RATHBONES

RATHBONE HIGH QUALITY 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.

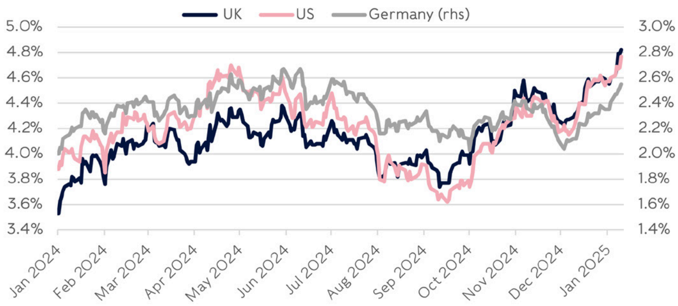
Ahead of the US Federal Reserve (Fed)'s jumbo 0.5% rate cut in September, many government bond yields had dropped to yearly lows. But since then, they've popped much higher. A lot of the selling pressure that's pushed yields up seems driven by nervousness that inflation is proving so sticky that it may 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.

US 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 (the yield had fallen to 4.65%). 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 it was a timely reminder that investing in shorter-duration bonds (as we do in this fund) can limit sensitivity to aggressive swings in government bond yields, and, as a result, should help to limit drawdowns when such swings occur.

In the final quarter, we added to our exposure to 'duration' (the sensitivity of a bond's value to changes in rates) by buying some slightly longer-dated bonds towards the 'belly' (middle part) of the yield curve, mainly some **UK Treasury 4.5% 2028s** and also some Dutch bank **ING 4.875% 2029s**, We see the belly as a bit of a sweet spot because the yields of bonds maturing at this part of the curve could snap back particularly significantly, offering scope for sizeable price gains.

Performance review

	3 months	6 months	1 year	3 years	5 years
Rathbone High Quality Bond Fund	0.41%	2.45%	3.83%	1.72%	3.09%
Bank of England Base Rate + 0.5%	1.33%	2.76%	5.68%	13.30%	14.82%

	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
Rathbone High Quality Bond Fund	3.83%	7.61%	-8.97%	-1.53%	2.93%
Bank of England Base Rate + 0.5%	5.68%	5.16%	1.95%	0.61%	0.73%

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.

A tougher backdrop for corporate borrowers?
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 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 ground lower for most of 2024. The ICE Bank of America Sterling Corporate Bond Index, which measures those spreads, narrowed from 115 basis points (bps) on 30 September to a yearly low of 91bps in the final quarter. The spread started the year at 134bps.

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 that could change if it looks like the economy is weakening.

The growth outlook looks pretty patchy in most places apart from the US. In mid-December, the Bank of England (BoE) announced that the UK economy was doing worse than it had expected and probably didn't grow at all in the fourth quarter of last year. Europe's big economies, like France and Germany, seem to be struggling too. And the IMF is warning that Trump's plans for universal tariffs on imports to the US (which imports more than any other country) risk depressing growth rates world-wide.

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 also to our 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. In the final quarter, 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.

Buying more covered bonds
We bought quite a few covered bonds during the quarter, including some euro-denominated UK building society **Nationwide 2.25% 2029s**, some **Commonwealth Bank of Australia 3% 2026s** and some Spanish high-street bank **Santander 5.75% 2026s**. Covered bonds 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 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. The Commonwealth Bank of Australia and Santander bonds, for example, have the strongest possible (AAA) credit ratings.

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. In mid-December, credit rating agency Moody's downgraded the country's long-term sovereign debt rating because of concerns that political volatility will constrain the country's ability to tackle its huge fiscal deficit. Because we felt this downgrade would hit some French banks' credit ratings too, driving their credit spreads wider, we opted to trim our exposure slightly and sold some of our sterling French bank **BFCM (Banque Fédérative du Crédit Mutuel) 1% 2026s**.

Buckled up for a bumpy ride

We're expecting the BoE to cut rates around four times in 2025, which suggests there's scope for short-dated gilt yields to fall further. Even if concerns about fiscal sustainability trigger more bouts of gilt market volatility, longer-dated gilts are likely to be impacted most. The shorter-dated nature of this fund suggests that such volatility would have less effect on its performance.

The largely relentless tightening in credit spreads this year means we've got our eyes peeled for growing economic weaknesses 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 high quality, short-dated credit 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.

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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