RATHBONES

UPDATE FOR CLIENTS OF RATHBONES FINANCIAL PLANNING

Q2 2024 REPORT

CONTENTS

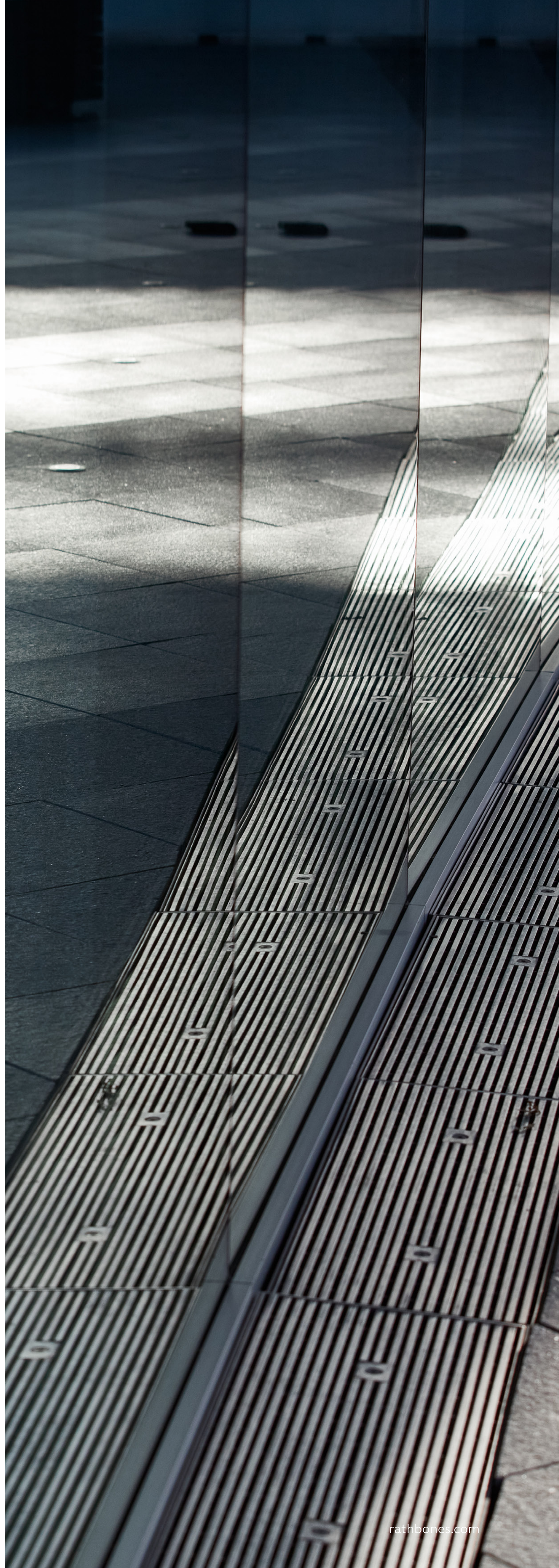
Quarterly investment update 3-5

Asset allocation 6-7

Holdings in focus 8-9

Keeping you updated 10

Important information 11



QUARTERLY INVESTMENT UPDATE

BROAD EARNINGS IMPROVEMENT BRINGS GOOD NEWS

The change of government may bolster UK sentiment, while the US election is on a knife's edge.

Earlier this year, stock price gains had been broadening out from last year's very narrow list of winners, but substantial profit growth was still relatively rare and the average company's profit outlook was being downgraded by industry analysts. As we end the second quarter, we're pleased to report that profit expectations have also broadened out, in line with our more optimistic assessment of the wider global economy as some key risks have continued to fall away. Given the evidence that stronger and broader earnings momentum today tends to herald ongoing market gains tomorrow, this is encouraging.

US earnings breadth — more companies receiving upgrades than downgrades — is at a two year high. More notably, it's been negative for most of that period. Counterintuitively, stock price gains have narrowed again over the past six weeks even as profit expectations have improved more widely. In fact, the average US share price has fallen over this time. The standard US equity benchmark, which gives greater weight to larger companies, has outperformed the non-weighted average by more than it has in any six-week period in the recent past, bar the period that followed the launch of ChatGPT-4 in early 2023 — the game-changing moment that catalysed the market boom in AI-connected stocks. Indeed, the non-weighted average stock has fallen a touch in the last month and a half.

