

Rathbone SICAV Ethical Bond Fund

Update, September 2019

Overview

Bond markets took a wild ride in September, but ended up in virtually the same place. The 10-year gilt yield started the month at 0.48%, dropping to an all time low of 0.406% before shooting up to 0.76%. It then ebbed all the way to finish at 0.49%.

These are some pretty large moves. We were on the right side of them this month, selling high duration (interest-rate-sensitive) bonds as yields slumped and buying duration as the yield ballooned. It can be very painful when you get this wrong, however, so we've been careful about just how much risk we put on the table when trying to play Tom & Jerry in these markets.

The fleeting yield jump was driven by several factors. An aerial strike on Saudi oil fields shut down 5% of global crude oil capacity and fully half of the country's output. Oil prices spiked, and inflation expectations and bond yields with them. The supply was quickly filled out by reserves stored by the US and Saudi Arabia. The damage to the refineries was apparently patched up even more quickly. Global yields were pushed higher by hopes that the US and China were coming to an accord over the trade war. That pushed up value companies and risk in general, sending government bond yields higher as investors shifted their positioning. Crazy, right? That seems like ages ago. We've been through a few iterations of hope, despair, acceptance since then and it's only been a month. Plenty more to go too, we reckon.

However, as the month closed out, doom-mongering came back into fashion. Economic data has been iffy for a couple of months, but it took a noticeable downturn in September. Global PMIs – a mixture of businesses' upcoming orders, hiring intentions and general mood-taker of economies – have been sinking steadily. Everywhere, that is, but in China and Japan, which have actually held up ok. The European Central Bank also announced that from November it would buy another €20bn of quantitative easing (QE) each month for the foreseeable future, firing the starting gun on QE infinity. This will continue to put even more pressure on European bond yields, both government and corporate, which seem to head inexorably toward the zero bound – and beyond.

There are some bright spots out there. US housing is doing pretty well and Americans just keep spending ever more money. Many shops and businesses on Main Street are nervous about the future, but the suburbs seem to be in great spirits. Regardless, gloominess in vogue and the US Federal Reserve (Fed) has received the signal loud and clear, cutting interest rates by 25 basis points in September. The central bank is widely expected to shave yet another 25bps off rates in October. If so, the Fed will have reversed a third of its rate hikes in just three months. No wonder government bond yields are in a state of confusion.

Trades

We bought several new issues last month, including **Royal London Finance 4.875% 2049**, **Nationwide Building Society 5.875% Perpetual-2024** and **Beazley Insurance 5.5% 2029**.

Interesting fact: companies issued \$434bn of bonds around the world in September, the highest monthly slug ever.

We added to our financials holdings further by picking up some **AXA 5.453% Floating Rate Subordinated Perpetual-2026** and **Barclays Bank 3.25% Senior 2027**. We also bought the **Scottish Hydro Electric 2.3% 2035** green bond during the month.

Outlook

It was a busy month for the Fed, as it had to start meddling in the ‘repo’ market, an important interest rate at the bedrock of US financing. ‘Repo’ rate stands for the repurchase rate and it’s a large and liquid market where banks and other large institutions can borrow money for short periods (often overnight) secured by US treasuries.

The repo rate is the interest rate that the banks pay determined by the difference between the price they sell the treasuries for and what they pay to repurchase them. The repo rate tends to roughly follow the Fed Funds rate and other low-risk short-term interest rates. However, in September the repo rate shot up from 2.4% to a high of 10%. What happened out there? The trouble was caused by a shortage of cash and too many treasuries. Greater demand for a smaller pool of available cash meant banks were squeezed selling their treasuries for much lower prices than usual and agreeing to buy them back for much more. That sent the repo rate soaring.

This led some people to worry that the sky was falling, which seems an overreaction. The cash shortage was partly because US corporations tapped lots of money market funds so they could pay quarterly taxes. That coincided with a particularly large treasury issue as the US government finances Donald Trump’s steadily widening budget deficit. The Fed put up \$75 billion of its own cash for use in the repo market at prevailing interest rates – essentially increasing the amount of cash in the system to keep rates from spiking again. Some investors will continue to grumble about this, but in the meantime – until it becomes entrenched or recurring – we believe it can be put down to a glitch in a complex system.

Post-month end, UK Prime Minister Boris Johnson and Irish Prime Minister Leo Varadkar came together in unexpected solidarity about solving the Irish border problem. The news sent the pound and gilt yields soaring along with people’s hopes for a Brexit deal.

JPMorgan economists increased their probability of getting a deal struck from 5% to 50% within hours. Both sterling and yields retreated once the EU players had made obligatory tut-tutting noises, but there really does appear to be the smell of compromise in the air. We’re pretty jaded – it’s been a long few years – but we’re hoping something actually comes of this. There’s a long way to go though. This is still a very similar deal to the one Parliament batted back to Theresa May multiple times – would the House of Commons give this one a pass? Remember that Mr Johnson is 41 votes short of a secure majority. He is a fast-talker though, and there is a general feeling that this has to be settled for the good of the nation.

Still, if a deal is actually inked, the next job will be figuring out what it means for British businesses, and how government and monetary policies will proceed. Any binding agreement will be feted with joy and relief, but that impatience to “just get on with it” could mean settling for something that may be a bit second rate. We’ll be carefully looking at the agreement and likely reactions to determine how it will affect our holdings.



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Source performance data, Financial Express, mid to mid, net income re-invested.

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