Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Strategic 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 Strategic Bond Fund	-1.19 %	3.07%	12.80%	12.23%	27.06%
IA Sterling Strategic Bond Sector	-1.23%	2.36%	12.44%	13.21%	25.09%

	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 Strategic Bond Fund	12.80%	-2.20%	1.73%	3.11%	9.81%
IA Sterling Strategic Bond Sector	12.44%	-1.35%	2.07%	2.32%	7.99%

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 this 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 government bonds that are particularly interest rate-sensitive. As yields began to spike, we bought the **UK Treasury 1½% 2047** and topped up this exposure towards the end of February as yield curve steepening intensified.

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 US 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 **HSBC 7.2% 2097** dollar bonds.

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 bonds issued by UK supermarket **Iceland 4.375% 2028**. The group has sharply increased its sales over the last year or so. Its focus on frozen foods and smaller stores on local high streets has proved popular with consumers keen to stock up their freezers during lockdowns, while also shopping close to home. Iceland is seeking to build on this success by tapping into consumer demand for easy-to-shop local stores and rolling out a new convenience store format, known as Swift. This offers fresh as well as frozen food and recognises that many people will be keen to stay away from larger, crowded supermarkets even as COVID infection rates fall.

We also 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 be a boost for big network operators like Orange.

Fresh opportunities

As ever, we didn't let the market tumult over the quarter prevent us from making the most of our active role and exploring new opportunities when they arose. We ventured into new territory for our fund by buying 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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