

Rathbone Ethical Bond Fund

Quarterly update December 2021

Central banks have pivoted away from “wait-and-see” mode and firmly signalled their commitment to tighter monetary policy to try to tame inflation.

Government debt prices fell in response as investors sold these bonds because their low fixed returns look unattractive in a world where inflation and/or rates are higher. The yield on US 10-year Treasuries (which moves in the opposite direction to prices) began the quarter at 1.49% and ended it at 1.51%. By contrast, the yield on 10-year gilts fell from 1.02% to 0.97% – evidence, perhaps, that gilt investors are more uncertain about what the Bank of England (BoE) will do next (more on that later!). Although, by early January the yield was hovering around 1.17%.

One of the biggest trends of the quarter was the sharp flattening in government bond yield curves – the difference between yields of shorter and longer maturity bonds decreased. This was driven by very intense selling of shorter-dated bonds as more people started to expect central banks to hike interest rates sooner. That selling pushed up the yield of short-term bonds by much more than for longer-dated bonds.

It was a volatile quarter in credit markets. Credit investors were unnerved by the emergence of the Omicron strain of COVID-19 in November. Credit spreads – the extra return above government bond yields for taking on default risks – widened significantly amid worries that the variant might inflict serious economic damage and hurt borrowers' ability to repay their debts. Spreads tightened again in December as investors grew more confident that Omicron wouldn't derail the recovery. The iTraxx Crossover started the quarter at 253 basis points (bps) and had narrowed to 242 bps by its end.

	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	-0.50%	-0.49%	-0.41%	21.81%	30.50%
IA UK Sterling Corporate Bond Sector	0.08%	-0.38%	-1.92%	15.74%	18.89%

	31 Dec 20- 31 Dec 21	31 Dec 19- 31 Dec 20	31 Dec 18- 31 Dec 19	31 Dec 17- 31 Dec 18	31 Dec 16- 31 Dec 17
Rathbone Ethical Bond Fund	-0.41%	8.94%	12.27%	-3.08%	10.54%
IA UK Sterling Corporate Bond Sector	-1.92%	7.77%	9.49%	-2.22%	5.06%

Source: FE Analytics; data to 31 December, I-class, mid price to mid price.

These figures refer to past performance, which isn't a reliable indicator of future returns.



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.

Navigating Omicron and policy pivots

Central banks around the world grew more hawkish and/or tightened policy (albeit from extraordinarily loose levels in many cases) as inflation kept increasing and hanging around longer than they'd expected. Consumer price inflation hit 5.1% in the UK in November and 6.8% in the US.

Things got more complicated when Omicron surfaced in November, with the World Health Organisation announcing that it was a "variant of concern". This sparked worries that it might derail the recovery that had given policymakers the confidence to start readying markets for less support. The resulting (relatively short-lived) spike in investor risk aversion drove a government bond rally, while credit sold off. Going into December, bond investors seemed to accept that while Omicron was causing huge infection numbers (alongside major disruption), it was not resulting in mass hospital admissions (at least among the vaccinated).

Against this backdrop, central banks continued to pivot towards a much more hawkish policy stance. In November, the US Federal Reserve (Fed) announced its widely signposted 'tapering' of US quantitative easing (QE) bond buying, while stressing that it didn't envision rate hikes until tapering was finished (then scheduled for around mid-2022).

The following month Fed chair Jerome Powell pledged to step up the pace of QE tapering to tackle "elevated levels of inflation". This seemed to pave the way for three Fed rate rises in 2022: more than bond investors had been expecting, though they responded, by and large, with considerable equanimity.

However, the Treasury sell-off has picked up a fair bit of pace in the first few weeks of January, driven in particular by the release of the minutes from the latest Fed meeting. They suggested it may move to raise rates and tighten financial conditions even more quickly because inflation gauges "had been higher and were more persistent than previously anticipated".

