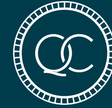
BOND COMMENTARY
1ST QUARTER, 2018



QUILTER CHEVIOT

Quilter Cheviot provides bespoke investment management for private clients, trusts, charities and pension funds. To provide a truly personal service, we assign to each client an investment manager whose role is to design and implement an investment strategy tailored to the needs of the client. A local presence and easy accessibility to investment managers is a key element to the personal attention we give our clients. Quilter Cheviot has a network of regional offices located in major cities in the UK, Ireland and Jersey.

Quilter Cheviot Investment Management
Best UK Investment Manager 2015

Past performance is no guarantee of future returns.

EXECUTIVE SUMMARY

- **Conventional gilts made small positive returns despite speculation about rising interest rates.**
- **Index-linked gilts slightly underperformed conventionals as inflation expectations fell.**
- **Investment grade corporate bonds struggled amid growing geopolitical and trade risks.**
- **We retain a cautious stance on bonds in general given the prospect of less supportive central banks.**

UK

Conventional gilts managed to eke out a small positive return over the first quarter, despite a lot of speculation about rising interest rates both in the UK and the US. Much of that return though came from longer-dated debt, as pension fund demand remained strong whereas shorter-dated gilts fell modestly in value.

The UK economy held up reasonably well amid the ongoing Brexit negotiations, although growth still lagged behind most global peers. On a positive note, inflation pressures waned somewhat as the impact of Sterling's depreciation began to wear off. However, wages also began to increase, which was great news for consumers but meant that the Bank of England felt compelled to signal that further rate hikes were on the agenda.

At the end of March, 10-year UK government bond yields had risen to 1.35% but 30-year yields dropped to 1.71%, resulting in a much flatter yield curve. Index-linked gilts marginally underperformed conventional gilts over the quarter as inflation expectations eased.

EUROPE

European government bonds made quite strong returns in Q1, mostly driven by a relief rally in Spanish and Italian markets as political concerns eased. The market also remained supported by the ECB's ongoing QE programme, which is set to stay in place for most of 2018.

The economic backdrop in Europe remained fairly positive but there were signs of a loss in momentum,

with leading indicators dropping from very high levels. Business confidence in Germany also slipped and may have been affected by the growing trade disputes between certain major economies.

German 10-year yields rose on the quarter to 0.5% but French yields were little changed, while Spanish 10-year yields fell quite sharply to 1.16%.

US

US Treasury yields rose during the first quarter as inflation picked up and growth remained strong. Trump's tax cuts also raised concern about the risk of large government deficits and increased government bond issuance.

There was clear evidence that wage pressures were increasing amid a tight labour market, so it was no surprise that the Federal Reserve, under new Chair Jay Powell, raised interest rates to 1.75% in late March. At least another two rate hikes are expected over the course of the year.

10-year US Treasury yields ended the period at 2.74% at the end of the quarter, while 30-year yields climbed to 2.97%. Inflation-protected TIPS outperformed as inflation expectations increased.

CREDIT MARKETS

UK investment grade corporate bonds struggled during the first quarter and underperformed conventional gilts by around 2%. The asset class was affected by the general reduction in risk appetite as investors worried about rising protectionism, geopolitical risks and an increase in corporate borrowing costs.

The overall yield of the market ended the period at 2.78%, a spread to gilts of roughly 1.4%. Global credit markets also sold off, returning around -1.7% on a Sterling-hedged basis.

High Yield bonds held up slightly better but still produced marginally negative returns. Yields on the US High Yield index ended Q1 at around 6.4% or 3.7% over Treasuries.

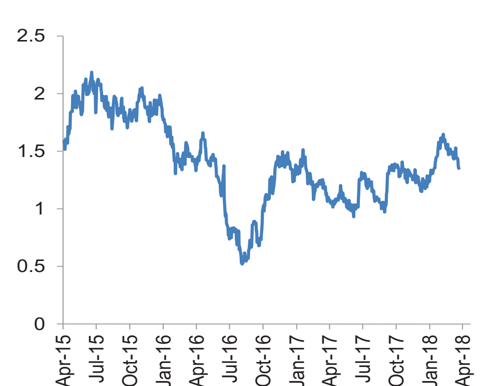
Emerging market local currency bonds made slightly positive returns in Sterling terms, despite the pound strengthening against a number of EM currencies.

