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Rathbone SICAV Ethical Bond Fund

Monthly update May 2021

Bond markets proved relatively composed in May. The yield on US 10-year Treasuries stood at 1.63% at the start of the month. It nudged to a low of 1.47% (yields run in the opposite direction to prices), only to rise back to 1.61% by month-end. Similarly, the yield on 10-year gilts stuck to a narrow range, beginning May at 0.84% and ending the month at 0.80%.

This broadly stable backdrop helped credit markets maintain their poise. 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 249 basis points (bps) and ended it at 246bps.

Too hot to handle?

Unlike the soggy weather that challenged many UK staycationers during May, the global economic outlook has been growing distinctly sunnier. The OECD, for example, has upgraded its global growth forecasts in a big way. It now expects global economic growth of 5.8% in 2021, as opposed to the 4.2% it forecast just a few months ago. And business confidence in the UK is running at its highest level in five years, according to the Lloyds Bank Business Barometer.

The big blot on the landscape is the evidence that the economic recovery could be hotting up too much and thereby driving up inflation. It was to be expected that reopening would drive up the prices of a wide range of goods and services. But the extent of the inflationary spike (particularly in the US) has alarmed many investors. This alarm has touched virtually every corner of financial markets.

As we've noted, bond market investors have proved relatively level-headed over the last couple of months. But it's not long since we saw bond markets rocked by concerns about inflation eroding the value of bond cash flows, as well as fears of imminent interest rate rises and the tapering of central banks' huge quantitative easing (QE) bond-buying programmes that neuter much of the upward pressure on yields. Longer-duration government bonds are most sensitive to changes in yields/interest rates and therefore proved most vulnerable during those bouts of bond market volatility.

Policymakers have certainly steadied investor nerves by steadfastly resisting suggestions that they're planning to take the heat out of the recovery via big policy shifts. But inflation worries haven't disappeared. Investors are still asking whether inflationary pressures really are as 'transitory' as the US Federal Reserve (Fed) believes, or whether they'll become a more permanent problem.

For inflation to stay elevated, we'd have to see lasting increases in the cost of raw materials and in wages. We're watching signs of higher labour costs particularly closely. In the US, there are tentative signs that some employers are hiking wages as they struggle to find enough workers. Higher wage costs tend to prove the pivotal driver of more enduring inflation. They make goods more expensive to produce and services more expensive to provide – so people demand higher wages to offset their lost buying power. This kind of negative feedback loop risks longer-term inflationary pressures that can be tough to tame.

For now, the jury is well and truly out as to whether higher inflation is here to stay and, if so, how policymakers will respond. Against this backdrop, we're keeping calm and carrying on with the kinds of bonds that have served us well for several months.

Prioritising ESG credentials in the financials space

In particular, we continue to like many bonds issued by banks, insurers and other financial providers, like specialist lenders and investment firms. Many are thriving, well-capitalised businesses that we expect to do well as economic recovery accelerates. When economies are growing at a healthy clip, financials' earnings and profits tend to follow suit.

As ethical investors, we monitor carefully the environmental, social and governance (ESG) credentials of all the companies whose bonds we hold. We've been getting concerned about the progress some financial institutions have been making in meeting their ethical and sustainability goals. Some are more skewed towards supporting carbon-intensive projects and businesses than we would like. As a result, we've been gradually selling some of our financials bonds and buying into others that rate better on ESG metrics. In May, we sold the **Barclays Bank 3% Senior 2026** and **Barclays Bank 3.25% Senior 2027**. We used the proceeds to buy bonds issued by lenders and insurers which show more awareness of sustainability, such as **Virgin Money**'s **2.625% 2031**. We are particularly impressed by Virgin Money's recent progress in developing sustainability-linked business loans and green mortgages.

Funding environmental research and renewable energy

Meanwhile, we helped fund the **American Museum of Natural History** by purchasing its dollar-bond **3.12% 2052**. This New York museum is one of the world's most distinguished scientific and cultural institutions. Since its founding in 1869, it's been committed to discovering and disseminating information about the natural world through scientific research and education. Some of the bond proceeds will be used to fund the museum's new Richard Gilder Center for Science, Education and Innovation. This will expand access to the museum's scientific and educational resources, supporting broad understanding of human health challenges, climate change and biodiversity conservation.

Is social the new green?

Environmental or green issues have tended to dominate the ethical investing landscape, but we're starting to see social bonds grab more attention. These bonds can fund a wide range of socially beneficial projects, including affordable housing, educational resources and healthcare. We've been investing in social bonds for some time now. Given the surge in issuance in green bonds in recent years (green bond issuance is estimated to total more than $500 billion this year) and strong investor appetite for ESG investments, we think social bonds are going to become an increasingly important part of the fixed income market.

In May, we bought **Notting Hill Genesis** housing association **2%** bonds that mature in **2036**, as well as **Paradigm Homes 2.25%** bonds maturing in **2051**. Notting Hill Genesis, as its name suggests, provides high-quality housing to low-income renters and shared ownership buyers in London's Notting Hill area and elsewhere. Demand for affordable housing is particularly intense in Notting Hill, the least affordable place to live in the UK since the price of the average property is almost 17 times higher than average earnings. Paradigm fulfils a similar function in Buckinghamshire, Hertfordshire and Bedfordshire. We like housing associations' ethical credentials: they provide good-quality homes for people with low incomes or special needs. And they're trying to address the UK's acute shortage of affordable housing by building new homes to rent and shared ownership properties. COVID-19 has made it even more difficult for many people to afford private sector housing. Earlier this year, housing and homelessness charity Shelter reported that COVID-related financial pressures mean that one in four people living in privately rented accommodation worries about how to pay their rent and bills. More recently, the charity expressed its concerns about a surge in homelessness now that the ban on enforced rental evictions, in place earlier in the pandemic, has been lifted. We believe that housing associations' commitment to affordability mean they should play a crucial role in helping to mitigate the pandemic's disproportionate impact on people on lower incomes.

Housing associations are carefully regulated and, as non-profit charitable organisations, they tend to be pretty risk averse. As a result, we believe that investing in select long-duration housing association bonds can give us access to stable and secure cash flows far out into the future.

Bonds for the 'new normal'?

Despite increasingly positive projections about the post-pandemic outlook, we still don't know how much long-term economic and social damage it 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 and which we expect to stay profitable and solvent in these uncertain times.

Despite the challenges that lie ahead, we're excited about the prospects for our holdings in 2021 and beyond. Many of our investments are helping to improve the world, whether by financing ethically minded businesses, protecting our natural resources or providing good housing for those in need.

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