Rathbones
Look forward

Rathbone Ethical Bond Fund

Monthly update August 2021

Government bond yields continued to creep higher in August.

The yield on US 10-year Treasuries (which runs in the opposite direction to prices) nudged up from 1.23% at the start of the month to reach 1.31% by its end. And the yield on 10-year gilts rose to 0.62% from 0.56%.

Credit spreads — the extra return above government bond yields for taking on the risk of default — tightened, with the iTraxx Crossover European high yield spread index ending the month at 228 basis points (bps), down from 236bps at its start.

Is recovery at risk?

The big reopening recovery seems to be faltering a bit. Growth rates have been slowing as Delta has swept the globe. Vaccines are (fortunately) preventing most from getting severely sick, but not completely stopping infections. This has kept people away from work and sapped consumer confidence and spending rates. The 'pingdemic' hit the UK economy so hard in July that it barely grew at all. Supply logjams and chronic staff shortages are throwing businesses (and consumers) off balance. Shortages of vital stuff have fuelled inflation, keeping it at multi-year highs.

In the UK and the US in particular, job markets seem mired in a post-pandemic muddle. Several sectors are growing fast and face chronic worker shortages. Others are probably in terminal decline and won't ever rehire all the people they've shed. It will take time to clear these hiring bottlenecks as people get retrained before coming back to work in new occupations. In the meantime, the big changes in working patterns inflicted by COVID-19 seem to be hindering economies' efforts to get back to full throttle.

A tricky taper timeline

All this leaves policymakers with a dilemma. The US Federal Reserve (Fed) has repeatedly signalled that it'll start reining in (or tapering) its super-accommodative policy support when it sees clear and lasting evidence of a jobs recovery. August's nonfarm payrolls survey was shockingly weak: US employers created only 235,000 new jobs over the month, less than a third of the number expected. It may turn out to be just a midsummer blip after several months of steady and significant jobs growth. But the survey revealed other challenges that may prove more persistent: well over 10 million new jobs have yet to be filled. Meanwhile, job vacancies in the UK have shot past the 1 million mark for the first time ever.

Do these huge supply/demand gaps suggest the recovery may be too fragile to start pulling out the support rug? Or would it be riskier to keep it in place and perhaps further fuel inflation (which may already be getting stoked by the higher wages offered to lure workers to sectors with the worst staff shortages)?

Some stimulus may well have to be eased as inflation stays stubbornly above policymakers' targets. (The European Central Bank (ECB) has already curbed the pace of its pandemic emergency bond purchases.) But the Fed seems likely to taper its bond-buying programme only very gradually given the shakier recovery trajectory. And it has emphasised that interest rate hikes will come well after tapering starts.

Keeping duration down and prioritising quality

However softly-softly the Fed proceeds, we're braced for some bond market wobbles ahead. We've been doing what we can to protect our fund from any future fallouts. Earlier in the year, we dialled down our exposure to longer-dated (long duration) bonds, which are most sensitive to changes in yields/interest rates.

We've also been careful not to overstretch in the search for yield by buying bonds issued by less creditworthy companies with weaker balance sheets.

Credit spreads have got tighter and tighter over the summer despite the gentle rise in government bond yields over the past couple of months. This means some higher-yielding and lower-quality corporate bonds simply aren't offering enough of a yield buffer to compensate investors for their higher default risks. In the current uneasy limbo-land, we think it's critical to own bonds issued by high-quality and resilient businesses that we believe will stay solvent even if times get tougher

We didn't sell any bonds in August and bought only a few that we are confident will benefit our fund's long-term return and income potential. We've also let a little cash build up so that we can swiftly put it work when we find particularly compelling opportunities.

Topping up select financials

For some time now, we've been buying bonds issued by select banks and insurers that we regard as well-capitalised, profitable businesses that manage their risk exposure very carefully.

In August, we bought Dutch **Rabobank's 6.5% Tier 1 Perpetual** bonds which offer an attractive extra coupon payment at year-end. This comes about because the bond is very junior in the bank's credit structure, giving it some characteristics of equity, despite being a bond. When the ECB banned equity dividends early in the pandemic, this bond was unexpectedly caught up and was not allowed to pay its coupons. The extra coupon is a bumper payment to make bondholders whole. We also bought lender **Rabobank 4.63% 2029**, Nordic bank **Nordea 3.75% AT1 Perpetual-2029** and specialist UK insurer **Beazley 5.88% Subordinated 2026** bonds.

Tapping into a broadening green bond opportunity set

COVID may have thrown a huge spanner into the works of nearly everything else, but thankfully it hasn't slowed the seemingly inexorable surge in green bonds. These are being issued by more and more governments and companies to earmark funds for environmental projects aimed at combating climate change. Bank of America reports that green bond issuance this year has topped $200 billion, higher than the total for 2020. The UK government will (at last) launch green gilts later this month. And more companies operating in 'mainstream' sectors (i.e. outside things like wind and solar energy) are getting in on the act.

In August, we bought the first ever green bonds issued by UK house builder **Berkeley**. The money raised by these **2.5% 2031** bonds will be used to develop green properties (energy efficient homes) at several of Berkeley's large-scale brownfield regeneration sites.

What do we think about when we're deciding which green bonds to buy? We must always prioritise downside risks. How much money could we lose if the issuer can't pay the coupons? We must also be certain that the money raised will be ringfenced for a specific green purpose. The issuer must have a clear sustainability goal from the outset that we're confident is achievable and will bring measurable environmental benefits. We're looking for maximum transparency on what happens to the money raised: we expect the issuer to report back regularly on what's been spent and its environmental impact.

Getting this level of comfort involves a lot of painstaking work. But it's critical to ensure that the green bonds we own really can bring positive action on climate change.

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