Rathbone Unit Trust Management

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Rathbone Multi-Asset Strategic Income Portfolio

Monthly update April 2021

If we weren't still all working mostly from home, inflation would be the subject flying around the watercooler.

Perhaps more than at any time since the 1970s, the path of inflation is crucial for investment decisions. Back then, the issue was that wages and prices were chasing each other higher at double-digit rates as valuations (prices relative to earnings) were the lowest ever seen. Today, that's flipped. Inflation has been muted for years and years, regardless of a series of gigantic public sector stimuli, and stock valuations are at all-time highs.

In the '70s, you would need large moves in inflation to have any effect on stock prices. These days, even the thought of inflation is enough to cause pretty spicy falls in some shares – particularly those 'growth' companies that shun dividends in favour of reinvestment to become as big and profitable as possible in many years' time. This is a function of much higher stock price-earnings multiples.

There's little argument that inflation rates are going to shoot higher all around the world in the coming months. American inflation has already started its move, jumping to 4.2% in April, the highest level since the global financial crisis. Canadian inflation reporting lags the US a bit, but it shot higher in March. European inflation is on the rise too, albeit remaining much lower than in the US. However, just how long this global inflation will stick around is the real issue. If it's just a passing spike, it will be irrelevant for investments. If it persists, then it will have significant consequences that will flow through all sorts of assets.

We believe that inflation is likely to be transitory. It will spike as a whole bunch of dislocations in spending, employment, production and logistics flow through economies. After that, we think there are too many heavy, long-term phenomena that will still be there pushing inflation lower, as they have for many years now. The rampant progress of automation and digitisation is literally the discipline of producing more with less. Meanwhile, the world is even more indebted than it was before the pandemic, which reduces the amount households and businesses have to spend. Finally, there are a whole bunch of people all over the world who have been thrown out of work by the pandemic. This should keep a lid on wage inflation, albeit we do see risks here which we'll go into shortly.

We used inflows over the month to add to existing holdings where prices looked reasonable.

Bottom dollar

The global inflation story can be partly explained by the weak run for the dollar. It means lower buying power for the bills in Americans' wallets and it boosts the value of money in other nations. Take New Zealand, whose inflation has remained remarkably low despite an early reopening boom and a shipping backlog that is causing shortages in some goods. The Kiwi dollar has appreciated more than 10% against the greenback in the past year. It's the same story for the Israeli shekel and Chinese renminbi, the currencies of two other nations who successfully reopened early.

Bound up in this dollar weakness are soaring raw material prices. When the dollar weakens, it tends to send commodity prices higher. However, the moves in these prices are mostly being driven by large changes in supply and demand. When you see the commodities that have popped higher, it makes sense. Housing is booming in the US, so the price of lumber has gone through the roof because sawmills haven't been able to keep pace with orders. The price of computer chips has taken off because of the chronic shortages that happen when companies all at once start kitting their employees out with laptops and other hardware for home working. Finally, prices for all the metals that go in renewable energy generators and electric cars and scooters have also increased (copper, rare earth metals, aluminium and steel). With almost every major nation planning huge investment in green infrastructure, this makes sense too.

We would expect these sorts of supply-demand imbalances to be sorted out by the market in reasonable time: the higher prices will encourage suppliers – or new entrants – to invest in building their output and then that extra supply will end up swamping demand and prices will fall again. Commodity cycles are forever swinging from highs to lows and back again. Yet if higher commodity prices linger for longer than we expect, these bonds offer us some protection.

That's not to say that this period of higher prices shouldn't factor into our thinking at all. higher commodity prices are seeping through to production costs for a whole range of industries, from electric cars to wind turbines, electronics, building products and plenty else. That's why we are trying to ensure that our companies are those with strong market positions that allow them to push through price rises. Businesses that can't raise their prices will have to watch higher costs steadily eat into their profits unless they can increase their sales enough to offset the impact.

The potential for green energy investment, pushed us to buy UK infrastructure company **National Grid**. Along with owning the English and Welsh power transmission networks, it is in charge of running the transmission system for the whole of Britain. It also owns wholesale gas pipelines in the UK. Both of these businesses are regulated, meaning they offer a set return for a specified level of assets. We believe the shift to greater usage of renewable energy will mean investment in new assets, which would boost profits, something that is an unusual opportunity for a regulated utility. National Grid also owns several power transmission and distribution assets in the US, some of which are unregulated, which means it has more scope to set its own prices. 'Transmission' means huge pylons that carry huge amounts of electricity from one area to another, while 'distribution' refers to the lower-voltage lines that supply power from substations to people's homes.

Workers of the world

One of the great unknowns that has sprung from the year of massive upheaval and unprecedented public sector largesse is how the labour market will look after the dust settles.

At first huge numbers of Americans were laid off as businesses shuttered, and the federal government massively increased the generosity of jobless benefits. Meanwhile, on the other side of the Atlantic Europeans were given a lifeline by furlough state subsidies, keeping them employed but idle. US unemployment has rapidly shrunk from a high of almost 15% to a still-pretty-high 6%. European unemployment stats are artificially low, leaving some uncertainty about just how many furloughed jobs will not be coming back.

There is some nervousness among investors that the boosted US unemployment payments are making some people reluctant to return to work for little more pay. The number of new jobs in April was extremely low, despite job openings hitting all-time highs. However, many states are already moving to lower benefits in an attempt to entice people back to work. And in Europe, exactly what will happen when furlough is wound up is impossible to forecast. As an example, the UK has 4.2 million people on furlough. Putting that in context, just 1.7 million people are currently unemployed, making for an unemployment rate of 4.9%. That's a whole lot of shaky jobs in the wings.

This matters because wages are what really drive longer-term inflation: when you get the feedback loop of higher pay flowing through to greater costs for all industries which makes for more expensive goods and services. And then workers see the money in their pockets buying less than it did and start agitating for yet more wage growth, which drives costs higher, etc, etc. While stock markets have been very sensitive to inflation scares, the bond market has been muted. Government bond yields rose sharply in late 2020 and the first couple of months of 2021 in anticipation of reopening, but they have plateaued since.

De La Soul

This puzzling mix will only sharpen investors' nerves. We're expecting a volatile year as people get spooked by erratic economic data, any anecdotal reports of American truck drivers having money fights in highway laybys and governments touting huge new infrastructure projects.

When you expect higher risks, it often pays to take out insurance. So with the expectation of greater stock price volatility we bought the **UBS Resettable S&P 500 Put Option Structured Product**. This works just like a normal put option: it gives us the right to 'sell' part of our US equities at a set price in the future, effectively creating a floor for the value of our holdings to protect us against market falls. And like with any form of insurance, we pay a fee for the privilege. Where this product differs is that the price we can 'sell' at can reset higher each quarter if the market continues to move upward.

We're taking the long view, brightened by the simple fact that the developed world is firmly on the road to recovery. The emerging world is still struggling, but thanks to a flurry of vaccines the West can now lend a hand to inoculate and give aid to those countries that need it. The efficacy of vaccines is holding up well, even in the face of a flurry of nasty COVID-19 mutations. That gives us confidence that people will feel safe enough to re-emerge and live and spend once again.

Back when the pandemic first struck, we were all very overoptimistic about how quickly we would fight off the virus and get back to normal. This time round, having been burned several times by additional waves of infection and lockdown, people could well be getting too pessimistic about the prospects for the coming year or two. Thrice infected, twice shy, you might say. With all that change to come, it's going to be a choppy year or two for investments, we reckon. But, if we can manage to beat back the virus for good and see old friends once again, it should be a wonderful time for the soul.

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