

RATHBONES

RATHBONE STRATEGIC BOND FUND

MONTHLY UPDATE AUGUST 2026

August reinforced the message that bond markets have entered a more demanding phase. While broad unease about the scale of developed governments' spending abounds, the month's sharp rise in government bond yields was actually driven by expectations that central banks will hike interest rates by roughly a full percentage point. While the Bank of England (BoE) held off raising after month-end, the US Federal Reserve did start tightening once more, taking the benchmark overnight rate to the 3.75-4.00% band. We used the broad-based weakness in global government bond yields to add to our 'duration' (the sensitivity of our portfolio's value to changes in interest rates).

We think central banks are more likely to make one to two hikes over the coming year, depending on how the Middle East conflict proceeds and how it flows through to Western inflation via energy and fertiliser prices. That's roughly half the tightening that the market expects. Here in the UK especially, domestic inflation is weak, employment data is uninspiring, and the risks remain skewed to recession as opposed to an overheating economy. While the Middle East energy shock will likely push the BoE to hike rates, that would make the chance of an economic recovery even less probable. Given the much stronger starting point for the US economy (partially driven by AI capex spending), that's where we see the greatest chance of a central bank being able to deliver rate hikes in line with current market pricing.

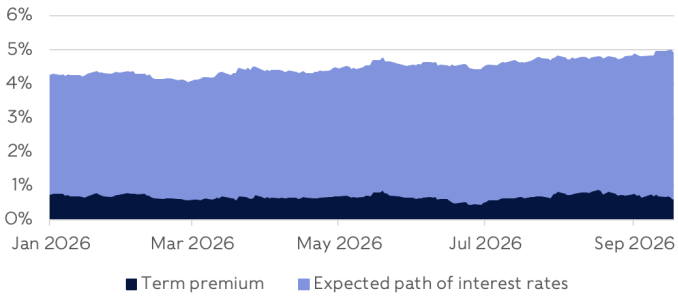
While the market effects of worsening government fiscal deficits and greater borrowing are higher than they've been in recent years, and these concerns are cropping up a lot in news coverage, they aren't the primary driver of recent upticks in yields. As you can see from the chart below, the US 'term premium' – the portion of a government bond yield that can't be explained by the market's expectations of how short-term rates will shift in the future – has actually fallen back in the last month or so. This term premium is influenced by several factors, but generally rises with uncertainty about the path of rates and falls when the market is more benign or when safe-haven assets are in high demand.

Concerns about heavy government borrowing and supply-and-demand dynamics are exerting a greater influence on both government bond and credit markets than in previous years, however. And higher yields are making public debts look increasingly unsustainable. We are taking this risk seriously. Yet, given that much of the most recent uptick in yields has been driven by what we think are overly aggressive forecasts of rate hikes, we felt it was prudent to increase our duration as bonds sold off.

Putting repricing in context

Investors are now demanding much higher yields: most developed countries' 10-year government bond yields have spiked much higher over the last couple of months. The 10-year US Treasury yield, for example, was 4.47% at the start of June and had risen to just above 5.0% at the time of writing, while the 10-year gilt yield rose from 4.90% to more than 5.30% over the same period.

FUTURE RATE HIKES LARGEST DRIVER OF HIGHER US 10-YEAR YIELDS



Source: New York Fed; Adrian, Crump, and Moench model-implied term premium between 1 January 2026 and 17 September 2026

During August, the yield moves were starkest at the longer-dated end of the curve. Mid-month, very long-dated government bond yields across the world's major economies were brushing up against multi-decade highs – the UK 30-year flirted with 6%.

The surge in longer-dated sovereign yields eased after the US Treasury started supporting the long end of the Treasury market by making larger buybacks of longer-dated Treasuries, and after the Fed announced a unanimous 25-basis-point rate hike in mid-September. We think there's probably a ceiling on how much further government bond yields will rise from here.

Treasury Secretary Scott Bessent's interventions in the Treasury market show that policymakers aren't comfortable with Treasury yields drifting much higher. And the Fed's decision to raise rates in September (its first hike in three years) seems to be doing the opposite of what hikes usually do. Instead of driving up Treasury yields further, they've levelled out since the Fed announced the move, mainly because the hike has helped instil confidence that the Fed will be sufficiently hawkish to prevent inflation getting out of control.

Here in the UK, the BoE has finally addressed how its quantitative tightening (QT) programme has been pushing gilt yields unnecessarily higher. QT is where the BoE steadily sells down the huge amount of gilts bought during the quantitative easing of the past two decades. It has been doing this much faster than other central banks, which increases the supply of gilts that the market must absorb. This has been particularly acute in the 30-year space. We have long argued that the BoE should stop operations at the long end of the curve, given the pressure we have seen on yields there.

The BoE has come around to our way of thinking: in early September, it announced a big overhaul to its strategy. It will now hold about 70% of its remaining gilts to maturity instead of selling them over the coming years. It will halt its QT sales until April at the earliest while it investigates selling roughly £150 billion of them to the Debt Management Office (the government, essentially), rather than continuing to drop them into the market. That way just one public body (the DMO) would again be in charge of selling government debt, which would help make the market more efficient. It has also indefinitely stopped selling very long-dated bonds.