It may be that stock prices have reacted (or overreacted) to a slight soft patch in the economic data towards the end of the quarter. It takes time for fundamental analysts to update their earnings models and communicate their views, but stock prices react to new information nearly instantaneously (although not particularly efficiently, for all sorts of psychological biases that the behavioural economics revolution has taught us about over the last few decades).

Economic data have started to disappoint consensus expectations in China, the European Union, and, especially, the US. Although to be clear, disappointing consensus does not mean it is worryingly weak in Western economies. Ongoing weakness in China may have surprised the consensus (although only just), but we've been cautious about having large direct or indirect exposures to the Greater China region for some time. Loan growth at Chinese banks hit a record low in May but, more importantly for the outlook, People's Bank of China (PBOC) Governor Pan Gongsheng has argued that the PBOC isn't likely to provide stimulus in response to weak credit data. Pan argued instead for allocating China's ample stock of capital more effectively, without the stock necessarily needing to grow. We don't disagree, but sorting through the 'ineffectively' allocated credit (a euphemism if we ever heard one) takes time. Still, we think recent modest stimulus has already put a floor under the economy even if a significant rebound isn't likely to be forthcoming.

Political uncertainty on the Continent

European data has only just started to disappoint consensus expectations, largely due to surveys carried out in the wake of the surprise announcement of a French election. This sort of noise is common ahead of elections: it's rarely a signal.

As at the quarter end, opinion polls suggested President Emmanuel Macron's centrist alliance would be unseated by enlarged left and right-wing opponents, which would lead to a new government led by one or the other (with Macron remaining as head of state), the prospect of which had spooked European markets. The parties-in-waiting, faced with debt greater than GDP and heavy spending, plan to increase spending, roll back modest pension reforms, while on the left they are talking of nationalisation. Prices for French government bonds and bank shares (a large cohort in the French stockmarket) have dropped sharply. Yet, our research on hundreds of elections across

Past performance is not a reliable indicator of future performance.

nine major countries over 40 years shows that they rarely divert an economy or its financial markets from the path they were already on. The outliers occur when properly radical governments are elected, particularly of the left.

The best example is Francois Mitterrand, who entered the Elysée Palace in 1981 and ushered in the first socialist government of the Fifth Republic. The French stock market welcomed Mitterrand with a 20% plunge and the franc dropped like a stone. And yet, after a couple of years, French stocks actually kept pace with other nations' after Mitterrand tacked slightly towards the centre. In other words, markets are very good at adjusting once, and moving on. Things happen quicker these days. The sizeable moves ahead of the election have already encouraged right-wing prime ministerial hopeful Jordan Bardella to row back on many promised splurges. Just as populist and secessionist governments in Italy and Greece did in the 2010s, perhaps the 28-year-old has already grasped that the premiership is a poisoned chalice, recently saying he wouldn't form a government unless his National Rally party won an absolute majority.

As for the US, there are a few signs that middle-class consumers are starting to come under pressure from past changes in interest rates. Inflation-adjusted retail sales have been stagnant in 2024, and now that restaurant sales are trending down this might be a precursor to weaker spending on services — which takes the lion's share of the US economy. However, US consumers are generally in reasonable health and not showing the excesses that can characterise the eve of a recession. The risk is that some (although not all) indicators of labour market health are suggesting rising job losses later this year. Personal income is the main determinant of spending, not wealth or household balance sheets, so jobs are the key risk to watch. We are optimistic, and we ascribe just a 25% probability to a US recession developing over the next year. That does stop us from being very overweight riskier assets, however. Accordingly, we prefer to lean away from consumer-oriented companies in favour of industries that stand to benefit from investment spending on the long-term themes of a changing world, such as cloud computing, AI, government-mandated industrial policies or ageing societies.

The race for the White House

With a potentially very significant and uncertain US election approaching, some investors are nervous about the prospect of Donald Trump returning to the White House. In contrast with the foregone conclusion of the UK election, the race for the White House is on a knife edge, and the contests for the Senate and House are almost as tight. There are also big differences between the Republicans and Democrats in the consequential policy areas of corporate taxation and trade, and no clear view on which outcome markets would prefer — that's likely to vary from issue to issue. In this context, it doesn't make sense to premise investment decisions on any single outcome — we need to be prepared for a range of possibilities.

