Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Ethical Bond Fund

Quarterly update September 2020

The 10-year gilt yield rose slightly over the quarter, yet it remains extremely low. Starting at 0.17%, it slid to 11 basis points in July before rising as high as 0.34% the following month. It ended September at 0.23%.

Credit spreads – the extra return above government bond yields for taking on the risk of default – marched lower over the quarter. The iTraxx Crossover European high yield spread index started the period at 383bps and got as low as 292bps in mid-September – its lowest level in a bit over a year – before closing the quarter at 345bps.

	Year to date	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	4.1%	3.0%	10.3%	5.7%	16.2%	35.1%
IA UK Sterling Corp. Bond Sector	4.3%	1.6%	9.1%	4.2%	13.7%	28.4%

	30 Sep 19-30 Sep 20	30 Sep 18-30 Sep 19	30 Sep 17-30 Sep 18	30 Sep 16-30 Sep 17	30 Sep 15-30 Sep 16
Rathbone Ethical Bond Fund	5.7%	9.4%	0.5%	6.4%	9.3%
IA UK Sterling Corp. Bond Sector	4.2%	9.0%	0.1%	0.6%	12.2%

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

Source: FE Analytics; data to 30 September, I-class, mid price to mid price.

Backward-looking GDP numbers showed some truly incredible falls all round the world, yet markets were laser focused on forward-looking data like business PMIs (measures of optimism, upcoming orders and hiring intentions). These generally came in stronger than expected, as did US employment figures.

Debt tsunami, barely a ripple for yields

There was a wave of debt issued over the quarter. Just shy of £89 billion was added to the gilt pool in Q3. While much less than the £170 billion increase of Q2, it's still more than double the amount issued over the whole of the 2019/20 fiscal year. A similar trend is playing out on the Continent as well. European Union restrictions on national budgets have been suspended until 2022 at the earliest because of the pandemic. We are likely to 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.

But central banks are buying up debt like hotcakes. As a local example, the Bank of England (BoE) is still routinely buying gilts to keep interest rates low; it purchased more than £73 billion of government debt in the third quarter. That is much reduced from the £194 billion it bought between mid-March and the end of June, yet it accounts for more than 80% of the gilts issued over the quarter. The BoE wrapped up its corporate-bond-buying programme in September after hoovering up about £9.5bn worth since mid-March. It can buy more, but said it would declare its intentions before doing so.

Investors have flocked to government and corporate bond markets too. This has meant demand has easily absorbed the extra debt. So, while Q3 was perhaps a more normal quarter than the previous two, we're still living in extraordinary times. All that quantitative easing (central bank bond-buying) around the world has helped keep government bond yields remarkably stable despite the tsunami of new debt. We struggle to see much value in government bonds currently. Indeed, if inflation were to return in coming years, investors holding long-dated bonds would suffer sizeable losses.

A sweet spot

We did well compared with our peers over the quarter. This was down to our low exposure to sterling European Investment Bank debt (an ethical alternative to gilts) and a larger allocation to higher-yielding investment grade bonds. We avoided more losses as government bond yields rose and then we reaped more of the gains from falls in the spread of corporate bonds.

We added to our subordinated financial bonds during the quarter, as we believe this area of the market consistently offers value. Many of these bonds were existing holdings, including the **HSBC Capital Funding 5.844% Perpetual-2031**, **BUPA Finance 4.125% 2035**, **BPCE 5.25% 2029**, **Scottish Widows 7% Subordinated 2043**, **AXA 5.453% Floating Rate Subordinated Perpetual-2026** and **TSB Banking Group 5.75% Floating Rate LT2 2026-21**. We also added to our position in the **Aviva 6.875% 2058-38** because we're confident in the company's new strategy following last year's management change. We think some promising restructuring is on the way, which should improve the company's credit profile.

We added to our credit risk in September, buying the **Phoenix Group Holdings 5.75% Perpetual-2028** and the **Virgin Money UK 5% 2026**.

Retail commercial property took 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 bounced back in August, so we used the opportunity to sell, as we are obviously concerned about retail property exposure in the wake of the pandemic. Another property company we sold was the government-backed **PRS Finance 2% Senior Secured 2029**, which lends money to large corporate landlords for thousands of UK houses and flats. We sold this bond because we felt, with interest rates so low, there's limited value in long-duration assets (investments with high sensitivity to interest rate changes).

Speaking of the pandemic, we also bought the AAA-rated **Ford Foundation 2.415% 2050** newly issued social bond which raised $1 billion for grants to non-profits, helping keep them afloat in the wake of the virus. The Ford Foundation is extraordinarily well funded; it has tapped the bond market simply to expand the aid it can give (endowments are restricted to a certain level of spending under American law). The money is planned to help organisations that support social justice, human services, arts and culture. Something we really need in our societies in the best of times, let alone the worst of times!

Winter beckons

As September slipped into October, investors became more nervous about the darkening outlook. The pandemic began spreading quickly once again in Europe, then the UK and then the US. Albeit, thankfully, the number of deaths has been nowhere near the proportion of cases seen back in March and April. Western nations are yet to crack how to reopen their economies without allowing COVID-19 to creep back in. There are several promising vaccines in the pipe, but they could be anywhere between a month to a year or more away. Their efficacy may be blunted, too, because extraordinary demand for a viable vaccine will overwhelm the ability to manufacture it.

Meanwhile, Brexit returned to the fore as Prime Minister Boris Johnson tried to renege on the internal market rules he made with the EU just a few months prior. The deadline for an agreement in principle for a trade deal is fast approaching and it looks set to come down to the wire. Sterling will no doubt be volatile when this jack-in-the-box finally pops up with a result.

In the US, a bitter election looms. Most electoral college forecasts suggest Democrat Joe Biden will romp home, yet pollsters have been burnt badly before. Early indications of voting show turnout is likely to be much higher than in the past, which will mess with many prediction models. It seems like markets have positioned for a Biden win, so a surprise upset victory for Republican incumbent Donald Trump could cause some volatility.

In October, the credit spread has shot higher and the gilt yield has become volatile due to the resurgence of the pandemic in the West. It is no doubt going to be a bumpy winter, with the virus likely to keep roaring back alongside economic activity whenever social and commercial restrictions are eased. Then, they will likely move in lockstep in the other direction too.

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