

Rathbone Multi-Asset Strategic Income Portfolio

Update, February 2018

Overview



The pickup in volatility that we had been positioning for in recent months came to fruition in a dramatic way in February, though markets had settled back down by the time of writing.

With central banks embarking on what looks likely to be a gradual and protracted tightening process, we had been building up defensive assets in the portfolio for some months, including cash, gold and a put option on the S&P 500 index.

With yields on 10-year gilts rising above 1.5% recently, we used some of that cash to start dipping our toes back in to gilts, which are looking like a better bet for portfolio protection than they have for some time. We also deployed some of our cash position in equities after the sharp February correction, although cash still remains at high levels. We don't see volatility going back into hibernation, and that cash could be particularly useful in the event of a more sustained correction in both equities and bonds, as economies and markets adjust to the removal of easy money.

The direction of US economic data still looks clearly up, though signals from the new Federal Reserve Chair Jay Powell were a bit mixed. His latest testimony to the Senate indicated that he sees no signs of the US economy overheating, with gradual rate rises on the cards. That was a more pared back commentary compared to his first-ever testimony to the US Congress earlier in the week, which left some wondering whether he might be more hawkish than his predecessor Janet Yellen. More clarity is likely following the Fed's March meeting.

The Italians went to the polls in early March, and voted for populism. The anti-establishment Five Star movement made sweeping gains, but not enough to declare victory. The likely outcome is a hung parliament, with the Italians potentially having to go back to the polls. Economic populism could push Italian bond yields higher, but for the wider eurozone bond markets and the euro this will be offset by clarity for Germany, as Chancellor Angela Merkel secured a coalition agreement with the Social Democrats (SPD).

Meanwhile, US President Donald Trump set markets spinning with proposed new trade tariffs. He enthusiastically tweeted that "trade wars are good" and "easy to win", but to students of British economic history it will feel like the clocks have been turned back 200 years to the disastrous Corn Laws of 1815. Time will tell whether President Trump's move was more of an opening gambit in trade negotiations, or a more worrying trend toward rising global trade friction. That would be bad news for global growth and equity returns, and we'll be monitoring the situation closely.

The UK was hit with two "Beasts from the East" in late February, one emanating from Siberia and the other bringing cold winds from Brussels, in the form of an EU threat to create a customs border between Northern Ireland and the rest of the UK if no agreement is forthcoming on the Irish border issue. This will only add to the rising risk of a contraction by potentially pushing the two sides further apart and creating

further uncertainty for the UK's future. Other worrying signs that usually stalwart UK consumers may be flagging included weak house price growth and a Visa report noting the first January sales dip since 2013.

This month's trades

We made our first foray into gilt markets in over a year, with a purchase of bonds maturing in 2026, as 10-year yields broke through the key 1.50% threshold in February. The 10-year yield eventually topped 1.60% before settling back down toward 1.50% again.

Following the recent market weakness we also took the opportunity to add a new holding in **ASML**, the world's leading lithography equipment maker (machines that make computer chips for specific products and tasks). Historically, this Dutch company has enjoyed a large market share and it is firmly embedded in its customers' supply chains. Importantly, ASML occupies a monopoly position in next-generation extreme ultraviolet lithography (EUV) technology. EUV machines will become critical as semiconductor chip sophistication and volume increases in several applications – artificial intelligence and automotive markets, for example. Owning ASML means we don't need to bet which chipmaker is the ultimate winner, because it will be supplying all the contenders. We also like that 30% of ASML's revenue comes from servicing, usually a recurring income. Moreover, the company has more cash in the bank than liabilities on its books, giving it strong defensive characteristics.

With a sense of calm prevailing once again, we have added some relatively inexpensive put options to provide some protection in the event of another significant market correction.

Outlook

After some somewhat mixed messages in his first testimony to the US Congress, we await further clarity on the outlook for US rates from the new Fed Chair and his colleagues after their March meeting. The cat and mouse game of rising interest rate expectations leading to falling economic growth expectations, leading to a lowering of rate expectations, and so on, could well continue. So we expect markets to be choppy.

We're not in the business of forecasting rate hikes, but we remain comfortable with the prospect of gradually rising US rates. We're less sanguine about the prospects for the UK economy, which feels less resilient to the removal of easy money.

February's rude interruption to the long-running bull market may well be a foretaste of what's to come as the Fed tries to bring interest rates back to something that more resembles normal. We have already used some of our cash to add to equities and gilts, and will continue to do so if falling equities or rising yields present the opportunity once again.

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