Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Strategic Bond Fund

Update, December 2019

Overview

Driven by the convincing Conservative victory in mid-December, 10-year gilt yields finished the year at 0.82%, up from 0.70% at the start of December.

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 boost in real terms is mostly due to a drop in inflation, with wage gains relatively modest. This combination may be less likely to rev up people's appetite to spend.

Trades

We added to our duration (interest rate sensitivity) on days when yields rose. We did this by purchasing the **UK Treasury 4¼ % 2032**.

Outlook

In the US, everything seems tickety-boo on the surface. Households are happy and spending money, while economic data has been generally good.

Services PMIs are still holding up, albeit they have come off the boil that was 2018/19 and the Trump tax cuts. Manufacturing has been a bit poor, but it has been so all around the world. The first-phase trade deal between the US and China introduced some optimism to the market, with some hoping that this will square away trade scares at least until after the US election in November. We're not so sure. Trade policy is one of the precious few areas where President Donald Trump has unrestrained control. He has already been making waves over transatlantic trade, so a full-on bust-up with the EU could be just over the horizon. It's especially likely to happen if Mr Trump is thwarted on policy in Congress. Rumours are buzzing around DC that the President wants to unveil "tax cut 2.0" ahead of the election. This may come a

cropper in the Democrat-dominated House of Representatives, given the economy is doing well on its own and the nation's debt and federal budget deficits are on track to hit levels not seen since World War II.

Credit spreads in both the US and Europe have slumped to extreme lows and share prices are high as well. There seems to be quite a lot of confidence in the future, despite the reasonable chance of disappointment in economics and individual company results. We're not expecting recession in the foreseeable future, but we reckon there could be a few stumbles and shocks that would rattle stocks and send bond yields lower. If these opportunities do emerge, we will try to add to our holdings at more attractive yields.

In the meantime, we're finding that shorter-dated bank bonds are looking expensive compared with their longer-term counterparts. We have been buying those longer-dated bonds, and selling those bonds that 'roll down' over their life into that overpriced maturity. At that point we use put that cash back into longer-term bank bonds. This 'carry trade' boosts our potential returns in return for taking greater 'duration' risk (increases our portfolio value's sensitivity to changes in interest rates). That means that a rise in interest rates would lead to greater losses in our portfolio, all things being equal. However, because the Bank of England seems likely to keep rates where they are or cut them, we are comfortable taking more duration risk. If rates are cut, the value of our portfolio would rise.

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