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Rathbones
Look forward

Rathbone Ethical Bond Fund

Update, December 2018

Overview

December was a torrid month for credit as a number of fears converged to panic investors.

Ten-year gilt yields started the month at 1.36% and ended at 1.28%. They bottomed out at 1.19% on 11 December. Despite the US Federal Reserve (Fed) pulling the trigger on another 25-basis-point hike last month, taking benchmark interest rates to the 2.25-2.50% band, US 10-year yields *fell* from 2.99% to 2.68%. That is the technical manifestation of what drove markets last month. In English, investors thought the Fed was being overly hasty with its monetary policy. That dampens inflation and growth expectations, which in turn sends longer-term bond yields lower. The worries about a Fed mistake were heightened by some poor economic news and disappointing company results which led people to believe that worldwide growth is weakening. A slowdown increases the chances of a global recession and therefore encourages people to sell equities and riskier bonds. Sprinkle a bit of US government shutdown, Trumpian bombast and "Brexit means Brexit" on top and you've made yourself a particularly foul version of market eggnog.

Credit spreads widened over the month, with the subordinated financials index jumping 17bps to 228bps and high yielders up 25bps to 353bps. Equities and credit markets were myopically focused on the few scary signals. There was plenty of good news out there too, including the ISM Non-Manufacturing PMI which defied analyst expectations of a fall by rising to an exceptional 60.7 in November. It did fall back following month-end, but it remains comfortably in expansionary territory. Another post-month data print was rosier: Nonfarm payrolls showed 312,000 net jobs were created in December – almost twice as many as forecast – while wage growth accelerated.

At bottom, it was a terrible month for anything other than the safest of assets. Any and all reassuring data was completely ignored as investors continued the late-2018 trend and took flight.

Trades

As the year wound down we increased our cash level to reduce risk as we entered a time of typically low liquidity. We did this by selling **European Investment Bank 3.875% 2037** and **Korea Development Bank 1.75% Senior 2022** bonds.

Outlook

Historically, after periods of high volatility that don't end in recession, prices have snapped back quite markedly. That has led to strong returns for a reasonably high-beta credit fund, like ours, as the market mood improved. Past returns aren't a guide to the future – we are as clueless as everyone else about when the next recession will hit – but we think we should be able to offer good returns in the coming months. We are adding to bonds that looks more attractive now they are significantly cheaper after a rocky final quarter of 2018.

Despite reasonable data out of the UK and the US, investors are still fixated on the bum notes out there. Markets are fickle things and they have proved the rule again this time round. The reaction to recent events and Federal Reserve comments has been extreme. Yes, there are risks around the world: a heavily indebted China is slowing, most Western governments are inept and the tide of monetary policy is turning. But many of these risks have been hanging around for years.

We think it's too early to sit out of markets just yet. You may be on the sidelines for quite a while.

Move to single-pricing

As we've previously communicated, from 21 January our fund units will move to a single-price, dropping the current dual-price system. Rather than have a buy price and a marginally lower sell price, a single price will be issued for our funds at noon each day. Both purchases and sales of units will be based on this single price. In line with the industry, we intend to operate a 'swinging' single-pricing mechanism for our funds. This ensures the fair treatment of all unitholders by minimising the effects of the 'dilution' that occurs when stocks are bought and sold. The single price will swing in response to large purchases or sales in order to mitigate these effects. Once the single price of a unit has been determined, a 'dilution adjustment' will be applied to the price in accordance with the policy outlined in the prospectus for our funds. For example, when there are net inflows to a fund, a dilution adjustment increases the price (price swings up) and when there are net outflows from a fund, a dilution adjustment reduces the price (price swings down). However, regardless of whether the price is adjusted up or down, all investors buy and sell at the same price.

Bryn Jones
Fund Manager

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Assistant Fund Manager

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