Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Ethical Bond Fund

Update, August 2019

Overview

Ten-year gilt yields dropped 13 basis points over the month, down to 0.48%. This fall was driven by a number of factors, namely trade-related concerns about global growth, possible rate cuts and the increasing likelihood of a hard Brexit.

The US-China trade tussle rumbled on which is doing economic prosperity no favours. Now there are calls for more stimulus within China, including the reduction of reserve requirements and other tools to support the economy. If this happens, it's likely to be supportive of global growth. The continued belief that central banks around the world will continue to reduce interest rates pushed yields further down. The UK's own domestic headache – a hard Brexit was looking increasingly likely – just aggravated this phenomenon.

Generally, UK economic data disappointed last month. An early estimate of second-quarter GDP growth came out at -0.2% and industrial production was weak too. The UK construction PMI languished at 45, down from 45.3. These are further signs that political uncertainty is quashing capital investment. It wasn't all gloom, though: retail sales surprised to the upside.

Credit was generally volatile over the month – selling off at the start and rallying into month-end. Overall, most sectors have been doing quite well, so a correction in bond prices (and rising yields) might be on its way.

Trades

We used the rally in yields to sell some long-dated housing association bonds – **Karbon Homes 3.375% Bonds 15/11/2047** – to take some profit. We added to some existing names like **Bupa Finance 6.125% Perpetual-2020**, which can next year be bought back, giving us a decent yield for a year or so.

We also bought the **Aviva 5.9021% Perpetual-2020**, which has a similar option to the Bupa bond, because we believe the company will also buy back the bonds early. The **Hong Kong & Shanghai Bank Floating Rate Note Perpetual** bonds had an attractive yield and the company's liability management looks reasonable, so we bought them too.

Outlook

For some time we've been saying that the US Federal Reserve (Fed) has been trying to engineer a soft landing. The latest rate cut confirms it.

Historically, the Fed starts to cut rates when the three-month government T-bill's real yield (so after subtracting the inflation rate) is above the neutral interest rate (the 'Goldilocks' rate, where monetary policy would be neither stimulatory nor a handbrake on the economy). Put plainly, the Fed typically begins cutting interest rates after a period of tightened monetary policy. That's not the case this time round. In July, when the Fed cut interest rates for the first time in a decade, the three-month T-bill yielded less than that Goldilocks neutral rate. So monetary policy was actually *already* helping the economy, rather than holding it back. The Fed appears to be making very sure that it doesn't smother the economy and bring about a recession.

There are risks out there, some pretty glaring. Yet the US appears to be ticking along ok. It's a puzzle and a difficult one to solve. Whether the smoke signals are forecasting recession or just a slowdown, we've been clearing our decks of bonds that we think would struggle in either environment. We've been minimising our duration, or sensitivity to changes in interest rates, because we're aware that a run of better news could cause a painful sell-off of government bonds that would hurt longer-dated bonds. We've retained some late-cycle-appropriate risk on the table, however.

Bryn Jones
Fund Manager

Noelle Cazalis
Fund Manager

This is a financial promotion relating to a particular fund. Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments may go down as well as up and you may not get back your original investment.

The information contained in this note is for use by investment advisers and journalists and must not be circulated to private clients or to the general public. Source performance data, Financial Express, mid to mid, net income re-invested.