Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone SICAV Multi-Asset Total Return Portfolio

Monthly update August 2022

A long and honourable reign has ended. We are deeply saddened by the passing of Queen Elizabeth II, and our thoughts are with the Royal Family.

It has been a tough year, in so many ways. Everything, it seems, is changing. The reopening from the pandemic swiftly and radically changed how many of us work. Russia's invasion of Ukraine punctured the idea of a peaceful Europe. Combined, the invasion and the pandemic's upheaval have shunted global markets out of a very long period of abundant, cheap energy, extremely low interest rates, virtually non-existent inflation and stagnant wages. The death of the Queen is another reminder that all things must pass. And that the longer we live with something, the more powerful its passing.

It's passé to say, but life is complicated. The effects of these events aren't as neat as these broad narratives suggest. Often, we investors simplify things because it's the only way to make sense of economies and societies that are too complex to fathom in their entirety. It helps you focus on what is really driving changes and shaping the landscape, rather than getting lost in countless details that will likely cancel each other out anyhow. Albeit, you know that it's usually one of those details that will sting you at some point – there's a reason the term 'unknown unknowns' that Donald Rumsfeld coined was adopted so wholeheartedly by investors. This is a paradox, but one we simply have to live with. We must take the general's view from 400 feet up, yet stay alert to worrying details that may belie the larger picture. And keep cool heads.

Life is messy

Remote working and investment in great new technologies free more skilled people to take up jobs that distance or personal circumstances would previously have barred them from. Young parents can return to work more quickly and comfortably. People living far from offices can produce work as effectively as if they were in the pod next door. Workers can cut their time spent commuting, as well as their expenses and perhaps even their carbon footprints (especially those who used to live on red-eye flights criss-crossing the globe). However, remote working also makes it harder to build rapport in a team and easier for employees to spend their workdays searching for better jobs elsewhere. People can become isolated at home and mental health is an increasing concern in many businesses and organisations. Managing people in the new age is a tricky task, requiring new strategies and processes. In coming years, this may slip into a level of digital monitoring that many may find uncomfortable.

At a stroke, the invasion of Ukraine and the consequent sanctions on Russia ended the era of cheap energy. It wasn't just oil and gas, either, but a gamut of food, metals, nuclear fuel, timber and other raw materials besides. This has driven the first real worrisome bout of inflation in decades and dramatically increased the cost of living for people all over the world. Yet it has also pushed countries to look harder at their energy strategies and their plans to reduce carbon intensity. The cost of energy could be crippling, so it increases the incentives for developing truly better, cleaner – and ultimately cheaper – alternatives. Power bills that are many multiples higher create an urgency that a steadily warming world and activists simply cannot.

All of these chaotic events and phenomena have led central bankers to push interest rates higher in a fashion that many people haven't experienced and those who have, struggle to remember. Markets were pushed higher in July and into the first half of August in the hope that the US Federal Reserve (Fed) might abandon its aggressive interest rate hikes and even *cut* them in 2023. We felt this was a bit fanciful, so we were unsurprised by Fed Chair Jay Powell's insistence that rates will continue to rise. Last month's bounce back in stock and bond prices has since reversed and seems more aligned with our view of the path of rates.

Bond yields rose rapidly in August (i.e. bond prices fell) as inflation continued to rise and the resilience of the American economy led the Fed to tell investors, bluntly, that it would continue to hike interest rates for a while yet. Tighter US monetary policy tends to mean tighter policy for the world generally, and European nations are struggling with an energy crisis that is putting yet more pressure on households, businesses and inflation indices.

With government bonds in the US and UK yielding more than 3%, we decided to start carefully increasing the 'duration', or interest-rate-sensitivity, of our bond portfolios. We did this by buying more **US Treasury 1.875% 2032** and **UK Treasury 4¼% 2032** bonds. While rates likely have further to rise, we believe it's time to start adding these sorts of assets to protect ourselves if yields fall suddenly, as they would if the world tumbles into recession, for instance. It helps our decision that these bonds are now offering yields that begin with a three rather than a zero.

