Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Ethical Bond Fund

Quarterly update March 2021

The first quarter saw big moves in government bond markets. The yield on US 10-year Treasuries (which rises as prices fall) shot up from 0.92% at the start of the year to reach 1.74% by quarter-end. And the yield on 10-year gilts surged from 0.20% to 0.85%.

Credit markets were less tumultuous, though credit spreads - the extra return above government bond yields for taking on the risk of default – did widen. The iTraxx Crossover European high yield spread index started January at 243 basis points and ended the quarter at 253 bps.

	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	-2.19%	2.35%	12.93%	17.79%	36.28%
IA UK Sterling Corporate Bond Sector	-3.25%	-0.04%	9.02%	13.12%	25.26%

	31 Mar 20-31 Mar 21	31 Mar 19-31 Mar 20	31 Mar 18-31 Mar 19	31 Mar 17-31 Mar 18	31 Mar 16-31 Mar 17
Rathbone Ethical Bond Fund	12.93%	1.00%	3.26%	5.26%	9.92%
IA UK Sterling Corporate Bond Sector	9.02%	0.78%	2.96%	1.70%	8.88%

Source: FE Analytics; data to 31 March, I-class, mid price to mid price.

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

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.

Big bond moves ahead of the 'great reopening'

Three months ago, much of the developed world was firmly in the grip of COVID-19. Fast forward to today and several of the world's biggest economies are making decisive moves to open up again as the vaccine rollout has gathered momentum. By mid-April, more than 900 million vaccine doses had been administered world-wide. Notwithstanding the emergence of alarming new COVID mutations and new lockdowns in parts of Europe, the UK is gearing up for a 'great reopening'.

As all this has been happening, economists have been ratcheting up their growth and inflation forecasts. By early February, these had begun to suggest that pent-up demand, fuelled by the sizeable savings that many have accumulated during lockdowns, could lead to a red-hot recovery. Bond yields have been climbing as optimism has been growing about an economic rebound — alongside expectations that reflation (a recovery in prices as economies get back to full throttle) would soon follow.

In early February, bond investors began anticipating that reflation would morph into full-blown inflation and concluded that this would drive big central banks to hike interest rates sooner than they'd previously expected. (Higher rates can tame rising prices because they make it more expensive to borrow and, therefore, curb propensity to spend.) This drove a scramble to sell out of government bonds, whose value would decline if rates went up.

Bond investors have been shoving their carts well ahead of their horses. Central banks have repeatedly insisted that they're not going to raise rates anytime soon. US Federal Reserve (Fed) chair Jay Powell has stressed the Fed will keep rates at rock-bottom levels until it sees firm evidence that inflation and employment have settled at its longer-term targets.

The government bond market selloff had begun to ease by quarter-end. Indeed, the 10-year US Treasury yield was back to 1.57% by mid-April. But the intense selling pressure at the longer end of government bond markets (which is most sensitive to changes in yields/interest rates) has ensured that the yield curve has steepened significantly. That's to say, the yields on longer-dated bonds have risen relative to those on shorter-dated bonds. We see this as no bad thing: a steeper yield curve often signals that the economy is recovering or expanding.

We took advantage of yield curve steepening to buy in areas that we have avoided or kept only small holdings in because we thought prices were too expensive. Namely, longer-dated, safer quasi-government bonds that are particularly interest rate-sensitive ('higher duration'). 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.

Keeping calm and carrying on...

When markets turn very volatile, as they did in February, it's easy to get panicked. We don't join short-term selling (or buying) stampedes just because that's what lots of other people were doing. We tuned out the market noise and stayed focused on opportunities that we believe will benefit our fund's long-term return and income potential.

As a result, we stuck to several longer-term themes that have proved rewarding for us over the last year. When we could, we bought dollar-denominated bonds. The cost of hedging dollar-denominated investments back to sterling has dropped dramatically. Because US treasury yields are markedly higher than gilt yields, US credit investments can offer much more attractive yields than their UK counterparts. Pricy currency hedging costs used to wipe out some of this yield boost. But it's got much cheaper for sterling investors like ourselves to hedge out the currency risks associated with dollar bonds, so we added significantly to our US dollar exposure, hedged back to sterling, over the quarter.

