Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone High Quality 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 (bps) 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 European investment grade spread index started the period at 66bps and got as low as 50bps in early September – its lowest level since early 2018 – before closing the quarter at 59bps.

	YTD	3 months	6 months	1 year	Since Launch
Rathbone High Quality Bond Fund	1.72%	0.83%	4.49%	1.94%	5.21%
Bank of England Base Rate + 0.5%	0.58%	0.15%	0.30%	0.89%	1.98%

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

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

The value of your investments and the income from them may go down as well as up, and you could get back less than you invested.

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 during the whole of the 2019/20 fiscal year. A similar trend is playing out on the Continent as well. European Union (EU) 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 £9.5 billion 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.

Avoiding the mines, buying financials

The pandemic has made for another challenging quarter for many businesses, so it's unsurprising that fundamentals have deteriorated. Interest cover, the amount of cash a business has to pay its borrowing costs, has been hit hard by the lockdowns and reduced custom. Revenues of retailers, energy companies and property businesses, among others, are under significant pressure. This led to a brace of credit rating downgrades – fortunately, there have been few of these among our fund's holdings.

It is of course something we continue to reassess, and in particular as the threat of a second "lockdown" or additional restrictions are growing. The BoE corporate bond purchase programme has created dislocation in valuations. But we were early to buy to some of the bonds benefiting from this support. The question now is whether more stimulus will be added in November and there are growing pressure for the BoE to tweak the programme (with some suggesting they should focus on UK businesses for example).

We have retained our bias to financials over other corporates, and have been adding to our favourite bonds in this space as we take in more investors inflows. These included **Close Brothers Finance 2.75% 2026**, **Skipton Building Society New Issue 2% 2026** and **Fidelity International 6.75% 2020**. Since the COVID-19 outbreak, banks have had to increase their provisions for potential bad debts and their earnings have been hit. However, as creditors, we're comfortable with the shape they're in. For a decade, we've been protected by creditor-friendly policies that left banks with strong capital positions. This culture of regulatory conservatism has continued with the suspension of dividends – something that is also helpful to bondholders.

We added to our short-dated, subordinated bonds, which continue to offer attractive yields versus their more senior equivalents. This bucket of higher-risk debt is a small proportion of our portfolio overall, but it helps boost our yield. We added the **AVIVA 6.125% Perpetual-2022**, **BUPA Finance 6.125% Perpetual-2020** and **Friends Life Holdings 12% Subordinated 2021**. Often, these types of bonds are called early, which is a bonus for us. Two such bonds were called during the quarter, in fact, as per our expectations. We had bought them at attractive yields during the March sell-off.

One interesting trend during the pandemic has been the increasing number of green bonds being issued. We added one, the **Landesbank Baden-Wurttemberg 1.125% 2025**, to our fund during the quarter. While our fund doesn't have a specific environmental, social and governance (ESG) mandate, our analysis takes these risks into account. It's also worth mentioning that green bonds tend to raise money to finance specific projects. And many companies have short-term project cycles... therefore, more of these types of green bonds are likely to make their way into the fund if we like the look of the project.

Another theme for corporates: we are seeing a lot of companies tendering their debt (offering to buy them back early at a premium). Some examples this quarter are **BP 1.177% 2023, BP 2.03% 2025** and **Segro 6.75% 2024**. With revenues under pressure and interest rates at a record low, it feels like treasurers are saving pennies and optimising the cost of debt to help margins as much as they can.

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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Fund Manager

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