Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone UK Opportunities Fund

Monthly update November 2022

Equity markets continued their recovery in November as central banks acknowledged that the pace of interest rate hikes could slow. Focus will now turn to what's the 'right' peak for rates, rather than how quickly to move.

Inflation is in a topping-out process: a wide range of prices, such as freight, gas and other commodity costs, are falling sharply, while others, like food and accommodation, are proving more sticky. The Catch-22, of course, is that inflation is coming down because demand is falling away. To put it another way, we are used to rate hikes occurring because growth is strong. At the moment, growth is weak and getting weaker. This isn't a classic set-up for strong equity performance. We've barely begun to see the impact of lots of monetary policy tightening on economies and companies yet. Downgrades and recession will be the story for 2023. For equity investors, the key question is: to what extent is this priced in?

Expectations (and prices) are low

We don't have to look far to find a market that's already pricing in recession and trading at multiples below its historic trough (far below its pre-COVID level) and where earnings estimates have already been cut by 25%. It's UK mid caps that bear this dubious distinction. But remember that low expectations and low prices can be a great mix during tough times. In this fund, we use a sturdy quality filter to guard against macro risks. We think it's particularly valuable at this point in the cycle and will only get more important as we head into early 2023 and economic data gets worse.

The outlook is challenging, but investor appetite for UK equities seems to be returning after the Truss debacles of the autumn. Sterling has bounced nicely too, and the Bank of England has been clear that market expectations for the peak in rates are still too high. Both these things are supportive for domestic equities. Valuations are the clincher – mid caps were sold down en masse, with little distinction between enduring franchises and challenged value traps. So, in our view, their potential for catch-up is all the greater. Mid caps are already outperforming large caps, and our oversold quality names are outperforming further still. Companies that miss expectations (long-term holding **GBG**, the identity verification specialist, is one frustrating example) are still being punished, but not nearly as aggressively as before.

Companies believe they're pulling the right levers

We've seen more than half of our portfolio companies in the last month. There's a lot going on, but a top-level summary would be *'decent 2022, keep expectations down for 2023, hiring and supply chains are getting easier, demand is less clear but we're pulling the right levers.'* How companies cope with inflation will once again be key in driving stock selection. This year, it was all about who could raise prices to offset higher costs. Next year, we will see who can keep prices firm, despite lower costs.

Our big positions like software writer **Kainos**, gaming industry services provider **Keywords** and specialised distributor **Diploma** have all raised their profit expectations in the past month. As growing businesses, this is what we should expect to happen. But the market had lost faith in these structurally advantaged, expertly managed and cash-generating companies because central banks have been raising rates. The coming recession will further separate world class businesses from simply parochial ones, even though right now valuations do not. What an opportunity! We've got a bit more cash on hand now to deploy across some truly outstanding businesses.

Alexandra Jackson
Fund Manager

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