OUTLOOK

The backdrop for bonds is more challenging than it has been in recent years. Inflation is picking up, especially in the US, and interest rates look set to rise in the UK as well. In Europe, the ECB's QE programme, which has been a big factor in depressing yields, is likely to be gradually wound down towards year-end. We will therefore continue to take a cautious stance towards bond markets, although any rise in yields may be limited by ongoing geopolitical and trade tensions.

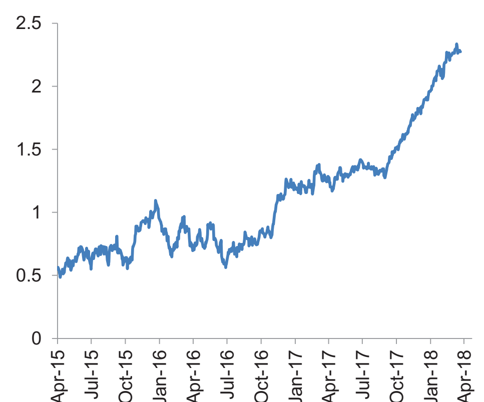
In terms of credit risk, we are generally exposed to the more liquid and secure end of the spectrum. Credit spreads have widened in recent weeks but are still below historical averages, so we have a bias towards sovereign debt and have little High Yield exposure. Index-linked gilts still look fully valued to us, but at least they provide something of a hedge against political risk returning to the UK and causing a further fall in the pound.

UK 10-YEAR GILT YIELD



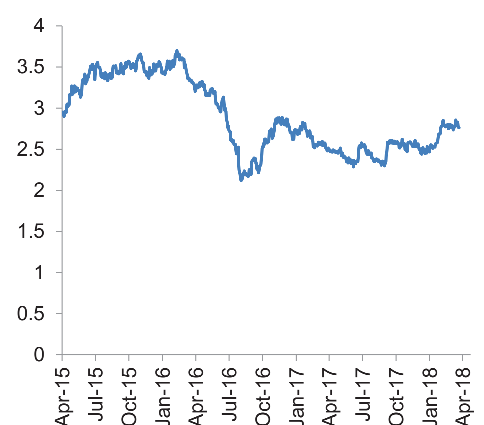
Source: Datastream

US 2-YEAR TREASURY YIELD



Source: Datastream

STERLING CORPORATE BOND YIELDS



Source: Datastream

Investors should remember that the value of investments and the income from them can go down as well as up. Past performance is not a reliable indicator of future results. This commentary is not intended to constitute financial advice, investments or investment services referred to may not be suitable for all investors.

CONTACT US:

For more information, please contact your investment manager or business development manager.

w: quiltercheviot.com

Quilter Cheviot Limited is registered in England with number 01923571. Quilter Cheviot Limited has established a branch in Dublin, Ireland with number 904906, is a member of the London Stock Exchange, is authorised and regulated by the UK Financial Conduct Authority, is regulated by the Central Bank of Ireland for conduct of business rules, under the Financial Services (Jersey) Law 1998 by the Jersey Financial Services Commission for the conduct of investment business in Jersey and by the Guernsey Financial Services Commission under the Protection of Investors (Bailiwick of Guernsey) Law, 1987 to carry on investment business in the Bailiwick of Guernsey. Accordingly, in some respects the regulatory system that applies will be different from that of the United Kingdom.

This commentary has been prepared for information purposes only and is not a solicitation, or an offer, to buy or sell any security. It does not purport to be a complete description of our investment policy, markets, or any securities referred to in the material. Please note that this commentary may not be reproduced, distributed, disseminated, broadcasted, sold, published or circulated without prior consent from Quilter Cheviot Limited.