Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Strategic 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 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.

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. 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 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 £194bn 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 Bank of England 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.

	Year to date	3 months	6 months	1 year	3 years	5 years
Rathbone Strategic Bond Fund	3.06%	2.50%	9.44%	4.19%	9.70%	25.12%
IA Sterling Strategic Bond Sector	2.82%	1.83%	9.85%	3.59%	10.81%	24.00%

	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 Strategic Bond Fund	4.19%	4.36%	0.89%	5.34%	8.28%
IA Sterling Strategic Bond Sector	3.59%	7.08%	-0.11%	3.27%	8.37%

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.

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.

Snapping up new issues

We bought several new issues that we felt were attractively valued. They included the **Virgin Money UK 5% 2026** and **Skipton Building Society 2% 2026**. Another was 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.

In early August, we added to the **Muzinich Emerging Markets Short Duration Fund** because we felt valuations in the area looked relatively attractive. At the same time, we sold some of the high-yield **Muzinich Americayield Fund**.

As gilt yields widened in mid-August, we bought some **UK Treasury 4.75% 2030** at (relatively) cheaper prices.

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 European Union 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.

Bryn Jones
Fund Manager

Noelle Cazalis
Fund Manager

Stuart Chilvers
Assistant Fund Manager

Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000
Fax 020 7399 0057

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

7046.11.20