Rathbone Unit Trust Management

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Rathbones
Look forward

# Rathbone Strategic Bond Fund

## Monthly update July 2020

The 10-year gilt yield stayed very low in July despite the government issuing an extraordinary amount of bonds to pay for its COVID-19 response policies. Starting at 0.17%, it closed the month at 0.11%, having got as 'high' as 21 basis points.

In the three months to 30 June, £170.7 billion of gilts were issued (less those gilts that matured during the quarter) which is almost as much as the total issuance of the past four years combined. Toward the end of July, the supply of gilts was about £226bn, which represents just 57% of the 2020-2021 fiscal year's estimated issuance. So there is plenty more UK government debt coming down the pipe between now and the end of March 2021.

August is traditionally a quiet month for issuance as traders head on holiday and markets usually get a little sleepier over the summer. That has not been the case so far this month, anecdotally the government has kept the hose of debt flowing into the market regardless. That seems to have pushed gilt yields slightly higher so far in August. A similar trend is playing out on the Continent as well. EU restrictions on national budgets have been suspended until 2022 at the earliest because of the pandemic. So we could see more European government spending funded by issuing bonds. In particular, Germany, France and Spain have sold tens of billions of euros of bonds recently. Italy is highly likely to add to that. The US is already selling a record amount of bonds and is forecast to substantially ramp up its issuance in the coming quarter.

This river of debt has pushed yields slightly higher, but not as much as you may think. The dramatic increase of government bonds around the world has been met with a concurrent surge in demand from investors. You can see that in large inflows to all bond markets, which have easily absorbed the extra debt. Not only investors, but central banks have also been soaking up lots of the debt through their quantitative easing (QE) schemes. As an example, the Bank of England has bought about £230bn of gilts since it restarted QE in March. With yields as low as they are, we see very limited value in government debt, so we have kept our fund's holdings of European Investment Bank bonds (a European-listed, ethical sterling alternative to gilts) as low as possible.

Meanwhile, in the corporate debt markets there's been a common summer theme of companies tendering to buy back their bonds or exercising early calls on them (some bonds include the option for their issuers to buy them back at a set price). With interest rates so low, even at the longer-dated end of the yield curve, it makes sense for issuers to pay up to replace bonds that pay higher coupons with new ones at much lower interest rates. As more companies do this, the buying pressure should push corporate bond credit spreads lower.

We bought the **Banco Bilbao Vizcaya Argentaria 3.104% 2031** new issue of tier two bonds, as we felt they offered good value. We added to our existing holdings in subordinated financial credit, including the **Scottish Widows 7% Subordinated 2043**.

Also, we have added to some of our legacy instruments, including the **NatWest Group 7.648% Floating Rate Perpetual-2031** and **Rothschild Continuation Finance 9% Subordinated Perpetual-2024**.

Retail commercial property has taken a battering from COVID-19. We have only a few holdings in these areas. One, **CPI Property Group 2.75% Senior 2028**, finances a shopping landlord in Eastern Europe. The bond price has bounced back recently so we used the opportunity to sell as we are obviously concerned about retail property exposure in the wake of COVID-19. Another is **Pinnacle BidCo 6.375% 2025**, which you will know as PureGym. We sold because of the risk of a second wave that would likely force gyms to shut again. The bond had recovered really well following the reopening, so we decided it was a good time to cut our risk exposure.

We bought high-yield bond **Dignity Finance 4.696% Asset-Backed 2049**, because we believed an ongoing UK government consultation was unlikely to result in price caps for funerals. An interim decision came back in mid-August, vindicating us as the Competition and Markets Authority ruled out price caps during the pandemic. That helped push the bond price higher. We also bought the **Eros International 6.5% Senior 2021** media company on hopes that it will be bought by a bigger company.

We increased our high yield and emerging market exposure, but kept our investments to the shorter-duration part of the market. To do this, we bought the **BNY Mellon Short Duration High Yield Bond**, the **Royal London Short Duration Global High Yield Bond** and the **Legal & General Emerging Markets Short Duration Bond** funds.

The pound rose considerably against the dollar over July, but that was completely down to dollar weakness. Sterling was flat against the euro. While there has been concern in some quarters that the UK's GDP fall was the worst of advanced economies, it should be remembered that you would expect a services-fuelled economy to take the hardest hit from a lockdown. About 80% of the UK is services, much of which simply can't operate remotely. The good news is that two-thirds of businesses were fully operational in July, up from just half in June, according to a survey by the Confederation of British Industry (CBI). There's a tough and bumpy road ahead – as shown by increased restrictions in the north of England since the survey was taken. And the CBI survey shows that businesses are struggling most with a lack of customer demand. Hopefully the UK economy will be able to continue reopening without losing control of the virus.

In the UK, people haven't been this gloomy since 2013 and the recovery in confidence hasn't been as sharp as in other places. Investors also seem generally pretty wary, if not actually gloomy, despite the relatively strong run for markets in recent months. Similarly, across the Atlantic, American consumers are less confident than they have been since 2015. Just how long it takes for people to regain their optimism will be an important factor in national and worldwide recoveries. As summer flows into autumn, the Groundhog-Day-funk that we're all feeling because of the pandemic disruption could turn into a bit of a pull-back. We're still relatively cautious at the moment, trying to take advantage of opportunities as they arise while also keeping some cash in reserve to jump in if markets take another tumble.

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