Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Ethical Bond Fund

Quarterly update September 2022

There have been plenty of outsized moves in financial markets during the last few years. But they pale in comparison with the turbulence that followed the UK's mini-budget in late September. UK bond markets were at the epicentre of the pain.

	3 months	6 months	1 year	3 years	5 years
Rathbone Ethical Bond Fund	-9.57%	-17.19%	-22.77%	-14.52%	-5.99%
IA UK Sterling Corporate Bond Sector	-9.22%	-15.93%	-20.53%	-16.15%	-8.49%

	30 Sep 21-30 Sep 22	30 Sep 20-30 Sep 21	30 Sep 19-30 Sep 20	30 Sep 18-30 Sep 19	30 Sep 17-30 Jun 18
Rathbone Ethical Bond Fund	-22.77%	4.74%	5.67%	9.39%	0.54%
IA UK Sterling Corporate Bond Sector	-20.53%	1.26%	4.21%	9.02%	0.10%

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.

Mini-budget mayhem

For most of the quarter, the biggest story in global bond markets was central banks' forceful pivot away from low interest rates as they sought to choke off stubbornly high inflation. US Federal Reserve (Fed) chair Jerome Powell made it abundantly clear that the Fed would hold its nerve and keep hiking rates despite signs of slowing economic growth. Bank of England (BoE) Governor Andrew Bailey said there were "no ifs or buts" in his commitment to get inflation under control despite forecasting that surging energy prices would probably drive the UK into a recession. This hawkish rhetoric drove bond yields, which run in the opposite direction to prices, up further since higher rates and high inflation eat into bond's fixed returns. The yield on 10-year US Treasuries stood at 3.02% at the start of the quarter, but had reached 3.83% by its end.

This steady, if relentless, sell-off in government debt turned frenetic in the UK in late September when Chancellor Kwasi Kwarteng unveiled his mini-budget. It aimed to kickstart economic growth with a massive package of help with energy bills, huge tax cuts and a raft of regulatory reforms. Its main aim is to inject significant extra spending power into an economy struggling with high inflation, without a corresponding increase in the supply of goods and services. If you give people more money to buy widgets, without increasing their supply, the result tends to be higher prices for widgets.

Injecting extra demand into an economy struggling with high inflation (UK inflation is hovering at around 10%) suggests the government is pulling in the opposite direction to the BoE. How could the government be loosening fiscal policy (taxes) as the BoE doggedly tightens monetary policy (interest rates)?

Investors feared the mini-budget could further inflame hot prices, forcing more aggressive and faster BoE rate cuts than they'd previously expected. Investor confidence was further troubled by the government's failure to spell out how its proposals would be funded, or to provide the independent forecasts and analysis from the UK's taxation and public spending watchdog that would usually accompany a budget. Investors immediately demanded a higher premium for holding UK assets via a cheaper currency and lower government debt prices.

The value of sterling slumped to an all-time low versus the US dollar and UK government bond (gilt) yields ballooned. The yield on 10-gilts rose from 2.24% at the start of the quarter to hit an intra-day peak of 4.58% on 27 September, before retreating slightly to end the quarter at 4.10%. To put these price moves in context, the surge in yields to around 4.5% meant that gilt yields briefly rose above those of Greek government bonds.

Gilt yields began sinking back down when the BoE was forced to intervene and start buying long-dated gilts whose yields were getting pummelled in the mayhem. A big slice of the UK pension sector — which dominates demand for long-term government debt — struggled to stay solvent as yields surged. To avert the potential collapse of some pension funds, the BoE stepped in with a promise to buy long-dated bonds on "whatever scale is necessary" to absorb these funds' forced selling.

The turbulence in gilt markets flowed through to corporate bond yields as well, with their spreads (the extra return over government bond yields to compensate for the risk of default) flying much higher. The iTraxx European Crossover Index, which measures spreads across a universe of higher-yielding European (including UK) corporate bonds, began July at 580 basis points (bps) and had widened to 639bps by its end. Unsurprisingly, sterling corporate bonds witnessed the most aggressive credit spread widening. In late September, average yields in sterling corporate bond markets were hovering at around 7%, up from around 5.5% before the mini-budget and around 2% last year.

