

Rathbone Strategic Bond Fund

Update, January 2019

Overview

Ten-year gilt yields fell over the month, from 1.28% to 1.22%. Despite this fall, likely driven by lower inflation and growth in the UK, credit spreads tightened considerably as well. Equities, corporate debt and emerging markets all shot higher as investors swung from despair to optimism.

In short, investors sold risky assets so aggressively at the turn of 2019 that the market implied a strong possibility of recession in 2019. Economic data never really worsened enough to justify this belief, however. In the end, investors decided to jump back on the market bandwagon and indices shot higher. This was no doubt helped by an about-turn by the US Federal Reserve (Fed). The central bank ended January by implying that it may in fact *cut* interest rates this year, rather than increase them from their 2.25-2.50% level. Many have taken this message at face value, with derivative prices showing no expected Fed hikes for the next 12 months. The Fed's position was no doubt reinforced by US inflation continuing to fall, hitting 1.6% in January. However, the drop in CPI has mainly been the effect of lower petrol prices – core inflation (stripping out fuel and food) has been steady at 2.2% for five of the past six months. Central banks tend to ignore fluctuations in petrol prices, where possible, because it's not something they can control. Whether the Fed is simply trying to support the stock market or has seen some nasty, not-yet-public data in the pipeline is anyone's guess.

We stuck to our guns throughout the turmoil of the start of the year and benefited from the market bounce as the month wore on. As we've said many times before, this is classic Tom and Jerry markets: you've got to scurry around to pick up return on offer without getting walloped by sentiment turning conclusively against you.

Trades

When markets shot lower early in the month we took the chance to invest across the risk spectrum at lower prices. We took on more senior credit in our favoured names: **Principality Building Society 2.375% Senior 2023**, **Coventry Building Society 1.875% 2023** and **Paragon Group of Companies 6% 2024**. And we increased our global credit at the same time, buying the hedged versions of the **Pimco Global Investment Grade Credit** and **Investec Global Strategy Investment Grade Corporate Credit** funds. We also boosted our emerging market exposure by purchasing the **Ashmore Emerging Markets Short Duration**, **Muzinich Asia Credit Opportunities** and **Barings Emerging Markets Debt Blended Total Return** funds.

We used the rally in corporate credit at the tail-end of January to cut our holdings in some of our higher-risk bonds, as well as those that we have cooled on over the past few months. These included the **TSB Banking Group 5.75% Floating Rate Note LT 2 2026-21**, **Metro Bank 5.5% 2028**, **John Lewis 4.25% 2034** and the **Intermediate Capital Group 5% 2023**.

Finally, we also continued to add to our stock of UK T-Bills, very short-term debt that is equivalent to cash but with a better yield.

Outlook

Worrywarts have a smorgasbord to feast on at the moment: the US and China keep battering each other over trade, the Fed is quickly eroding its credibility, Chinese growth is running low on steam and Europe is tottering because of it, and American households aren't quite the red-hot item they were in 2018. And then there's Brexit. Interminable Brexit.

Despite all this, sterling credit has held up well. Partly due to a lack of new debt being issued and partly because of strong UK company balance sheets. As for the pound itself, everything seems to be about Brexit.

We're keeping all of our portfolio in sterling-denominated assets to protect against large shifts in the currency. We may miss out on some gains if the pound falls, but our mandate is to protect the value of our unitholders' investment in sterling. Our only overweight is to sterling credit, which looks cheap at the moment; virtually every other risk has been dialled down substantially. We are likely to remain in this defensive stance at least until the Brexit deadline in March.



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