Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Ethical Bond Fund

Quarterly update June 2021

Government bond markets have clawed back some of the big yield rises of early 2021.

The yield on US 10-year Treasuries fell from 1.74% on 31 March to reach 1.47% by quarter-end. Likewise, the yield on 10-year gilts nudged down to 0.72% after rising sharply to 0.85% in the preceding quarter (when yields fall, bond prices rise).

Credit markets benefited from the falling yield trend. Credit spreads — the extra return above government bond yields for taking on the risk of default — narrowed, with the iTraxx Crossover European high yield spread index ending the quarter at 232 basis points, down from 253 bps at the end of March.

	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	2.32%	0.08%	7.85%	20.69%	37.34%
IA UK Sterling Corporate Bond Sector	1.76%	-1.55%	3.29%	15.34%	23.44%

	30 Jun 20-30 Jun 21	30 Jun 19-30 Jun 20	30 Jun 18-30 Jun 19	30 Jun 17-30 Jun 18	30 Jun 16-30 Jun 17
Rathbone Ethical Bond Fund	7.85%	5.43%	6.15%	2.26%	11.28%
IA UK Sterling Corporate Bond Sector	3.29%	5.76%	5.58%	0.58%	6.40%

Source: FE Analytics; data to 30 June, I-class, mid price to mid price.

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

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.

Bond markets stay (mostly) steady

The economic recovery from COVID-19 gathered considerable pace in the second quarter, while also broadening out to more countries and economic sectors.

It's estimated that US GDP may have grown by a blistering 9% annualised over the quarter as its economy continued to roar back to life. At the same time, the UK, Europe and Japan appeared to be starting to join in the big post-pandemic growth rebound.

As growth has picked up, inflation rates have been rising too. The US leads the way, with its 5% inflation rate the highest level since August 2008. Concerns over higher inflation generally coincide with higher bond yields. As a proxy for interest rates, bond yields tend to price in the expectation of interest rate hikes when inflation hots up. But recently bond yields have proved surprisingly steady (bar the odd few bouts of skittishness). The yield on 10-year US Treasuries settled into a narrowish range below 1.50% during the quarter, significantly below their yearly peak of 1.78% amid inflation collywobbles in February and March. The yield has fallen even as inflation data continues to hot up. Bond investors seem to be accepting the US Federal Reserve's (Fed) oft-repeated insistence that the current inflation spike is going to prove "transitory".

At its June policy-setting meeting, the Fed acknowledged that inflation and growth were coming in higher than it had expected. But it also stressed that it wanted to see clearer evidence of a firm jobs recovery before reining in its super-supportive policies. The recovery in US jobs has proved somewhat sluggish. June's payrolls report was a bit mixed. While more than 850,000 jobs were created (more than had been expected), the overall unemployment rate rose to 5.9% versus the previous month's 5.6%.

The Fed may remain patient about pencilling in interest rate rises until it sees substantial progress in repairing pandemic-inflicted labour market damage. But in June's meeting the Fed acknowledged that it's gearing up to kick off discussion on when to slow the pace of its quantitative easing (QE) bond purchases. This would be a first step in reining in its easy policies as QE helps keep a lid on bond yields.

For now, bond investors seem to be accepting that we're in a 'wait-and-see' world and it's just too early to tell whether the recovery rebound (and attendant inflationary pressures) will begin to ease back a bit or whether they'll stay on the boil. Whatever happens, bond investors appear more confident about the Fed's insistence that any eventual policy tightening is going to be slow, gradual and signalled well ahead of time.

Against this outwardly calm backdrop, we've stayed focused on adding to bonds that we believe will benefit our fund's long-term return and income potential. We've allowed a little cash to build up so that we can swiftly put it to work when we find particularly compelling opportunities.

We've also been paring back our exposure to some longer-dated bonds. The prices of these long-duration assets are most sensitive to changes in yields/interest rates and may prove most vulnerable if more prolonged bouts of market volatility start to break out.

