

Rathbone Ethical Bond Fund

Update, October 2018

Overview

October was a rough ride for investors, but all that movement created a few opportunities for us.

Ten-year gilt yields started the month at 1.57% and ended the month at 1.44%. Blink at the wrong time and you would have missed them shooting up to 1.73% in between. UK yields spiked alongside US Treasuries in early October as investors increased their forecasts of US rate hikes because Federal Reserve (Fed) Chair Jay Powell said that rates were “a long way from neutral”. Better (and typically short-lived) Brexit news also helped push gilt yields higher during the month. That’s because a more orderly exit should boost UK GDP growth, which is the base for calculating the yield along with expected inflation and the term premium.

Following this quick rise, UK 10-year yields bled away for the rest of the month as Brexit news returned to the sad and confusing norm and concerns about global economic growth drove UK investors to buy up safe haven debt. All over the world, investors sold equities and credit, sending markets tumbling. However, credit rallied into the month-end. It really is Tom and Jerry Markets out there, a cat and mouse game where you have to take small, calculated gambles each day to eke out returns.

UK economic data were ok and the Bank of England kept interest rates steady at 0.75%. PMIs are still in positive territory and average weekly earnings picked up in the three months to August – year-on-year pay packet growth actually hit an almost 10-year high of 3.2% (excluding bonuses) in the third quarter (released in mid-November). Property remains a weak spot and retail sales growth fell slightly on the previous month. Business optimism was softer and inflation was below forecast.

On the other side of the Atlantic, the economy seems to be rolling on very nicely indeed. The US Federal Reserve is expected to hike its rate by 25 basis points to the 2.25-2.50% range at the December meeting. ISM and other business surveys are robust – confidence surveys are virtually all about as high as they get in the best of times. Unemployment remains very low, even as more people rejoin the labour force.

As for Europe, politically things look ropey while economically things are not overly horrible. Italy is entering the sharp end of a showdown with the EU over its Budget. Italian 10-year yields have ballooned well above German debt and are more than double those of Spain. The Italian/Spanish pair used to trade broadly in line. The eurozone unemployment rate fell slightly to 8.1%, retail sales beat forecasts, accelerating to 1.8% growth on a year earlier.

Trades

Early in the month, we reduced our residential mortgage-backed securities exposure by selling the **Mansard Mortgages 2007-2 Floating Rate 12/49**. We also sold some of our senior debt that we felt was getting overvalued.

After the sell-off in markets, we reduced our **European Investment Bank 6% 2028** bonds and bought the **Aviva 6.125% Subordinated 2036** and **Aviva 6.875% Variable 2058-38**. We also sold some of our floating rate bonds so that we could take advantage of higher yields (and therefore lower prices) for fixed rate bonds.

Outlook

October was a pretty crazy month for markets, yet at the end of it not much seems to have changed for us.

US yields will continue to rise steadily from here as the Fed continues to roll on toward “normalisation” (whatever that is). We’re not expecting the US to return to the rates we’ve seen in the more distant past, but we think the general trend will be up. That’s not to say there won’t be setbacks and rallies in yields along the way, and when they occur we’ll be trying to make the most of any opportunities they present.

Most assets in the world are heavily influenced by the US government yield curve, but they of course have their own quirks as well. Most relevant to our fund is the price of sterling. And that, more than ever, seems to be driven by the wrangling between the UK and EU. This is important for us because currency movements can bleed into bond yields. They can also make or break offshore investments in different currencies. To combat this, we have completely eliminated any foreign currency exposure through hedging. No-one has any clue what will happen with Brexit. Following the month-end, Theresa May unveiled her draft deal to Parliament and the nation only for Dominic Raab – her key lieutenant in bashing it out – to immediately resign because he couldn’t support it. Good times.

While I potentially have more than my share of Gypsy blood, given my Welsh heritage, I’m certainly not in the fortune-telling business. It seems likely to me that the sheer complexity of the UK’s departure will make it painstaking and piecemeal, but, again, I have no preternatural foresight. That’s why we’re being cautious. Rather than taking large risks on single events or ideas, we are taking many smaller ones when we think market fluctuations make them attractive. By remaining flexible and nimble, we hope to deliver good returns for you without getting ourselves trapped on the wrong side of fickle markets.



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