Rathbones
Look forward

Rathbone SICAV Multi-Asset Strategic Growth Portfolio

Monthly update February 2022

In the space of a few weeks, everything we have all been pondering has been scattered like leaves in the wind. Our world appears to have changed, although exactly how is obscured by the clouds of war.

Russia's invasion of Ukraine was predicted by US intelligence services, but those warnings seemed like part of an information war right up until the moment tanks rolled across the border. Russia's advance has been much slower than many expected, facing stiff Ukrainian resistance, and evidence of rockets and artillery targeting urban areas is multiplying. The growing death toll and the huge flow of refugees is devastating to watch.

Western sanctions have also been much stiffer than Russia – and the rest of the world – ever expected. Embargoes on trade in all sorts of important industries, from pharmaceuticals through to technology, armament suppliers and airlines, have been combined with freezing the assets of the Russian President and many of his leadership. Western nations have cut off several Russian lenders from European and US markets, frozen their offshore assets and barred some from the SWIFT cross-border payments system. The West has also taken a bold new step, something that has happened only once before (during the Iranian hostage crisis of 1979): freezing the assets of a central bank, this time preventing Russia's from selling any of its Western foreign exchange reserves.

For years, Russia's central bank has amassed a huge pile of bonds, gold and cash – about $630 billion (£470bn) as of last month – which it could use to prop up its currency and to pay for any imbalance in the nation's payments because of sanctions. This was thought to make Russia 'sanction-proof'. However, at a stroke, Western governments cut off Russia from assets held in their nations by barring brokers, custodians and central banks from dealing with it. These assets make up the lion's share of Russian reserves. By convention, central banks typically have sovereign immunity to such sanctions, but the West has ignored this.

Like a lightning bolt, the news hit the rouble. At one point, it had dropped 40%, driving the Russian central bank to more than double its interest rate to 20%. Many Russians rushed to withdraw their money in euros and dollars to protect their savings; bank runs and a potential financial collapse look very possible.

Russia's resources

The paths of inflation and monetary policy have been the focus for investors for many months now. That remains the case but so many of the assumptions underpinning analysis of them have been undermined by the war in Ukraine.

The clout of Russia's economy is sometimes denigrated by comparing it with the economy of Texas, which is a tenth larger. However, that belies the pivotal role Russia has in the global market for raw materials and energy. It is the world's largest exporter of oil (Saudi Arabia pips it for crude oil, but for all types of the black stuff Russia is supreme). It is by far the largest supplier of gas to Europe, accounting for roughly 40%. Russia is a major exporter of wood, coal, enriched uranium, nickel, aluminium, copper, platinum, palladium and steel. Russia also sells the most wheat worldwide; Ukraine is also in the top five exporters of this crucial food staple, and it's a huge supplier of corn as well. And the list goes on…

These commodities are the bedrock for virtually everything that our higher-valued economies produce and consume. With this context, you can begin to understand why the West has carved out all these industries from its extensive sanctions. Any disruption to these markets will have tremendous implications for the cost of virtually everything. Very simply, it would amplify global inflation that is already running red hot. Just the potential for disruption has sent the prices of all these commodities markedly higher. Inflation is now likely to be higher for longer than investors were expecting just a month ago.

What does this mean for central banks? Inflation grinding yet higher puts pressure on them to increase interest rates to prevent prices getting out of control. Yet they are unable to control the supply of these crucial substances. All they can do is reduce the demand for them by increasing borrowing costs, which leads to lower economic growth and potentially recession. It's still unclear exactly how they will react. The risk of them making a mistake – either by tightening too much or by not tightening enough – has risen significantly.

At the beginning of the month, because of the rising geopolitical risks, we added to some of our sovereign bonds, including the **UK Treasury 4 ¼% 2032** and **US Treasury 1.5% 2030**. We also introduced the first 30-year gilts to the portfolio for a very long time, specifically **UK Treasury 3.75% 2052** bonds. We took this step because of the increased risk that the cost of living crisis and rising interest rates will push Britain into recession this year.

During the month we have also added to our quality 'growth' companies — those companies with reliable earnings that are growing faster than the global economy — because their prices have dropped back this year, making them more attractive. Some of this cash came from selling bleach and home goods producer **Clorox**. The business's profit margin has fallen back in recent results, lending weight to concerns that it will have to absorb rising input costs rather than passing them on to customers or offsetting them with lower expenses.

We reduced our holding of oil major **BP** both before and after the invasion of Ukraine, because of its 20% stake in Russian oil and gas company Rosneft. We took profits from wind turbine manufacturer **Vestas** and oil major **Shell**.

We continued to build our position in American stockbroker, ETF provider and wealth manager Charles Schwab. The company is growing well, driven by its compelling zero-fee approach to execution-only accounts. **Charles Schwab** makes most of its revenue from the interest earned on cash in client accounts, so it is actually an interest-rate beneficiary in disguise.

We also continued to buy **Caterpillar** the big yellow truck and dozer company. This business's fortunes are closely tied with global economic growth because its customers are raw materials producers, farmers and construction firms. These industries tend to run hot and cold depending on the economic cycle, yet Caterpillar is in no way a boom or bust company. It is renowned as a quality brand and it is run by cautious managers who are careful not to oversupply the market or degrade the quality of its machines. It focuses on selling to quality operators who are more likely to still be around in 10 years to swap in new machines, rather than ramping up production to sell as much as possible. This is important to ensure that the company doesn't overstretch itself and walk into an economic funk with more machines and production lines than it can sustain.

One theme that has interested us for a while is the opportunity for disruption and powerful new products and services in farming and food production. Climate change and limited resources mean clean and efficient production in these areas is vital to the future. Many of the most promising companies in this space are a bit small for us, so we bought the iShares Agribusiness ETF to gain exposure to an industry basket.

Staying defensive

Put bluntly, at the moment, our outlook is to not have an outlook. There's just too much going on, too many variables, too much conflicting information, too much risk to take a bet on how markets will go from here. For many months now, we've been adjusting our portfolio to be as balanced as possible. We've beefed up our defensive assets — government bonds from several safe haven nations, commodities and structured products that protect us from stock market falls and greater volatility in interest rates. This has helped dampen drawdowns from the market turbulence of February and early March.

There are some very long-term effects of the war in Ukraine that do seem overwhelmingly likely, however. After the jolt of an invasion of a democracy on its outskirts, EU nations will probably bolster defence spending, which will mean higher taxes, all else being equal. That will have an impact on household finances and therefore growth in the world's third largest market. Also, most countries will be reviewing their energy strategies and supply of important natural resources. Self-sufficiency — or, at least, tie-ups with solid allies — will be front of mind. There will no doubt be changes to the energy mix in many cases — coal is likely to be seen as a necessary evil, especially in places like Germany. The transition to cleaner energy has been further complicated by this conflict.

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