Rathbone Unit Trust Management
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Rathbones
Look forward

Rathbone Strategic Bond Fund

Update, November 2018

Overview

It has been a rough couple of months. Ten-year gilts fell 8 basis points from 1.44% to 1.36% in November alone. Over in the US, the S&P 500 dipped into correction territory and credit spreads blew out.

At their highest, five-year high-yield spreads shot up to about 420bps, while investment grade spiked higher too. Ever since early October when Federal Reserve (Fed) Chair Jay Powell said that US interest rates, at 2.25%, were "a long way" from neutral, investors became worried about virtually everything. This concern sent the difference between two-year and 10-year US Treasuries to just 13bps, the lowest level for the yield curve since the financial crisis. When this difference goes negative, i.e. when the 10-year yields more than the two-year, it could signal a recession is on the horizon.

Still, we think investors are getting ahead of themselves by worrying about slight inversion of the three-year/five-year curve during November. The last time the threes and fives inverted was in 2005, a full two years before the US stumbled into the great recession. That's a long time to be sitting around in cash, which could mean the loss of yield while you hang around. Added to that, while global growth is expected to slow in 2019, it shows little sign of slumping to the point of recession. Oil prices have fallen rapidly, but we think that has a lot to do with a risk of greater supply on the horizon rather than lower demand, which would signal a greater economic slowdown. Emerging market debt spreads hit 430 basis points in late November, the highest level since June 2016. Of course, a few months earlier in 2016 these spreads had shot to 540bps because the oil price had slumped, and investors were worried that stalling growth meant recession. Sounds awfully familiar. This time round, growth is even more robust than it was then and oil has sunk below $60 a barrel, not $30, so it seems a little early to be clambering into the bomb shelters.

All of the goings-on in UK politics may be wonderfully invigorating for legal nerds and constitutional professors, but it's a bit of a mess for investors and businesses who simply want to know what the playing field will look like so they can make informed decisions. And so, investors have responded by selling UK assets and buying gilts, if they are locals. It's a bit harder for businesses to pick up and leave, but many are grumbling loudly and quietly arranging drawn-out exit plans. It's all a bit grim for the UK. Growth estimates are very low, despite a good manufacturing PMI reading. And the potential for more sterling weakness means inflation could increase rapidly once more, making British workers yet poorer. Brexit is simply a mess.

Trades

We took advantage of the rally in gilts to reduce our long-dated and mid-maturity holdings. We then put that money into short-dated T-bills instead. We reinvested our existing T-bills when they matured as well.

Our fund grew over the month and we used the extra cash to increase our existing holdings in businesses suffering under the debacle that is Brexit. They included **Center Parcs UK Finance 3.69% 2028**, **Investec Bank 4.5% Senior 2022** and **Liverpool Victoria 6.5% 2043-23**. We believe this is where the value is.

Outlook

Throughout 2018, sterling followed the wending road of Brexit negotiations. Up when hope rose, but mostly down when gloom and intransigence prevailed. As the year comes to a close, sterling credit remains in the doghouse, though some multinational businesses have had a boost to their earnings from the weak pound. One thing we can expect from next year is more heat from US President Donald Trump's

trade war, especially after he lost control of the House of Representatives in November's midterm elections. Meanwhile, the effects of his tax cuts are likely to fall away as the year progresses and interest rates continue to rise. This doesn't mean the US is going to slow dramatically, but we think it will decelerate modestly. We can't see evidence that wages – or inflation – are going to soar rapidly, so we think the surprise of the year may be a notable slowdown in the Fed's rate hikes.

We think 2019 will be another rocky year for markets as the dispersion performance potentially increases. Markets are becoming more flighty, creating large moves for short-term reasons. We think there should be opportunities for active managers to take advantage of the dips. To do this, though, investors will have to accept higher volatility.

Bryn Jones
Fund Manager

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