There are some risks. Though our research suggests that elections rarely tend to matter, this is based on 40 years' of history over which inflation had been on a downward path. This was driven by institutional changes, such as independent central banks or changes in labour contracts, and by economic and social trends, like expanding globalisation, and ample workers relative to retirees. We think that structural trend is reversing slowly. Rather than, say, inflation between 1% and 3%, it may move to a range between 2% and 4% — but there are risks that this range could head higher still because of policy mistakes or unforeseen shocks.

We think the US election does present some risks to inflation, by way of a very carefree attitude to government spending, as well as the potential to undermine some of the domestic and global institutions which have played an important role in anchoring inflation since the mid-1980s.

This may be an oversimplification, but in general deficit spending that is directed to household tax cuts or spending on day-to-day government items is inflationary. Spending on infrastructure or tax cuts that may incentivise private investment is less so. Republican deficit spending may be more about the latter, but there are some risks, particularly if it is enacted at a time of existing inflation pressures. Undermining free trade by way of a 60% tariff on Chinese imports and 10% on everything else

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would also be serious if enacted at a time of existing inflation pressures too (although the imported content of US consumption is 10% and about 20% of imports are from China, and so this wouldn't be as inflationary as perhaps you might first think, especially given how adept companies are at redirecting supply chains and how much lobbying for exemptions will occur).

The real doozy, to borrow an American phrase, would be mooted proposals by some Trump loyalists to take away some of the Federal Reserve's (Fed's) independence. But any such proposal would face a long Congressional battle, and currently doesn't have the support of Trump's top economic advisor, Robert Lighthizer. We don't dismiss this grave risk to central bank independence, but it is likely to be a last resort if other policies intended to devalue the dollar and/or decrease the trade deficit fail.

Importantly, we think lingering US inflation stresses will continue to wane throughout 2024. Inflation was stronger than expected in March and April. However, the US Consumer Price Index didn't rise at all in May and non-housing services prices, which Fed officials are paying particularly close attention to, even fell slightly on the month. Admittedly, Fed policymakers will want to see the positive news in May continue over the coming months. But we think there are good reasons to believe this is likely to happen.

For one, US wages (a key input cost for service sector firms) are growing at a much slower pace than they were a year or so ago, and a number of metrics suggest that will continue. The rate of vacancies to workers has fallen back to where it was before the pandemic, as has the proportion of workers voluntarily leaving their jobs for new opportunities. Meanwhile, growth in salaries advertised via online job boards has also slowed to where it was before inflation took off. Elsewhere, some firms seem to be having a tougher time passing on any rise in costs to customers, as more households on lower and middle incomes are feeling the financial strain from higher interest rates.

Following the result of the UK election, we have published a special edition of our quarterly Investment Insights magazine, including an article with more on the US election, which you can find **here**. In the run-up to America's presidential election, we'll also be publishing a full report exploring the differences between the two parties' economic platforms in much more detail.

Amid the contrasting uncertainty surrounding the US versus the UK election, it's worth remembering that the outperformance of US equities over global peers that we've become accustomed to over the past decade or so is not a permanent state of affairs. We suspect it will come as a surprise to many that the UK equity market has delivered almost the same return as the US market over the three years to 14 June. In fact, over the three years to mid-June, the UK's FTSE 100 index has delivered double the return of the average company in the main US equity index, the S&P 500. For sure, we believe in making the most of a global opportunity set and America is abundant with opportunities, but investment flows have been coming back to the UK to take advantage of valuations that our analysis suggests are inexplicably cheap. As we've discussed previously, we believe UK equities warrant a higher allocation than the 4% or so in the global equity benchmark. When our fundamental analysis no longer suggests that, we will trim UK equities accordingly.

Investment Insights webinar

Rathbones' co-chief investment officer, Edward Smith and head of asset allocation, Oliver Jones discuss the key themes shaping the investment outlook and some of the principles of long-term investing through the lens of UK equities.

Watch here

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ASSET ALLOCATION

EQUITIES

UK

The risks to the future path of interest rates appear tilted to the downside in major economies including the UK. Despite some positive economic surprises in the past few months, the UK economy seems to be on a weaker footing than the US economy, with slower underlying growth.

UK equities are trading at a large valuation discount to their global (particularly US) peers (figure 1). This discount is much greater than justified by differences in sector composition, growth and quality characteristics. The size of the gap may be contributing to an increase in acquisitions of UK firms, which is positive for shareholders. That has helped momentum in the market to improve recently.

