Rathbone High Quality Bond Fund Stuart Chilvers - Fund Manager

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So as at the 12th of September, the fund has returned 3.66% versus 4.02% for the benchmark of the Bank of England base rate plus half a percent over that time frame.

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Five year guilt yields were nearly 20 bips higher.

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Remember we had a large rally in government bonds into the end of last year after a dovish Fed press conference.

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Hence the strong ends of the year versus benchmark last year.

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We've seen credit spreads continue to tighten, which has helped offset some of this move as has keeping duration short given these moves shorter dated and lower rated.

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For instance, triple B credit in the context of this fund have tended to be the strongest performers.

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The fund also benefited from the call of two subordinated bonds from a Swiss reinsurer that had been purchased an attractive yield to call as you identified the call likelihood to be far higher than was priced in the market due to changes in regulation.

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So when we look at the relative steepness of credit curves, actually you get relatively better compensated credit risk down at the short end and barely of the curve with credit curves actually inverted further out along the curve, that means you're receiving less credit spread for taking on more duration risk.

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This means we can generate better return from roll down benefit towards the front end of credit curves.

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When you combine this with the current shape of the guilt curve, we end up with a relatively flat curve overall.

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Therefore we prefer to be towards the shorter end of the curve as we're generating similar yield.

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We'll suffer less if we see credit spread widening given our shorter spread duration.

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Yes, I would expect rate cuts to continue, but I would caution, but at the moment we expect to see a fairly slow and steady approach to rate cuts, not too dissimilar to what is priced into the markets currently.

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To my mind, that would see the Bank of England going at roughly a pace of 1A quarter, which would align nicely with monetary policy reports.

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At the moment I do not see a pressing urge to cut rates at a quicker pace from this given the current environment and the recent inflationary experience.

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The caveat to that is if assuming we do not see a sharp move higher in unemployment, if that were to be the case, I'd expect the bank feeling to cut rates at a much sharper pace given the flexibility they have given the current levels of interest rates.

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So by the nature of this fund, it will always have a short duration exposure.

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Duration is currently around the 2.3 years mark having reduced duration slightly after the sharp rally we saw in government bonds in early August as part of the risk off moves we saw in markets.

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With heavy issuance expected to continue in September.

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This will likely offer us the opportunity to add some of this back assuming that rate market expectations remain reasonable.

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Given where we see it as a range for neutral and assuming a return to a standard curve shape rather than the inverted shape we have now, I do not see a strong incentive to have too long a duration in a fund of this nature.

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Furthermore, when we look at the steepness of the credit curves, you're actually receiving the highest amount of roll down return at the front end of the curve alongside attractive carry.

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This fund has a high quality credit mandate and at the moment we're at the high quality end of that.

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This is driven by a variety of factors.

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Firstly, we've seen a general compression in credit spreads that means we're being compensated less for taking on credit risk than we were previously when we compared to history.

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We see more scope for further compression in single A credit to AA credit rather than treble B credit to single A credit for instance, which means it makes more sense for our credit skew to be towards the high quality end of reimbursement universe.

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This will reduce our exposure to credit spread winding.

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If we do see unemployment pick up in the UK enter a recession, I expect inflation to pick up marginally but remaining under 3%.

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So it's a very marginal move compared to where we've been recently as we see the negative impact of energy on the inflation figures decrease from here on out.

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From there, I expect inflation to slowly trend back to target driven by services inflation slowly coming down as benefits from goods and energy deflation have largely finished.

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A potential risk to this could be if we had to see a large increase in the minimum wage next year.

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Clearly we remain watchful for any further information about such risks.

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So liquidity and short dated credit, similar to credit more broadly has been really strong this year.

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We've generally found it very easy to transact, meaning it's a more conducive environment to take advantage of relative value opportunities generally for this fund that has been looking to trade up in quality for minimal drop in spread this year.

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I think when we look at what is priced into markets in terms of rate cut expectations, it's challenging to see us exceeding these levels without a really sharp rise in unemployment.

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So thinking about this fund, I expect to see UK rates markets somewhat range bound into year end unless we see weakness really come through an employment data in which case we should expect to see rates rally.

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For credit spreads, it could be slightly more challenging or where they may get short term boost from the Fed beginning their rate cutting cycle as investors look to reallocate cash into fixed income.

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With it clear the global rate cutting cycle has begun.

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But aside from that, spreads are relatively tight and I'd expect to see widening on any indications of economic weakness as well as potential volatility as we approach the US election.

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That being said, given the high quality and short duration nature of the fund, we would expect the impact of any credit spread widening to be relatively limited.

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With the yield on offer from these bonds, I feel I'm being compensated for the risk being taken here.