Rathbones
Look forward

Rathbone High Quality Bond Fund

Update, June 2019

US Federal Reserve (Fed) chief Jerome Powell has maintained his dovish rhetoric and US interest rate expectations have continued to decline, driven by falling Treasury yields, which in turn decline with expectations of a rate cut: the spiral continues. This hasn't been helped by weaker US economic data and growth expectations – primarily dismal PMIs. The UK isn't any better, returning an array of soft data over the past month. Industrial production has been weak, retail sales are soft and consumer confidence also weak. House prices are stagnating as property continues to wallow in murky Brexit waters.

The German ZEW survey (economic sentiment) was dire, falling amid industry concerns. It came in at -24.5 vs -22.3 expected (ouch) in mid-July, close to its weakest in seven years. Looking at the current conditions they fell below zero for first time in nine years, meaning more respondents think it's getting a whole lot worse before it gets better. Germany is struggling with waning global demand with its most important trading partner, China, reporting its slowest growth since 1992. Indicative of the growth weakness is BASF, the world's largest chemical company, which warned profits may fall by 30%. We have no exposure to the name.

The only glimmer of hope comes from UK employment data which is still holding up. Unemployment stayed at 44-year low and non-bonus nominal pay growth hit 11-year highs, so not normal conditions for a rate cutting environment. Average earnings rose above expectations of 3.1% to 3.4% and ex-bonus the rise was from 3.4% to 3.6%.

We're late cycle and it seems to us that the Fed is changing tradition by actually trying to engineer a soft landing. A more dovish approach may now mean that it can engineer a softer landing than it has in the past. As investors are wary of credit risk, A- and above rated bonds have seen strong demand over the quarter.

In the UK, the curve is inverted at the short end. We have therefore kept our duration (interest-rate sensitivity) very low at 2.08, and we continue to like floating-rate instruments.

As the fund continues to grow, we added to existing positions and looked for additional investment opportunities.

We added some exposure to senior parts of the capital structure within Australian banks, such as **Westpac 2.625% 2022 and Commonwealth Bank of Australia 1.125% 2021**, which we believe provide good value compared with UK banks. These bonds are backed up by strong balance sheets and low loan-to-value ratios.

We added **London Stock Exchange 9.125% 2019** bonds, which provide an attractive Brexit premium and are very short dated.

As an alternative to sovereign debt, we also added some **Province of Alberta 1.5% 2022** bonds, giving an additional pick-up in yields.

We continue to like floating rate debt linked to SONIA, the successor to Libor, and added **Lloyds Floating Rate 2024**.

Trade tensions keep resurfacing and there's more and more talk of the Fed engaging in some kind of currency manipulation or non-standard rate policy to weaken the dollar. It will be interesting to see if the central bank does have any of this up its sleeve.

Faced with years of record low interest rates, bondholders have crept further and further towards higher-yielding assets. The BBB bond market has exploded more recently as companies take advantage of investors' craving for yields. Credit spreads are nearing the tightest they have ever been; in Europe, some junk bonds are now earning negative yields. We think that when the bust comes, bondholders are likely to run to the safe havens of A- and above. These assets should hold up well while the BBB and junk beneath it could see more volatility.

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