Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update January 2023

Stability in markets encourages investment in 'long-duration' assets, businesses whose valuations are built upon their promises of big profits a few (or many) years down the line. When cash is cheap, inflation low, and central bank policy predictable, investors feel they can rely on the status quo. They are comfortable waiting a long time for their investments to be paid back. Conversely, episodes of volatility and increased uncertainty remind us of the relevance and value of the money you actually earn today, the cash profits and dividends that are the birds in the hand of investment returns. Volatility has reigned supreme for the last three years, and 'value' investment strategies have begun to pay handsome dividends, both literally and figuratively.

We are only one month into the year, but already a unique set of challenges are ranged ahead of us. There are definite signs of economic recovery, but this muddies the waters for central banks who are battling inflation. In this letter, we look back on a remarkable opening to the year, and discuss what it means about our positioning looking forward.

2022 — curiouser and curiouser

In spring 2022 we began to highlight some very unusual factor behaviour beneath the surface of UK equity markets. Value and defensive stocks were outperforming at the same time; 'growth' and cyclical stocks were simultaneously underperforming. The drivers of this performance were well-known. Sharper-than-expected interest rate hikes were punishing long-duration growth stocks, whose values are more sensitive to changes in prevailing rates than their shorter-duration value counterparts. Additionally, stubbornly high inflation and higher rates were increasing recession fears, leading investors to prefer the safety of defensive stocks over more economically sensitive cyclical names. By the end of 2022 the style performance gap was stark:

Rising rates clash with recession fears

Source: FE Analytics, Rathbones; data total return for 2022

These figures refer to past performance, which isn't a reliable indicator of future performance.

On a stock-by-stock basis, we felt that this rotation had been too severe. Over the course of the year, we nudged up our exposure to cyclical names, such as metal foundry plant supplier **Vesuvius**, fluid dynamics engineer **IMI**, paper and packaging giant **Smurfit Kappa**, and bargain store chain **B&M European Retail**. We also increased the weighting of some severely de-rated growthier holdings such as construction equipment rental company **Ashtead**, veterinary medicine supplier **Dechra Pharmaceuticals**, wargaming manufacturer **Games Workshop** and storage business **Big Yellow**. These decisions were based upon two principal foundations: the intrinsic quality of the individual businesses, and the valuation opportunities afforded by the aforementioned rotation. In the very short term, these tactical moves look to have paid off.

2023 — the Christmas lunchers are celebrating

In the days when such things were allowed, City restaurants buzzed in December with stockbrokers treating their clients to a well-earned Christmas lunch. A favourite parlour game at the end of the meal was for the broker to ask their fellow diners for their top stock-pick for the coming year. Emboldened by the short time horizon – and perhaps a couple of glasses of wine – these picks were often deeply contrarian. The simple logic being that this year's worst performers were surely due a bounce next year. We're only just over a month into the new year but the Christmas lunchers are winning so far (certainly when it comes to cyclical stocks and the most badly beaten-up fallen tech angels).

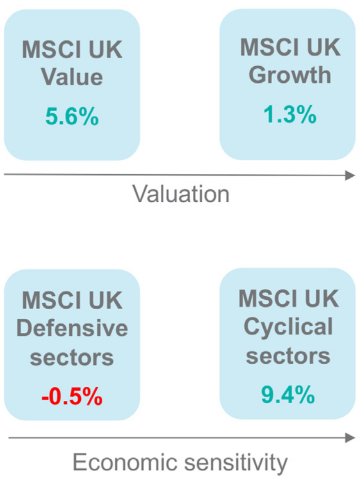
With recession fears abating (a little), sentiment picking up (a little) and valuations still (very) attractive, cyclical stocks have rallied hard in the new year. The table below shows how our fund's 10 worst performing stocks of 2022 have started the new year.

Our 2022 laggards have rebounded sharply

Year-to-date total return

FTSE All-Share	**5%**
Persimmon	16%
Dechra Pharmaceuticals	9%
Bellway	11%
Taylor Wimpey	15%
Halfords	-2%
Big Yellow	7%
DCC	13%
IMI	12%
WPP	15%
Smurfit Kappa	10%

Source: Bloomberg, Rathbones; data one-month return to 31 January



Source: FE Analytics, Rathbones; data total return January 2022

These figures refer to past performance, which isn't a reliable indicator of future performance.

As the old adage goes, it's better to be lucky than good; our timing certainly seems to have been opportune. The rebound in these names is as much to do with the lowly valuations going into the start of the year as any change in the economic dynamic. But as we have always been aware: the better price you pay for a stock, the greater the potential upside. Valuation does matter.