Longer-term repercussions?

The worst short-term turmoil in UK financial markets now seems to have eased. BoE intervention averted a pensions meltdown and it's calmed gilt markets a bit. In the near term, the extra spending power unleashed by the mini-budget should reduce the risk of a very deep recession in the UK starting later this year — which had seemed entirely possible without the government's energy support package. Nevertheless, the turbulence has inflicted some longer-lasting scars. The BoE will probably have to raise rates significantly higher to counter the mini-budget's inflationary impact. As this raises the cost of borrowing for banks and building societies offering mortgages, mortgage lenders have been withdrawing fixed-rate deals en masse to reprice them.

The jump in mortgage rates will further squeeze household finances. And borrowing costs for businesses will also be significantly higher, while we see plenty of reasons to be sceptical about the government's tax cuts and regulatory reform agenda significantly boosting long-term growth as intended (see our budget update for more details). Despite the near-term injection of stimulus, all told the budget has arguably worsened the UK economic outlook for next year.

Buying longer-term bonds

As we head into the final few months of 2022, the year to date has clearly proved bruising for bond investors. And the combination of more monetary policy tightening, persistent inflation and any number of unknowns could bring yet more pain.

Investing is always risky and bond prices may drop further as central banks hike rates up to levels that we haven't seen for many years. To guard against nearer-term risks, we've been carefully paring back some of our shorter-dated bonds and adding to longer-duration ones that move more in line with inflation and growth expectations than changes in rate expectations. If we start to see inflation peaking and a broad growth slowdown, we believe it should be a better time to own longer-dated debt. During the quarter, for example, we bought **Zurich Finance 5.125% 2052** and **UK 1.5% Green Gilt 2053** bonds.

High energy prices and steeper borrowing costs bring extra challenges for corporate borrowers. As a result, we've been dialling down our exposure to companies that we felt were more exposed to the ups and downs of the business and economic cycle, particularly their short-dated debt. For example, we sold mobile phone operator **Orange 3.25% 2032** and also the largest UK private residential landlord **Grainger 3% 2030** bonds.

We still like bonds issued by select, well-capitalised banks, insurers and other financials that manage their risk exposure carefully. During the quarter, we snapped up some newly issued bonds that we felt offered good value. As well as the Zurich bonds, we bought **Banco Santander 4.75% 2028**, French banking group **BPCE 6.34% 2028** and **Svenska Handelsbanken 4.88% 2032** bonds.

We also sold units in of one of our very few equity investments: the Ireland-listed **Greencoat Renewables** investment company. This investment has performed strongly but we felt it was time to sell. We bought the fund because it offered a strong income yield. The sharp rise in rates over the last few months means that we now have ample opportunities to buy attractive bonds offering similarly compelling yields.

The income opportunity

In the wake of the extreme turbulence of the last quarter, it's important to remember that the surge in bond yields marks a significant shift in the income investing landscape that's largely prevailed since the global financial crisis. Higher bond yields present opportunities as well as risks. If these yields are compounded over decent periods of time, they can deliver attractive returns. Bonds offering attractive yields are positive for income-hungry investors, particularly since they may offer safer income streams than other asset classes because coupons must be paid and principal paid back before equity investors if a business fails. Equity dividends can suddenly get cut when equity markets run into trouble. There's much less risk of income-slashing when it comes to higher-quality bond investments.

At the same time, the turn in the rates cycle and the reversal of central bank bond-buying programmes introduced after the global financial crisis suggest that bond investments will start to offer a better safety net against equity market volatility. Ever since the financial crisis, low rates have contributed to most equity markets rising consistently, while central bank buying pushed bond prices up and their yields down. Now that rates are rising and buying programmes are being reversed, bonds and equities have been selling off at the same time.

We're now at the point where the yields on many important government bonds are firmly in positive territory (at least nominally). That means bond investors can once again earn an income for taking out an insurance policy on their equity portfolios on the assumption that the traditional lack of correlation between equity and bond prices will return as extraordinary policy supports keep on being removed.

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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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