

Rathbone SICAV Ethical Bond Fund

Monthly update April 2021

After a tumultuous first quarter of 2021, in which government bond yields surged higher (yields run in the opposite direction to prices), composure returned to bond markets in April. The yield on US 10-year Treasuries stood at 1.74% at the start of the month. It rose slightly mid-month, only to slip back to 1.63% by month-end. Similarly, the yield on 10-year gilts barely changed. It began April at 0.85% and ended at 0.84%.

This relatively benign and stable backdrop helped credit markets maintain their composure. Credit spreads – the extra return above government bond yields for taking on the risk of default – tightened modestly. The iTraxx Crossover European high yield spread index began the month at 253 basis points (bps) and ended at 249 bps.

Calm breaks out...

The disquiet that roiled markets earlier in the year certainly hasn't disappeared, but it took a breather in April. Bond investors had got jittery about fears of economic overheating as the world starts to get back to normal. Investors were particularly troubled by signs of stronger inflation. Higher inflation erodes the value of bond cash flows and investors worried that it could also signal interest rate rises and the tapering of central banks' huge quantitative easing (QE) bond-buying programmes that help ease excessive upward pressure on yields. These inflation concerns drove a scramble to sell government debt, particularly the longer-duration bonds most sensitive to changes in yields/interest rates.

Policy makers have worked hard to calm bond investors. Federal Reserve (Fed) chair Jay Powell stressed that the Fed expects a temporary price spike as economies reopen, but that it wouldn't rush to change policy because of "transitory" inflation gains. He confirmed that interest rates would stay on hold and there was

no reason to expect that to change for some time. Mr Powell also emphasised that "it's not yet time to have a conversation about tapering" QE. Similarly, soothing noises have come out of the Bank of England and the European Central Bank. Indeed, the latter is going to step up QE in a bid to keep spreads on the riskier bonds issued by so-called 'peripheral' EU countries (Greece, Italy and Spain) relatively tight versus those issued by 'core' EU states (Germany and France).

For much of April, this reassurance kept bond markets more tranquil than they'd been for months. But volatility resumed in May, with the 10-year Treasury yield reaching 1.69% mid-month when it emerged that US consumer price inflation had hit 4.2% in April – a higher rate than had been expected.

Meanwhile, much economic data has been broadly upbeat as vaccine-led reopening and recovery have begun in earnest. US GDP expanded at an annualised rate of 6.4% in the first quarter. The UK economy shrank by 1.5% in the quarter as a whole, but steamed ahead in March when it grew by 2.1%. Continental Europe also seems to be getting its act together after a rocky few months of vaccination delays. Germany has quickened its vaccination drive and France is following suit. If these two big economies make headway, this could help drag the EU out of the third-wave despondency that sent it back into recession in the first quarter.

Sticking to our knitting...

Against this broadly positive backdrop, we've been 'sticking to our knitting' and buying more of the bonds that have served us well for several months. In particular, we like many bonds issued by banks, insurers and other financial providers, like specialist lenders and investment firms. Many of these are thriving, well-capitalised businesses. Traditional banks, for example, are reporting fewer bad debts from COVID-driven headwinds than anticipated. Financials should now benefit from economic recovery. When economies are growing at a healthy clip, financials' earnings and profits tend to follow suit.

During the month, we bought sterling-denominated bonds issued by private equity investment firm **3i 5.75% 2032**, and also by Spain's **Banco Santander 1.5% 2026**, as well as health insurer **BUPA Finance's 4.125% 2035**.



Disco fever!

One of the added attractions of the financials space is the opportunities it affords to buy the 'legacy' 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. Banks and other issuers 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've been steadily adding to our legacy financial bonds. In particular, we've been buying legacy DISCOs (more prosaically known as discounted perpetual bonds). Legacy DISCOs are due to be phased out pretty soon as financials move over to new-style securities, so we believe there is potential to lock in price gains if issuers repurchase them at favourable prices. We are seeing more and more calls and tender offers being announced in the DISCO space so we've been (almost!) consumed by disco fever. As our DISCOs have been called, we've been reinvesting the proceeds in more of the same.

During the month, we bought life insurer **Rothesay Life**'s sterling discounted perpetual floating rate notes **6.875% 2028**, and **HSBC**'s sterling **5.844% 2031 DISCOs**, as well as the euro-denominated **Banco Santander Floating Rate Guaranteed 2021 DISCOs**.

Bonds for the 'new normal'?

As we pointed out last month, the big bond market moves we've been seeing reflect investors' attempts to price in recovery before it's fully bedded down. We don't yet know how much long-term economic damage the pandemic has inflicted or what our 'new normal' is going to look like.

For these reasons, we are continuing to favour investments in businesses that look in good shape post-pandemic and which we expect to stay profitable and solvent once the 'great reopening' is fully under way.



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