

Rathbone Ethical Bond Fund

Update, May 2018



Overview

The Italian political crisis sent gilt yields plummeting in late May, with the 10-year hitting 1.20%, the lowest level since December. The 10-year gilt yield started the month at 1.42% and ended at 1.23%. Intra-day, the yield got as low as 1.11% on 29 May as investors fled to safe havens. That storm in an espresso cup has since mostly blown out, but people are still keeping a close eye on how Italy's government operates from here on out.

Damaging policies dreamed up by the right-wing/left-wing coalition sent Italian debt yields surging higher in mid-May. The two-year government bond got as high as 2.77% in the last week of the month; it was -0.25% a month ago. At the time of writing, that had calmed somewhat to about 0.65%. As for the 10-year yield, it got as high as 3.16% on 29 May and it's now around 2.63%.

UK economic data were pretty lacklustre last month. Industrial production – one of the key silver linings of a weaker pound – disappointed (it undershot again following month-end). The UK trade balance blew out to the largest deficit since September 2016, GDP estimates were cut and inflation was steady at 2.4% (it was forecast to rise 10 basis points). Wage growth decelerated for the second month on the trot, taking the measure to 2.5%. This run of rubbish data has caused the Bank of England to row back on its plans to hike interest rates this year.

Meanwhile, the US economy has been roaring along pretty well. Consumer and business confidence has retrenched a bit, but remains very high. Inflation has picked up there, rising from 2.4% to 2.5% in May. Following month-end it jumped even more than expected to 2.8%. Still, wage inflation is nowhere to be found here either ...

Despite the lack of wage growth, higher inflation and a robust economy appears to be emboldening the US Federal Reserve. It is forecast to follow up its 25bps rate rise in June with another two before the year's end.

Trades

We took advantage of the large rally in rates to reduce our duration during the month by selling **European Investment Bank 6% Bonds 2028**, **European Investment Bank 3.875% 2037** and **Kreditanstalt für Wiederaufbau 5.75% 2032**. We used the cash from these sales to buy the **Santander UK Floating Rate Senior 2020** and **Royal Bank of Canada Floating Rate Senior Secured 2020**.

We bought part of a new issue from UK social impact housebuilder Aster Group, the **Aster Treasury New Issue 4.5% Mortgage-Backed 2043**. This organisation plans to build 11,000 homes around the

country by 2024. It also provides apprenticeships for young tradesmen. We swapped our **Yorkshire Building Society 3.5% 2026** for the longer-dated 2028 issue because it offered a better yield.

It's been really tough on the High Street of late. We cut our exposure further over the month by selling the **Marks & Spencer 4.75% 2025**, **Marks & Spencer 3% 2023** and **Intu (SGS) Finance 4.25% Senior 2030**.

Outlook

It's certainly noisy out there. European politics, Brexit muddles, tariff threats and rumbles of unrest in emerging markets.

Europe is a difficult place to read at the moment. Economically it's doing much better than it has for much of the decade, but politically it feels brittle. It's an interesting time for the European Central Bank to start winding down its quantitative easing programme. In early June it announced it would halve its €30bn monthly bond purchases from October. That will take the pressure off the central bank somewhat, and probably lead to higher sovereign bond yields to boot. Higher borrowing costs could focus the minds of the more restive governments around the currency bloc ...

The bickering over trade tariffs between the US and China has now widened to include South America and Europe. Many investors have been relatively unmoved by the risk of Donald Trump's administration derailing global trade. Most people figured that he was mostly bluster and that if not he would be talked down by sage advisers or common sense. So far, no dice. However, apart from a few limited and short-lived falls, markets have remained very calm.

We're relatively confident about the future and believe any market ructions should give us the opportunity to make some advantageous trades. In particular, we have been aiming to reduce our duration when yields slump in times of panic. We then look to add them back to the portfolio when they return to the 1.50% level. Our pipeline of ethical ideas is looking strong too, and we look forward to sharing them with you in the coming months.

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