The BoE's messaging has been a lot trickier to read, prompting much grumbling that it keeps catching markets out and, therefore, behaving like an "unreliable boyfriend". Bond investors were unsettled (to put it mildly!) when the BoE didn't hike rates in November after stating it would "have to act". And they were equally startled when it increased them to 0.25% in December just as the UK began to be engulfed by a wave of Omicron infections.

Dialling down long-dated housing bonds...

We felt that October's big yield curve flattening was an overreaction. As a result, we opted to sell some longer-duration bonds whose prices we felt had probably risen too much. (The rally in longer-dated debt was driven, in part, by investor concerns that growth wouldn't prove strong enough in the longer term to persuade policy makers to drive up longer rates.) We then held on to the cash raised until rates and spreads started to settle down a bit. In October, we sold several long-dated bonds issued by housing associations to fund long-term housing projects. These included London housing association **Peabody Capital No2 3.25% Senior Secured 2048** and **Peabody Capital 5.25% Senior 2043**, North West England housing association **Onward Homes 2.125% Senior Secured 2053**, and Midlands-focused housing association **Orbit Group 3.375% Senior 2048** and **Orbit Capital 3.5% 2045**.

Going into November, we continued to reduce our exposure to longer-dated bonds, ensuring that our duration, as a whole, was shorter than the sector average. For example, we sold the UK government's debut **Green Gilt 7/8% 2033**, taking advantage of the increase in these bonds' prices since they were issued in September.

Our low duration proved rewarding when global bond yield curves began to steepen late in the year as bond investors grew more confident about the growth outlook despite Omicron and policy tightening.

Keeping calm and 'carrying' on

We added to bonds that we believed offered attractive 'carry' (essentially bonds that gave 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 like bonds issued by select, well-capitalised financial companies that manage their risk exposure carefully and should hold up well if life gets more difficult.

In October, we bought pensions insurance specialist **Rothesay Life 5% Perpetual-2031** and **4.875% Perpetual-2027** bonds. We topped these up with Rothesay's **6.875% Subordinated Perpetual-2028** bonds in December. Rothesay takes on the assets and liabilities of corporate pension schemes from companies that no longer want to manage them. Its focus is investing in long-term assets to match its long-term liabilities so it's planning to fund new long-dated fixed rate mortgages in the UK to help meet this objective.

In November, we added several financial bonds offering good carry, including the **Legal & General 5.625% Perpetual-2031**, **AXA Group 6.379% Perpetual-2036** and **Scottish Widows 7% Subordinated 2043**.

When credit spreads were tighter we felt that some of the new bonds being issued looked overly expensive. Because prices were cheaper in November as spreads widened we bought newly issued bonds, including French banking group **BPCE 2.5% Lower Tier 2 2032** and **NatWest 2.057% Senior 2028**.

What can we expect in 2022?

The final few months of 2021 were certainly gruelling for bond investors as the emergence of Omicron further complicated the tricky shift towards less extraordinary policy support. That said, we're pretty happy with how the quarter (and year) went investment-wise.

Will 2022 prove less challenging? We can always hope, but it seems unlikely...

There's still a lot of uncertainty about Omicron's eventual impact – not to mention the obvious risk that new COVID strains could emerge. Equally, there are hopes that Omicron might just hasten COVID's transition from pandemic to an endemic disease.



Inflation doesn't seem like it's going away any time soon. Central bankers have made it clear that they must try to tame this particular beast with tighter policy since both output and employment are strong. Expect government bond yields to keep grinding higher as investors rush to price in quickening policy tightening. As governments rein in bond buying, supply and demand dynamics will change. A supply glut could exert extra pressures on some bond prices.

And how will higher rates impact on credit markets? At this early phase of the shift towards rate tightening, we're happy to hold on to our corporate bonds. But we may grow more cautious when tightening gets more entrenched and corporate defaults start to rise.

Notwithstanding the challenges ahead, we're very excited about the prospects for our holdings in the year to come – and beyond.



Bryn Jones
Fund Manager



Noelle Cazalis
Fund Manager



Stuart Chilvers
Assistant Fund
Manager

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