Rathbones
Look forward

Rathbone High Quality Bond Fund

Update, December 2019

Driven by the convincing Conservative victory in mid-December, 10-year gilt yields finished the year at 0.82%, up from 0.49% at the start of October.

This new optimism about the UK's future was short-lived – or at least, shot through with doubts. Since month-end, the yield for 10-year government debt has fallen back below 0.60% because of mixed economic data. They have also followed the US treasury yield, which has dropped sharply due to concerns that the Wuhan virus outbreak could disrupt global economic growth.

Expected UK economic growth and inflation (the two main determinants of a government bond yield) have glided downward all year, which is why yields are now so far below where they started 2019 (the 10-year yield was 1.28%). A particularly low inflation print of 1.3% in December led many investors to believe the Bank of England would need to step in and support the economy by cutting interest rates by 25 basis points to 0.5%. Until mid-January, the chance of the central bank cutting rates ahead of Andrew Bailey replacing Mark Carney at the top was seen as very slim. In the end, the Bank of England kept rates where they were, leaving the Brexit interest rate conundrum to the new man at the helm. We're likely to see a lot of these erratic moves in sentiment and markets as Brexit shakes itself out and the economy continues to bump along.

In December, UK retail sales posted their second consecutive weak month of year-on-year growth. The 0.9% increase in December (0.8% in November), was significantly lower than the 2.4% to 3.8% band of the previous six months. Manufacturing has been pretty soft too. The manufacturing PMI (a mixture of business optimism, hiring intentions and future orders) has been below 50 since May. As a rule of thumb, sub-50 means the sector is shrinking. There has been good news in residential property though. Several measures of house prices ticked upward in January, which could be the beginning of a resurgence in the consumer sentiment. Unemployment remains extremely low in Britain and wages are rising faster in real terms (after the effect of inflation) than any time since the global financial crisis – excepting a brief period in late 2015. Granted, this real terms boost is mostly due to a drop in inflation and relatively modest wage gains, which may be less likely to rev up people's appetite to spend.

Overall, we've been running a 'barbell' portfolio. This means that our holdings are split sort of like weights on either end of a weightlifter's bar. About 50% of our portfolio is invested in bonds that mature within three years (with a large skew toward bonds that mature within a year). The duration (the sensitivity of the bond price to interest rates) is really low for this end of the barbell. Another bloc of the portfolio (about 10%) is held in bonds that have more than five years till they mature. Because of their longer lives, these bonds have much higher duration. The remainder of the portfolio is, broadly speaking, the weightlifting bar itself. This part of the fund is made up of floating rate notes, bonds whose coupons rise and fall with interest rates. Because their coupons float, the duration of these bonds is close to zero regardless of how long they have till they mature.

For the short-term side of our investment barbell we've been buying UK T-Bills, **European Investment Bank 2.25% Senior 2020s** and **Electricity Supply Board Finance 6.5% 2020s**. For the longerterm end, we bought the AAA-rated **Westfield Stratford City Finance 1.642% Asset Backed Senior Secured 2026** and **Bank of Nova Scotia New Issue 1.0375% 2026**.

We have used some of the concerns floating about the globe to buy bonds at more attractive yields. We bought **HSBC Holdings 2.175% Floating Rate Note Senior 2023** after it was rattled by the Hong Kong protests. This bond is senior, so far up the credit hierarchy, and we are comfortable with the strength of its balance sheet and the diversification of its global reach.

We also bought a new bond during the quarter: the **Logicor 1.875% Senior Secured 2026**. We believe this warehouse and logistics company should be well placed as e-commerce accounts for an ever greater share of shopping. We picked up this newly issued bond at a good price, considering the quality assets that back it, because it was the company's first sterling issue.

In December, demand for credit was strong. We used cash received from maturing bonds and fund inflows to build up our money pile (5.6% of the portfolio at year-end) ahead of what we expected to be a busy January for bond issuance. With funding costs low, many issuers – banks in particular – are front-loading their annual issuance programmes. In early January, we had the busiest week of euro issuance since March 2016, with €39 billion (£33.1bn) of corporate debt released.

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, which are becoming all too common.

Noelle Cazalis
Fund Manager

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Source performance data, Financial Express, mid to mid, net income re-invested.

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