Rathbone Unit Trust Management

Rathbone Luxembourg Funds SICAV
Contact us +44 (0)20 7399 0800 international@rathbones.com

Rathbones
Look forward

Rathbone SICAV Ethical Bond Fund

Monthly update August 2020

The 10-year gilt yield shot up from 0.11% to 0.31% in August as investors' moods were brightened by the bounce back in economic data. It has since wobbled in early September, retreating below 0.20% as Brexit worries bubbled back to the fore.

Credit spreads (the return above government yields to account for the risk of default) continued to fall during August. One measure of subordinated financial bonds' credit spreads fell from 153 basis points to 128bps.

Economic data roared back in the post-lockdown summer, albeit as expected given the dramatic falls that needed to be recouped. Most measures of activity remain significantly below pre-pandemic levels. After a long extension, the UK government is planning to end its expensive furlough scheme at the end of October. However, the government will come under tremendous pressure to keep it in place if (as is likely) unemployment starts to rocket. The furlough scheme costs billions of pounds each month, yet that extra spending is but a drop in the bucket of government bond issuance. Its life (or death) shouldn't have too much influence on the supply and demand dynamics of UK benchmark government bonds. Much wider unemployment and less money circulating in the economy could affect inflation, however, which is extremely volatile right now because of the one-off effect of the government's Eat Out to Help Out restaurant subsidy.

Over in the US, inflation has climbed steadily since the initial shock of early lockdown. Driven by higher transportation and vehicle costs and a base line of rising food prices, the headline rate was 1.3% in August. Meanwhile, the US Federal Reserve (Fed) announced changes to its inflation-targeting strategy. It will now aim for an average of 2% over longer periods, meaning it would allow inflation to run above 2% if it had undershot for a long period of time. The Fed's favoured inflation measure has been running below 2% for most of the past five years, so the assumption is that the Fed will keep rates lower for yet longer, even if inflation starts to rise above 2%.

Cases of COVID-19 are rising again in many countries, yet hospitalisation rates and deaths are nowhere near where they were earlier this year. This is heartening, in that it shows that nurses and doctors have learned how to treat people. It may also mean that the virus itself is weakening. Yet it also seems to be because younger age groups make up most of the new infections. Localised lockdowns have become commonplace, with authorities trying to keep the virus from spreading out of control and endangering older and more vulnerable people. A vaccine would be a godsend, but it seems a way off yet. For now, we have to hope that the safety measures put in place work as intended and keep the virus from exploding out of control once more.

We're going to be bouncing along in second gear until the virus plays itself out or we get a viable vaccine. That could take well into next year, so we feel it's important that we can be sure that our investments can be profitable and solvent in a protracted quasi-lockdown environment. Some businesses benefit greatly from lockdowns and the new environment, others face bankruptcy, most are somewhere in between.

During the month we sold the **Banco Bilbao Vizcaya Argentaria (BBVA) 3.104% LT2 2031** because we wanted to raise cash and, since issue, the bond had performed well relative to gilts of a similar duration.

New bond issuance has been quiet, so we have been hunting for existing holdings to put inflows to work. We added to our holdings of the **HSBC Capital Funding 5.844% Perpetual-2031**, **BUPA Finance 4.125% 2035**, **BPCE 5.25% 2029** and **AXA 5.453% Floating Rate Subordinated Perpetual-2026**.

In September, Brexit concerns have ratcheted up once again as Prime Minister Boris Johnson unveiled an aggressive internal market bill that contradicts prior agreements with the EU. Britain's top legal adviser immediately resigned as the EU threatened to sue the UK for a breach of international law. Sterling slumped as well. All in all, not a resounding approval of Mr Johnson's understated strategy. Analysts now think the probability of the very hardest Brexit has increased.

Inflation is another wild card. While interest rates seem set to remain extremely low for the foreseeable future, inflation could go either way. This matters for bond investors, especially with yields so low because it doesn't take much inflation to eat up most of your return (if not more). There has been so much stimulus cash splurged, both here in the UK and around the world. Add in a volatile pound and a pandemic-induced recession that has already slashed economic demand, and you've got yourself a swirl of macroeconomic forces that's impossible to predict.

We're focusing on how different sectors will be able to fare in the hamstrung economic environment that may prevail well into next year. Not just that, but we have to try to look beyond the pandemic itself and imagine how the world may pan out after this dislocation.

Bryn Jones
Fund Manager

Noelle Cazalis
Fund Manager

Stuart Chilvers
Assistant Fund Manager

Investment manager:
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Management company:
FundRock Management Company S.A.
Authorised in Luxembourg and regulated by the Commission de Surveillance du Secteur Financier

International information line
+44 (0)20 7399 0800
international@rathbones.com
rathbonefunds.com

Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ

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