

# Rathbone Ethical Bond Fund

## Monthly update November 2021

Government bonds rallied as investors sought out safe haven assets amid huge uncertainty about the impact of the new Omicron strain of COVID-19.

The yield on US 10-year Treasuries (which moves in the opposite direction to prices) fell from 1.58% to 1.46% in November, while the yield on 10-year gilts fell from 1.05% to 0.81%. More meaningful though was the continued flattening in government bond yield curves as investors sold short-dated bonds and bought longer-dated ones, narrowing the yield advantage that the latter usually command over the former. By the end of November, the yield gap between two-year and 10-year Treasuries was hovering around 99 basis points (bps), while the gap between two-year and 10-year gilts was around just 33bps.

The volatility in rates markets, along with worries that Omicron could inflict economic damage and hurt borrowers' ability to repay their debts, unnerved credit investors. Credit spreads – the extra return above government bond yields for taking on default risks – widened. The iTraxx Crossover started November at 262bps, but had hit 287bps by month-end.

### What are bond investors telling us?

As a rule of thumb, short-term government bond yields tell us what investors think is coming on the interest rate front, while longer-term bond yields illuminate investors' expectations of GDP growth. The flattening of the yield curve suggests investors expect early interest rate rises and believe that growth won't prove strong enough over the longer-term to persuade policy makers to drive up longer rates. This seems to reflect investor concerns that policymakers may choke future growth by moving forcefully and quickly to rein in policy support as they seek to tame inflation.

When COVID first arrived and economies tanked, there was a lot of clarity of purpose behind policy makers' dramatic interest rate cuts and big fiscal commitments. Things are much more complicated now, which makes the choices much tougher.

In the US, the Federal Reserve (Fed) has got more hawkish about inflation just as investors are getting rattled about Omicron's ability to thwart growth. In its December meeting US Fed chair Jerome Powell seemed to look beyond Omicron and pledged to tackle "elevated levels of inflation" by stepping up the pace of tapering its quantitative easing bond purchases. This paves the way for three Fed rate rises next year, more than markets had been expecting but they seem to have responded, by and large, with considerable equanimity.

By contrast, bond investors seem to have been unsettled by the Bank of England (BoE)'s surprise hike in interest rates to 0.25% at its December meeting. The majority of investors had expected the BoE to keep rates on hold until more was known about Omicron despite the continued rise in inflation, which hit 5.1% in November. Expect more grumbling that the BoE keeps on catching markets out and, therefore, seems to be behaving like an unreliable boyfriend.

All this to-ing and fro-ing is exerting a toll. Bond investor expectations as to when policy makers finally will raise rates have been swerving all over the place. This lack of clarity risks stoking more intense market volatility as investors scramble to stay ahead of policy pivots.

### Keep calm and 'carry' on...

If bond investors get things wrong about the interest rate and growth outlook – and we do think the rally in long-term rates has gone too far – we're braced for what could be an uncomfortable few months as investors rush to readjust their positioning as their expectations shift.

To help protect us against messy rate markets, we've reduced our exposure to longer-dated bonds, ensuring that our duration, as a whole, is shorter than the sector average. For example, we sold more of the UK government's debut **green gilts 0.88% 2033**, taking advantage of the increase in these bonds' prices since they were issued in September.

We added to bonds that we believe offer attractive 'carry' (essentially bonds that give us scope to lock in decent yields without us having to worry too much about big changes in their prices). As has been the case for some time, we continue to like bonds issued by select financial companies that we believe are well-capitalised businesses that should hold up well if growth starts to slow. Over the month, we added several financial bonds offering good carry, including **Legal & General's 5.63% 2031**, **AXA Group's 6.38% 2036** and **Scottish Widows' 7% 2043** bonds.



When credit spreads were tighter, we felt that some of the new bonds being issued looked overly expensive. Because prices were cheaper this month as spreads widened, we bought French banking group **BPCE's** new **2.5% 2032** and **NatWest's** new **2.16% 2028** bonds.

### And then?

The emergence of Omicron undoubtedly further complicates central banks' already thorny task of trying to wean financial markets off extraordinary policy support. Until we know more about the variant, and how much it might trouble the recovery that has given policy makers the confidence to start readying markets for less support, we're not rushing to judgement. As Christmas and the New Year approach, it makes more sense than ever to take a step back and reflect on long-term convictions rather than immediate uncertainties. Thank you for your support in 2021 and happy holidays!



**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.**