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The Kames Absolute Return Bond Global Fund returned 0.06% in April, outperforming the 3-month GBP LIBOR return of 0.03%. The year-to-date return is 0.82% compared to 0.12% for 3-month GBP LIBOR.*

In April financial markets were once again focused on politics and geopolitical risk, which helped fuel uncertainty and volatility in bond markets. Following the failure to repeal the Healthcare Act, President Trump's decision to take military action against Syria and to verbally spar with North Korea only served to fuel the risk-off sentiment in the early part of the month. Having touched 2.40%, 10-year US Treasury yields then fell to 2.15% before moving higher into month-end. Part of this move was driven by a reassessment of the Trump 'reflation' trade, with expectations falling on what 'pro-growth' policies can and will be enacted. It was also influenced by the French election. Although opinion polls were consistent ahead of the vote that Macron would lead after the first round and face Le Pen in the second round, the market continued to hold its breath up until voting day. The collective sigh of relief after the result saw core rates markets sell-off in the days that followed, with 10-year bunds backing up 15bps, while French government bonds rallied 12bps. Risk assets performed well with credit spreads narrowing.

Credit and Asset Allocation

The Credit and Asset Allocation module fulfils two functions within the overall global strategy, namely selection and protection. The first theme allows us to exploit idiosyncrasies within the broader fixed income market. We look for trades with asymmetric payoffs, in which the downside is defined and limited while the upside is significant. The second theme looks for trades which will provide downside protection and dampen the volatility of the overall Fund. Within selection, new issues and short-dated callable bonds added value. The protection trades that seek to provide diversification detracted over the month. This is akin to an insurance premium for an event you do not want to happen but if it did would have mark-to-market consequences for the Fund.

Rates

The Rates module also had a positive month. The Fund benefited, in particular, from new positions that were added over the period. Early in the month we opened a long position in ultra-long-dated UK index-linked bonds versus 10-year UK bond futures. The long end of the linker market had been weak, leaving them cheap compared to medium-dated assets – this prompted us to open the trade. In the days that followed the 2068 maturity bonds that we held rallied sharply, outperforming 10-year gilt futures, aided by strong demand for long-dated sterling assets. This move allowed us to close the trade profitably.

We also added a long 10-year US Treasury versus short 10-year Australia position. The Australian bond market had been trading very strongly on a relative basis, supported by more mixed domestic data and a central bank that was increasingly looking towards macro prudential tools rather than interest rates to cool its housing market. This move caused rate hike expectations to dissipate and the 10-year bond spread to compress to only 18bps versus US Treasuries. This allowed us to open a position to oppose that move, with the increase in the spread that followed generating alpha for the Fund.

We closed-out our long 15-year Spain versus short 10-year Italy position at a loss. As we approached the French election we became nervous that a Macron victory could be more supportive for Italian than Spanish bonds, particularly as the positioning in Italian government bonds is generally short. With this in mind we closed the position to protect against further losses. We did come back to Spanish bonds again at the end of the month when we added exposure to 10-year Spanish inflation-linked bonds against 10-year French government bonds. We see scope for inflation in Europe to surprise to the upside and the issue of a new Spanish linker offered an attractive entry point. Selling French futures on the other side allowed us to sell assets that looked to be fully valued ahead of the second round of the French election.

Carry

The Carry module had a positive month. It invests in investment-grade-rated bonds with a final legal maturity of less than five years – these are held overwhelmingly on a buy-and-hold basis. The additional spread available on global investment grade spreads provided an offset to a small rise in short-dated government bond yields. We manage the spread and interest rate risk at an overall fund level and some trades within the Credit and Asset Allocation module have the effect of dampening the volatility and managing downside risk.

John McNeill

*Source: Lipper as at 30 April 2017, noon prices, NAV to NAV returns, income reinvested, net of ongoing charges, excluding entry or exit charges; local currency B (Acc) GBP share class. Index based on closing prices.

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