Rathbones
Look forward

Rathbone High Quality Bond Fund

Quarterly update June 2020

The 10-year gilt yield remained in a relatively tight trading range last month. Starting at 0.18%, it closed 30 days later at 0.17%, having got as high as 36 basis points. At the short end of the gilt curve, yields are still in the basement. The two-year gilt yield was negative virtually the whole month, ending at -0.08%.

Meanwhile, credit spreads — the extra return above government bonds for taking on the risk of default — have kept falling. The iTraxx European investment grade spread index started the month at 70bps and finished at 66bps. Following June-end it had continued lower, within touching distance of 60bps.

Central banks in both developed and developing markets are buying up debt as part of quantitative easing programmes. This sustained demand is hammering down yields for bonds of virtually all stripes. In the UK, this fillip to demand has been accompanied by relatively low issuance of sterling-denominated corporate bonds, helping to push those yields yet lower. In the US and Europe, there has been much more activity.

Economic data started to look better in June, especially in the US and Europe. Retail sales improved dramatically in the US and Europe, coming to within 5-6% of the same time the previous year. The US ISM Manufacturing survey rocketed back to the highest level in more than 12 months. The Eurozone PMI came in much higher than expected too, albeit it was still slightly below 50, the level that divides shrinking and growing commercial activity. In the UK, the construction PMI has bounced back extraordinarily well, hitting 55.3, the highest level since July 2018. Manufacturing also stopped shrinking; however, the all-important services PMI, while highly improved, remains in contraction. While June UK retail sales shot up compared with May, spending is still 13% below June 2019. It will be interesting to see whether all these measures (and the rest) continue to rally in the coming months and whether they will hit a ceiling before reaching pre-pandemic levels.

The COVID crisis and the widespread lockdowns played havoc with credit ratings this quarter. Many solid companies were downgraded, as cash flow dried up and risks rose. A few of our holdings were downgraded from As to BBBs, yet their credit spreads didn't reflect this deterioration in credit quality. Because we felt we were no longer getting adequate compensation for their increased risk, we sold **United Utilities Group 2% Senior 2025**, **Bupa Finance 3.375% Senior 2021**, **Wessex Water Services Finance 4% Senior 2021** and **BNP Paribas 5.75% 2022**.

In response to the pandemic, the Bank of England (BoE) cut its interest rate twice, from 0.75% to 0.10%. That meant the coupons we receive from floating rate notes (FRNs) decreased, making them less attractive than fixed-rate bonds. We sold the **Yorkshire Building Society FRN 2024**, **National Westminster Bank FRN Senior 2023** and **Nationwide Building Society FRN 2022**, among others. We used the proceeds to buy fixed-rate senior bonds from insurers, banks and the London Stock Exchange. The BoE isn't allowed to buy financial bonds as part of its quantitative easing programme, so valuations are still quite attractive due to reduced distortion. Some of the larger purchases for this trade were **Banque Fédérative du Crédit Mutuel 1.875% Senior 2022**, **Friends Life Holdings 12% Subordinated 2021**, **Citigroup 2.75% Senior 2024**, **HSBC Holdings 6.5% Senior 2024** and **London Stock Exchange 4.75% 2021**.

The BoE also rebooted its quantitative easing (QE) programme, adding corporate bonds to the shopping list as well. Ahead of the programme's start and then throughout the quarter, we added to eligible bonds to take advantage of the potential uplift in prices (falls in yields) from the central bank's demand. Oil companies in particular enjoyed strong performance because the depressed oil market had pushed their prices into the doldrums. These QE-eligible bonds included **BP Capital Markets 1.827% Senior 2025**, **Total Capital International 2.25% Senior 2020**, **Procter & Gamble 1.8% Senior 2029**, **Siemens Financier 1% Senior 2025** and **Unilever 1.375% Senior 2024**.

Because of the need to raise secure cash during lockdowns of unspecified length, there was a record issuance of new corporate bonds in dollar and euros during the quarter. Even in sterling this led to some attractive deals, several of which we bought into: **GlaxoSmithKline Capital New Issue 1.57% 2028**, **Dexia Credit Local 0.5% Senior 2023**, **Lloyds Bank 1.5% 2023** and **CPP Investment Board Capital 0.375% Senior 2023**.

We sold all of our **Westfield Stratford City Finance 1.642% Asset-Backed Senior 2031** bonds because retail-facing commercial property is going to have a tough time, probably into next year as well. Westfield is the top-tier operator in the UK, and still sports a AAA credit rating. Yet we think that could come under pressure as more retailers fold and consumers spend less due to the recession. We felt it was prudent to switch this retail exposure toward warehousing and distribution hubs on the edges of towns and cities. We bought the **Logicor 2019-1 UK 1.875% Senior 2026** and **Segro 6.75% 2021** bonds, whose tenants are underpinned by strong ecommerce sales.

It has been an intense quarter. COVID-19 sent markets tumbling rapidly, before they recovered in the blink of an eye. This has whipsawed investors' minds as much as their portfolios. The more pessimistic people see the recovery as fragile and likely to disintegrate within a few months; the more optimistic think the rebound shows how quickly we will be able to shake off the pandemic given the extraordinary government responses coupled with the safety net of technology that allowed many industries to keep ticking over during a lockdown.

We have a hunch that the reality will be somewhere in the middle. This was a tremendous shock on the global economy that few businesses were ready for. In the event, some were more prepared than they knew, which will no doubt pave the way for more flexible working.

A significant shift in how (and where) we work could have seismic effects on economies. Roughly a third of our lives is whiled away at the daily grind, creating a baseline for how we spend the rest of it. Fewer people flowing into cities for the daily shift will mean less need for all the cafes, restaurants, bars, bank branches, barbers and myriad other businesses that service that flood of humanity. It may mean that those businesses would be better placed in the suburbs or commuter towns instead.

The huge amount of debt racked up – still being racked up – by governments will need to be repaid somehow, or inflated away. And it's a rare central bank that isn't sporting a balance sheet groaning under the weight of billions of pounds' worth of government bonds hoovered up from private investors and pension funds.

At the moment, corporate bonds look generally fairly priced to us, with a few highly priced exceptions. Government bond yields are ludicrously low, but that's what we've come to expect as central banks really get rolling in the 21st century. Broadly, we'll be trying to use any periods of panic and market falls to buy bonds with solid risk-return profiles. And when markets swing higher again, we'll be looking to take profits when prices get ahead of themselves.

Noelle Cazalis
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

6963.07.20