Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone High Quality 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	31 Dec 19-31 Dec 20	31 Dec 18-31 Dec 19	Since Launch 16 Nov 18
Rathbone High Quality Bond Fund	-0.71%	-0.96%	-1.53%	2.93%	3.37%	4.83%
Bank of England Base Rate + 0.5%	0.16%	0.31%	0.61%	0.73%	1.25%	2.77%

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

Source: FE Analytics; data to 31 December, 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).

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.

Shifting money to the belly of the yield curve

We felt that the big moves in the shape of the yield curve over the quarter warranted some repositioning of our duration (interest rate risk) exposure. While the curve flattened overall, the shortest dated debt right at its front end sold off less aggressively than bonds maturing in three to five years. Because we felt this left the latter looking better value than the shortest dated debt, we sold some of our shortest duration bonds, including **DNB Bank 1.375% Floating Rate Senior 2025**, **China Development Bank 1.25% 2023 Senior 2023** and **Coventry Building Society 1.875% 2023** bonds. We reinvested the proceeds in bonds at the 'in-between' (or belly) of the curve to lock in a better balance of yield to risk. For example, we bought property management company **Logicor 1.875% Senior Secured 2026** and **Lloyds Bank 1.875% Senior Secured 2026** bonds.

In a similar trade, we sold some of our longer-duration bonds whose prices we felt had probably risen too much as the curve flattened, including **Yorkshire Building Society 1.5% Floating Rate Senior 2029** and merchant bank **Close Brothers 1.625% Senior 2030** bonds. Again, we reinvested the proceeds in bonds in the belly of the curve.

Our duration positioning proved rewarding when global bond yield curves began to steepen late in the year. This steepening was driven by a sell-off at the long end as investors grew more confident about the growth outlook despite Omicron and policy tightening.

Finding value amid credit market volatility

When credit spreads were tighter we felt that some of the new bonds being issued looked overly expensive. Because prices were cheaper when Omicron drove spreads wider, we bought some newly issued bonds that we felt looked attractive, including French banking group **BPCE 2.5% Lower Tier 2 2032** bonds. BPCE is France's second largest banking group; its strong solvency ratio ensured we were comfortable investing in its bonds lower down the capital structure. We also bought investment firm **Blackstone Property Partners 2.0% Senior 2025** bonds. Blackstone is one of the world's largest alternative asset managers and is benefiting from strong investor demand for higher yielding alternative strategies and investments as protection against rising rates and inflation — a trend that we expect to continue.

Blackstone issues bonds only infrequently so we were keen to snap up its bonds when they were issued in late November. Likewise, we moved swiftly to buy more of our 'favourite' hard-to-source bonds as and when opportunities arose. In early November, we bought Swiss banking group **UBS 8.75% Subordinated 2025** bonds which offer attractive income. We also added to housing association bonds that we believe are underpinned by strong fundamentals. We already held some of London and Southern England housing group A2 Dominion's bonds and added to these in mid-November, buying **A2 Dominion 3.5% 2028** bonds. And in October and November, we bought **Places for People 4.25% 2023** bonds, topping these up with its **2.875% Senior 2026** bonds. Places for People is one of the UK's largest housing associations, whose credit rating has benefited from its decision to sharpen its focus on its core social housing lettings business.

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

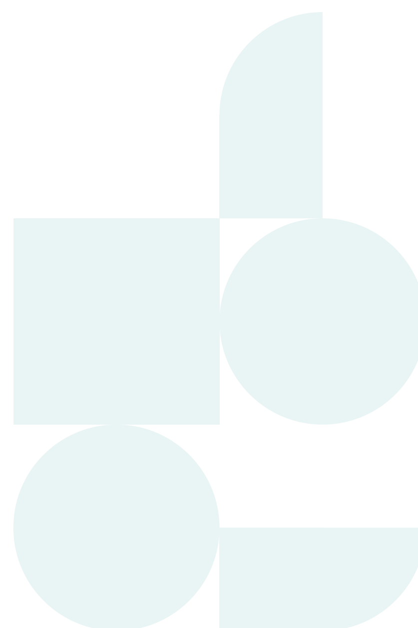
There's still a lot of uncertainty about Omicron's eventual impact — not to mention the obvious risk that new COVID strains could emerge. Equally, there are hopes that Omicron might just hasten COVID's transition from pandemic to an endemic disease.

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. We may grow more cautious when tightening gets more entrenched and corporate defaults start to rise. However, your fund's focus on bonds with credit ratings of A- and above suggest that default risks are distant.

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

Noelle Cazalis
Fund Manager



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