Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Strategic Bond Fund

Quarterly update September 2021

The energy price spike is building a wall of worry about stronger inflation and weaker economic growth.

Government debt prices have fallen in response as investors sold these bonds because their low fixed returns look unattractive in a world where inflation and/or central bank interest rates are higher. The yield on 10-year gilts stood at 0.72% on 30 June, but shot up to 1.02% by quarter-end (when bond prices fall, their yields rise). The yield on US 10-year Treasuries also increased, albeit less dramatically, rising from 1.47% on 30 June to reach 1.49% by quarter-end.

Inflation and growth concerns also unnerved credit markets, driving credit spreads — the extra return above government bond yields for taking on default risks — wider. The iTraxx Crossover European high yield spread index began the quarter at 232 basis points (bps) and widened to 253bps by 30 September.

	3 months	6 months	1 year	3 years	5 years
Rathbone Strategic Bond Fund	0.27%	2.38%	5.51%	14.73%	21.93%
IA Sterling Strategic Bond Sector	0.40%	2.22%	4.63%	16.07%	19.73%

	30 Sep 20-30 Sep 21	30 Sep 19-30 Sep 20	30 Sep 18-30 Sep 19	30 Sep 17-30 Sep 18	30 Sep 16-30 Sep 17
Rathbone Strategic Bond Fund	5.51%	4.19%	4.36%	0.89%	5.34%
IA Sterling Strategic Bond Sector	4.63%	3.59%	7.08%	-0.11%	3.27%

Source: FE Analytics; data to 30 September, 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.

Energy price spike jolts bond markets

At the start of the quarter, government bond yields were meandering gradually upwards as investors anticipated the eventual withdrawal of pandemic-driven policy support. They seemed reassured by policymakers' repeated insistence that immediate inflationary pressures triggered by supply chain bottlenecks in the wake of COVID-19 shutdowns would likely prove 'transitory' and wouldn't, therefore, drive sudden policy tightening.

But the energy price spike in September triggered a big shift in investor expectations about inflation. The price of Brent crude oil rose above $80 per barrel for the first time in more than three years. And shortages of European natural gas drove its price to record highs: the gas price in the UK and Europe shot up to $200 a barrel of oil equivalent — nearly three times the price of crude.

This forced a sharp rethink about the inflation outlook, prompting concerns that a lengthy bout of high inflation could pressurise central banks into raising rates earlier than investors had previously expected.

Rising inflation expectations hit most big government bond markets, quickly driving up bond yields. These increases have proved particularly steep in the UK, suggesting that investors believe a particularly challenging period may lie ahead. UK bond markets are now pricing in an interest rate rise as early as December.

Prioritising credit quality

Well ahead of September's moves, we've been expecting bond markets to grow more volatile. We sought to protect our fund from future fallouts by gradually dialling down our exposure to longer-dated (long-duration) bonds, which are most sensitive to changes in yields/interest rates. In July, for example, we sold **Barclays 3.25% Senior 2033** and **Verizon Communications Senior 5.25% 2037 bonds**.

Importantly, we've been very careful not to overstretch in the search for yield by buying bonds issued by less creditworthy companies with weaker balance sheets that might struggle to stay solvent in an environment in which inflation and/or interest rates are higher.

The outlook for many businesses has undoubtedly grown murkier during the third quarter. Business and consumer confidence have weakened, job growth has underwhelmed and supply logjams are everywhere. The energy price spike has sharply intensified worries about inflation's capacity to undermine the post-pandemic growth rebound. Will it dent company profitability and crimp consumer spending? Could the slowdown from the furious initial pace of the rebound prove much sharper than previously expected?

For some time now, we've been buying bonds issued by select banks, insurers and investment firms that we regard as well-capitalised, profitable businesses that manage their risks very carefully.

We view Dutch lender **Rabobank**, for example, as a high quality and resilient business, underpinned by its low risk domestic mortgage loans. During the quarter, we bought its **6.5% Tier 1 Perpetual** bonds. The latter offer an attractive extra coupon payment at year-end. This comes about because the bond is very junior in the bank's credit structure, giving it some equity characteristics despite being a bond. When the European Central Bank banned equity dividends early in the pandemic, this bond wasn't allowed to pay its coupons. The year-end extra coupon is a bumper payment to make bondholders whole.

In the financials space, we also bought investment firm **Investec**'s **2.625% 2032** bonds, as well as insurer **Liverpool Victoria's 6.5% 2043-23** bonds.

... and paring back emerging market debt

Many emerging markets experienced a tricky third quarter. Signs of weaker growth from China prompted unease across the whole developing world, which was further exacerbated by September's energy price spike. Many major emerging markets (China, South Korea, India and Mexico, for example) are net importers of fuel and therefore stand to lose from higher energy prices.

With emerging market assets under pressure, we opted to pare back some of our exposure. Over the quarter, we sold the **Ashmore Emerging Markets Short Duration**, the **Barings Emerging Markets Debt Blended Total Return**, the **Legal & General Emerging Markets Short Duration Bond** and the **Ninety One Emerging Market Local Currency Debt** funds.

Bryn Jones
Fund Manager

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Fund Manager

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Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment.

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