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Rathbones
Look forward

Rathbone Strategic Bond Fund

Update, September 2018

Overview

Ten-year gilt yields started the month at 1.43% and finished at 1.57%. Post-month end, they shot even higher to 1.70% after unexpectedly strong US jobs data sent the 10-year US Treasury soaring to 3.20%.

US economic data have been on a good run lately. Second-quarter GDP growth was an annualised 4.2%, PMIs were strong, particularly manufacturing, and consumer confidence increased from already elevated levels. Real wages were 0.5% higher than a year earlier, and inflation moderated more than expected to 2.7% from 2.9% the previous month. All of this led the Federal Reserve (Fed) to push ahead with its third 25bps interest rate hike of the year toward the end of September. There's a good chance that the Fed will add another in December, which would cement a much swifter tightening schedule than 2017.

The UK's macro numbers have been pretty constructive as well. Second-quarter GDP growth bounced back to 0.4%, or an annualised 1.2%. Consumer confidence remains a bit indifferent, but August retail sales were 3.4% higher than a year earlier. Inflation spiked unexpectedly to 2.7% – most economists had forecast a 10bps fall to 2.4%. This rise supports our decision to remain underweight duration. When inflation rises, bond yields tend to increase in line, which reduces the value of the bonds.

Trades

Emerging market debt spreads spiked above 400 basis points early in the month. We took the opportunity to add to the **GAM Multibond Emerging Markets Bond** and **Ashmore Emerging Markets Short Duration** funds. The market has recovered somewhat since, with the spread on emerging debt falling to around 365bps by the end of September.

We have been reducing our floating rate notes and lower-yielding senior bank bonds in favour of the **Rothesay Life 6.875% Perpetual-28** and **Prudential 6.25% 2068** new issues. We felt the new bonds offer better yields.

Finally, toward the end of the month we bought more gilts as yields rose.

Outlook

It's been a pretty punchy few weeks for interest rates. More US rate hikes are pencilled in over the coming six months, so this excitement is likely to linger.

Also hanging around is the bad smell caused by the new radical Italian coalition government. It's playing chicken with the EU over its first Budget and rattling Italian bond markets. The effects are mostly contained in the country, but big moves are creating small spill-overs into the wider European debt market. Meanwhile, all is not well in the UK retail space. Despite relatively strong UK retail sales growth, several stores have run into trouble lately. John Lewis's profits virtually vanished overnight and House of Fraser has been shuttering stores across the country in a bid to stay alive.

Quantitative tightening is well and truly underway, and it feels a lot like the effects are now starting to feed through to the economy and debt markets. Monetary policy takes a good few months – and sometimes years – to be felt in the real economy. For about a year now, the Fed has been reducing the huge stack of bonds it bought up after the global financial crisis. And recently the European Central Bank has lessened the number of bond purchases it makes for its QE programme.

Brexit looms large, as much as we are all sick of hearing all the squabbling about it. One day – probably close to or soon after the 29 March deadline – a decision will be made. When it comes it will create waves in the currency markets, which will have big consequences for bond investors. So as dull and mind numbing as the back and forth of negotiations can be, we're stapling our eyes open to ensure we're as prepared as we can be.

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