Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Strategic Bond Fund

Monthly update July 2021

Government bond markets continued their seemingly relentless rally during the month.

The yield on US 10-year Treasuries (which falls as prices rise) dropped from 1.47% at the start of the month to reach 1.23% by its end. Likewise, the yield on 10-year gilts edged down from 0.72% to 0.56%.

Credit markets benefited from the falling yield trend, as well as from the usual summer lull in new bonds to buy. Credit spreads — the extra return above government bond yields for taking on the risk of default — narrowed, with the iTraxx Crossover European high yield spread index ending the month at 236 basis points (bps), down from 232 bps at its start.

Bond yields defy inflationary gravity

Who would have thought back in February/March that government bond yields would be whoppingly *lower* by mid-year even as growth has roared back and inflation has heated up? But that's exactly what's happened.

The rise in the number of COVID-19 cases linked to the highly infectious delta variant has sparked fears that the economic boom driven by global reopening might just start to falter. These fears seemed to have outweighed the concerns about inflation that flustered bond investors earlier this year and drove the 10-year US Treasury yield up to a 1.78% peak.

Since then, US Treasury prices have run up big gains — and other bonds around the world have followed in their wake. Higher inflation generally coincides with higher bond yields, with the latter pricing in the expectation of interest rate hikes when inflation hots up. But many investors seem to believe the inflation spike is largely rooted in inevitable bottlenecks as the global economy opened up fast when lockdowns were chipped away. This is the message that the US Federal Reserve (Fed) has been reinforcing, with its oft-repeated insistence that the spike will prove 'transitory'.

We believe that the apparent contradiction between plunging bond yields and higher inflation won't last forever. A big jobs boom (particularly in the US) may prove the trigger for a yield pullback. Government bond prices have been slipping back since early August when nonfarm payrolls data showed the US creating more jobs than had been expected. The data covering July showed the US adding nearly 1 million jobs, compared with estimates of about 870,000.

The Fed has said that employment gains will be critical in determining when it starts to rein in its super-supportive policies. It's also stressed that it wants to see clear and lasting evidence of a jobs recovery before it responds. For now, policy makers (and bond investors) are in 'wait and see' mode.

Against this backdrop, we continued to pare back our exposure to some longer-dated bonds over the month. The prices of these long-duration assets are most sensitive to changes in yields/interest rates and may prove most vulnerable if markets turn more volatile. In July, we sold **Barclays 3.25% Senior 2033** and **Verizon Communications 5.25% Senior 2037** bonds.

We've also allowed a little cash to build up so that we can swiftly put it to work when we find particularly compelling opportunities. Over the month, we added to several bonds that we believe will benefit our fund's long-term return and income potential.

Banks bounce back...

Our long-standing confidence in the financial sector (banks, insurers, specialist lenders and investment firms) was vindicated when many delivered nice surprises at their interim results during the month. Several banks in particular reported better-than-expected profit recoveries, probably helped along by the housing boom and fewer bad loans than they might have feared as government support kept customers afloat until the economy reopened.

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.

The interim results were good news not only for those who own their shares. Profits are important for bondholders too: if they falter, this can fast erode a company's capital and so potentially jeopardise its ability to make coupon payments. We remain optimistic about the sector's future. It seems as if the pandemic has accelerated many financial institutions' efforts to digitalise. Over time, this should enhance their efficiency and also profitability.

In July, we bought sterling-denominated bonds issued by insurer **Liverpool Victoria 6.5% 2043-23**, investment manager **Investec 1.875% 2022** and as well as sterling-denominated floating rate notes issued by **Virgin Money 5.125% 2030**.

Adding to diversifiers

We also added to assets that we believe offer attractive diversification benefits away from the ups and downs of more 'mainstream' financial markets. These included units in the **Pacific G10 Macro Rates** and **MontLake Angel Oak Multi-Strategy** funds. The former is an interest rate and foreign exchange macro strategy, while the latter invests in asset-backed securities, particularly collateralised mortgage obligations, collateralised loan obligations and other collateralised debt obligations.

We also added to our holding in the **iShares China CNY Bond ETF**, which is invested in Chinese government and policy bank bonds (the latter are issued by government-controlled institutions that lend to official projects). The ETF provides an accessible way to gain exposure to these bonds, which are now included in one of the world's most important global bond indices. China is a highly rated sovereign and these bonds offer an attractive yield relative to high-quality alternatives.

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Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment.

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