28%, briefly spiked to around 4.45% after Trump's win and then fell back again to 4.18% by month-end. That retreat seems likely to be an acknowledgement that the Trump playbook suggests his bark can be worse than his bite. Some policy pledges may prove more negotiating tactics than concrete plans. And, of course, it's still some time before he even sets foot in the Oval Office (inauguration day is 20 January).

Most investors are confident that the US Federal Reserve (Fed) will cut rates again when it holds its final rate-setting meeting on 17-18 December. That would amount to one full percentage point in cuts from the Fed in 2024. After that, we're firmly in 'wait and see' mode. US inflation has been edging very slightly higher over the last couple of months, suggesting Fed policymakers will be cautious about pressing ahead with bold rate cuts.

Uncertainty about the inflation outlook, in part due to the potential policies of a second Trump presidency, is a good part of the reason why government bond yields have been popping higher. Another part is the expectation that the already ginormous US fiscal deficit (the gap between government expenses and revenues) could swell still further given Trump's promised tax cuts. The US government isn't alone in living beyond its means. Most major developed countries have struggled to rein in their fiscal deficits, especially since the pandemic. For a long while, big investors in government bonds haven't worried too much about countries piling up their borrowing. But that now seems to be changing as concerns grow that it could result in too much debt supply for bond markets to absorb.

As we explained last month, investors have got decidedly twitchy about just how much the Labour government plans to scale up its borrowing. Labour's first Budget on 30 October signalled it intends to borrow around an extra £30 billion per year over the next five years and to hike taxes by around £40 billion per year (mostly by increasing Employer National Insurance Contributions (NICs) and halving the threshold at which they kick in). On Budget day itself, the 10-year gilt

(UK government bond) yield stood at 4.31%, but it had risen to well above 4.50% by the first half of November. The surge seems driven by worries about the big increase in government debt supply alongside fears that businesses might try to offset their higher costs by raising prices, forcing up inflation and ensuring the Bank of England (BoE) cuts rates less and more slowly. By month-end, those fears had eased a bit and the 10-year gilt yield had dropped to 4.24%. But the Budget fall-out shows that investors are demanding extra compensation (via higher yields) when lending to governments that keep issuing more and more debt.

That was very much in evidence towards the end of the month when France got shoved into the hot seat. Ever since its inconclusive parliamentary polls over the summer, France has been stuck in a political gridlock. Parliament is divided into three fractious blocs, none of which enjoys a commanding majority. When Prime Minister Michel Barnier tried to force through an austerity Budget aimed at reining in France's mighty deficit, his opponents united to oust him. President Emmanuel Macron is now struggling to appoint another prime minister who might be able to forge some sort of consensus. In the meantime, investors have been voting with their feet. In late November, France's borrowing costs briefly surged above those of Greece – once deemed the Eurozone's riskiest borrower. Those costs have since come down a bit, but investors are still demanding a hefty risk premium to hold French debt rather than German bunds. As a precautionary move, we trimmed some of our French bank **Credit Agricole 4.875% 2034s** and bought some US life insurer **MassMutual 4.625% 2029s** instead. (The latter benefits from a higher credit rating than Credit Agricole.)

Among the big central banks, we think the European Central Bank (ECB) could be the most persistent on the rate-cutting front. Inflation isn't quite as sticky in the eurozone as it is in either the US or the UK and regional growth in Europe 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. It 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.

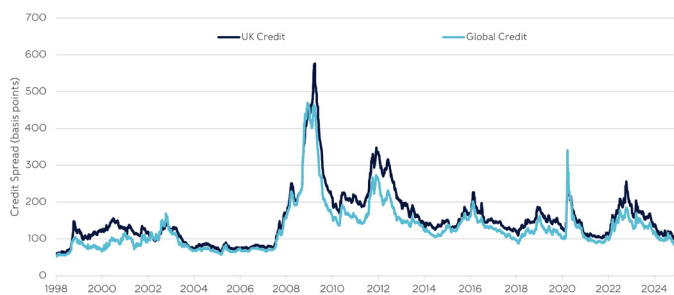
That would exert meaningful downward pressure on the yields of short-dated eurozone government debt and also on the value of the euro. We've been increasing our exposure to bonds whose prices are likely to benefit from these trends. For example, we sold some of our sterling **1.75% 2029s** issued by **Motability**, the business that leases cars, scooters and powered wheelchairs to people with disabilities, to buy some of its euro-denominated **4% 2030s** instead. Likewise, we sold some sterling **Royal Bank of Canada 5% 2028s** to buy some euro-denominated UK building society **Nationwide 2.25% 2029** covered bonds.

**Buying more covered bonds**

We've bought quite a few covered bonds this month. They get their name because they're backed ('covered') by a pool of high-quality assets on the issuer's balance sheet (like mortgages and public sector lending, for example). If the issuer were to run into trouble, these pools are protected from the claims of its other creditors. That puts covered bonds at the top of the issuer's capital structure – they're at the front of the queue to get paid back before other borrowings. This extra layer of credit protection means that covered bonds typically benefit from particularly strong credit ratings.

Despite the volatility in government bond markets, credit spreads (the extra yield that corporate bonds offer over government debt to reflect their higher default risks) have kept grinding lower. The ICE Bank of America Sterling Corporate Bond Index, which measures credit spreads, narrowed from 107 basis points (bps) to 102 bps.

**CORPORATE BOND SPREADS ARE EXTREMELY LOW**



Source: FactSet; data 1 January 1998 to 29 November

As we approach year-end, most measures of this spread are at multi-decade lows. And 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. If it continues to chug along in decent health, then corporate bonds should continue to hold up well. But that could change if it looks like the economy is weakening.

We've got more worried about the economic outlook in the UK in the wake of the Budget. In particular, we worry that the increase in Employer NICs, alongside a higher national living wage, could force employers to cut back their workforces, driving up unemployment and thereby increasing the risk of a recession in the UK. Business leaders are warning that Budget "ripples will be felt across the wider economy".

Against this backdrop, we want to own bonds with very strong credit ratings and defensive characteristics (i.e. the bonds of issuers less likely to be impacted directly by a weaker economic backdrop). When we could, we've been buying bonds that rank higher in companies' capital structures (as we've explained above, that puts you nearer the front of the queue to get paid back if the issuer runs into difficulties). For example, we sold some of our **NatWest 3.619% 2029** bonds to buy some of its newly issued **5% 2029s** that rank higher in its capital structure. In a similar vein, we sold some of our Belgian bank **KBC 5.5% 2028s** to buy some UK lender **Lloyds 6% 2029** covered bonds.

**Seeking stability in high-quality short-dated credit**

The largely relentless tightening in credit spreads this year means we've got our eyes peeled for any signs of economic weakness that might drive them wider. That being said, given the high-quality and short-duration nature of this fund, we expect the price impact of any widening to be relatively limited. Moreover, the yields on offer from these bonds mean we feel we're being compensated for the risk being taken.



**STUART CHILVERS**  
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.

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