

RATHBONE SICAV ETHICAL BOND FUND

MONTHLY UPDATE JANUARY 2025

Government bond markets had an uncomfortable start to 2025 as investors demanded more compensation for the risks associated with sticky inflation and big fiscal deficits (the gaps between what governments spend and the income they get from taxes).

Ahead of the US Federal Reserve (Fed)'s jumbo 0.5% interest rate cut in September, many government bond yields dropped to yearly lows. But ever since, they've largely been rising (and their prices falling) as investors have worried that inflation isn't falling fast enough to allow central banks to cut rates much. The sell-off in US Treasuries intensified at the start of the year amid fears that President Donald Trump's commitment to tariffs and tax cuts risked stoking US inflation. That drove the 10-year US Treasury yield up from 4.57% at the start of the month to nearly 4.80% by mid-January.

Gilt sell-off sparks largest ever demand

Gilt markets followed suit and sold off too. Because investors were already worried about the UK government's decision to ramp up spending in its Autumn Budget, the spike in gilt yields quickly developed into a nasty 'doom loop'. Higher yields increased the government's borrowing costs, fuelling worries that it might run out of 'fiscal headroom' (the money it has available to fulfil its spending ambitions without breaking its pledge to rein in borrowing over the next five years). Those worries, in turn, drove investors to demand yet higher gilt yields to compensate them for their concerns about the tricky state of the government's finances. As a result, gilts sold off even more aggressively than Treasuries: the 10-year gilt yield had soared from 4.57% at the start of the month to almost 4.90% by mid-month.

The pressure on gilt yields was most intense at the long end of the yield curve because of the extra uncertainties involved in lending very long term. By mid-month, the 30-year gilt yield had hit an unwelcome milestone as it rose to more than 5.40% for the first time since the late 1990s.

Then markets came to the rescue: yields at multi-decade highs attracted a wave of demand from investors. In January, DIY investors on investment platform Hargreaves Lansdown bought more than double the amount of gilts they did a year earlier. And institutional investors got involved as well. Two syndicated gilt sales in January and February – where a few big investment banks line up big customers to buy direct from the government – had the highest demand ever recorded. Customers offered £119 billion in January and £140bn in February in deals only looking for £8.5bn and £13bn respectively. Notably, about a third of the gilts placed went to overseas investors.

Along with the news that UK inflation eased 0.1% to 2.5% in December, this helped calm yields. Although, inflation continued to rise in January, with the US rate hitting 3.0% and UK inflation reaccelerating dramatically to 3.1% in numbers released after month end. Having fallen back to 4.54% by the end of January, 10-year gilt yields had risen again to around 4.60% by the time of writing. As their prices had rallied, we pared back some of our longest-dated government bonds, selling some **1.5% 2053 Green Gilts** to buy some shorter-dated **0.875% 2033 Green Gilts** instead.

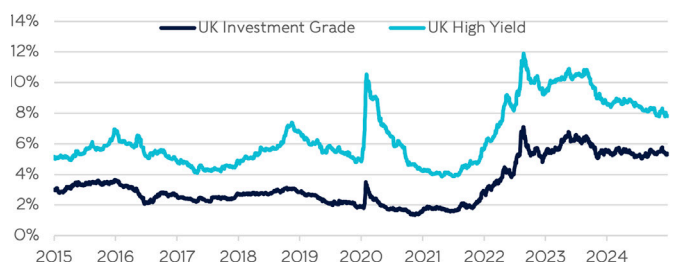
We're not out of the woods yet inflation-wise. The Bank of England (BoE) has warned that it expects UK inflation to rise quite a bit by the autumn (largely because of higher energy and transport prices) before falling back once more. This tempered initial optimism on potential rate cuts after two BoE policy-setters voted for a half-percentage-point cut when the bank made a 0.25% reduction in early February.

The BoE's inflation warning was part of the pretty grim forecasts that accompanied that rate cut. It slashed this year's GDP growth forecast from 1.5% to just 0.75%, saying that the Budget increase in employers' National Insurance Contributions would hit both jobs and prices more than it had initially expected. Rising inflation alongside super-s sluggish growth would represent a tricky dilemma for UK policymakers.

Corporate bond markets tend to be sensitive to economic jitters. So it's surprising that credit investors have shrugged off all the gloomy headlines about impending trouble from President Trump's tariffs and a UK slowdown. Credit spreads (the extra yield investors get for lending to corporates over 'risk-free' government bonds) were tight by historical standards at end of last year. They tightened yet further in January, with the spread, as measured by the iTraxx European Crossover Index, narrowing from 314 basis points (bps) to 288bps.

While spreads are relatively tight, the yields on offer from high quality corporate bonds are attractive and well above their longer-term averages. As this chart shows, investment grade bonds currently offer yields once only available from riskier high yield.

GOOD QUALITY NOW OFFERS GENEROUS YIELDS



Source: FactSet, Rathbones: ICE BofA Sterling Corporate Bond Index YTW, ICE BofA Sterling High Yield Index YTW

Adjusting exposure to insurers, buying new issues

As we explain [here](#), we've been worried for a while that the UK might hit a rough patch. As a result, we've been dialling down our exposure to bonds issued by firms that might come under pressure in tougher economic circumstances. For example, we further trimmed our UK insurance firm **Phoenix 7.75% 2053** bonds during the month because of concerns about the strength of its solvency ratio (the measure of an insurer's ability to withstand unexpected shocks given all the risks they're exposed to).

We also sold some Swiss insurance giant **Zurich 5.125% 2052** and **3% 2051** bonds. Zurich's subsidiaries include one of California's largest insurers. The Los Angeles wildfires may end up being one of the mostly costly natural disasters in US history and could result in billions of dollars' worth of insurance claims. If Zurich's subsidiary is forced to pay out mega-claims, there's a risk that could dent its parent's solvency ratio.

We bought some insurer **Direct Line 4.75% Perpetual** bonds. Insurance giant Aviva recently launched a takeover bid for its smaller rival Direct Line, the latest in a wave of takeovers and acquisitions across the UK financial services industry. We expect the Aviva deal to benefit the prices of Direct Line's bonds.

When companies issue new bonds, they generally try to attract investors to buy them by offering this debt at a slightly wider spread than similar bonds already being traded. This is known as the 'new issue premium'. Because there's a lot of investor demand to buy corporate bonds, many issuers have been dialling down their new issue premiums. That's made us extra-picky about the new bonds we buy, though we're still finding some offering decent new issue premiums. Over the month, for example, we bought some new **Leeds Building Society 5.5% 2031s** and Spanish **Banco Santander 5.63% 2031s** that we felt offered good value. We also bought some new French state-owned railway **SNCF 5.88% 2055 green bonds**. (The firm has a strong track record in issuing green bonds to fund rail infrastructure intended to support the transition to lower-carbon transport.)

A silver lining in stormy weather?

We're still expecting global bond yields to edge lower this year, but it could be a bumpy ride with fiscal concerns coming to the fore and complicating the interest rate outlook still further.

We'll learn more about the state of the UK's public finances when Chancellor Rachel Reeves gives her Spring Forecast on 26 March. That will include the UK fiscal watchdog's latest outlook for the economy and tax receipts. Gilt investors will be watching closely.

Bouts of market volatility are always unsettling. But it's important to remember that higher bond yields present opportunities as well as risks. Generous yields offer the prospect of durable, long-term income streams. And with yields relatively high, it reduces the price falls that accompany any further increase in yields.



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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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