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Rathbones
Look forward

Rathbone Strategic Bond Fund

Update, August 2019

Overview

Ten-year gilt yields dropped 13 basis points over the month, down to 0.48%. This fall was driven by a number of factors, namely trade-related concerns about global growth, possible rate cuts and the increasing likelihood of a hard Brexit.

The US-China trade tussle rumbled on which is doing economic prosperity no favours. Now there are calls for more stimulus within China, including the reduction of reserve requirements and other tools to support the economy. If this happens, it's likely to be supportive of global growth. The continued belief that central banks around the world will continue to reduce interest rates pushed yields further down. The UK's own domestic headache – a hard Brexit was looking increasingly likely – just aggravated this phenomenon.

Generally, UK economic data disappointed last month. An early estimate of second-quarter GDP growth came out at -0.2% and industrial production was weak too. The UK construction PMI languished at 45, down from 45.3. These are further signs that political uncertainty is quashing capital investment. It wasn't all gloom, though: retail sales surprised to the upside.

Credit was generally volatile over the month – selling off at the start and rallying into month-end. Overall, most sectors have been doing quite well, so a correction in bond prices (and rising yields) might be on its way.

Our fund has very low volatility. We've taken a lot of risk off the table, from both a duration perspective and a credit perspective, and correlations with equities are currently very low. This is a short-term play for a long-term win.

Trades

We're keeping everything short-dated and bought T-Bills over gilts as we think the latter's yields have fallen too low.

We bought the **Aviva 5.9021% Perpetual-2020** because we believe the company will buy back the bonds early. The **Hong Kong & Shanghai Bank Floating Rate Note Perpetual** had an attractive yield and the company's liability management looks reasonable so we bought them too.

In a bid to keep up with the healthy younger generations, we purchased **Pinnacle Bidco 6.375% 2025**. This debt was issued by PureGym's holding company. Millennials are choosing gyms over pubs, reflecting their growing health drive. PureGyms are popping up everywhere and they create a lot of cash flow.

We sold our shares in the **Hadrian's Wall Secured Investments** fund on the back of a number of issues surrounding investment companies.

Outlook

For some time we've been saying that the US Federal Reserve (Fed) has been trying to engineer a soft landing. The latest rate cut confirms it.

Historically, the Fed starts to cut rates when the three-month government T-bill's real yield (so after subtracting the inflation rate) is above the neutral interest rate (the 'Goldilocks' rate, where monetary policy would be neither stimulatory nor a handbrake on the economy). Put plainly, the Fed typically begins cutting interest rates after a period of tightened monetary policy. That's not the case this time round. In July, when the Fed cut interest rates for the first time in a decade, the three-month T-bill yielded less than that Goldilocks neutral rate. So monetary policy was actually *already* helping the economy, rather than holding it back. The Fed appears to be making very sure that it doesn't smother the economy and bring about a recession.

There are risks out there, some pretty glaring. Yet the US appears to be ticking along ok. It's a puzzle and a difficult one to solve. Whether the smoke signals are forecasting recession or just a slowdown, we've been clearing our decks of bonds that we think would struggle in either environment. We think government bonds have risen far enough that it warrants us selling them and keeping our stocks of them low. We've been minimising our duration, or sensitivity to changes in interest rates, because we're aware that a run of better news could cause a painful sell-off of government bonds that would hurt longer-dated bonds.

Bryn Jones
Fund Manager

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Fund Manager

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