Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update January 2022

2022 has started with a bang. Central banks, concerned about the possibility of sustained inflation, have turned more hawkish. This suggests more interest rate hikes, more rapidly delivered. All of a sudden, investors are having to come to terms with this changing environment and the realisation that maybe, just maybe, 2022 is the year when market leadership shifts. Investors need a Plan B because the Plan A of owning long-duration growth stocks no longer looks a 'slam-dunk' as markets have become more volatile. If the mood continues to change, even greater value will be placed upon earnings visible today versus profits accrued further in the future whose present value is eroded by higher rates and inflation.

When markets get difficult, it is always good to double-down on investment process and focus on what is relevant. It's also important to distinguish between 'process' and investment 'philosophy' or 'style'. They're close cousins, but they do differ. Process helps to shut out unhelpful noise. For us, process means focusing on the decisions that management teams make on capital allocation. It also means thinking about market structures and margins, supply chains and efficiencies – all the things that come together to create an informed notion of **Business Risk**. We look at balance sheets and form a view as to the stresses that may ensue at times of economic discomfort, especially if managements are playing fast and loose with share repurchases and dividends; this is **Financial Risk**. And we think about valuation, the price we pay for a stock in compensation for the risk we are taking, the calculation we make that the market is missing something – the **Price Risk**. This tri-partite concept of risk is central to our process, whatever the market conditions.

All this is not the same as investment philosophy or style. As income fund managers, we are naturally drawn to the attractions of 'value' because that's the practical hunting-ground for yield. But that's not our process; it's a style bias that can be tweaked and pulled around as much as we see fit depending on the circumstances and market conditions. We will allocate capital according to these conditions, but our process should always determine individual investment decisions.

Bearing all this in mind, how do we see the world? Well, first, we recognise the conflict being played out between a benign view of a 'Goldilocks' future of controlled inflation, a normalised yield curve and synchronised global growth, and the opposing opinion that a flat yield curve reflects bond market fears that central bank policy mistakes will lead to global recession and a rapid row-back on thoughts of quantitative tightening. Our instinct is that it's the benign view that's correct, but we remain alert to what the yield curve is implying.

Equity markets have been supporting this more upbeat view for a while. For much of 2020 and the early part of 2021, hopes of swift economic recovery led to cyclical stocks strongly outperforming their more defensive counterparts. Since then, it has been a more stock-picker-oriented market.

However, so far this year, as central bank narratives around interest rates have become more hawkish, confidence in those quality and growth names that have powered investor returns for so long has been evaporating. Meta Platforms (Facebook) plummeted over 20% after it released disappointing Q4 earnings, wiping more than $200 billion off its value. More interesting was the reaction of shareholders in Amazon. They had so little confidence ahead of its numbers that they sold down their shares after the Meta results, only to buy them back two days later after Amazon ended up announcing impressive results. On Wednesday 2 February, the shares were trading at around $3100, and that's just about where they ended up on Friday 4 February, having fallen by 10% in the interim. That's a $160bn round trip in itself! The numbers are huge, but it's investors' lack of confidence, in light of the Meta news, that may be the most instructive aspect of the whole episode.

For UK investors, and UK income investors in particular, this has been a less frightening start to the year, on the back of a very good 2021. We are certainly looking forward to the year ahead. We hope that global GDP stays robust, supported by a post-Omicron boost. As central banks wind down stimulus, we expect this to push real yields higher so that they better reflect the recovery in global economies. And we hope inflation will warm investor appetite for growth that is evident today. Companies exposed to the economic cycle will demonstrate such growth so that growth itself will become less scarce. As a result, growth stocks will de-rate. If all this comes to pass, investors will become more interested in the UK stock market, which is both global and cyclical. This does not need to be all-out enthusiasm, just less of the opprobrium that's characterised attitudes to the UK over the last five or six years.

Finally, we will look to avoid mistakes. This is no time for heroics. As we progress through a crucially important Q4 results season, we will want to see evidence of business efficiency and capital discipline, pricing power, supply chain management and cash generation before we increase our positions. Now is a time to be humble and to recognise that there's a lot we don't know about the future.

However, we are allowed to be optimistic. We do believe that global economic growth will encourage a **change in market leadership**. The UK market offers the **cyclicality and value** that play into such a shift; and UK equity income can provide a solution to the **financial repression** that inflation inflicts on savers. This is our mantra for 2022.

Recent Trading: Following an extended period of good performance on the back of a soaring oil price, we have taken a little bit of money off the table by trimming **Shell** and **BP**. We used the funds to bolster our financial exposure by adding to **NatWest Group** and **OSB Group**, and also created small positions in two new businesses for us, recruitment consultant **Hays** (complementing our existing holding in Page Group) and specialist retailer **Games Workshop**.

Companies seen in the month: Croda, Ferguson and **DCC**.

Carl Stick
Fund Manager

Alan Dobbie
Fund Manager

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