Adding to financials via floating rate notes

As has been the case since last year, we like many bonds issued by banks, insurers and other financial providers, like specialist lenders and investment firms. Many are thriving, well-capitalised businesses that should do well as the economy continues to heal. When economies are growing at a healthy clip, financials' earnings and profits tend to follow suit.

Over the quarter, we bought sterling-denominated floating rate notes issued by **Australia and New Zealand Banking Group** (usually known as **ANZ**) **1.809% LT2 2031** and **Lloyds Bank 1.985% LT2 2031**. As their name suggests, floating rate notes are bonds whose coupons adjust as interest rates/yields move so their prices are less sensitive to higher rates/yields than traditional bonds. We think they offer attractive protection against the risk of capital erosion in a more uncertain rate/yield environment.

Housing 'haves' and 'have nots'

Within the financials space, we've been seeking out more opportunities in building societies as they benefit from the surge in mortgage lending driven by the UK's post-pandemic housing boom. Fuelled by the shift to home working, demand for larger properties with space for home offices and also for properties in locations further afield than traditional commuter hotspots has driven the market higher. This has been exacerbated by the pandemic-driven slowdown in house building.

Building societies have some of the strongest capital buffers of any UK lenders. This suggests they'll prove better insulated from any property market jitters that could transpire in coming months than many of their for-profit peers. Over the quarter, we bought **Nationwide Building Society**'s **1.03% Senior 2031** floating rate notes and also **Coventry Building Society**'s **2.25% 2030** bonds.

We're keenly aware that while a stronger housing market is good news for those who already own property, it's challenging for those not yet on the property ladder. Property ownership — long a struggle for low earners — has largely become the preserve of the better-off, especially in big cities like London where prices are highest. The price boom looks set to further widen the housing inequality gap. Early in the quarter, we bought a couple of bonds that fund affordable housing for those on lower incomes and/or with special needs, such as housing associations **Notting Hill Genesis 2% Senior 2036** and **Paradigm Homes 2.25% 2051**.

Notting Hill Genesis provides high-quality housing to low-income renters and shared ownership buyers in London's pricy Notting Hill area and elsewhere. We like housing associations' ethical credentials: they're trying to address the housing inequality gap by building affordable shared ownership properties. Some housing association bonds are particularly long-dated assets so, in line with our thrust to dial back our longest duration exposure, we sold the Paradigm bonds towards the end of the quarter.

Funding environmental research

We helped fund the **American Museum of Natural History** by purchasing its dollar-bond **3.12% 2052** in June. This New York museum is 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 seeks to expand access to the museum's scientific and educational resources and thereby support broad understanding of human health challenges, climate change and biodiversity conservation.

Green gilts are go!

We're thrilled that we're soon going to be able to invest in the UK government's new green sovereign bonds! Right at the end of June, the government published a 'green financing framework' for the £15 billion in green gilts that it plans to issue in 2021-2022. This framework sets out a comprehensive set of eligible expenditure categories for the money raised from green gilts, as well as outlining ways the government plans to measure the impact of projects that green gilts fund.

We're pleased that the government has listened to potential investors (like us!) who argued that nuclear power projects should be explicitly excluded from green gilt funding. We also like that biodiversity and natural capital projects are highlighted as funding priorities. It's a further positive that the framework includes nature-based solutions (such as peatland restoration) as eligible for funding.

The metrics proposed to measure the impact of projects funded go beyond the bare minimum (which would involve only calculating tonnes of greenhouse gases avoided) to include extra environmental impacts, like improvement in air quality and the size of the areas of natural land they protect. It's also good news that these metrics will include projects' social benefits (like their job creation potential). We think this should help emphasise that the transition to a low-carbon economy can and should be a just process that treats everyone affected fairly.

We view the framework as well aligned with the government's broad sustainability policy and goals. This bolsters our confidence in green gilts' potential to help open a clear sustainability pathway. We look forward to adding them to our ever-broadening bond toolkit!

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