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Rathbones
Look forward

Rathbone Multi-Asset Total Return Portfolio

Monthly update October 2022

The strangest thing has happened in the UK: by accident or design, centrists are back in fashion for the first time since Brexit. This is a very heartening development.

In October, Rishi Sunak and Jeremy Hunt replaced the short-lived leadership of Prime Minister Liz Truss and her Chancellor Kwasi Kwarteng and hammered home their aims of stability and living within the country's means. It brought relief to bond markets, with yields dropping sharply (prices rising) after their brief spaceflight driven by the aborted policy directions of Team Truss. The return of Sunak means professional centrists are in control of both the government and the Opposition — the first time since Brexit. When Theresa May was in charge, Jeremy Corbyn offered a radical option in the wings; while Keir Starmer's trademark boring competence has been a foil to Boris Johnson's helter skelter premiership as well as the revolutionary whirlwind that was Truss's time in office. The kooky fringes will still be tugging at the corners, but looking from Sunak to Starmer, the UK political situation looks much more grown-up. That's pretty rare in today's world!

British bond yields remain higher than they were, but that is true all over the world because investors are expecting the US Federal Reserve (Fed) and other central banks to continue increasing interest rates for a little while yet. Globally, investors are hoping for a pause or a pivot, but they may be disappointed. We think US interest rates shouldn't need to rise as much as some believe, but the Fed will feel it needs to hold its anti-inflation stance until it's beyond all doubt that inflation is sinking briskly back towards its 2% target.

Powell talks tough

Shortly after the month end Fed Chair Jay Powell punctured a mini-rally in stocks by warning that the 75-basis-point Fed Funds rate increases to the 3.75%-4.00% band would likely be followed by more hikes than investors expect.

Powell's comments were more nuanced than simply "higher", however. He said that the Fed's next rise would be a more moderate 50bps in December and then the committee would be firmly fixed on the economic data. But he thought the speed of hikes would probably slow, even as the peak in rates could be higher — the implication is that it would now be about 5%. The Fed has acknowledged the sheer scale of its moves and admitted that the economic effects come with a significant lag. We think this is very much the rub: the Fed is in danger of overtightening and sending the world into recession because of this lag, which can be between a year and two years. We hope Powell is simply trying to weaken the hopes of stock market investors to ensure the 'wealth effect' is working to reduce exuberant household demand and help alleviate inflation. That is, he's trying to keep stocks from rushing higher, making 401(k) retirement accounts comforting enough to push people to spend more.

This won't help US technology stocks in the short term. These companies have been hit hard by the rapid rise in interest rates because their values today are overwhelmingly reliant on profits coming far out in the future. We haven't been immune to this, holding **Amazon**, **Adobe**, **Alphabet** and **Microsoft** as we do, yet we had taken profits from these companies when they had looked expensive before. We have now been buying these shares back at lower prices. We think these are strong businesses that will continue to grow for years and decades to come. It shouldn't be forgotten that many of them have faced stiff headwinds to profit growth from a rampantly strong dollar this year. That makes overseas revenue worth much less when converted to dollars, yet despite that earnings expansion hasn't been terrible.

With interest rates marching higher all around the world, yields on bonds have obviously increased too. For many years bonds were often, bluntly, return-free risks. Yields were so low that there was no real return accruing to the holder. There was precious little cash flowing back to bondholders in coupons and there was a lot of risk of capital loss if interest rates rose from record lows (which came to fruition), particularly for bonds that matured in five, 10, 20 years plus. This is no longer the case. Therefore, we have been buying bonds like bandits. We bought the **UK Treasury 4¼% 2032** and **1½% 2026**, the **US Treasury 1.875% 2032**, and the **European Investment Bank 5.5% 2025** in sterling. We then took profits in the gilts toward the end of the month after they had rallied strongly.

