Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Strategic Bond Fund

Monthly update August 2021

Government bond yields continued to creep higher in August.

The yield on US 10-year Treasuries (which runs in the opposite direction to prices) nudged up from 1.23% at the start of the month to reach 1.31% by its end. And the yield on 10-year gilts rose to 0.62% from 0.56%.

Credit spreads — the extra return above government bond yields for taking on the risk of default — tightened, with the iTraxx Crossover European high yield spread index ending the month at 228 basis points (bps), down from 236bps at its start.

Is recovery at risk?

The big reopening recovery seems to be faltering a bit. Growth rates have been slowing as Delta has swept the globe. Vaccines are (fortunately) preventing most from getting severely sick, but not completely stopping infections. This has kept people away from work and sapped consumer confidence and spending rates. The 'pingdemic' hit the UK economy so hard in July that it barely grew at all. Supply logjams and chronic staff shortages are throwing businesses (and consumers) off balance. Shortages of vital stuff have fuelled inflation, keeping it at multi-year highs.

In the UK and the US in particular, job markets seem mired in a post-pandemic muddle. Several sectors are growing fast and face chronic worker shortages. Others are probably in terminal decline and won't ever rehire all the people they've shed. It will take time to clear these hiring bottlenecks as people get retrained before coming back to work in new occupations. In the meantime, the big changes in working patterns inflicted by COVID-19 seem to be hindering economies' efforts to get back to full throttle.

A tricky taper timeline

All this leaves policymakers with a dilemma. The US Federal Reserve (Fed) has repeatedly signalled that it'll start reining in (or tapering) its super-accommodative policy support when it sees clear and lasting evidence of a jobs recovery. August's nonfarm payrolls survey was shockingly weak: US employers created only 235,000 new jobs over the month, less than a third of the number expected. It may turn out to be just a midsummer blip after several months of steady and significant jobs growth. But the survey revealed other challenges that may prove more persistent: well over 10 million new jobs have yet to be filled. Meanwhile, job vacancies in the UK have shot past the 1 million mark for the first time ever.

Do these huge supply/demand gaps suggest the recovery may be too fragile to start pulling out the support rug? Or would it be riskier to keep it in place and perhaps further fuel inflation (which may already be getting stoked by the higher wages offered to lure workers to sectors with the worst staff shortages)?

Some stimulus may well have to be eased as inflation stays stubbornly above policymakers' targets. (The European Central Bank (ECB) has already curbed the pace of its pandemic emergency bond purchases.) But the Fed seems likely to taper its bond-buying programme only very gradually given the shakier recovery trajectory. And it has emphasised that interest rate hikes will come well after tapering starts.

Keeping duration down and prioritising quality

However softly-softly the Fed proceeds, we're braced for some bond market wobbles ahead. We've been doing what we can to protect our fund from any future fallouts. Earlier in the year, we dialled down our exposure to longer-dated (long duration) bonds, which are most sensitive to changes in yields/interest rates.

We've also been careful not to overstretch in the search for yield by buying bonds issued by less creditworthy companies with weaker balance sheets.

Credit spreads have got tighter and tighter over the summer despite the gentle rise in government bond yields over the past couple of months. This means some higher-yielding and lower-quality corporate bonds simply aren't offering enough of a yield buffer to compensate investors for their higher default risks. In the current uneasy limbo-land, we think it's critical to own bonds issued by high-quality and resilient businesses that we believe will stay solvent even if times get tougher.

Topping up select financials...

For some time now, we've been buying bonds issued by select banks and insurers that we regard as well-capitalised, profitable businesses that manage their risk exposure very carefully. In August, we bought Nordic bank **Nordea 3.75% AT1 Perpetual-2029** and specialist UK insurer **Beazley 5.88% Subordinated 2026** bonds.

... while paring back emerging market debt

China was the first big economy to start recovering after the first wave of COVID infections. But it too is now being impacted by a surge in Delta and severe supply disruptions. Growth has begun to weaken, with factory output and retail sales growth hitting one-year lows in August. The government's regulatory crackdown on a range of sectors, including technology, education and property, has further complicated things, triggering some sharp selloffs across its financial markets. These developments have prompted unease across emerging markets as a whole.

With these assets under pressure, we opted to pare back some of our holdings. We sold the **Ashmore Emerging Markets Short Duration**, the **Legal & General Emerging Markets Short Duration Bond** and the **Ninety One Emerging Markets Local Currency Debt** funds.

Bryn Jones
Fund Manager

Noelle Cazalis
Fund Manager

Stuart Chilvers
Assistant Fund Manager

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.

Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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