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Rathbones
Look forward

Rathbone Strategic Bond Fund

Update, July 2019

Overview

Markets have been jumping around more than a frog on a pogo stick this summer.

That's led to a sharp drop in the yields of government bond safe havens. Over July, the 10-year gilt yield fell from 0.83% to 0.61%. Since month-end that drop accelerated, taking the yield to a record low of 0.46%. Boris Johnson taking the nation's helm hasn't helped risk appetite either. His strident talk of a crash-out Halloween exit from the EU if an (unlikely) renegotiation isn't offered by the continental powers has encouraged the pound to plumb new lows. This has made UK businesses ever glummer.

The effects of Brexit on the British economy are on full display right now. The indecision and lack of preparation – by both the government and many small private businesses – have led to paralysis, confusion and a second-quarter 0.2% contraction in GDP. Every part of the economy was weak except for households, which are muddling along ok with rising wages and lower unemployment.

But Brexit is really only a bit part on the global scene. The main driver of diving gilt yields was the US Federal Reserve's U-turn on interest rate hikes and the slowing global growth that precipitated it. It's turned into a bit of a race to the bottom, with central banks around the world seemingly competing with each other to be more accommodating to their borrowers than the next person. Europe is now knee-deep in negative-yielding bonds as its monetary maestro hints that it will take benchmark rates even farther below zero. New Zealand shocked markets by slashing its interest rate by 0.5% when many analysts thought 0.25% would have been a bit of an overreaction. Thailand and India cut their interest rates too.

The link between all these jumpy nations? China. All of them – Europe, NZ, Thailand and India – are bound to the world's largest exporter with ties of trade. China's decision to allow its currency to depreciate (a response to yet more tariff threats from the US and a deceleration in its GDP growth rate) would have deep ramifications for its trading partners. Many nations are already running uncomfortably high trade deficits with China (buying more from China than they sell). A cheaper renminbi makes Chinese exports cheaper, encouraging foreign households to buy them instead of locally made alternatives. That's why Donald Trump was so incensed by the move, calling the nation a currency manipulator. Unfortunately for Mr Trump, China wasn't actually devaluing its currency; it has simply stopped propping it up. At the end of the day, a cheaper renminbi is a consequence of the trade war that the President initiated himself. Perhaps this realisation (or wise counsel from White House advisers) was why Mr Trump has since rolled back some of his tariffs to December.

Trades

As yields fell in July, we sold our longer-dated gilts, including **Treasury 4½% 2034**, **Treasury 4¼% 2032**, **Treasury 1/8% Index-Linked 2026**, **Treasury 1.625% 2028** and **Treasury 1.5% 2047**. We moved that money into shorter-dated bonds and T-bills, to reduce our portfolio's sensitivity to changes in interest rates and the yield curve. As it turned out, we made the trade a bit early in the month, with yields continuing to plummet to all time lows.

We bought the **Hiscox 6.125% Floating Rate Note 2045**, adding to our insurance exposure with little interest rate risk. Hiscox earns most of its cash in dollars, which gives us some protection against a weaker pound.

We added the newly issued **Nemean BondCo 7.375% 2024** high yield bond to our portfolio. The company issuing the bond, NewDay, is an interesting business that offers a range of credit cards and store credit cards in the UK. Its own-brand cards are aimed at near-prime borrowers, offering small amounts that should help them rejuvenate their credit records.

Outlook

Worldwide, economic data is falling into a bit of a funk.

It's not as dire as some of the market moves would have you think. Things have really just come off the simmer, but it's so late in the cycle that a lot of investors feel like it will be nothing but gloom from here. Everyone you talk to now thinks there will be a recession late this year and those that don't are saying early next. The resignation is palpable. Days at the desk are getting as sad and brooding as spending your time at the Tower of London surrounded by ghost stories and the squawk of the crows.

The prices of longer-term government bonds have soared aggressively (and therefore sending yields falling), making it difficult to justify buying them. This is a bit of a dilemma: government bonds are the traditional source of portfolio defence, yet paying way too much for protection can be as painful as loading up on bad credit right before a downturn. It's a hard decision to make though – we're all aware just how much Brexit keeps giving. And it's impossible to determine whether Mr Trump will escalate or defuse trade tensions on any particular day.

For all the risks, a lot of sterling-denominated bonds are maturing in the next few months. This means the demand for credit should help buoy prices. There may also be a silver lining in a hard Brexit: the Bank of England may decide to buy up sterling credit, like it did following the global financial crisis (and like the European Central Bank is still doing). If it did so, this would lend further support to UK bonds. Credit has been pretty rocky over the past few months, but spreads (the extra yield offered above government debt) are still pretty tight. At the start of the year the iTraxx Crossover spread was about 360 basis points (or 3.6% above the government bond yield). That got as low 240bps in early July, but at writing was hovering around 280bps.

What does this all mean? Risks are high, prices are high and investors are twitchy. That's why we're being careful about the risks we take and the prices we pay for bonds of all stripes. As markets sell off, we're trying to add to our holdings. When prices rise, we're trying to lock in some of our profits.

Bryn Jones
Fund Manager

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