RATHBONES

RATHBONE HIGH QUALITY 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').

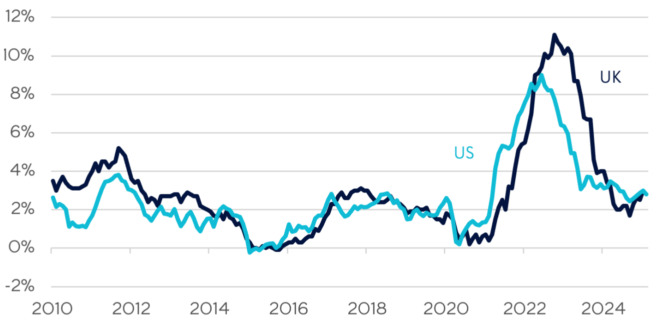
Government bonds rally amid tariff turmoil

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: Office for National Statistics, LSEG; data for February 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 were high for the Chancellor ahead of the Spring Forecast on 26 March, which included the UK fiscal watchdog's latest report card on the economy and tax receipts. While she managed to stave off an emergency, concerns remain. If the government can't put these concerns to bed in coming months, gilt investors may demand yet higher yields to compensate them for their concerns about the health of the government's finances.

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 ICE Bank of America Sterling Corporate Bond Index, which measures credit spreads (the extra yield investors get for lending to companies versus 'risk-free' government bonds), widened from 88 basis points (bps) to 94bps over the month.

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 more than 250bps amid concerns that the higher interest rates intended to tame inflation would strangle growth. At their current tight levels, spreads don't suggest investors are expecting the kind of deluge of corporate downgrades and defaults that a recession might entail. Moreover, when credit spreads widen, those of bonds with weaker credit ratings and which mature a long way ahead tend to widen most. We believe our focus on short duration, high quality investment grade credit should help insulate our fund from bouts of spread volatility.

During the month, we bought some newly issued bonds that we felt offered good value, including some Dutch bank **ABN Amro 4.75% 2029s** and **Rabobank 4.875% 2030s** as well as some Swedish bank **Swedbank 4.875% 2030s**. We sold some bonds issued by a couple of US insurance firms, notably some **MassMutual 1.375% 2026s** and **MetLife 4.125% 2025s**, to buy some slightly longer-dated MetLife 4.5% 2027s instead.

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, 'safe haven' government and quasi-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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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.

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.

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