This reinforced our decision to increase our duration, as we think this should help bring down gilt yields, all else staying equal. The summer's big reset in sovereign debt yields (and the resulting falls in bond prices) has been unsettling. Government bonds are generally expected to provide stability, so the scale of the moves at the long end has attracted a lot of attention. But higher yields also mean more income relative to the price investors pay. After the big rise in bonds' starting yields over the last four years, that income now provides a more meaningful cushion against near-term price volatility, particularly in higher-yielding markets such as the UK.

There's still strong investor demand for long-dated gilts at current yield levels. In early September, the government paid a yield of more than 5.80% in a £4bn 30-year gilt auction, prompting some alarming headlines because it represented the highest borrowing cost for debt of that maturity since 1998. Yet the auction also showed that investors are keen to snap up gilts when they offer super-attractive yields.

That doesn't mean the next few months will be plain sailing. The gilt market may well stay more jittery than other big bond markets, given the uncertainties associated with new Prime Minister Andy Burnham's first Budget on 28 October. That said, the government is acutely aware that it's not in a position to let its borrowing costs rise much higher.

Are hyperscalers the new sovereigns?

Because the hyperscalers have issued so much so quickly, they're having to sweeten their yields to attract investors. In mid-August, Google parent Alphabet paid 1.05% over US Treasuries on the 20-year tranche of its August USD issuance – this compares with 0.75% over Treasuries for the 20-year tranche of its February USD issuance. We can also see this in Alphabet's inaugural Australian dollar bond issuance in August – the company had to pay just under 7% total on the 20-year tranche of this deal, its highest cost of borrowing ever. This does suggest that the hyperscalers are having to pay higher borrowing costs to get deals away. In turn, this may be helping drive up governments' long-term borrowing costs as they try to compete with the tech giants to attract a limited pool of long-duration capital.

Finding value in duration

The changing market backdrop is creating opportunities across both government bonds and credit. While higher sovereign yields have weighed on bond prices, they've also improved the value available in selected areas. As active managers with the flexibility to invest across the credit spectrum, we've been able to reposition our fund to capture opportunities where we believe we're being more than adequately compensated for the risks we're taking

We added to our longer-dated gilts in August, buying more **UK Treasury 4.25% 2040s** and **Green Gilt 1.5% 2053s**. Our rationale was threefold. First, gilt yields now offer powerful income potential after the repricing of recent years. Secondly, a lot of bad news already appears priced in, so even modest improvements in the UK's fiscal outlook could bolster gilt prices at some point. Third, the technical backdrop has become more supportive as the Debt Management Office scales back issuance at the long end of the market (September's 30-year gilt auction was the first since May 2025).

By buying more longer-dated gilts, we extended the fund's duration (sensitivity to the direction of interest rates). We prefer to concentrate our duration exposure in government bonds rather than credit. That's because very long-dated corporate bonds carry significant 'spread-duration risk' (the risk that any widening in credit spreads further into the future could offset some or all the gains generated by falling government bond yields). This preference helps explain why we haven't been tempted by any of the ultra-long-dated issuance from the AI hyperscalers. These companies enjoy strong credit fundamentals, but we worry that the additional spread available on their very long-dated corporate bonds doesn't always adequately compensate investors for the extra spread-duration risk they're taking.

Selective opportunities in credit

While the big surge in government bond yields exerted downward pressure on corporate bond prices in August, credit spreads tightened. The iTraxx European Crossover Index (a widely watched gauge of high-yield credit risk) began the month at 261 basis points (bps) and had narrowed to 241bps by its end.

We bought some French bank **Crédit Agricole 5.375% 2037s**. French bank bond spreads have widened because of political uncertainties ahead of France's presidential election next year and what it might mean for the country's already stretched public finances. We felt that created an opportunity: investors are worried about France's debt trajectory and deficit, not the financial resilience of its banks. Crédit Agricole remains in solid shape, so those wider spreads looked good value to us.

We also bought some German fitness group **LifeFit 9.557% 2029s**. These high-yield bonds offer very generous income and we think they could be called (redeemed early) as soon as next year, which would mean we could collect that income over a shorter horizon than the 2029 maturity date implies. We felt that made for an appealing risk/return trade-off.

In addition, we bought some **Hungarian bank OTP 4.625% 2036s**, while selling some of our German bank **Norddeutsche Landesbank 4.375% 2035s** and insurer/asset manager **Aegon 5.625% Perpetuals** because we felt we could find better value elsewhere.

Compensation for uncertainty

As we move through the remainder of the year, bond markets are unlikely to enjoy a smooth ride. Questions around inflation, government borrowing and fiscal sustainability are likely to stay centre stage, and investors may continue to demand more compensation than in the past for lending to governments long term.

For active managers like us, the more demanding backdrop is creating opportunities as well as risks. In August, we responded to market volatility by selectively adding longer-dated gilts where yields looked compelling, avoiding areas of very long-dated credit where we felt spread risk was not adequately rewarded, and adding to corporate bonds where we believed valuations and underlying fundamentals remained attractive.



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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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