RATHBONE HIGH QUALITY BOND FUND

QUARTERLY UPDATE MARCH 2024

US inflation ran hot and investors reined in their interest rate cut expectations in the first quarter, putting immense pressure on government bonds. But corporate bonds continued to rally.

At the beginning of the year, investors were confident that the US Federal Reserve (Fed) would deliver around six 0.25% rate cuts this year, perhaps starting as early as March. But persistently sticky inflation, alongside a roaring US jobs market, have forced them to rein those bets in big time.

The Fed came under a lot of fire for its insistence that the pressures that drove US inflation up to a peak of 9.1% in mid-2022 would prove “transitory”. It will be acutely aware that cutting rates too much and too soon this year might risk inflation getting stuck at an uncomfortably high level — or even reaccelerating. That would damage its credibility badly.

Hopes of early US rate cuts wane

Investors no longer see much chance of the Fed cutting rates any time soon. Most expect around two 0.25% cuts in the second half of 2024, though a fair few think the Fed might not cut at all this year. Because government bonds are the asset class most sensitive to rate moves, this reassessment has driven bond yields up significantly, forcing down their prices.

The benchmark 10-year US Treasury yield stood at 3.87% at the end of last year. By the end of the first quarter, it had soared to 4.21%. And it’s kept moving higher in April on more evidence that US inflation is creeping higher. At the time of writing, the yield is around 4.65% — much higher than it was last summer when the Fed was still raising rates! UK 10-year yields have risen as well (from 3.54% to 3.98% during the quarter) and have continued rising in early April, hitting 4.35% as we write. The big variation is in shorter-term bonds, which tend to be a better barometer of expected changes in central bank interest rates. The gap between the yield of the two-year US Treasury and the two-year gilt is double what it was at the start of the year, because many expect the Bank of England (BoE) to cut rates well before the Fed. The BoE should be able to move earlier because the UK’s economy is much weaker and inflation appears to be more under control this side of the Atlantic.

We felt that the rally in government bond prices at the start of the year was way too strong and that yields could well back up. But, equally, we didn’t want to pare back our duration (interest rate) exposure too much because it’s government bonds that will rally most when rates do get cut.

The inflation and rate-cutting picture seems a bit clearer in the UK and Europe than it does in the US. Indeed, at the BoE’s most recent rate-setting meeting, BoE Governor Andrew Bailey seemed positively itching to cut rates. He announced the UK’s latest inflation data was “very encouraging and good news” and signalled that cuts were on the way. We traded the **UK Gilt 1.625% 2028** during the quarter, selling the bonds early in the year because we felt their yields had dropped too much and then buying them in February as their prices cheapened.

While corporate bonds have kept rallying

Even though government bonds had a turbulent first quarter, corporate bond markets kept powering ahead. Credit investors grew increasingly confident that high interest rates aren’t about to tip economies into harsh recessions that might result in a deluge of corporate defaults and downgrades.

With investors seeming to buy fully into a ‘soft landing’ for the global economy, the extra yield (or spread) that corporate debt offers over government bonds to compensate for default risks continued to narrow. 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 quarter at 134 basis points (bps) and had tightened to 114bps by its end. This has reversed a bit in April as disappointments about the path of US rates (which are the global benchmark for borrowing costs), more trouble in the Middle East and a sell-off in Continental stock markets weighed on corporate bonds. At the time of writing, the spread had crept back up to 119bps.

The outlook for economic growth certainly seems a bit more positive than it did at the beginning of the year, April credit spread wobbles aside. This has been particularly important in the UK and Europe, where things have been pretty dire for quite a while. There’s more evidence each day that the UK and Europe are now emerging from last year’s stagnation/mild recessions. Monthly GDP data showed that the UK grew again in February after an upwardly revised performance in January, so it’s highly likely that the economy returned to growth in the first quarter as a whole. Yet UK inflation is expected to fall sharply again in the next set of monthly figures, with Ofgem’s energy price cap falling this April. UK headline inflation could very soon be well *below* the BoE’s 2% target, as food inflation also falls a lot further.

Performance review

	3 months	6 months	1 year	3 years	Since Launch 16 Nov 18
Rathbone High Quality Bond Fund	0.63%	4.83%	6.42%	-1.53%	11.71%
Bank of England Base Rate + 0.5%	1.39%	2.82%	5.50%	9.20%	3.34%

	31 Mar 23-31 Mar 24	31 Mar 22-31 Mar 23	31 Mar 21-31 Mar 22	31 Mar 20-31 Dec 21
Rathbone High Quality Bond Fund	6.42%	-3.89%	-3.73%	4.23%
Bank of England Base Rate + 0.5%	5.50%	2.80%	0.69%	0.60%

Source: FE Analytics; data to 31 March, I-class, mid price to mid price.

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

Against this backdrop, we are finding plenty of attractive 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 (i.e. there's less time before maturity for rates to change and defaults to occur). During the quarter, for example, we bought some attractive newly issued bonds from several French banking groups, buying some new **Banque Populaire and Caisse d'Epargne (BPCE) 4.875% 2030**, **Credit Agricole 5.375% 2029** and **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**.

Income yields are at multi-year highs

The stickiness of 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.

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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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