

Rathbone Ethical Bond Fund

Update, February 2019

Overview

Ignoring erratic market signals and sticking with the macroeconomic data served us well last month.

Earlier this year, equity and credit market prices were implying a very high chance of recession this year. However, reliable economic measures suggested investors were letting fear blind themselves to good value. We stuck with our bias to credit over safety – even buying up some bargains as they appeared – and this turned out to be a very good decision for us.

Gilt yields rose sharply in late February, closing up 8 basis points at 1.30% as investors departed the safe harbour for riskier assets. At the same time, the iTraxx Crossover spread index (a proxy for European credit risk) fell from 308bps to 276bps. This was partly due to greater optimism in global markets about the Sino-American trade situation. The old rumour is again doing the rounds that the US and China are close to scratching out a deal that will cool the tariff tensions between them. Following month-end, Chinese IT and telco giant Huawei unveiled it was challenging the US government's enforced boycott of the company as unconstitutional. Not altogether positive then, but, given the Chinese top brass were preparing to rubberstamp a new framework for IT and foreign businesses at the China People's Congress in early March, it seems like a good time for the pair to announce something both sides can class as a victory.

Sterling credit in particular has had a bump from the feeling that Westminster could be close to concocting a Brexit deal. Sterling corporate bonds had lagged other European markets somewhat, but they played catch-up in February.

Trades

We've used this rally to continue cutting back on some of the assets we are no longer so hot on. They included Clydesdale Bank debt (**CYBG 3.125% Floating Rate Senior 2025**) and digital business services firm **DXC Technology 2.75% Senior 2025**. We swapped the cash raised for financiers **Citigroup 2.75% 2024** and **BPCE 5.25% 2029**.

Also, we bought **MORhomes New Issue 3.4% Senior Secured 2038**. This is the first bond issued by a new financing joint venture set up by 60 UK housing associations. The money raised by the issue will be lent on to the housing associations so they can develop the homes that are in such dire demand. This deal spreads risk among all the associations and gives them much greater economies of scale in the capital markets. By creating a larger pool of like bonds, instead of 60-odd smaller issues, the debt becomes more liquid and more valuable, reducing the housing associations' financing costs and allowing us to invest with lower risk. The end game? More affordable housing for Brits.

Outlook

Global trade winds will continue to blow the way of US-China trade talks, while in the UK improved market weather will depend on some form of progress on Brexit negotiations.

We're not expecting the world to sink into recession this year – it would take a large swing in several economies that just doesn't look likely as things stand. Still, global growth is slowing down as the US comes off its tax-cut-fuelled peak and China struggles with over-indebtedness and export barriers. Because of this, we're trying to stay as vigilant as possible, trying to take notice of the real issues in a world awash with information and emotion.

Italy is a particular area of suspicion for us. This debt-bomb of a country is bigger than you think, with the ability to upend the European debt market if it goes off. A tenth of the loans made by Italian banks have gone bad, according to the European Central Bank. Even worse is the absolute total of Italy's bad debts: at €159bn it is easily the highest of any country in the bloc. Thankfully, up till now the Italian government – radical as it is – has shown itself to be very aware of the implications of going thermonuclear with its finances. Every time things come to a head, the Italian coalition has backed down. There's always a risk that one day it stands its ground, however.

And, of course, there's China. The nation has slowed significantly in the past few years, from 10% in 2010 to just more than 6.5% in 2018. This was always going to happen as the country grew to become a much larger share of the global economy. But there is a chance that this expected slowdown could spin out of control into a fully fledged slump. China is trying to move from a heavily industrial model to a more modern, services and hi-tech economy. To do this it needs to be deft, careful and have friends abroad. It will also have to resist the temptation to pour ever more debt on its problems and instead trust more in market dynamics.



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