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Rathbones
Look forward

Rathbone Ethical Bond Fund

Update, March 2019

Overview

Three financial weather systems collided in March, creating a perfect storm that sent polar air flooding through bond markets.

The US Federal Reserve's (Fed) sudden halt on interest rate hikes, the ever-compounding Brexit kerfuffle and poor German economic data sent global bond yields swooning. The yield on 10-year gilts fell sharply, from 1.30% to 1.00%; the US Treasury yield dropped roughly 30 basis points as well to 2.41%. As for the German 10-year, that fell to -0.07%, down from 0.18% at the start of the month.

The reason for this aggressive shift down was that analysts significantly reassessed their expectations of future interest rates, inflation and growth. That reappraisal was driven mostly by the Fed's dramatic U-turn in the face of the fourth-quarter stock market correction and slowing economic growth. Some forecasters started to give decent weight to the probability of the Fed *cutting* interest rates in 2019 (just three months ago investors expected two 25-basis-point increases). On top of this, lower growth means lessened chances of inflation and therefore lower yields. Worries about economic health also made credit (corporate bonds) wobble as well. Subordinated financials, the riskier end of bank and insurance bonds, was hardest hit with the spread above gilts rising to 161bps from 149 at the beginning of March.

From where we're sitting, this all seems like an overreaction. We think the Fed is unlikely to cut rates this year. Instead, the Fed has taken stock of the economy and changed its strategy. The global economy is slowing, Europe in particular isn't looking great, but overall we see a slim chance of worldwide recession this year.

Trades

We bought the newly issued **Coventry Building Society 6.875% ATI Perp-2024**, which offers a strong yield, and sold the **John Lewis 4.25% 2034** because of the deterioration in high street retailers. We added to our position in the **Prudential 6.25% 2068**, as we feel UK insurers are looking cheap considering the chances of them paying a premium to restructure their debt.

Outlook

The worldwide drop in government bond yields caused a large jump in the value of corporate bonds. The combined value of investment grade and high yield debt in issue around the world soared an eye-popping $1.6 trillion to $55tn in the three weeks to March's end. Meanwhile a full fifth of government bonds now offer negative yields.

Again, all of this seems overdone. We rode out the storm of the fourth quarter and we are doing the same now. We have taken profits where we think it's prudent, focusing on the value we see in the financial sector and keeping our duration (interest rate sensitivity) low. Credit spreads will remain volatile and heavily dependent on investor sentiment, which will in turn be driven by the Fed's policy, global economic data and (in the UK) a Brexit resolution.

We have hedged all of our foreign currency exposure because it's just too difficult to call how (and when) Brexit will end. Whatever happens, sterling is virtually guaranteed to shoot up or down. It's just too much risk for us to stake on the flip of a coin.

Bryn Jones
Fund Manager

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Assistant Fund Manager

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