

Rathbone Strategic Bond Fund

Update, May 2019

Overview

Gilts fell 30 basis points to 0.89% in May. High-yield credit spreads widened from 249 basis points (bps) to 310bps during the month, before rallying somewhat to 288bps after the month-end.

These are the kinds of fluctuations that you see towards the back-end of a business cycle. Concerns about a slow down in growth and the trade war rumbling on between the US and China haven't helped many investors' nerves. American economic data has wobbled a bit lately. Where the numbers go from here will likely have a significant impact on the Federal Reserve's interest rate policy as well as on how investors see the world.

As for Britain, the UK has kicked the Brexit can so much that the prime minister has finally tripped over it. Theresa May is stepping aside for one of her bold underlings to take the reins. First up will be a frenzied race to whittle the 10+ pack of hopefuls to an (un)lucky winner. By the time Mrs May's successor moves into No.10, the Brexit deadline of 31 October will probably seem uncomfortably close. The "flexextension" agreement that delayed the Brexit fun till Halloween (a more appropriate date for the event in my opinion) actually has a review due in late June. At the time of the agreement, it was understood that the review was only to appraise the situation. The EU said it was not an opportunity for yet more delays. More fluctuations in sterling markets are probably coming down the pipe too ...

Recently, we have seen a big rise in the macro-implied probability of recession. The yield of the 3-month gilt is about 15bps higher than that of the 5-year gilt (inversion, in the parlance). The US Treasury yield curve has also inverted in parts, and to a greater degree than in the UK. Yield curve inversion is never a good sign about an economy, and in the US it tends to foreshadow recession and slumps in credit and stock markets. Exactly how long between an inversion and the downturn is extremely difficult to predict, however. Sometimes it's nine months, other times it's two years or more.

We're not calling the end of the market – that's a dangerous thing to be doing. Before you know it you're a perma-bear wheeled out onto CNN every week to talk about how your portfolio of gold and linkers is holding up. Besides, I've already got a semi-regular slot on CNBC. Instead, we think it's time to start winding down our fund's risk, starting, of course, with the riskiest parts of the portfolio.

Trades

Last month, as part of a de-risking strategy we continued to sell our higher-risk credit and emerging market funds. We cut back our holdings of the **Ashmore Emerging Markets Short Duration**, **Algebris Macro Credit** and **Barings Emerging Markets Debt Blended Total Return** funds. We have now got rid of all our convertibles, last month's departure was the **NN Global Convertible Opportunities Fund**.

We used that cash to buy higher-rated bonds, like the **Province of Alberta 1.5% Senior 2022**. We also bought a lot of gilts, particularly the 2027s, 2032s, 2034s and T-bills (short-dated UK debt that will mature in less than a year). Added to that, we picked up index-linked gilts as well (government debt whose value is tied to inflation).

Outlook

It's an interesting time in debt markets. Spreads have been getting volatile, but they remain relatively tight. Despite America picking trade wars with friends and enemies alike, bond covenants (essentially the

loan contracts) being less stringent for borrowers and rising defaults around the world, people are still paying up for credit risk.

We've started to become more cautious. We've started reducing our credit risk by selling into some of the rallies. We've completely dispensed with our convertible bond exposure (these bonds can be converted to shares if certain criteria are met), which is effectively selling all of our equity-like exposure. Similarly, we have exited emerging market debt. Now we're slowly winding down our high yield debt too. A number of factors have led us to this point: the OECD leading indicator has turned south, accompanied by a raft of global PMIs. Confidence indicators are declining around the world and Asian export orders have gone into reverse. Banks are tightening their lending, too, which may start to squeeze consumers.

We're not expecting the world to end tomorrow – that's not what this is. Rather, it's us trying to prepare ourselves for a future that now looks like it will be different than the recent past. We've benefited from a very good run for credit and now we feel it makes sense to cash in a few of our chips. When we made the call to buy higher-yielding credit several years ago it was based on improving credit quality – particularly in UK financials – and an unreasonably pessimistic probability of bond market defaults. Now that we see the opposite, we would be remiss if we didn't change our strategy once again. There's a good chance that we are making this change too early, but as my mother always told me: people forgive you for being early, they never forget when you're late.



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