RATHBONES

RATHBONE HIGH QUALITY BOND FUND

MONTHLY UPDATE FEBRUARY 2024

Government bonds remain under pressure as investors trim their bets on how quickly and how much central banks might cut interest rate cuts this year.

Those holding out hope that rate-cutting could start this spring had those hopes dashed as inflation eased less than had been expected. Last month's US inflation data was hotter than estimated even as inflation continued to drop from its June 2022 peak of 9%. Moreover, this month's data (covering February) had been expected to show the annual inflation rate staying at January's level of 3.1%, but came in higher at 3.2%. Inflation is also proving stubbornly sticky in both the UK and continental Europe.

It seems to be persistently high services inflation that's keeping inflation above central banks' target of 2%. As its name suggests, services inflation measures prices driven mainly by the cost of employing people to deliver services (eating out, entertainment, etc). It's not dropping by as much as the cost of goods because people will spend money on everyday services like a haircut or a meal in a restaurant even when they're more cautious about buying big ticket goods, like a new car or laptop. Services inflation has also stayed high because it's heavily influenced by wages, which are still rising because tight labour markets are forcing companies to pay up to attract and retain staff.

Investors rein in rate cut bets

Central banks have warned time and again that there will be bumps in the road to target inflation. And they insist they're in no rush to drop rates because of concerns that cutting too soon could reignite price pressures.

Not too long ago, investors were forecasting as many as six rate cuts from the Fed this year. But they've scaled down their rate cut bets significantly as the central bank has pushed back on these expectations. Investors currently expect the Fed to deliver only about three 0.25% cuts in 2024. That's broadly in line with what the US Federal Reserve (Fed) has indicated is the likeliest outcome (other central banks haven't given such clear guidance, but their rhetoric suggests something in the same ballpark.)

This has driven down the US 10-year government bond price, pushing its yield up from 3.92% at the start of the month to 4.25% by 29 February. UK government bond (gilt) yields have followed suit, with the 10-year gilt yield rising from 3.80% to 4.13%.

Central banks may have quashed hopes of rate cuts as early as this spring, but they are signalling that rates will likely move lower in the second half of the year. Because we expect government bond prices to rally when this happens, we felt February's pull-back in prices offered a good opportunity to add to our duration (interest rate) exposure cheaply. As a result, we added to our **UK Gilt 1.625% 2028s**.

But credit keeps powering ahead

Although government bond prices have rallied hard and then fallen almost as forcefully over the last few months, corporate bond markets have kept powering ahead. Credit investors still seem confident that central banks will pull off a 'soft landing' and manage to slow the economy down enough to cool inflation without tipping it into the kind of harsh recession that might result in a deluge of corporate defaults and downgrades.

US economic growth in particular has been stronger than expected over the last few months. Things are less rosy in the UK, but even here it looks like Bank of England Governor Andrew Bailey might have got it right when he recently responded to the news that the UK fell into a mild recession in the second half of 2023 by arguing that our economy was now showing "distinct signs of recovery". Even if this proves over-optimistic, the risk of a really savage recession driven by much higher borrowing costs does seem to have receded.

With investors seeming to buy fully into a soft landing narrative, the extra yield (or spread) that corporate debt offers over government bonds to compensate for default risks continues to tighten. The ICE Bank of America Sterling Corporate Bond Index spread (the extra yield that corporate debt offers over government bonds for taking on default risks) began the month at 129 basis points (bps) and had tightened to 119bps by month-end.

We're still finding plenty of attractive credit opportunities in shorter-dated investment grade (high-quality) corporate bonds. Many of these bonds' yields come close to those on offer from longer-term corporate bonds. This means they can deliver attractive carry (coupon income) alongside less credit and duration risk because of their shorter maturity. In February, for example, we bought some attractive newly issued French co-operative bank **Banque Fédérative du Crédit Mutuel 5% 2029** bonds.

We bought these bonds after selling others that had performed well, including some lender **NatWest 6.625% 2026** bonds. We also sold some insurer **Just Group 3.5% 2025** bonds. These are subordinated bonds that rank lower in the company's capital stack (which means these debts would be paid back only after more senior borrowings if the company were to default). Because we think there's a risk that the big credit rally could stall, or even reverse, at some point, we prefer to hold higher ranking bonds when we can.

Income yields are at multi-year highs

The recent uptick in US inflation is a salutary reminder that financial markets and big economies rarely glide along entirely smoothly. There are likely to be plenty more bumps in the road towards lower inflation and lower rates.

But the yields now available on both interest-rate sensitive government debt and growth-oriented investment grade credit are a lot more attractive than they've been for many years. That huge reset means bond yields offer very decent buffers against any further volatility in bond prices, while also offering investors a way to achieve their long-term return objectives through income yields alone.

We continue to believe that both government and corporate bonds have potentially rewarding roles to play in investment portfolios. And pairing government bonds with credit can help mitigate risks outside the most likely assumed scenario of a mild economic downturn (for example, a nasty resurgence in inflation or a painful recession).

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.

Rathbones Asset Management

8 Finsbury Circus
London EC2M 7AZ
+44 (0)20 7399 0000
Information line:
+44 (0)20 7399 0399
ram@rathbones.com
rathbonesam.com