The future — more to go for

The past is the past, so where do we go from here? While we don't think it warrants leaning too much further into, we do think this trade could have further to run. The valuation of many of our more cyclical holdings are still deeply depressed. Should macroeconomic data continue to point to a milder recession than previously feared then these stocks could have room for further outperformance. We'll come back to this in part 2.

The jobs market is the key theme for 2023 and beyond — discuss

Wages, vacancies, lay-offs, retirement, demographics, and their impacts on policy are part of a huge theme that will dominate 2023, and many years to come. How will labour markets develop – across the world – and how will that affect monetary policy, GDP growth and businesses' ability to hire the skills they need.

There's certainly been a lot of noise so far. In the US there have been big headlines on both sides of the employment equation. Technology giants **Amazon**, **Alphabet** and **Microsoft** have all announced significant redundancies, and in all there have been just shy of 100,000 lay-offs in the tech space since the start of the year and 250,000 since the start of 2022. Those firms who went on relentless hiring sprees during the pandemic, arguably becoming bloated versions of their previously lightweight and supple selves, are culling rapidly. Where will these ex-employees go?

Who knows at the moment, but any slack in the jobs market seems to be snapped up by the travel and leisure industries, the economic re-opening plays that are huge employers of people. These two large industries swamp the numbers employed at the more glamorous and high-profile tech sector. And this means, you see, that the jobs market is really worrying the US Federal Reserve (Fed), especially after the recent 'blow-out' employment data in January. Apparently 1.1 million more people are employed in the US than thought at the end of December. What does that mean for wage growth? Or inflation?

The Fed's monetary policy committee has a dual mandate to ensure price stability and maximise sustainable employment. Joachim Klement, strategist at Liberum Securities, warns that the Fed is at risk of making a crucial policy mistake. Twenty years ago, there was a 'jobless recovery' following the 2001/02 recession. Lowering rates to stimulate the economy didn't result in improved US employment numbers because jobs had migrated overseas as a function of globalisation and low-cost production. Two decades later, the forces of globalisation have deteriorated, but policy links to job creation remain distorted. Klement fears that a hitherto tight labour market, forcing wages higher, may encourage the Fed to raise rates too far, causing a major recession, and thereby catalysing a torrent of redundancies. The contradictions laced through headlines are symptoms of this conundrum.

In the UK, the Bank of England is also worried about the labour market: the over 50s who left the workforce in their droves during the pandemic have not returned. This reduction of available labour, exacerbated by the upheaval of Brexit and the haemorrhaging of foreign workers that it sparked, has severely tightened the market for labour. Headline inflation may well come down as energy costs slip, but core inflation will remain elevated, all else being equal, with unemployment low, wages going up, and demand surprisingly resilient.

Investors and business managers ignore the employment conundrum at their peril. By way of example, auto service and bike retailer **Halfords** is experiencing its own trials and tribulations, being ironically a victim of its own success and ambition. The UK market for MOTs is robust, with an aging fleet of cars stoking pent-up demand, and Halfords wants a bigger share; the problem is the limited supply of qualified technicians, and it takes three years to train one from scratch. So Halfords is on a hiring spree. But the basic economics of supply (limited) and demand (they need lots of mechanics to take advantage of the space they're in) means they will need to offer greater incentives, including money.

Halfords argues that apprenticeships should be available to any age group, and they have recently taken on a 68-year-old as a level-two apprentice through their Rediscover Work Programme. It's a great story, but it in itself highlights the imbalances and stresses within the system. Ageing populations, a mismatch between the gaps in the labour market and the supply of workers available, and the economic dynamics forged by wage inflation, consumer demand and business cycles present a unique set of challenges for central bankers, business leaders and investors alike.

Curiouser and curiouser part 2

What do we conclude from all this? We may suggest that this year's dramatic stock moves show what happens when low expectations and even lower valuations respond to data that belies the gloomiest of predictions. If you think this year's moves are dynamic, just check out how shares have rebounded from the darkest days of the Truss/Kwarteng mini-budget.

More importantly, we must recognise how crucial it is to try to understand the idiosyncratic risks of every business that we own. If labour is a factor, how does it affect a housebuilder, or a retailer, or an industrial player? We must do the work at the micro level, because forecasting the macro is futile. The forces in play – inflation, economic cycles, central bank policy, geopolitics, commodity prices, energy transition, demographics – are too huge; when they clash, who knows the result? But by studying the minutiae that matter a great deal to our businesses we can give ourselves an edge. And that is what fund management is all about.

Recent trades: In January, we increased our consumer exposure by adding to retailers B&M European Retail and Games Workshop. We also rejigged our housebuilders by selling a bit of **Bellway** and creating a new holding in **Redrow**.

Companies seen in the month: Halfords and **Aviva**.

Carl Stick
Fund Manager

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Rathbone Income Fund

Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

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