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Rathbones
Look forward

Rathbone SICAV Multi-Asset Enhanced Growth Portfolio

Monthly update April 2020

Overview

There seem to be three broad paths for the global economy this year.

First, generally well-executed public responses to the pandemic allows economies to safely and steadily exit lockdown and restart commerce over the summer. This, combined with the huge amounts of central bank and government spending helps global GDP recover in a shallow-V or Nike-swoosh shape. This is almost definitely the one that stock markets have priced in.

Second, protracted and acrimonious reductions of lockdown. Economies take too long to shift back into normality, with protracted arguments about the balance of risks sending businesses down the tubes and steadily increasing the numbers of unemployed around the world. You could add to this scenario arguments about waiving pharmaceutical patents in the interests of eliminating the pandemic. This path is where co-operation, both within nations and businesses and between them, starts to break down.

Third, nations come out of lockdown too fast and without sufficient tracing systems. Countries that had the virus under control start to experience sharp spikes in new cases and deaths, forcing them to return to lockdown to save lives and prevent their health systems from being overwhelmed. If this comes to pass, we think it would be a massive shock for stock markets. They could test new lows. It would be havoc for businesses too, putting the fight back months could push many into bankruptcy and stress governments' finances to the limit.

These are *broad* paths. Reality will be a mixture of all three, to varying degrees, as different nations battle the pandemic as best they can. Essentially, what we're trying to explain is that there are several important facets: strong and competent responses by governments; pragmatism and compromise between workers and those that employ them; and of course, the development of a vaccine *and its swift delivery to the whole world* by the pharmaceutical industry.

At the moment, given the swift market recovery since mid-March, it certainly looks like equity investors are over-optimistic about the future. The market seems pretty well priced for a very benign pandemic endgame. Yet, it may be that investors aren't actually all that optimistic. Between gargantuan government subsidies and support and the massive central bank loan schemes and asset purchases, there's so much money in the system right now. The run-up in stock markets could be a grudging squeeze driven simply by the weight of money that has been poured into the financial system.

We have some sympathy for this argument. Most investors seem dubious about the rally at best; at worst they are downright hostile. Just look at how many talking heads are pointing out how the markets are "decoupling from economic reality". The idea that there are thousands of bullish investors out there preparing to bail seems strange in this context (they already expect the worst, according to the latest American Association of Individual Investors survey).

Essentially, what we're left with is another begrudged and distrusted rally that is supported, once again, by a huge implied US Federal Reserve (Fed) put contract – the central bank will prop up the market if it falls too much. To be honest, this has been the standard situation, on and off, for the past decade. And it has never paid to fight the Fed. We believe that means the markets should be able to weather more disappointment over the coming months than you might at first think, while looking at stock market levels. But beware protracted lockdowns or rising infection rates.

Trades

We added US laboratory equipment business **Thermo Fisher Scientific**. We believe this high-quality company will play an increasingly critical role in diagnostics and testing over the long term. We also topped up our existing equity holdings where possible.

Corporate bond markets have had a rough time, with prices bouncing around all over the place. Much of the dislocation is down to credit agencies downgrading hundreds of billions of dollars in debt as companies' sales dry up during lockdown. Some of these 'fallen angel' companies are in deep trouble. But not all. Many of these companies can tap plenty of cheap financing from governments and central banks, despite tumbling into junk territory. Meanwhile, many large institutions are forced to sell any bond that is suddenly re-categorised as sub-investment grade. This has sent prices tumbling to pretty attractive levels. We bought the **iShares Fallen Angels High Yield Corporate Bond** and **Invesco US High Yield Fallen Angels ETFs** to add to our equity-type risk through assets with lower valuations.

We bought the **Ashmore Emerging Markets Short Duration Fund** because the asset class looked bombed out. The fund is invested in many of the riskier parts of emerging market debt, some of which are effectively pricing in default, and we felt that the bonds were starting to price in worst-case scenarios (yields soared), providing a large margin of safety with some interesting potential capital upside. We feel like it's a reasonable risk to take.

We also bought a small amount of the short-dated **Carnival 1.625% Senior 2021 Bond**. The cruise-ship operator is in a world of trouble, yet it raised massive amounts of debt and equity in April, has plenty of credit lines, and has reacted quickly to staying afloat. We feel that being paid more than 20% to take the risk that it remains solvent till February next year is a reasonable investment.

Finally, we bought **UBS S&P 500 Put Contracts**, which give us the option to 'sell' our US exposure at a set level in return for paying a small premium (effectively this works like investment insurance). Typically, we buy contracts that pay out at 5% below the market level at the time of purchase. It's cheaper to buy puts that are further below the market, however, and we wanted to protect against a serious drop (which we think is relatively unlikely). So we bought contracts that pay out 25% below the market and expire in July.

Outlook

We believe the world will generally muddle through the coming months. Most governments will get their act together. Businesses and employees will eventually come to terms on the balance of risks between financial and physical health. Pharmaceutical researchers and companies will manage to find vaccines and treatments and scale them quickly, as is their business.

Yet we're not Pollyanna. There will be mistakes, setbacks and bad news. There will no doubt be times when markets take a dive because of it all, too. Yet, longer term, we feel that the alignment of everyone's interests in fighting the virus – in getting our world back – combined with the huge amount of liquidity from central banks, will help support stock markets.

Another point to make is probably not all that ground breaking, yet it's important nonetheless: there won't be one recovery. Different sectors and companies will take hugely different paths depending on what their business is, how they do that business and how much debt they have used to finance themselves. It will also matter how many friends companies and industries have in high places, too. Some industries and companies have gotten sweetheart deals from governments, while others have been left to tread water or drown on their own.

These sorts of things matter, because every time a government bails out a specific company or industry, the effects will ripple through the global economy. It could fundamentally alter the market for certain industries, if it props up a company whose main rivals go to the wall, for example, it would leave those sectors less competitive and therefore more profitable. That would in turn affect the pricing power of companies that supply those markets.

Meanwhile, similar ripple effects will extend from the government and central bank responses. This influx of cash could spark shorter-term inflation, especially when coupled with the chances of much less stuff getting produced in the world's factories and farms, as well as fewer restaurants and shops. That constraint on supply could make things more expensive right at the point when lots of people want to get out and spend. If this inflationary force comes into play it will vie with longer-term deflationary trends: the greater use of technology and debt tend to suppress inflation.

This year – and perhaps the whole decade – will be littered with the unintended consequences of decisions made in haste to protect our economies from slumping into another great depression. That isn't to say that we're doomed to a weird and terrible 10 years. It just means you have to be aware that some pretty spicy economic voodoo has to be unwound somehow, and that *how* will have an impact on your investments.

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Fund Manager

When operating in the EEA, Rathbone Unit Trust Management works in partnership with a tied agent. In Europe we market our funds through Rathbone Funds Advisers, Unipessoal Lda. ("Rathbone Funds Advisers") a company acting as a tied agent to Carne Global Financial Services (Europe), Unipessoal Lda. ("Carne Global") which is an investment advisory firm authorised under MiFID II and supervised by the Portuguese Securities Market Commission — the CMVM (Comissão do Mercado de Valores Mobiliários). Rathbone Funds Advisers is registered in Portugal and has been appointed by Carne Global to provide investment advisory services on its behalf in relation to financial instruments, in particular units or shares in undertakings for collective investments.

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