

Rathbone Ethical Bond Fund

Update, June 2019

Overview

Gilts fell just five basis points in June, to 0.83%.

US interest rate expectations continue to decline, driven by falling Treasury yields, which in turn decline with expectations of a rate cut: the spiral continues. This hasn't been helped by weaker US economic data and growth expectations – primarily dismal PMIs. The UK isn't any better and we've returned an array of soft data over the past month. Industrial production has been weak, house prices are stagnating, retail sales are soft and consumer confidence weak. The only glimmer of hope comes from employment data which is still holding up.

We're late cycle and it seems to us that the US Federal Reserve (Fed) is changing tradition by actually trying to engineer a soft landing. The real three-month yield is *below* the neutral real rate. Historically, the Fed has started to cut rates too late – once the real three-month yield is *above* the neutral real rate. A more dovish approach may now mean that it can engineer a softer landing than it has in the past. It's on that basis that we've started to reduce risk where we think it's individual (or idiosyncratic), but leaving credit risk in where the names are more defensive. We believe this is appropriate for late-cycle dynamics.

Having increased our duration earlier in the year, we're now looking to cut it back.

Trades

We sold some **John Lewis 4.25% 2034** and reduced some illiquid names, like some charity bonds.

We bought a large slug of **Bank of Scotland 7.281% Subordinated Perpetual-2026**, which is a make-whole callable bond. Beyond 2022, all tier-one capital will have to have equity conversion triggers. This particular bond doesn't have an equity conversion figure, so we think it will be bought back by Lloyds Banking Group (the owner of Bank of Scotland) at the next opportunity in 2022. If so, this bond offers a very attractive yield, so we've taken quite a big position.

Outlook

Trade tensions keep resurfacing and there's more and more talk of the Fed engaging in some kind of currency manipulation or non-standard rate policy to weaken the dollar. It will be interesting to see if the central bank does have any of this behaviour up its sleeve.

Credit spreads are nearing the tightest they have ever been; in Europe, some junk bonds are now earning negative yields. It's a difficult time in debt markets: economic data has deteriorated, which is bad for companies' creditworthiness; yet central banks plan to cut interest rates, which is good for bond prices. Over the longer term, which direction are interest rates headed? Will there be one rate decrease by the Fed before they hold rates as they are? Are there more to come? Or will the world's most important central bank begin hiking rates again in due time? These questions are crucial when it comes to how we position our portfolio. For instance, how much duration (sensitivity to interest rate changes) we take on, the quality of bonds we focus on and the industries we lend to.

Answers to these questions are unclear. What is crystal, however, is that many of these decisions are binary: you either win big or lose big. Where possible we've been trying to reduce our risk until we are more comfortable with the state of the global economy. We're trying to pick up returns where we can find them.

A year ago, we noted that bond markets had turned into a cat and mouse game. We felt investors' mood swings would be just as dangerous as rising default rates, sharper inflation and changes to monetary policy. Just as then, we are reluctant to jump completely out of credit risk because there is a chance that economic data bounces back, as it has in the past. So we are still scurrying round the market a bit, picking up duration or credit when it's cheap, selling a bit when it's expensive.

Greater volatility is creating more of these trading opportunities, but it comes with risks. We're trying to be as cautious as possible: we don't want to go hungry, but we don't want to be caught with our back to the wall and a crazy cat in our face.



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