

Rathbone SICAV Ethical Bond Fund

Monthly update May 2020

Overview

The 10-year gilt yield fell five basis points to 0.18% over May. Interestingly, the two-year started at 0.01% and turned negative as investors start to weigh the potential for negative rates in the UK. That's open to debate, yet having talked to a few banks it seems they would push back hard on such a plan because it would have such a significant effect on their profitability. We're now into a waiting match as markets forecast negative rates and the Bank of England (BoE) keeps playing it down.

There are huge changes going on in the UK in terms of debt. It's not just the relaunching of quantitative easing by the BoE either, although that has greatly reduced interest rates and the cost of borrowing. To pay for all its pandemic support programmes, the government has had to ramp up the bonds it issues. Public debt to GDP has rocketed higher this year, from about 80% in 2019 to 100% by the end of May. Interestingly, only half of that increase was during the lockdown – the ratio had already started rising quickly from the turn of the year. Meanwhile, household debts are shrinking fast. The lockdown has hurt the finances of many people, yet the income of many others has stayed the same. With less to spend their cash on, it appears that Brits took the opportunity to repay debt. A record £7.4 billion of consumer credit was repaid in April, £5bn of that from credit cards. As for businesses, they have racked up at least £38.6bn of extra borrowing in April, on top of a record £30.2bn borrowed in March as the Covid-19 crisis struck.

Despite all the uncertainty and broadly greater indebtedness of companies, the demand for corporate bonds has been strong. Credit spreads – the extra return above government bonds for taking on the risk of default – have continued to fall steadily after their initial spike during the March sell-off. The Crossover European high yield spread index started the month at 490bps and finished at 428bps. Following May's end it has continued its descent, getting as low as 338bps before evening out around 400bps in mid-June.

The heavy demand for bonds can best be explained by extraordinarily large quantitative easing (QE) programmes and the fallout from dividend cuts. Central banks around the world have started buying up government bonds by the billions once again – and a few are even buying corporate bonds as well – and that flood of buy orders has pushed the yields on sovereigns and investment grade bonds sharply lower. At the same time, more than a few income investors who typically buy equities have no doubt drifted into fixed income markets in search of payouts after dividends were slashed in response to the pandemic.

This retightening of yields has pushed investors to take more risk in order to get the returns they want (which is, indeed, the point of QE). So those who would normally hold government debt have slid into high-quality investment grade, and those that would tend to go for investment grade start eyeing high yield bonds. Whenever bonds come up for issue, there tends to be many multiples of the deal size trying to buy.

So as we approach the halfway mark for a year that feels more like a decade, European investment grade credit spreads are just 20bps off the all-time lows of February. We're still fighting a pandemic, but markets surely don't seem to reflect that. The response by governments and central banks has been huge and heartening, but the chance of any disappointments doesn't seem to be included in some prices. There are some good opportunities out there, but you have to be very careful about what you're buying and the price you're paying for it.

Trades

As an ethical fund, we have never invested in oil and gas companies. Yet we have invested in many large financial companies, most of which make loans to fossil fuel businesses. It's hard to avoid this second-hand carbon exposure in financial giants – so much of our world is still powered by carbon that it would be impossible for lenders of any size to avoid financing such projects. However, we are trying to make a difference, and we believe our fund is large enough to make a certain stand here.

Over May, we have been selling down bonds that we hold in banks that make an outsized proportion of their loans to oil and gas businesses. These included North American giants **Citigroup 2.75% Senior 2024, Goldman Sachs 3.125% Senior 2029** and **4.25% 2026, Toronto-Dominion Bank Floating Rate Note Senior 2023** and **1.2% Floating Rate Note 2022, Morgan Stanley 2.625% 2027** and **Wells Fargo 2.5% 2029**.

We added to our position in the Danish-based renewables multinational Orsted, buying the **Orsted 4.875% Senior 2032**. We also invested in two wind energy projects, **WoDS Transmission 3.446% 2034**, which finances a connection that transfers electricity from an offshore windfarm to the mainland, and the **Greater Gabbard OffShore 4.137% 2032**, which finances a windfarm off the coast of Harwich.

We also bought the **Pearson Funding 3.75% Senior 2030**, a new social bond that will fund educational development, especially in digital learning.

Outlook

As countries continue to ease lockdowns over the summer and economies return to some form of normality, hopefully people's immunity can build. Our biggest concern right now is what won't reopen – or more specifically what does and then soon trips over. Companies have undergone possibly the greatest stress event of all time short of war. Yet even during wars

people are allowed to shop and there is a lot of work to be done to produce materiel. During the pandemic shutdown, many companies simply had to shutter themselves and wait, hoping that the lockdown clock would run out before their cash did.

Governments have been exceedingly generous with their support measures, yet for some it won't be enough. Especially those that went into the lockdown with too much debt or whose lease payments became punishing when there was no revenue coming in to pay them, for example. Others will have to deal with customers who behave differently post-pandemic, something that could cause serious problems for some business models.

We believe some companies will soon collapse as the support runs dry and they simply can't make ends meet given reduced revenues. Yet many more could fail in the winter once they get back into operation and find themselves no longer viable. We may sound pessimistic here. That's not quite how we feel, we're just trying to be realistic and judge the risks accordingly. We are trying to ensure we are investing in businesses that are solid enough to survive a tough and elongated reopening – particularly if second waves of the virus arrive. We're also targeting companies which should still have a promising future after the pandemic is consigned to the past.



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