Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone SICAV Ethical Bond Fund

Monthly update October 2020

The 10-year gilt yield trundled along during October. Having started at 0.23%, it ended 31 days later at 0.27%. However, following month-end and the announcement of several promising vaccines, the yield bounded higher. It briefly moved above 0.40%, its highest level since March.

Over October, European high-yield credit spreads (the return above government yields to account for the risk of default) rose slightly, from 345 basis points to 367bps. However, so far in November the spread has plummeted well below 300bps as investors cheered the vaccine news and piled into riskier debt.

Our fund performed well in October, despite the slight rise in gilt yields and corporate spreads, for two reasons. Firstly, because we have limited holdings of gilt-like assets, we were less affected by the slight fall in their prices. Secondly, there was a specific type of corporate bonds whose prices rose significantly over the month: 'legacy' tier one bank debt. These bonds were issued years ago under now-superseded regulatory rules aimed at ensuring lenders and insurers had enough capital to avoid bankruptcy in times of stress. These bonds tend to pay high coupons and in many cases are now highly inefficient for their issuers. Because of this – and given today's extraordinarily low borrowing costs – many banks and insurers have been offering to buy back these bonds and replace them with new borrowing on more generous terms.

For several years now we have been buying up a lot of these bonds because we expected them to be bought back and replaced. Last month, the European Banking Authority announced that many legacy tier one bonds will have to be replaced by the end of 2021, leading to a surge in demand for them as investors snapped them up in anticipation. Another cheering official announcement came from Chancellor Rishi Sunak. After years of lobbying, pleading and cajoling, the UK will issue its first 'green gilts' next year to coincide with the COP26 climate conference in Glasgow. This will be a symbolic gesture at first – the amount will likely be paltry – but it's a welcome step in the right direction. Money raised by green bonds fund only low-carbon infrastructure projects. The idea behind them is that, once mature, they offer a separate, benchmark lending rate for green projects that should be lower than that for dirty projects, thereby encouraging sustainable investment.

UK economic data was pretty poor before the second lockdown was announced, yet the market for corporate debt has held up very well indeed. Investors seem to remain optimistic that UK businesses will be able to stay afloat through the second wave and come out the other side in reasonable shape.

We continued to buy more 'legacy' tier one assets when the price was right and have been adding to our dollar-denominated bonds too. Those dollar bonds included Singaporean green energy business **Vena Energy CAP 3.133% 2025** and the **W K Kellogg Foundation Trust 2.443% 2050**. Launched in 1930 by the cereal titan, the W K Kellogg Foundation provides for the welfare, schooling, housing and general support of children in the US, Haiti and Mexico. We also bought the sterling-denominated Danish green energy company **Orsted 4.875% Senior 2032**.

Given the strain that the railway has come under from the pandemic, we sold the **Channel Link Finance 3.043% Senior Floating Rate 2050** (Channel Tunnel).

We sold private equity investor **3i Group 5.75% 2032** after its price recovered well from an initial pandemic-driven plunge. We sold Spanish lender **BBVA 3.104% Floating Rate Note LT2 2031** having bought the bonds at issue a few months back.

Finally, we've been moving some of our financials exposure away from companies whose ethical credentials haven't been improving as we would like. We have been selling those bonds and replacing them with those of lenders and insurers which show more awareness of sustainability, such as the **AXA Group 6.379% Perpetual-2036**. We will continue on this path for the coming months as part of a gradual shift in our portfolio.

As the year winds down, we're watching the economic data with part fascination, part dread and part optimism. Virtually everywhere you look, the numbers are ugly, bonkers and virtually useless. Historic plunges in measures like PMIs, retail sales and GDP were to be expected given the wholesale national shutdowns. And any reopening means recovery is meteoric from the phenomenal lows simply because of the base effect.

There are a few places where it seems prudent to take tabs, however. The first is the UK's housing market — and that of the US, for that matter. While still slightly distorted, the health of these markets bodes well for the underlying confidence of households despite the effects of the pandemic. A sustained downturn in the housing market would be a portent of trouble. Second is unemployment. In the UK, the jobless rate has been artificially capped by the government's furlough schemes. Yet the cost of this to the Exchequer is stupendous, so it's no surprise that the Chancellor has been reducing the generosity of these programmes as much as he can. Meanwhile, unemployment has been rising steadily over the past few months (in the three months to 30 September it was 4.8%). The higher it gets, the greater drag on the UK's economy, which is highly dependent on household consumption.

In the US, the unemployment rate continues to fall from its 14.7% high in April. As of October, it was 6.9%. COVID-19 is spreading rapidly throughout the country, however, so we will be watching carefully to see how it affects employment. The economic fortunes of America have a massive impact on those of the rest of the world. We hope that President-Elect Joe Biden, having won the US election in early November, will prove more competent in virus-fighting than outgoing President Donald Trump.

Meanwhile, we're right down to the pointy end of the Brexit negotiations. A deal will have to be made soon if the two sides are to be able to ratify it before the year — and the transition period — ends.

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