



RATHBONES

RATHBONE STRATEGIC BOND FUND

QUARTERLY UPDATE SEPTEMBER 2024

After a long, long wait, monetary policy easing has finally begun in earnest in the US and UK. Government bond yields tend to fall alongside interest rates when central banks ease monetary policy, leading to higher prices. This time around, government bond yields fell only briefly on relief that rates are heading lower as investors began to re-evaluate whether the BoE and Fed will keep cutting at the pace they'd hoped.

Ever since UK inflation fell to the Bank of England (BoE)'s target of 2% in June, investors have been impatient for the central bank to get cracking with its first rate cut in this cycle. At the start of August, the BoE cut rates by 0.25%, while signalling it intended to proceed cautiously. It kept rates on hold in September even as the US Federal Reserve (Fed) finally joined the rate-cutting club and opted for a double-strength 0.5% cut.

Fed chair Jerome Powell called its move a "good strong start" in policy easing, arguing that it was needed as US inflation continues to fall and concerns about the health of the US jobs market have grown. He described the unusually big cut as a "recalibration" of Fed monetary policy, seeming to suggest it wouldn't serve as a guide for the size of future cuts to come.

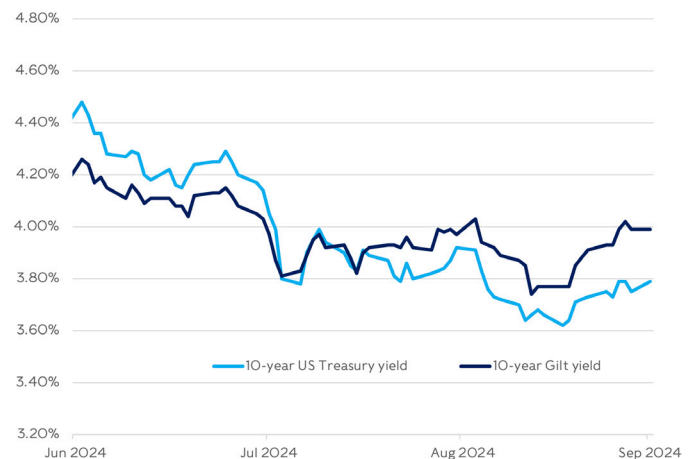
Big rate cutting tends to take place when central banks fear a recession is on the way. But, by and large, economic data in both the UK and the US is proving surprisingly good. The UK economy is growing more slowly than in the first half of the year, but it's still humming along quite nicely. And American GDP is growing by about 3% a year. That's higher than the trend of many years (barring the year of post-pandemic reopening). Yes, a rash of poor jobs data in early August fuelled a pessimistic turn in investors' views on the US economy. But there's since been a punchy rebound in some of the figures, painting a very different picture.

That raises questions about how much and how quickly the BoE and Fed will cut without a so-called economic hard landing. And that's driven investors to row back their expectations on the size and pace of rate cuts, pushing UK government bond (gilt) and US Treasury yields higher and their prices lower. (In continental Europe, by contrast, a tougher economic backdrop suggests that the European Central Bank is stepping up the rate-cutting it began back in June.)

The rates rally unravels

Because gilts and US Treasuries rallied a lot in August, we thought there was a good chance that their yields might subsequently unravel a bit. In the event, the yield on 10-year US Treasuries fell from 4.39% at the start of the quarter to as low as 3.66% in the first half of September, before then rising back up again. By mid-October, the 10-year Treasury yield had climbed above 4.0% for the first time since August. Gilt yields tracked a similar path. The 10-year gilt yield fell from 4.18% at the start of the quarter to as low as 3.76% in mid-September. But it had risen to 4.01% by quarter-end and to above 4.20% by early October.

BOND YIELDS RISE AS DATA SURPRISES



Source: FactSet, Rathbones

Some of that rise in gilt yields may have been exacerbated by investor jitters about how much the Labour government is planning to borrow when it unveils its first budget on 30 October. Investors can get spooked if they think governments intend to borrow above their means and will have to issue lots of new debt to pay for their spending plans. Remember former Prime Minister Liz Truss's mini-budget back in 2022? That sparked panic in gilt markets when the government announced tax cuts without explaining where it would get the money to pay for them. Investors feared much more gilt issuance than they'd expected, causing the UK's borrowing costs to skyrocket.

Chancellor Rachel Reeves is adamant that the Labour government won't repeat those "disastrous mistakes". Nevertheless, memories of the mini-budget are fresh enough in investor minds to raise some anxiety about gilt supply as the budget approaches and that may be triggering a bit of extra volatility in gilt prices.

