Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Ethical Bond Fund

Monthly update July 2021

Government bond markets continued their seemingly relentless rally during the month.

The yield on US 10-year Treasuries (which falls as prices rise) dropped from 1.47% at the start of the month to reach 1.23% by its end. Likewise, the yield on 10-year gilts edged down from 0.72% to 0.56%.

Credit markets benefited from the falling yield trend, as well as from the usual summer lull in new bonds to buy. Credit spreads — the extra return above government bond yields for taking on the risk of default — narrowed, with the iTraxx Crossover European high yield spread index ending the month at 236 basis points (bps), down from 232bps at its start.

Bond yields defy inflationary gravity

Who would have thought back in February/March that government bond yields would be whoppingly *lower* by mid-year even as growth has roared back and inflation has heated up? But that's exactly what's happened.

The rise in the number of COVID-19 cases linked to the highly infectious delta variant has sparked fears that the economic boom driven by global reopening might just start to falter. These fears seemed to have outweighed the concerns about inflation that flustered bond investors earlier this year and drove the 10-year US Treasury yield up to a 1.78% peak.

Since then, US Treasury prices have run up big gains — and other bonds around the world have followed in their wake. Higher inflation generally coincides with higher bond yields, with the latter pricing in the expectation of interest rate hikes when inflation hots up. But many investors seem to believe the inflation spike is largely rooted in inevitable bottlenecks as the global economy opened up fast when lockdowns were chipped away. This is the message that the US Federal Reserve (Fed) has been reinforcing, with its oft-repeated insistence that the spike will prove 'transitory'.

We believe that the apparent contradiction between plunging bond yields and higher inflation won't last forever. A big jobs boom (particularly in the US) may prove the trigger for a yield pullback. Government bond prices have been slipping back since early August when nonfarm payrolls data showed the US creating more jobs than had been expected. The data covering July showed the US adding nearly 1 million jobs, compared with estimates of about 870,000.

The Fed has said that employment gains, as opposed to inflation, will be critical in determining when it starts to rein in its super-supportive policies. It's also stressed that it wants to see clear and lasting evidence of a jobs recovery before it responds. For now, policy makers (and bond investors) are in 'wait and see' mode.

Against this backdrop, we continued to pare back our exposure to some longer-dated bonds over the month. The prices of these long-duration assets are most sensitive to changes in yields/interest rates and may prove most vulnerable if markets turn more volatile. In July, we sold B**ritish Telecom 3.625% Senior 2047, Verizon Communications Senior 5.25% 2037** and also **M&G 6.25% 2068** bonds.

We've also allowed a little cash to build up so that we can swiftly put it to work when we find particularly compelling opportunities. Over the month, we added to several bonds that we believe will benefit our fund's long-term return and income potential.

Banks bounce back...

Our long-standing confidence in the financial sector (banks, insurers, specialist lenders and investment firms) was vindicated when many delivered nice surprises at their interim results during the month. Several banks in particular reported better-than-expected profit recoveries, probably helped along by the housing boom and fewer bad loans than they might have feared as government support kept customers afloat until the economy reopened.

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.

The interim results were good news not only for those who own their shares. Profits are important for bondholders too: if they falter, this can fast erode a company's capital and so potentially jeopardise its ability to make coupon payments. We remain optimistic about the sector's future. It seems as if the pandemic has accelerated many financial institutions' efforts to digitalise. Over time, this should enhance their efficiency and also profitability.

In July, we bought sterling-denominated bonds issued by investment manager **Investec 1.875% 2022** and insurer **Liverpool Victoria 6.5% 2043-23**, as well as sterling-denominated floating rate notes issued by **Virgin Money 5.125% 2030**.

Adding to affordable housing bonds

As we've mentioned before, we're keenly aware that the ongoing house price boom looks set to further widen housing inequality. The boom may be good news for those who own their homes, but not for those who can't get afford to get on the property ladder. Property ownership – long a struggle for low earners – has largely become the preserve of the better-off, especially in big cities like London where prices are highest.

Over the month, we bought several bonds that fund affordable housing for people on lower incomes and/or with special needs. These included the **Metropolitan Housing Trust 1.875% Senior Secured 2036, Flagship Housing 1.875% 2061** and **Anchor Hanover 2.23% 2051** bonds. The Metropolitan Housing Trust provides affordable housing in London, the South East and the Midlands, while Flagship does likewise in the Cambridge area. Anchor Trust is a not-for-profit provider of housing and care for people with special needs, particularly older people.

We like these housing providers' ethical credentials: they're trying to address housing inequality by making decent, affordable homes available to people on lower incomes to part-own or rent.

The environmental imperative

It won't have escaped anyone's attention that we're being bombarded by grim headlines about the impact of climate change on an almost daily basis. Early in the month, temperatures in Canada and parts of the north-western US remained at dangerous highs of nearly 50°C. In mid-July, Belgium and Germany experienced disastrous flooding as a result of torrential rains which killed more than 180 people. This was followed by even deadlier floods in central China. And more recently, of course, we've seen awful devastation caused by wildfires triggered by protracted heatwaves in Greece and Turkey.

It's widely believed that climate change played a role in all these exceptional weather events. The message was hammered home when the Intergovernmental Panel on Climate Change (IPCC), the world's leading authority on climate change, issued its first report in eight years in early August. The IPCC found that the combined effects of human activity have increased the global average temperature by about 1.1°C above its late 19th century norm. Without drastic moves to eliminate greenhouse gas pollution, our planet could warm by 1.5°C above this norm in the next 20 years, bringing extreme weather and widespread devastation.

All this provides a stark reminder that the world must urgently take action to combat climate change. One of the key themes underpinning our fund is our focus on bonds that help build a greener world, whether that's by supporting sustainable energy sources (like wind, solar and hydro) and development projects, protecting biodiversity and natural resources or funding environmental education.

We're very happy with the bonds we own that are helping to tackle climate change. As more and more governments and companies wake up to this pressing imperative, we think that our green bond opportunity set is only going to broaden and deepen.

Bryn Jones
Fund Manager

Noelle Cazalis
Fund Manager

Stuart Chilvers
Assistant Fund Manager

Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment.

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

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

Authorised and regulated by the Financial Conduct Authority

A member of the Investment Association

A member of the Rathbone Group. Registered No. 02376568

7445.08.21