We also added to quite a few sterling corporate bonds, again because yields became much more attractive. These included insurer **AXA 5.453% Subordinated Perpetual-2026**, French bank **BNP Paribas 1.25% Senior 2031**, lender **Leeds Building Society 1.5% 2027**, power and gas network **National Grid 1.125% 2033** and US investment bank **Goldman Sachs Group 1.875% 2033**.

We jettisoned the **iShares China CNY Bond ETF** as well. This tracker holds a range of government-issued and government-backed Chinese bonds. We have held it for some time as Chinese yields had long appeared higher than bonds with similar risk in the West. During the recent market falls, these yields actually held up relatively well, so we sold this position to recycle the cash into Western markets now that their yields have increased to more attractive levels.

We bought US-listed pharmaceutical, veterinary medicine and vaccine manufacturer **Merck**. Its sales have grown steadily over many years and it sports exceptionally high gross profit margins (gross profit is revenue less the costs of production). The business should also be less susceptible to rising costs from inflation, which would bolster its already strong pricing power.

As stock markets rose in early August, we added to our **UBS Put Spread** structured product, which protects us if markets drop between 5% and 25% (we are exposed to any fall greater than 25%). These options are effectively an insurance policy on our US stock portfolio. We pay an upfront premium in return for the right to 'sell' a given value of the S&P 500 Index at a pre-agreed level.

Finally, we crystalised our gains in oil services company **Schlumberger** after this year's strong rally.

Some lights in the gloom

Investors have been gloomy for quite some time now. We think we could be approaching the peak of these concerns.

Rising interest rates are a stiff headwind for stock returns and the value of bonds. However, they also introduce greater yields and expected future returns. Two years ago, $18 trillion of worldwide debt had a sub-zero yield. Now, the amount of debt where investors have locked in a guaranteed loss is less than $3tn. This is a sign of normalisation, not distress. It is a symptom of the end of zero-interest-rate policy — for the next few years, at least — whether we are destined to return to the deflationary environment embodied for decades by Japan is an open question.

Right now, for all the economic whirlwinds and tightening monetary policy, we are still optimistic about the state of the US. The American economy is running hot. How long that can be sustained and how it will influence inflation is, again, an open question. But it does give us confidence about the ability of US households and businesses to stay relatively upbeat. Employment prospects appear strong, the housing market is going through a strange phase: opened up in one sense by remote roles allowing people priced out of larger centres to seek more affordable alternatives elsewhere. It is also being buffeted by the rapidly rising cost of a mortgage.

Here in the UK, the cost-of-living squeeze has been mitigated massively by new Prime Minister Liz Truss's extraordinarily generous energy price cap. Guaranteeing a two-year ceiling on power bills for households and six months' support for businesses is expected to cost between £100 billion and £150bn, depending on the trajectory of wholesale prices. That would be between 5% and 7.5% of GDP; in comparison, the furlough scheme cost about £70bn.

By capping energy bills, the government should stop inflation galloping higher. Economists expect CPI to plateau at the current 10-11% level before declining over the course of 2023. Inflation had been expected to peak at around 15% in January. The cap will, however, leave more cash in people's pockets which, in theory, could increase inflationary pressure in other areas like goods and services.

Another effect of the energy cap will be a large increase in the issuance of debt — government bonds or 'gilts' — to raise the required cash to pay the power generators. All other things equal, an increase in the supply of a thing causes its price to fall (demand for it being unchanged). Rising bond yields mean higher borrowing costs for the government. Yet, government bond markets are complicated, so it doesn't always play out that simply.

In the shorter term, the cap on power bills dramatically reduces the strain on energy users and therefore the chance of severe recession in the UK. We will all have to pay for it in higher taxes down the line. However, this way we don't pay for it in lost economic potential and widespread economic hardship. If managed adroitly, the increase in government debt is manageable. But people must be in no confusion: there are no magic money trees. The bill always comes due. The smart operators make sure that the due date is when it's best for them.

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