Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Strategic Bond Fund

Monthly update June 2020

Overview

The 10-year gilt yield remained in a relatively tight trading range last month. Starting at 0.18%, it closed 30 days later at 0.17%, having got as high as 36 basis points. At the short end of the gilt curve, yields are still in the basement. The two-year gilt yield was negative virtually the whole month, ending at -0.08%.

Meanwhile, credit spreads — the extra return above government bonds for taking on the risk of default — have kept falling. The iTraxx Crossover European high yield spread index started the month at 428bps and finished at 383bps.

Central banks in both developed and developing markets are buying up debt as part of quantitative easing programmes. This sustained demand is hammering down yields for bonds of virtually all stripes. In the UK, this fillip to demand has been accompanied by relatively low issuance of sterling-denominated corporate bonds, helping to push those yields yet lower. In the US and Europe, there has been much more activity.

Economic data started to look better in June, especially in the US and Europe. Retail sales improved dramatically in the US and Europe, coming to within 5-6% of the same time the previous year. The US ISM Manufacturing survey rocketed back to the highest level in more than 12 months. The Eurozone PMI came in much higher than expected too, albeit it was still slightly below 50, the level that divides shrinking and growing commercial activity. In the UK, the construction PMI has bounced back extraordinarily well, hitting 55.3, the highest level since July 2018. Manufacturing also stopped shrinking; however, the all-important services PMI, while highly improved, remains in contraction. While June UK retail sales shot up compared with May, spending is still 13% below June 2019.

It will be interesting to see whether all these measures (and the rest) continue to rally in the coming months and whether they will hit a ceiling before reaching pre-pandemic levels.

Trades

We sold a few residential mortgage-backed securities that we have held since the aftermath of the global financial crisis. These included **RMAC Securities No.1 Floating Rate Mortgage-Backed 2044**, **Eurohome UK Mortgages 2007-1 Floating Rate Mortgage-Backed 2044** and **Eurohome UK Mortgages 2007-2 Floating Rate Mortgage-Backed 2044**. We had picked up these assets extremely cheaply in the years following the credit crunch, but now the yields are very low and we felt we could put our cash to better work elsewhere.

We sold some more liquid, higher-quality bonds as well, including **HSBC Holdings 3% Floating Rate 2030**, **Leeds Building Society 3.75% Floating Rate 2029** and **Barclays Bank 3.25% Senior 2027**. We also sold down Canadian provincial government bonds, **Alberta 1.5% Senior 2022** and **Quebec 1.5% Senior 2023** and **0.75% Senior 2024**. We had bought these Canadian bonds as a bit of protection earlier in the year. Oil markets had been walloped, hurting oil-rich Canada's state bonds. We felt they were a relatively safe bet, especially given the price, so we snapped them up. Recently, the Bank of Canada has been aggressively buying up these assets as part of quantitative easing, pushing up their price.

We bought high-yield specialty insurer **Ardonagh Group Midco 2 New Issue 11.5% 2027** because it came to the market at a very attractive price. We added to several existing holdings, including **BUPA Finance 4.125% 2035**, **Legal & General Group 5.625% 2031** and **Provident Financial 7% Senior 2023**.

Finally, we sold a bit of our position in the **Muzinich Americayield Fund**. A tidal wave of cash has flowed into US high yield debt so far this year, representing about 11% of the sector's entire assets under management, most of it through ETFs — essentially buying everything indiscriminately. America is still battling the pandemic, with several states and counties having to reverse themselves and head back into lockdown. That doesn't really square with high yield prices, which are roughly back to where they were before the corona crisis, so we decided to take a bit of profit.

Outlook

It's been an extremely intense quarter. COVID-19 sent markets tumbling rapidly, before they recovered in the blink of an eye.

This has whipsawed investors' minds as much as their portfolios. The more pessimistic people see the recovery as fragile and likely to disintegrate within a few months; the more optimistic think the rebound shows how quickly we will be able to shake off the pandemic given the extraordinary government responses coupled with the safety net of technology that allowed many industries to keep ticking over during a lockdown.

I have a hunch that the reality will be somewhere in the middle.

This was a tremendous shock on the global economy that few businesses were ready for. In the event, some were more prepared than they knew, which will no doubt pave the way for more flexible working. A significant shift in how (and where) we work could have seismic effects on economies. Roughly a third of our lives is whiled away at the daily grind, creating a baseline for how we spend the rest of it. Fewer people flowing into cities for the daily shift will mean less need for all the cafes, restaurants, bars, bank branches, barbers and myriad other businesses that service that flood of humanity. It may mean that those businesses would be better placed in the suburbs or commuter towns instead.

The huge amount of debt racked up — still being racked up — by governments will need to be repaid somehow, or inflated away. And it's a rare central bank that isn't sporting a balance sheet groaning under the weight of billions of pounds' worth of government bonds that it has hoovered up from private investors and pension funds.

At the moment, corporate bonds look generally fairly priced to us, with a few highly priced exceptions. Government bond yields are ludicrously low, but that's what we've come to expect as central banks really get rolling in the 21st century. Emerging market debt is still a relatively cheap pocket of value, however. Of course, that's because they face a lot of risks and difficulties. Many of these nations are still battling COVID-19, yet they are doing so with much fewer medical resources and no welfare nets to speak of. We're looking for select opportunities to invest in these markets while staying mindful of the risks we're taking.

Listening to all the frenzied discussions about what shape the economic recovery will take, I was reminded of a holiday in Kerala. The native language there is Malayalam, and one of its characters, Jha, strikes me as the sort of recovery shape to expect: Broadly, we'll be trying to use periods of panic and market falls to buy bonds with solid risk-return profiles. And when markets swing higher again, we'll be looking to take profits when prices get ahead of themselves.

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