

Rathbone SICAV Ethical Bond Fund

Monthly update October 2021

Growing concerns about a nasty combination of slowing economic growth and tighter monetary policy have gripped bond markets.

The value of government debt continued to fall as investors sold government bonds whose low fixed returns look unattractive in a world where inflation and/or central bank interest rates are higher. The yield on US 10-year Treasuries (which moves in the opposite direction to prices) rose from 1.49% to 1.58%, while the yield on 10-year gilts rose from 1.00% to 1.02%. More meaningful though was the sharp flattening in government bond yield curves – the difference between yields of shorter and longer maturities decreased. This was driven by very intense selling of shorter-dated bonds as more people expected 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.

The considerable volatility in rates markets unnerved corporate bond investors, driving credit spreads – the extra return above government bond yields for taking on default risk – wider. The iTraxx Crossover high yield spread index stood at 253 basis points (bps) on 1 October, but had hit 262bps by month-end.

Big yield curve flattening...

The world's big central banks are in an awkward spot. Inflation is stubbornly high and rising prices, fuelled by supply chain blockages and labour shortages, are starting to erode the economic recovery. But overreacting to surging prices by tightening policy too forcefully and too quickly could risk choking GDP growth just as it hits a rougher patch.

For several months, bond investors believed that central banks would tolerate the powerful burst of inflation unleashed by reopening. This confidence wobbled big time in October as they grew increasingly convinced that stronger-than-expected inflation was about to force a hawkish policy reaction.

These fears were most intense in the UK, where the Bank of England (BoE) seemed to give up on the idea that inflation would prove a temporary challenge. In mid-October, BoE governor Andrew Bailey warned that growing concerns about "medium-term inflation" meant the bank would "have to act". By month-end, the UK gilt market was pricing in four to five rate hikes between November and the end of 2022.

Back in April, government-bond yield curves were super-steep. Since then, curves have been flattening. Yields at the short end have been rising in anticipation of higher interest rates, while worries about weaker growth in coming years have kept a lid on longer-term yields.

In October, this flattening got much more extreme very suddenly. Short-dated bond yields leaped higher, while yields at the long end fell (in part because of concerns about the available supply of longer-dated debt). By late October, the yield gap between two-year and 10-year gilts was hovering at around only 40bps, not far off inversion. Inverted yield curves – when short-term yields are higher than longer-term ones – are often deemed a warning of economic trouble ahead.

... followed by a huge sigh of relief

So bond investors let out a collective sigh of relief in early November when policymakers confirmed that higher rates were still some way off. When the US Federal Reserve (Fed) announced its widely signposted 'tapering' of US quantitative easing (QE, or bond buying) in early November, it stressed that it didn't envision rate hikes until tapering was finished. That's currently scheduled for mid-2022. More surprisingly, the BoE said it would keep rates on hold in November (prompting quips that Mr Bailey had as little constancy as an "unreliable boyfriend"). The impact on government bond yields has been huge. The 10-year gilt yield touched 1.20% in the penultimate week of October, but soon tumbled to below 0.85%. It has since rebounded to about 0.90%.

Dialling down long-dated housing bonds

We felt that the big yield curve flattening was an overreaction. We opted to sell some longer-duration bonds whose prices we felt had probably risen too much. We then held on to the cash raised until rates and spreads started to settle down a bit. 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 Senior Secured 2.125% 2053**, and Midlands-focused housing association **Orbit Group Senior 3.375% 2048** and **Orbit Capital 3.5% 2045**.



Adding to innovative insurers

For some time now, we've been buying bonds issued by select insurers that we regard as well-capitalised, profitable businesses that manage their risk exposure very carefully. In October, we bought bonds issued by innovative insurance companies that we believe are getting ahead of the pack by making full use of their specialist expertise to deliver 'new wave' protection products. We bought specialist insurer **Beazley 5.5% Lower Tier 2 2029** bonds. Beazley is reporting strong demand for its cyber-security insurance, significantly buoying up the prices it can charge for coverage premiums. We also bought pensions insurance specialist **Rothesay Life's 5% Perpetual-2031 and 4.875% Perpetual-2027** bonds. 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.

Beyond COP26

One of the key themes underpinning our fund is our focus on bonds that help build a greener world, whether that's by supporting sustainable energy sources (like wind, solar and hydro) and development projects, protecting biodiversity and natural resources or funding environmental education. As a result, we kept a particularly close watch on the progress (or frustrating lack thereof) at the COP26 global climate summit. Taken in aggregate, balancing the possibilities and retaining the right to check on progress, we consider COP26 to have been just barely good enough for now.

But whatever governments do or don't do, we believe there are plentiful investment opportunities that can help the world make progress towards net zero and cope with the physical effects of climate change already with us. We're seeing many bond issuers ramping up their adoption of science-based climate targets. This sets out a better framework to judge success and allows investors like us to engage with issuers to drive positive change.



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