Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone High Quality Bond Fund

Quarterly update June 2021

Government bond markets have clawed back some of the big yield rises of early 2021.

The yield on US 10-year Treasuries fell from 1.74% on 31 March to reach 1.47% by quarter-end. Likewise, the yield on 10-year gilts nudged down to 0.72% after rising sharply to 0.85% in the preceding quarter (when yields fall, bond prices rise).

Credit markets benefited from the falling yield trend. Credit spreads – the extra return above government bond yields for taking on the risk of default – narrowed, with the iTraxx European investment grade index falling to 47 basis points compared with 52bps at the beginning of the quarter.

	3 months	6 months	1 year	30 Jun 19-30 Jun 20	Since Launch 16 Nov 18
Rathbone High Quality Bond Fund	0.86%	-0.58%	1.44%	2.01%	5.85%
Bank of England Base Rate + 0.5%	0.15%	0.30%	0.60%	1.07%	2.44%

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

Source: FE Analytics; data to 30 June, I-class, mid price to mid price; performance is a combination of I-class units and S-class units where I-class was unavailable (I-class launched 23 July 2019).

Yo-yo yields

Back in the first quarter, we took advantage of a rapid rise in government bond yields to buy longer-dated corporate bonds at cheaper prices. Because these bonds mature further into the future, their prices are more sensitive to changes in prevailing yields and interest rates. In Q2, as yields fell once again, we sold some of these bonds whose prices appeared to have rallied too far. They included **National Grid 1.125% Senior 2028**, **New York Life Global Funding 0.75% 2028**, **Segro 2.375% 2029** and **London Stock Exchange Senior 2030**. This meant that our portfolio's modified duration fell from 4.1 years to 3.9 years.

We didn't have to forgo yield to do this, as we managed to find attractive opportunities issued by businesses that we like at yields that offset those we sold. Many of these were financials, a sector we have liked for a very long time, such as **Credit Suisse 1.125% Senior 2025**, **JPMorgan 0.991% 2026** and **Goldman Sachs 1% 2025**. There were some other industries too, including food producer **Nestle Holdings 0.625% 2025** and housing associations **Places for People 2.875% Senior 2026** and **4.25% 2023** and **A2D Funding 4.75% 2022** and **A2D Funding II 4.5% 2026**.

Meanwhile, we continue to pick up many attractive and solid bonds at issue. To give you a taste of the sort of things we're buying, we go through a few below.

We bought the **SNCF 0.875% 2026**, a rare sterling bond from the French railway monopoly (this is only the second outstanding sterling issue). Owned by the French republic, the company runs the whole shebang, from rolling stock manufacturing to railway maintenance and passenger and freight transport. This gives it a great platform for buying up foreign businesses and selling its carriages and consultancy services to other operators. As Europe and the rest of the world reopens, demand for railway traffic should increase along with SNCF's cash flows.

The **NATS (En Route) 1.375% Senior 2031** was also issued by a monopoly. This one, NERL, is the air traffic controller for the UK and eastern Atlantic. We bought this as another beneficiary of reopening – as travel restrictions are loosened and more flights are scheduled, NERL's cash flows should bounce back. There is also a shade of implicit government support if things take another turn for the worst, given that this is an essential service that must be delivered for the UK.

Not all of the newly issued bonds we picked up during the quarter were sterling denominated. We bought several dollar bonds because they help diversify our portfolio, protecting us in case the UK economy underperforms. They can also help us get exposure to sectors where few British companies offer high quality credit. An example of the latter was our purchase of e-commerce giant **Amazon 1% 2026** and **1.65% 2028**. We bought state-backed Australian high-speed broadband network **NBN Co 1.45% 2026**, adding to existing bonds of this company that we hold. Another benefit of dollar bonds is that they offer higher yields than those in the UK and Europe. Meanwhile, the cost of hedging – locking in an exchange rate today to protect against currency fluctuations wiping out your future profit – is near zero.

Finally, we bought Australian investment bank **Macquarie 1.125% Senior 2025**. With high levels of capital, its balance sheet is solid, while its liquidity (available cash) is perhaps even stronger. It's posting strong loan growth and trading conditions look healthy.

Bond markets stay (mostly) steady

The economic recovery from COVID-19 gathered considerable pace in the second quarter, while also broadening out to more countries and economic sectors.

It's estimated that US GDP may have grown by a blistering 9% annualised over the quarter as its economy continued to roar back to life. At the same time, the UK, Europe and Japan appeared to be starting to join in the big post-pandemic growth rebound.

As growth has picked up, inflation rates have been rising too. The US leads the way, with its 5% inflation rate the highest level since August 2008. Concerns over higher inflation generally coincide with higher bond yields. As a proxy for interest rates, bond yields tend to price in the expectation of interest rate hikes when inflation hots up. But recently bond yields have proved surprisingly steady (bar the odd few bouts of skittishness). The yield on 10-year US Treasuries settled into a narrowish range below 1.50% during the quarter, significantly below their yearly peak of 1.78% amid inflation collywobbles in February and March. The yield has fallen even as inflation continues to rise. Bond investors seem to be accepting the US Federal Reserve's (Fed) oft-repeated insistence that the current inflation spike is going to prove "transitory".

At its June policy-setting meeting, the Fed acknowledged that inflation and growth were coming in higher than it had expected. But it also stressed that it wanted to see clearer evidence of a firm jobs recovery before reining in its super-supportive policies. The recovery in US jobs has proved somewhat sluggish. June's payrolls report was a bit mixed. While more than 850,000 jobs were created (more than had been expected), the overall unemployment rate rose to 5.9% versus the previous month's 5.6%.

The Fed may remain patient about pencilling in interest rate rises until it sees substantial progress in repairing pandemic-inflicted labour market damage. But in June's meeting the Fed acknowledged that it's gearing up to kick off discussion on when to slow the pace of its quantitative easing (QE) bond purchases. This would be a first step in reining in its easy policies as QE helps keep a lid on bond yields.

For now, bond investors seem to be accepting that we're in a 'wait-and-see' world and it's just too early to tell whether the recovery rebound (and attendant inflationary pressures) will begin to ease back a bit or whether they'll stay on the boil. Whatever happens, bond investors appear more confident about the Fed's insistence that any eventual policy tightening is going to be slow, gradual, and signalled well ahead of time. Even if other investors become concerned. Plenty of chance for that to be upended, however, so we're staying vigilant!

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