Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone High Quality Bond Fund

Quarterly update September 2021

A global energy price spike is building a wall of worry about stronger inflation and weaker economic growth.

Government debt prices have fallen in response as investors sold these bonds because their low fixed returns look unattractive in a world where inflation and/or central bank interest rates are higher. The yield on 10-year gilts stood at 0.72% on 30 June, but shot up to 1.02% by quarter-end (when bond prices fall, their yields rise). The yield on US 10-year Treasuries also increased, albeit less dramatically, rising from 1.47% on 30 June to reach 1.49% by quarter-end.

Inflation and growth concerns also unnerved credit markets toward the end of September. After grinding lower for most of the quarter, credit spreads — the extra return above government bond yields for taking on default risks — shot higher. The iTraxx European investment grade index ended September at 50 basis points, compared with 47bps at three months earlier.

	3 months	6 months	1 year	30 Sep 19-30 Sep 20	Since Launch 16 Nov 18
Rathbone High Quality Bond Fund	-0.25%	0.61%	0.35%	1.94%	5.58%
Bank of England Base Rate + 0.5%	0.15%	0.30%	0.60%	0.89%	2.61%

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

Source: FE Analytics; data to 30 September, I-class, mid price to mid price; performance is a combination of I-class units and S-class units where I-class was unavailable (I-class launched 23 July 2019).

Energy price spike jolts bond markets

At the start of the quarter, government bond yields were meandering gradually upwards as investors anticipated the eventual withdrawal of pandemic-driven policy support. They seemed reassured by policy makers' repeated insistence that immediate inflationary pressures triggered by supply chain bottlenecks in the wake of COVID-19 shutdowns would likely prove 'transitory' and wouldn't, therefore, drive sudden policy tightening.

But the energy price spike in September triggered a big shift in investor expectations about inflation. The price of Brent crude oil rose above $80 per barrel for the first time in more than three years. And shortages of European natural gas drove its price to record highs: the gas price in the UK and Europe shot up to $200 a barrel of oil equivalent — nearly three times the price of crude.

This forced a sharp rethink about the inflation outlook, prompting concerns that a lengthy bout of high inflation could pressurise central banks into raising rates earlier than investors had previously expected.

Rising inflation expectations hit most big government bond markets, quickly driving up bond yields. These increases have proved particularly steep in the UK, suggesting that investors believe a particularly challenging period may lie ahead. UK bond markets are now pricing in an interest rate rise as early as December.

The main trend over the quarter was to reduce the duration of our fund. Our modified duration, a measure of a bond portfolio value's sensitivity to changes in prevailing interest rates and yields, was 3.69 years, down from 3.88 at the beginning of the quarter. We made this adjustment by selling bonds with longer lives, because those longer-term cash flows are more sensitive to changes in prevailing interest rates. The bonds we sold were a mixture of pound-denominated and dollar-denominated debts. These duration-cutting sales included Dutch financial **ING Groep 1.125% Senior 2028**, UK pharmaceutical giant **GlaxoSmithKline Capital 1.25% Senior 2028**, US insurer **MassMutual Global Funding 2.15% Senior Secured 2031** and British property developer **Segro 2.375% 2029**.

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 credit spreads — the extra return above the yield of 'risk-free' government bonds that you get for taking on the risk of default — for some of these bonds had got very low as well, a sign of excessive value. The best example of ultra-low spread was e-commerce titan **Amazon 1.65% Senior 2028**, which had a spread of just 30 basis points when we sold it in early September.

Our rationale for cutting our duration was that sovereign bond yields had had a good run upwards since their first-quarter tumble. We believed the US Federal Reserve was likely to announce more news around 'tapering' its quantitative easing bond purchases, so it was a good time to start paring back our interest rate sensitivity. In hindsight we should have gone further and quicker, as have rates continued to shoot higher!

Open season for bonds

September is always a busy month for bond issuance. We took advantage of new issues that came at attractive premiums, some of their offer prices no doubt buffeted by the macroeconomic winds. Still, investor demand for quality credit remains strong, so some new issues came with no premium at all. As the month unfolded, we became more selective. We picked up a bunch of sterling-denominated bonds issued by lenders from home and abroad, including the **Leeds Building Society 1.375% Senior 2027**, **Yorkshire Building Society 1.5% Floating Rate Senior 2029** and **First Abu Dhabi Bank 1.125% 2026**. Another foreign lender was **OP Corporate Bank 1.375% Senior 2026**, which hails from Finland. OP is a retail and commercial bank with a strong brand in its home market. It is very well capitalised, sporting a common equity tier one (CET1) ratio of 19%.

Another interesting financial bond we bought at issue during September was the Belgium-domiciled **KBC Group 1.25% Floating Rate Senior 2027**. KBC has a good 'bancassurance' business model that creates cross-selling synergies between its bank and insurance divisions. It has a strong position in attractive growth markets in central and eastern Europe (namely, the Czech Republic, Slovakia, Hungary and Bulgaria). KBC has a strong credit rating and a CET1 ratio of 17.5%. The quality of its loans has also been improving, despite the pandemic.

We bought the very short-dated **Direct Line 9.25% 2042-22** because it represents a high finance cost for an A3-rated bond and so will likely be 'called' or bought back next year by Direct Line. Indeed, half of the original value of this bond issue was bought back in the open market by Direct Line in 2017.

We added to our holding of bonds issued by US life assurer Athene. This quarter, we bought the **Athene Global Funding 1.75% Senior 2027** and **1.875% 2028**. We think they offer an attractive level of spread for A-rated bonds. Athene continues to grow its business while maintaining a very solid capital base.

In the dying days of the quarter, as short-term UK interest rates shot higher we sold some of our floating rate notes that are linked to SONIA (the replacement for LIBOR) and which hadn't repriced to benefit from higher rates. The largest of these trades was the **Nationwide Building Society Floating Rate Note Senior 2031**.

The outlook for many businesses grew undoubtedly murkier during the third quarter. Business and consumer confidence have weakened, job growth has underwhelmed and supply logjams are everywhere. The energy price spike has sharply intensified worries about inflation's capacity to undermine the post-pandemic growth rebound. Will it dent company profitability and crimp consumer spending? Could the slowdown from the furious initial pace of the rebound prove much sharper than previously expected?

For some time now, we've been buying bonds issued by select banks, insurers and investment firms that we regard as well-capitalised, profitable businesses that manage their risks very carefully. We're sticking with that approach.

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Fund Manager

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