RATHBONES

RATHBONE STRATEGIC BOND FUND

MONTHLY UPDATE OCTOBER 2024

Among all the types of investments, it's government bonds that are generally regarded as the steadiest Eddies. But their yields (which rise as their prices fall) have been very far from steady since mid-September.

The yields on US, UK and many eurozone government bonds have all jumped significantly. The catalysts differ a bit from country to country. But, overall, these moves suggest investors are reining back expectations of a steady decline in long-term government bond yields.

Bond yields tend to fall alongside interest rates when central banks ease monetary policy. So it seems a bit strange that they've been rising as the US Federal Reserve (Fed), Bank of England (BoE) and European Central Bank press ahead with interest rate cuts. But central banks control only short-term borrowing costs. They have less influence on the yields and prices of longer-dated government debt. Longer-term borrowing costs tend to be associated more with what investors think will happen to inflation and economic growth in the future than with what central banks are doing right now.

Rising levels of government debt seem to be driving the recent spike in yields. Supply and demand are key in determining bond prices: the glut in supply is exerting downward pressure on prices. At the same time, investors worry that extra government spending funded by new debt issuance could reignite inflation, meaning central banks will cut rates less and more slowly.

Why are gilt yields rising as interest rates fall?
To focus on the UK, the 10-year UK government bond (gilt) yield was 4.01% at the start of the month and had risen to 4.45% by month-end. At the time of writing, it was just below 4.50%.

We think this spike was driven by three main catalysts:

1. Investors realised that the Labour government's first Budget on 30 October would bring more government borrowing. The big increase in how much the government plans to borrow raised the 'risk premium' on UK government debt – simply put, big investors in gilts demanded more interest in return for lending more. They also feared that all that extra spending might stoke inflation, forcing the BoE to rein in rate-cutting.

2. Like virtually all other nations' bonds, gilt yields take their cues from US Treasury yields. So the big rise in Treasury yields since mid-September explains at least part of the rise in gilt yields. The 10-year US Treasury yield soared by around three-quarters of a percentage point between mid-September and mid-November when it very nearly hit 4.50%. The surge seems initially to have been due to concerns that the next US President would ramp up government spending and/or cut taxes, spurring economic growth and fuelling inflation, while also swelling the supply of Treasuries. When Donald Trump won the Presidency, those concerns intensified given his promises of tax cuts, higher tariffs on imported goods and mass deportations that could raise labour costs. Investors concluded all that could add up to higher inflation and fewer Fed rate cuts. They also worried about a bigger budget deficit (the gap between government expenses and revenues). You can find out more here.

3. Finally, while very recent UK economic data has been a bit disappointing, things have been looking a bit brighter over the last few months. That encouraged investors to expect the BoE to cut rates at a measured pace, rather than hastily. Aggressive rate-cutting tends to happen only when central banks fear a recession is just around the corner.

There have been quite a few times this year when we've felt that government yields had fallen too much, largely because we felt investors were hoping for more rate cuts from the Fed and the BoE than we expected.

But the rise in longer-dated government yields over the last couple of months has, in our view, been too extreme. For example, the 30-year gilt yield hit more than 5.0% in early November.

As the chart below shows, except for a brief spike a year ago, it hasn't been that high for well over 20 years. We felt that meant longer-dated gilt yields looked exceptionally attractive, so we bought more **UK Treasury 4.25% 2040s**, **0.5% 2061s** and **1.5% 2053s**, switching into them from shorter-dated **3.25% 2033s**. We went farther afield, too, picking up **Australian Government 3% 2033s** at what we felt was an attractive yield.

LONG-DATED GILTS YIELD OVER 5%

Source: Bloomberg; data to 21 November

Corporate bonds hold up
Despite the intense volatility in government bond markets over the last couple of months, credit spreads (the extra yield that corporate bonds offer over government debt to reflect their higher default risks) hardly budged in October. The iTraxx European Crossover Index, which measures credit spreads, widened only very slightly from 311 basis points (bps) to 314bps. But it subsequently tightened to as low as 290bps in early November when Trump's victory drove a big rally in US stocks, probably driven in large part by hopes of another round of corporate tax cuts. (Corporate bonds usually don't quite match the performance of equities when the latter is on a bull run, though they tend to hold up better when investors rein in their appetite for riskier assets.)

Overall, we think credit spreads are looking fairly tight, although we're still finding attractive pockets of value. And investor demand for corporate bonds remains very strong. That should help limit the extent of any sell-offs in credit, as long as we avoid a nasty recession that brings lots of corporate downgrades and defaults.

While the UK economy has been humming along reasonably steadily, we've got a bit more worried about the economic outlook. In particular, we worry that the Budget increase in Employer National Insurance Contributions, alongside a higher national living wage, could force employers to cut back their workforces, driving up the unemployment rate and so increasing the risk of an economic slowdown.

Against this backdrop, we decided to buy more bonds with strong credit ratings and defensive characteristics (i.e. those from issuers less likely to be affected directly by tougher economic circumstances). For example, we bought some sterling-denominated **European Investment Bank (EIB) 0% 2028s**. The EIB is a supranational – an institution established by the governments of two or more countries to pursue specific policy objectives. This government backing means the EIB benefits from the highest possible credit rating.

We pared back some of our exposure to bonds issued by specialist insurers and reinsurers given a spate of recent costly catastrophes (including things like the Baltimore bridge disaster and a very brutal Atlantic hurricane season). For example, we sold some UK reinsurer **Lancashire Holdings 5.63% 2041s** and some UK specialist insurer **Beazley 5.5% 2029** bonds. We also sold some US homebuilder **Adams Homes 9.25% 2028s**. Compared with many other US homebuilders, Adams' business is unusually concentrated in relatively few states. These are in the south-east and include Florida, Georgia and the Carolinas, which bore the brunt of Hurricanes Helene and Milton. Given the massive structural damage these hurricanes caused, we worry that Adams could struggle to maintain 'business as usual'.

We recalibrated our high-yield exposure, selling some units in the **Pareto Nordic Corporate Bond Fund**, which holds a diversified portfolio of Nordic high-yield bonds, as well as some of our Greek bank **Piraeus Financial 7.25% 2034s**. Instead, we bought some UK soda ash producer **We Soda 9.5% 2028s** and some Italian winemaking equipment manufacturer **Della Toffola 7.34% 2031s**.

Locking in higher yields
While higher yields are putting a dent in the prices of government bonds, they also bring higher coupon (income) payouts. That means investors are being paid very attractive levels of income, regardless of whether there's any change in their value. With big central banks all committed to policy easing, we think there's a ceiling on how much further government bond yields will rise from here. Indeed, it seems pretty likely to us that gilt yields across short to very long maturities will dip below their current 4-5% level at some point. And if that happens, decent capital gains are on offer.

If you'd like to hear more from us, please register here to listen in to Bryn's webcast on 3 December in which he'll be sharing some of the key insights he's gained in the 20 years he's been managing bond funds at Rathbones.

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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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