We continue to like many bonds issued by banks and life insurers. Banks, in particular, tend to be more profitable when yield curves are steeper because they can earn income from borrowing money at lower interest rates and lending it at higher rates.

During the quarter, we bought dollar bonds issued by Swiss insurance group **Zurich Finance 3% 2051**, and also by UK life insurer **ReAssure 5.867% 2029**. ReAssure was recently bought by the bigger Phoenix life insurance group; its bonds are cheaper than those of its new parent, so we saw them as a good buying opportunity.

In the financials space, an added attraction are the 'legacy' financial bonds that banks and insurers issued to shore up their capital positions in the wake of the financial crisis. Many offer sizeable coupons and some are now being bought back by their issuers because the regulatory framework is changing and this legacy debt is being superseded. Insurers and banks have been offering to buy back legacy debt and replace it with new borrowing on more generous terms to bondholders.

This gives us scope to lock in attractive price gains when we exchange or tender our legacy bonds with the issuers. We expect this trend to continue this year, and quite possibly into 2022 too, so we added to our legacy financial bonds over the quarter. For example, we bought US dollar **NatWest discounted perpetual floating rate notes 2.628% 2027**. We regard these so-called DISCO bonds as (almost) as exciting as their name suggests! Legacy DISCOs are due to be phased out pretty soon as banks and insurers move over to new-style securities, so we like their potential to lock in price gains if the issuer were to repurchase them at favourable prices.

Bonds for the 'new normal'?

As we've pointed out, the big bond market moves over the quarter reflect investors' attempts to scramble to price in recovery and reflation before they actually happen. We don't yet know how much long-term economic damage the pandemic has inflicted or what our 'new normal' will look like. For these reasons, we continued to favour investments that have thrived in a COVID-dominated world and which we expect to stay profitable and solvent after the 'great reopening'.

Over the quarter, we bought dollar-denominated bonds issued by European telecoms group **Orange 8.5% Senior 2031**. It has benefited from our greater reliance on technology during lockdowns. In our view, appetite for faster data speeds and better network support will likely increase even as offices, schools, shops and cinemas open up again. COVID seriously disrupted the rollout of 5G last year, but it should get back on track in 2021. This should prove positive for big network operators like Orange.

The UK (finally) goes green

Early in March, Chancellor Rishi Sunak unveiled his much-anticipated 2021 budget. Unsurprisingly, this signalled that the UK government would continue spending its way out of trouble. Lots of the Chancellor's policy proposals focused on extending current emergency support to people and businesses. But he did warn that the spending binge can't last forever. Unlike many of his counterparts in other countries, he's already talking about plans to repay the money borrowed to keep things going until recovery firms up. This could be risky. If taxes are increased and spending is cut too quickly, this could throttle a fragile recovery. The Chancellor will need to tread very carefully!

One Budget announcement that seems to have been almost universally welcomed was the news that the UK is going to start issuing green bonds. At least £15 billion of green sovereign bonds (so-called 'green gilts') will be issued in 2021-2022. The money raised will help fund Prime Minister Boris Johnson's 10-point public investment plan for a "green industrial revolution". This envisages that investing in clean energy, transport, nature and innovative technologies will kick-start the UK's journey towards net zero greenhouse gas emissions by 2050.

With several other countries already issuing green sovereign bonds, it seems the UK government has finally woken up to the idea that these investments could help it meet climate change goals and objectives.

But the devil may be in the details...

We've been lobbying for green gilts for years so we're delighted they're on the way at last. But we eagerly await more details. The rules governing the green gilts haven't been finalised. We don't yet know how the money raised can be spent or how the government plans to report on that spending and its environmental impact. This framework matters.

In the case of green and social bonds, the proceeds raised must be used for what the issuer pledged. Whether issued by a government or a corporation, the proceeds can't simply be used for whatever they like. There has to be a specific sustainability goal from the outset, otherwise we have a problem. If the government's definition of 'green' ends up being cast too wide or if it isn't transparent enough about the lasting benefits of the money raised, this could end up undermining investor confidence. And, in turn, this could dilute its environmental impact.

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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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