Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone UK Opportunities Fund

Monthly update July 2022

After six months of underperformance, we are relieved to close the books on a very strong July, with your fund returning more than double its benchmark.

Equities in general staged a welcome relief rally, as the US Federal Reserve acknowledged interest rate hikes will likely not be more aggressive than currently priced in. Commodity prices have rolled over hard, which supports the consensus view that inflation is peaking and that central banks will have to cut rates next year to stave off recession. So 'growth' stocks finally bounced back while 'cyclicals' are retreating ahead of this widely expected slowdown. Mid-caps are also in the vanguard of this resurgence, having underperformed so far this year.

The FTSE 250 tends to outperform the FTSE 100 over most time periods, substantially over the last two decades, except during times of intense macro stress, which is exactly what markets have been trying to price so far this year. As we sit here now, the premium that investors typically must pay for nifty mid-caps over lumbering large-caps has all but evaporated.

Will profits hold up?

Earnings season has been broadly positive – operationally our companies are performing extremely well. And this time round, share prices have reacted in a more traditional way – good numbers have led to higher prices and vice versa. We were expecting more of a 'confession' from companies that they were seeing signs of slowing demand. Very few, aside from retailers (which we don't own), are mumbling mea culpas, for now at least. The tricky bit, however, has been profits: price rises are good for mechanically bolstering revenues, but profit margins can come under pressure. Companies are going as far as to acknowledge that uncertainty about the second half of the year is high and so have been reluctant to change their guidance for the full year despite a promising first half. To our mind, September/October will be the real test, when energy prices rise again as temperatures drop. Earnings estimates will need to come down – not an easy path for equities to tread, but share price falls year-to-date have already priced in a good deal of this.

So while we haven't yet seen the challenges of falling demand for goods and services, assessing pricing power (the ability to hold gross profit margins stable by raising prices in the face of higher costs) has been instructive. Our durable domination holdings like real estate portal **Rightmove**, student digs developer **Unite**, construction aggregates supplier **Breedon** and drinks giant **Diageo** have demonstrated this very nicely in recent weeks. Those companies that can hold on to, or even raise, margins during periods of intense inflationary pressure deserve to have their price-earnings multiples increase.

On the other hand, we've sold our holding in homebuilder **MJ Gleeson** as we became increasingly nervous about the end of Help to Buy, as well as new regulations around greener homes. For Gleeson, whose average selling price is around £150,000, these new rules are likely to squeeze margins more than other housebuilders.

A month isn't enough to call a sustainable change in market trends, but July has at the very least reminded us of the potency of quality mid-cap stocks.

Alexandra Jackson
Fund Manager

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