Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone SICAV Ethical Bond Fund

Monthly update February 2021

It's now a full year since COVID-19 started to shut down the global economy and financial markets went into a tailspin about how dire things might get. Investors responded by piling into the safest government bonds, driving up their prices so that their yields had plunged by late March last year.

Big bond moves in a short month

Since then, bond yields have been rising with each positive development on the vaccine front and the decline in COVID spread rates (when bond prices rise, yields fall). This February, the trend accelerated sharply as markets started to anticipate a red-hot recovery when the world opens up again. This prompted a torrid month in usually relatively staid government bond markets. Selling pressure began in the US, with the 10-year Treasury yield rising by more than 30 basis points (bps) to 1.40% over the month. The 10-year gilt yield also surged. Having started February at 0.32%, it had hit 0.82% by month-end.

Credit spreads – the extra return above government bond yields for taking on the risk of default – ended the month pretty much where they'd begun. The iTraxx Crossover European high yield spread index started February at 270bps and ended it at 265 bps.

Inflation and a steeper yield curve

As bond yields have been rising, so too have market expectations about inflation levels. Bond investors have grown increasingly concerned that reflation (a recovery in prices as economies get back to full tilt) could morph into full-blown inflation as pent-up spending suppressed by lockdowns is suddenly unleashed.

In more normal times, an inflation spike might be expected to drive up interest rates. (higher rates can tame rising prices because they make it more expensive to borrow and, therefore, curb propensity to spend.) In our current exceptional circumstances, central banks around the world have been keen to provide reassurance that rates aren't going to rise anytime soon. US Federal Reserve (Fed) Chair Jerome Powell showed that the Fed isn't in any rush to raise rates when he recently stated that it could take more than three years before the Fed reaches its inflation goal of 2%.

Against this backdrop, bond investors seem to be concluding that while rates may stay low in the short term, they're going to start reflecting expectations of stronger growth and higher inflation in the longer term. The result? The yield curve has steepened – which is to say, the yields on longer-dated bonds have risen relative to those on shorter-dated bonds. In fact, the US yield curve has been pushed to its steepest level since 2015. We see this as no bad thing: a steeper yield curve often signals that the economy is expanding or recovering.

Buying longer-dated debt

We took advantage of the steepened yield curve to buy bonds in areas that we have avoided in past months, or kept only small holdings in, because we thought prices were previously too expensive. Namely, longer-dated, safer quasi-government bonds that are more sensitive to changes in yields/interest rates. We don't invest in gilts as the government is involved in some areas that are prohibited by our screening criteria, so we use sterling-denominated supranational (quasi-government) bonds as an ethical proxy. As yields began to spike, we bought **International Bank for Reconstruction and Development** (the World Bank) **5.75% 2032** and **European Investment Bank 5.0% 2039** bonds.

Adding to social housing bonds

The steeper yield curve also encouraged us to add to our long-dated social housing bonds. For example, we bought the **Notting Hill Housing Trust 3.25% 2048** and the **Orbit Group 3.375% 2048**. The trust, as its name suggests, provides high-quality housing to low-income renters and shared ownership buyers in London's Notting Hill area and elsewhere. Demand for affordable housing is particularly intense in Notting Hill, the least affordable place to live in the UK since the price of the average property is almost 17 times higher than average earnings. Orbit fulfils a similar function in less pricey areas in the Midlands, East Anglia and the South East. We like housing associations' ethical credentials: they provide good quality homes for people with low incomes or special needs. And they're trying to address the UK's acute shortage of affordable housing by building new homes to rent and shared ownership properties. COVID has made it even more difficult for many people to afford private sector housing. Housing and homelessness charity Shelter recently reported that COVID-related financial pressures mean that one in four people living in privately rented accommodation worries about how to pay their rent and bills. We believe that housing associations' commitment to affordability means they may play a crucial role in helping to mitigate the pandemic's disproportionate impact on people on lower incomes.

Housing associations are carefully regulated and, as non-profit-making charitable organisations, they tend to be pretty risk-averse. As a result, we believe that investing in select long-duration housing association bonds can give us access to stable and secure cash flows far out into the future.

Sticking with tried-and-tested themes

It's important to recognise that the recent big moves in bond markets reflect investors' attempts to price in recovery, reflation and all the rest of the (broadly) good stuff before they actually happen. It's going to be a while before we find how much long-term economic damage the pandemic has inflicted and how life will have changed when we come out the other side.

As a result, we continue to favour investments that we expect should prove profitable and solvent even if recovery is difficult and some businesses and entire industries continue to struggle. For example, we continue to like companies that benefit from the lockdown-driven surge in online shopping. In February, we bought **Prologis 1.65% 2031**, one of the world's biggest warehousing landlords. Its business has been thriving as online shopping has encouraged retailers to lease more warehousing space. They need this extra space to ensure they've got enough inventory to fulfil their orders and also want warehouses near their customers so that they can deliver goods quickly and efficiently. We think people are going to continue to do lots of their shopping online well after bricks and mortar shops open up again, so we expect Prologis to continue to do well.

Jam today, but will it be gruel tomorrow?

Towards the end of February, we got the first big leaks about Chancellor Rishi Sunak's much anticipated 2021 budget. Unsurprisingly, these signalled that the government is going to continue spending its way out of trouble. Lots of the Chancellor's policy proposals focused on extending current emergency support to people and businesses. This is in line with Prime Minister Boris Johnson's recent pledge that his government wasn't planning to "pull the rug out" from under anyone and would "continue to do whatever it takes to protect jobs and livelihoods" during the phased exit from lockdown.

But the Chancellor was also keen to stress that the spending binge can't last forever. This marks a different tone from many of his counterparts in other countries, who assiduously avoid talking about how they plan to repay the money they've borrowed to keep things going until the recovery firms up. Our economy may be one of the first to open up again (given how speedily we're vaccinating people against the virus). But we may also be one of the front-runners in terms of trying to claw back the cost of paying for pandemic support.

This could be risky. If taxes are increased and spending is cut too quickly, we think this could throttle a fragile recovery. The Chancellor will need to tread very carefully in coming months!

Green gilts at last!

Finally, we're pleased that the Budget announcements revealed a bit more about the UK's first 'green gilts' programme. The UK intends to issue at least £15 billion of green bonds by year-end, via its first two green gilts. The money raised will help fund things like investments in wind and hydrogen power.

We've been lobbying for green gilts for years so we're delighted they're on the way at last. In themselves, this year's bonds probably won't prove hugely significant (they won't be big enough to do so). But we expect them to encourage more companies to start issuing green bonds as they recognise the extent of the demand for such securities. In our view, this should help broaden and deepen our green bond opportunity set. In particular, we hope to see more sterling-denominated green bond issuance as this has been pretty rare so far.

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