Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone High Quality Bond Fund

Update, September 2019

Government bond yields continued to slip ever lower in the third quarter, hitting all-time lows along the way.

The 10-year gilt dropped from 0.84% to 0.49%, bottoming at 0.406% in early September. Yields in Europe, the US and Japan have also slumped. This downward march has been driven by lower GDP growth estimates and generally weakened inflation around the world. The US Federal Reserve cut interest rates twice during the quarter, taking the benchmark borrowing rate to 1.75%-2.00%.

There was a short-lived spike in bond yields following an aerial strike on Saudi oil fields, which shut down 5% of global crude oil capacity and fully half of the country's output. Oil prices spiked, and inflation expectations and bond yields with them. The supply was quickly filled out by reserves stored by the US and Saudi Arabia, while damage to the refineries has apparently been patched up too. Yields quickly settled back on the bottom of the proverbial tank.

In the UK, the whirlwind that is Boris Johnson's premiership has whipped up excitement. Getting off to a rough start, the new Prime Minister barrelled straight into renegotiating the UK's Brexit deal with the EU. He banished a score Conservative MPs from his party for disagreeing with him and lost a slew of votes. But as October dawned, Mr Johnson appeared to be on the cusp of sealing a deal that satisfied the EU. If he can pull it off, it would likely remove the big rusty anchor that has held down sterling, UK GDP growth and bond yields.

Mr Johnson has a long way to go though. He still must get his deal past Parliament and the deadline to leave the EU is less than a fortnight away.

During the quarter, we parked some of our cash in UK T-bills – government debt that matures in less than a year. We did this because we felt longer-term government bonds were too expensive to warrant us buying them and therefore increasing the risk that interest rates move against us.

Buying debt with shorter maturities is somewhat of a game plan for us. Right now, you can actually get a better yield from debt with less time till maturity than you can from bonds with longer lives (known as a yield curve inversion). To take advantage of this, we bought **Heathrow Funding 6% 2020**, **Virgin Money Holdings 2.25% Senior 2020**, **Motability Operations Group 6.625% 2019** and **UBS 1.25% 2020**. We also sold **BP Capital Markets 1.177% Senior 2023** because the yield inversion intensified to the point where this bond had a yield similar to that of the 'risk-free' 3-month UK T-Bill.

Buying short-dated bonds isn't the only way for bondholders to protect themselves from movements in interest rates, which cause losses when they rise and profits when they fall. Another way is to buy floating rate bonds whose coupon payments are linked to interest rates. We have been doing this since launch, and continued to add to assets linked to the Bank of England's Sterling Overnight Index Average (SONIA) – a replacement for LIBOR. This quarter we bought **Nationwide Building Society Floating Rate 2022**, **Coventry Building Society Floating Rate 2023** and **Royal Bank of Canada 1.35% Floating Rate 2024**.

New bond issues are another avenue of getting reasonable yields, and this quarter was no exception. We picked up **Henkel 1% 2022** and **Banco Santander 1.502% 2024**.

As part of our move away from longer-dated bonds and their inherent interest rate risk, we took profit on some investments, such as the **ING Groep 3% 2029**, **Motability Operations Group 1.75% Senior 2027** and **Wells Fargo & Co 2.5% 2029**.

Right now, the global investor mood is pretty glum. It's not quite despair, but it's definitely pessimistic. Global PMIs – a mixture of upcoming orders, hiring intentions and general mood-taker of economies – have been pretty poor around the world for the past few months. As these numbers glide below 50, the level which separates growth and decline in business activity, concerns about a worldwide downturn rise. Chinese GDP growth is slowing. The UK is expected to dodge recession, but only just. Germany is looking like it will be less lucky. Even the US, that shining light of economic activity, has been fading lately.

This led the US Federal Reserve (Fed) to cut its benchmark interest rate twice in two months. It is widely expected to cut rates further over the next months. If it does, the central bank will have, in just a few months, reversed a third of all the interest rate increases that it took three and a half years to implement. Looking around the global economy, it's hard to tell whether we are sinking into recession or if this is just a temporary fluctuation in economic activity that will pick up again. We feel it's just too early to say. US employment is strong, household spending is skipping along and the American housing market has been doing well. These are atypical signs of impending doom for the US economy, which is the predominant driver of worldwide economic growth.

For the time being, we are continuing to focus on keeping our credit and duration risk low, grinding out small but steady returns that shouldn't be upended by large swings in yields.

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