We picked up quite a few corporate bonds as well, all in sterling, including high-quality listed lenders **Commonwealth Bank of Australia 3% Senior 2026**, **National Australia Bank 3% Senior 2026**, **Clydesdale Bank 4.625% 2026**, **Lloyds Bank 6% Senior 2029** and **Toronto-Dominion Bank 2.875 Senior 2027**. We also bought some riskier debts issued by companies in defensive industries, such as pharma giant **GlaxoSmithKline Capital 3.375% 2027**, gas network **Centrica 4.375% 2029**, **British Telecom 5.75% 2028** and tobacco manufacturer **BAT International Finance 2.25% 2028**. These bonds were all priced below their face value that will be paid back at maturity, so there should be a capital uplift over the coming years as long as their businesses don't disintegrate.

We rebalanced our stocks over the month, adding to existing holdings whose prices have fallen to realign them with the proportion of the portfolio we want them to represent. We also bought a new company, Singapore-based lender **DBS Bank**. Set up in 1968 as an arm's length development bank by the government of Singapore, it has grown into a solid and responsible commercial bank and lender. It operates across Southeast Asia, albeit with a heavy focus on Singapore and Hong Kong. It also has a presence in the UK, US, Australia and United Arab Emirates. It is growing modestly yet dependably, with a solid return on equity that should have a tailwind if global interest rates continue to rise.

We completely sold our **Legal & General All Commodities** and **Invesco LGIM Commodity Composite** ETFs because we believe that global inflation has now peaked and is likely to fade now (over the next year or two). We took profits from our **S&P 500 Energy Sector ETF** because we think oil and gas prices are likely to decline from here; however, we kept a smaller position to retain some protection in case of another spike in oil and gas prices. We also trimmed diabetes monitoring business **Dexcom**.

Behind the curtain

Much has changed this year, so much so that the developments in China haven't had the coverage that they otherwise would have.

Lately, evidence of dissents and conflicts have started popping up in China. Most directly, it could be seen a few months back with protests about ordinary people losing their money in banking failures linked to the rocky national property market. Slightly more obliquely, you can see the ruling party making some stiff changes, which must be reactions to things going on behind the curtain. GDP growth has been rockier than normal (albeit it seems to be recovering recently), its property market seems to be slowly imploding, and a whopping 20% of 16 to 24-year-old urban Chinese are unemployed. Abroad, China has been getting into scraps with the US and several neighbours, while its $1-trillion Belt and Road Initiative to help finance development of the developing world appears to have hit difficulties because of slower global growth and higher inflation and interest rates. Many client states are now struggling to repay massive debts they have racked up with China. The Wall Street Journal estimates some 60% of China's overseas loans are held by distressed nations.

President Xi Jinping recently secured a third term as leader, which was a shoo-in, yet his Cabinet choices shocked investors so badly that Chinese stocks slumped almost 10% in a day. Xi had removed the only remaining men who were considered 'pro-market' and replaced them with loyalists who seem less likely to challenge some of Xi's less business-friendly policies.

Part of the concern must be that the government will continue with its zero-COVID policy longer than it might otherwise. The severe and repetitious lockdowns and restrictions in China are straining the economy and seem likely to continue. Now, human ingenuity being what it is, each new lockdown does less economic damage than the previous as people get better at adapting to the situation. But this is just one policy. There have been others – the swift crackdown on technology, social media and education industries from earlier in the year being the most prominent for markets. The more strident stance over Taiwan and Hong Kong is another area of concern, in that it heightens the chance of conflict with the West and potential sanctions – or worse, expropriation of foreigners' Chinese assets.

All of this increases the worries of multinational businesses about their ability to operate in China and depend on supply chains based there. A lack of focus on GDP growth also reduces that huge potential future opportunity that draws businesses to China. It also means it may be harder for strong Chinese businesses to expand into other markets, especially in sensitive sectors like technology and engineering.

We sold our Chinese stocks, with the exception of pan-Asian insurer **AIA**, earlier this year and last quarter cashed out of our Chinese bond holdings as well. There are some arguments floating around now that following recent falls Chinese assets are going cheap. We're not so sure that's right. To us, all the machinations we outlined above mean China demands a much higher discount to compensate for the risks of investing there. Exactly how much of a discount is fair we're yet to determine. We will be discussing this in the next episode of our The Sharpe End podcast, so look out for it this month.

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