Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Ethical Bond Fund

Quarterly update June 2022

Bond markets stayed highly volatile as investors shifted from worrying primarily about inflation to worrying primarily about the risk of a global slowdown.

	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	-8.43%	-14.16%	-14.58%	-2.88%	5.42%
IA UK Sterling Corporate Bond Sector	-7.39%	-12.53%	-12.86%	-4.80%	1.09%

	30 Jun 21-30 Jun 22	30 Jun 20-30 Jun 21	30 Jun 19-30 Jun 20	30 Jun 18-30 Jun 19	30 Jun 17-30 Jun 18
Rathbone Ethical Bond Fund	-14.58%	7.85%	5.43%	6.15%	2.26%
IA UK Sterling Corporate Bond Sector	-12.86%	3.29%	5.76%	5.58%	0.58%

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.

For most of the quarter, concerns about inflation and higher interest rates (which eat into bonds' fixed returns) drove selling across global government bond markets. But towards quarter end investors began to expect the economy to slow rapidly, driving demand for the safety offered by government debt. The yield on 10-year US Treasuries began the quarter at 2.35% and then hit 3.48% in mid-June before falling back to 3.02% by quarter end.

UK government bond yields followed a similar trajectory. The yield on 10-year gilts rose from 1.61% at the start of April to peak at around 2.65% before falling back to 2.24% at the end of June.

Corporate bond markets were exceptionally turbulent. Credit spreads – the extra yield (or spread) offered relative to government bonds for taking on default risks – widened aggressively as investors began to anticipate an impending slowdown which would test borrowers' ability to repay their debts. The iTraxx European Crossover Index began the quarter at 339 basis points (bps) and had widened to 580bps by its end.

From fear of inflation to fear of recession

The biggest story in bond markets is the recent fall back in government bond yields. The simplest explanation is that investors' overriding concern is now the weaker growth outlook and the possibility that aggressive central bank rate rises intended to tame inflation will cool the economy far too much. Investors have started to think that central banks (particularly the US Federal Reserve (Fed)) will stop raising rates much sooner than they'd previously assumed. In fact, they're now expecting the Fed to start cutting rates as early as next spring. Is this a jittery overreaction that reverses and sees bond yields start grinding higher again? Or could longer-term government bond yields now have peaked?

There's certainly been a bad run of numbers that (at the very least) add to the growing signs that growth is slowing. Higher food and energy prices as a result of the war in Ukraine are beginning to curb consumer spending. And manufacturing output is weakening. But the jobs market (particularly in the US) is still strong: red-hot labour demand stoked yet another month of big US job gains in June. These contradictory clues mean it's hard to know for sure where the economy is headed, how central banks will react and how all this will impact on financial markets. We're braced for bond markets to remain volatile over the summer.

Trading green gilts, buying Australian dollar bonds

An economic slowdown that develops into a full-blown global recession isn't currently the most likely scenario, in our opinion. But the UK and some European countries seem more likely to contract than the US.

This leaves the BoE facing an uncomfortable trade-off between tightening policy to combat inflation and staying more accommodative to try to avert a recession. As a result, the BoE policy outlook is far from clear, which we felt opened up some mispricing opportunities during the quarter.

We don't invest in mainstream UK government gilts, as the government is involved in some areas prohibited by our screening criteria. Instead, we focus on the UK's green sovereign bonds ('Green Gilts') as an ethical alternative.

We traded the **Green Gilt 1.5% 2053** and the **Green Gilt 7/8% 2033** over the quarter. We bought the bonds when we felt that markets were pricing in more BoE cuts than we thought it would deliver and that gilts had probably sold off too much. We then sold them later in the quarter when we felt that gilt yields might grind higher again.

Australian government bond yields, at roughly 4% for the 10-year, are markedly higher than gilt yields so Australian state government debt and credit investments can offer much more attractive yields than their UK counterparts. As a result, we've been adding significantly to our Australian bond exposure, hedged back to sterling. For example, we bought **New South Wales 2.5% 2032** and also **Queensland 1.25% 2031** state government bonds.

Because many global companies issue bonds in several different currencies to tap the widest possible investor base, we can buy bonds issued by UK and European companies that are denominated in Australian dollars. During the quarter, we bought French bank **BPCE 4.5% 2028** and UK bank **Lloyds 5.4% 2027** Australian dollar-denominated senior bonds, again hedging the currency to protect ourselves from fluctuations in the exchange rate.

We sold some **Workspace Group 2.25% Senior 2028** bonds because we were concerned that the office leasing business could be vulnerable to more challenging economic conditions in the UK. Workspace lets out offices and industrial spaces to small and medium-sized businesses in London on a flexible basis, which suggests it could quickly feel the impact of any weakening in demand. We also sold some German **Landesbank Baden-Wurttemberg 1.5% 2025** bonds as we were worried about recent steep rises in gas prices in Europe after Russia cut supplies to several countries. Germany is hugely reliant on Russian gas. If Russia were to shut off the flow of energy to Europe entirely, this would inflict huge economic pain on Germany. Some 65% of Landesbank Baden-Wurttemberg's assets are located in Germany so it would come under pressure if a jump in energy prices stifled German growth.

Are corporate bonds pricing in too much bad news?

Credit spreads could continue to widen for a while, but we think that corporate bond markets may be pricing in too much bad news. The iTraxx European Crossover Index is now at the level it was back in April 2020 when fears of pandemic-driven global shutdowns were peaking. Credit spread levels are currently pricing in a five-year default rate for investment grade bonds (i.e. the highest quality corporate bonds deemed least likely to default) that's significantly above any actual five-year default rate for investment grade bonds over the past 50 years. Moreover, the fundamentals of most of the businesses issuing investment-grade debt suggest that, overall, they're in very good shape. They aren't over-burdened with debt and their earnings are strong enough to comfortably meet the interest payments arising from that debt.

And investment grade corporate bonds are 'lower beta' (less volatile and so lower potential return) investments than equities. They should be expected to outperform equities if an economic slowdown were to develop into a full-blown global recession (although, again, this isn't our base case). Companies' debts rank higher on the capital structure than shares: debtholders get paid first from a business's assets if it fails, while shareholders get paid last. With the moves seen year-to-date, we think investors are getting very attractive compensation for the risk of lending to investment grade corporates.

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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 what you originally invested.

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