Performance review

| | 3 months | 6 months | 1 year | 3 years | 5 years |
|--------------------------------------|----------|----------|--------|---------|---------|
| Rathbone Strategic Bond Fund | 3.26% | 3.92% | 12.53% | -0.27% | 9.63% |
| IA UK Sterling Strategic Bond Sector | 3.22% | 3.71% | 11.78% | 0.30% | 8.72% |

| | 30 Sep 23-30 Sep 24 | 30 Sep 22-30 Sep 23 | 30 Sep 21-30 Sep 22 | 30 Sep 20-30 Sep 21 | 30 Sep 19-30 Sep 20 |
|--------------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| Rathbone Strategic Bond Fund | 12.53% | 7.60% | -17.64% | 5.51% | 4.19% |
| IA UK Sterling Strategic Bond Sector | 11.78% | 4.94% | -14.49% | 4.63% | 3.59% |

Source: FE Analytics; data to 30 September, I-class, mid price to mid price.

These figures refer to past performance, which isn't a reliable indicator of future returns.

We felt that investors had got over-optimistic about the likely scale and speed of rate cuts, driving up the prices of long-dated government bonds a bit too much over the last few months. As a result, we sold some of our longest-dated gilts, including some **3.25% 2044s** and **1.5% 2053s** ahead of the BoE and Fed moves. When their prices later dipped, we added to the **2044s** again as a cost-effective way to manage our duration (interest rate risk) exposure.

As we explained last month, corporate bonds got caught up in August's big equity market sell-off driven by fears of a looming US recession. But most of the panicked surge in credit spreads (the extra yields that corporate bonds offer over government debt to reflect their higher default risks) reversed very quickly. Over the quarter as a whole, the iTraxx European Crossover Index, which measures credit spreads, narrowed from 321 basis points (bps) to 311bps. We're not expecting spreads to blow out again without a big rise in defaults or downgrades (and that seems unlikely if central banks manage to pull off a soft economic landing.)

We bought some newly issued bonds from a couple of UK insurers, notably **Just Group 6.875% 2035s** and **Aviva 6.125% 2054s**. Before issuing these bonds, Just Group and Aviva had 'tendered' (retired) some earlier issuance - we'd owned the Just Group bonds that it bought back in this tender offer. (When issuers make tender offers, they can sweeten the deal by offering to buy the bonds in question back at premium prices.) We also bought some French insurer **La Mondiale 4.8% 2048s**; we think that La Mondiale could well make a tender offer for these bonds at some point.

Emerging market debt tends to perform well when big central banks, especially the Fed, start to ease monetary policy. For the first time in a while, we added to our emerging market sovereign debt and bought some **Republic of South Africa (RSA) 7.3% 2052** and **5.875% 2032** government bonds. These offer very attractive yields and we expect South Africa's new coalition government to continue to make progress in bolstering the country's financial stability. We also bought a couple of bonds issued by emerging market corporates, notably some **Mauritius Commercial Bank 7.95% 2028s** and some Peruvian renewable energy producer **Kallpa Generacion 4.875% 2026s**. We sold a couple of high yield bonds issued by firms whose businesses we felt might see their profitability weaken, including some Chile-based **Latam Airlines 13.375% 2029s** and some German autoparts supplier **Adler Pelzer 9.5% 2027s**.

Last November, we bought some **Australian Federal Government 3% 2033** bonds because we felt they offered good value. But Australian bond yields have been falling by more than gilt yields, despite Australian inflation proving so painfully stubborn that the Reserve Bank of Australia has all but ruled out a rate cut this year. With prices higher and risks higher, we reduced our holding earlier this year and we sold more of the bonds this quarter.

Beyond the Fed's bumper cut...

Global government bond yields have been very sensitive to forecasts of rate cuts – especially to the expected path of US rates. Contradictory and volatile economic data, along with circumspect guidance from policymakers, has led the market to second-guess the path of rates many times over the past 12 months. This is likely to continue.

Nevertheless, we believe the outlook for fixed income investments is positive. Government bonds should be supported by the gravitational pull of lower rates as long as inflation stays in check, while also benefiting from their role as valuable protection from any further equity market volatility.

And gradual policy easing is a plus for corporate bonds too – it shows that the BoE and the Fed currently feel that a nasty recession that might drive a big blow-out in credit spreads probably isn't right around the corner.



BRYN JONES
Fund Manager

For more info on our fund, including factsheets, performance and fund manager views, please click [here](#).

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.

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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