

Rathbone Ethical Bond Fund

Update, June 2018

Overview

Ten-year gilt yields started the month at 1.23% and ended slightly higher at 1.28%. The big moves were in credit spreads.

They had a tough month, widening as concerns about a looming trade war between the US and the rest of the world intensified. Tit-for-tat tariffs started following the end of June, however we believe it will require an extreme escalation from here to affect global growth and, consequently, hurt corporate profits. Still, bondholders are more skittish these days with the US Federal Reserve aggressively hiking interest rates at a time when Europe and the emerging markets are still trying to offload non-performing loans. It also doesn't help that the summer's typically low trading volumes are being exacerbated by the World Cup. This illiquid market is probably exaggerating moves, in our view.

We think gilt yields are too low at the moment, the result of a flight to quality trade that should unwind as the fears mentioned above come to naught or retreat from the attention of bondholders. UK economic data were pretty good in June. PMIs, a measure of business confidence and output, were strong across all parts of the economy. Unemployment remains low and inflation is still above the Bank of England's 2% target (and expected to go higher, given the rise in oil prices). Even more importantly, house prices appear to have stabilised after a wobble earlier this year; this is exceptionally important for UK consumer confidence and therefore for the economy as a whole. The probability of a 25-basis-point rate increase in August was about 80% at the time of writing.

Given all this, we think a 10-year gilt yield of 1.30% (as of 10 July) is just too low.

Trades

We've continued to reduce our holdings of retailers' debt. We sold the **Intu (SGS) Finance 3.875% 2023** as well, because we are less sure of how its big regional shopping centres will fare against the e-commerce onslaught. Another retailer we cut was the **Mark & Spencer 4.75% 2025**.

Meanwhile, we bought the new issue of **Metro Bank 5.5% 2028**, because we think the yields on offer in the finance sector are attractive, particularly after recent spread widening. One exception was that we reduced our position in the **Assicurazioni Generali 6.269% Subordinated Perpetual-2026**. Another addition was **WoDS Transmission 3.446% 24/08/2034**, an offshore wind farm in the Irish Sea.

Finally, we bought the **Coigach Community CIC 5% Index-Linked 2030**. The £1.75m raised by the Scottish community

Outlook

We remain underweight duration (interest rate risk) by holding fewer European Investment Bank bonds (our proxy for gilts) and trying to keep our portfolio maturity lower than typical. We expect gilts to rise again over the rest of the year as recent worries recede and traders return from the holidays/football distractions. However, given the way liquidity and investor mood has gone, we think it will be pretty up and down. Some months are likely to look great, followed by others that are quite poor. Perhaps more so than in the past few years, easy gliding trends are probably behind us.

The UK is a difficult place to call at the moment. It's been a very gloomy spot for about 18 months now. GDP has slumped ever lower, businesses have been getting more and more leery of Brexit as the politicians tie themselves in knots. But perhaps even more worrying has been the slide in consumer confidence and spending growth. But the royal wedding in May and a run of sunny days in June and July has helped coax wallets out of pockets. A run of England wins could help spending and confidence even more.

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