

# Rathbone High Quality Bond Fund

## Update, March 2019

The US Federal Reserve's (Fed) sudden halt on interest rate hikes, the ever-compounding Brexit kerfuffle and poor German economic data sent global bond yields swooning. The yield on 10-year gilts fell sharply, from earlier highs above 1.50% down to 1.00% into the end of March; the US Treasury yield dropped by a similar magnitude to 2.41%. As for the German 10-year, that fell into negative territory, touching a low of -0.08%.

From where we're sitting, this all seems like an overreaction. We think the Fed is unlikely to cut rates this year. Instead, the Fed has taken stock of the economy and changed its strategy. The global economy is slowing, Europe in particular isn't looking great, but overall, we see a slim chance of worldwide recession this year.

The worldwide drop in government bond yields caused a large jump in the value of corporate bonds. The combined value of investment grade and high yield debt in issue around the world soared an eye-popping \$1.6 trillion to \$55tn in the three weeks to March's end. Meanwhile a full fifth of government bonds now offer negative yields. We have taken profits where we think it's prudent, focusing on the value we see in the financial sector and keeping our duration (interest rate sensitivity) low.

We increased our allocation to floating rate notes during the quarter. LIBOR is expected to vanish by 2022, a casualty of the investment bank manipulation scandals. Some banks have started issuing bonds linked to LIBOR's replacement: SONIA (Sterling Overnight Index Average). These bonds are backed by mortgages and are AAA-rated, so low credit risk, and because they are floating rate notes (FRNs) they carry no interest rate sensitivity. Yet they yield more than the 10-year gilt! It's a great fit for our fund. As a result, a fifth of our fund is in AAA FRNs. This area is likely to be a happy hunting ground for us, so we'll be watching for new issues.

We also bought the **Places for People 2.875% Senior 2026**, as it was upgraded to A-. This company has a strong balance sheet allied with attractive valuations. We're very happy to hold these bonds.

A few new issues were added to the portfolio, too. The **Vinci 2.25% 2027** is the first sterling bond issued by this French construction company. Vinci is a strong credit and the new issue was very well supported by UK investors. Another new issue we picked up was the **ING Groep 3% 2026**. European banks are doing a lot of refinancing at the moment as they move their funding from operating company level to the holding company to comply with new regulations. It throws up interesting opportunities in single-A rated bonds.

We reduced exposure to the auto industry during the quarter. We have a small amount left over, but they all mature this year. There are a clutch of problems here: trade tensions are hurting just-in-time production as well as export sales; that's on top of a global slowdown in demand as we hit peak car and new emission regulations bite. Then you have automation and electrification that are quickly chasing the future into the present. We think auto-manufacturers will have to invest more in research and development and new production lines, which – along with everything else we've mentioned – will put pressure on their ability to pay their debts.

Looking ahead, it seems likely that credit spreads will remain volatile and heavily dependent on investor sentiment. The market mood, in turn, will be driven by the Fed's policy, global economic data and (in the UK) a Brexit resolution.



## **Noelle Cazalis**

Fund Manager

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