While UK inflation is slowing, overall wage growth isn't on such a clear downward trajectory in the UK as it is in the US. So we could see stubbornness in the services component of inflation for a few more months (figure 2).

Meanwhile, markets are likely to be relatively unmoved by a new Labour government, partly because they have had plenty of time to prepare. It could even be a positive catalyst, given the role that domestic political instability and uncertainty over relations with the EU may have played in the emergence of the UK equity discount since 2016.

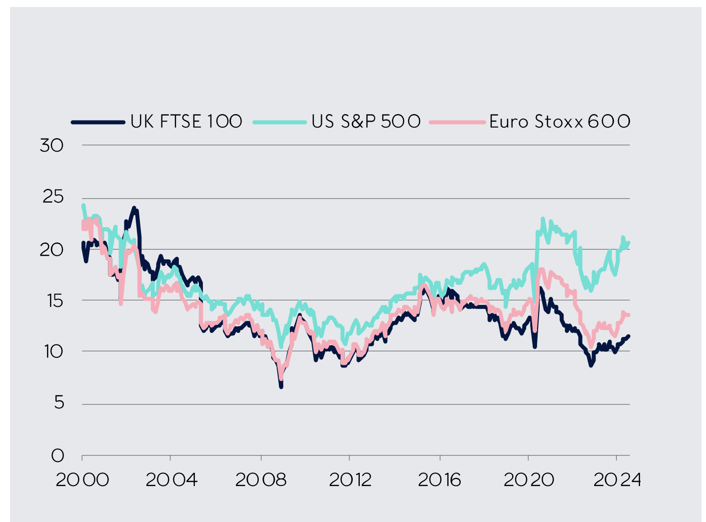

Figure 1

This chart shows 12-month forward price/earnings ratios for the major stock markets.

Source: LSEG, Rathbones, 31 March 2024

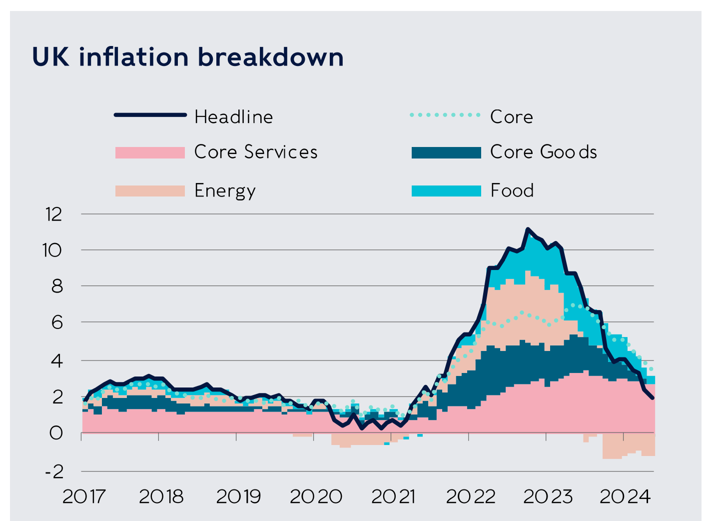

Figure 2

We could see stubbornness in the services component of UK inflation for a few more months.

Source: LSEG, Rathbones, 30 June 2024

Past performance is not a reliable indicator of future performance. The value of your investments and the income from them may go down as well as up, and you could get back less than you invested.

ASSET ALLOCATION

EQUITIES

Europe

The domestic economic backdrop in Europe is improving. Growth in the economy has been stronger than expected so far this year as the bloc emerges from last year's mild recession. Meanwhile, inflation has fallen back towards the ECB's 2% target, which has allowed the central bank to follow its peers in Canada, Sweden and Switzerland in cutting interest rates (figure 3).

Commercial banks in the euro area also plan to stop tightening their lending standards entirely. In the equity market, momentum has improved and has been better than the US this year if the impact of Nvidia is excluded. In contrast to the US, valuations do not appear stretched in Europe (figure 4), and earnings expectations are low.

However, earnings momentum is still relatively poor despite the improving economic backdrop and it has lagged other major markets. European equities are also more exposed than the US or UK to China, where there's still reason for concern about the economic outlook given the recent poor credit data. There is the possibility they could be hurt more than US equities if the US were to impose the 'universal tariff' proposed by the Trump campaign. Recent political developments in France are a threat too. The prospect of a new government keeping fiscal policy loose has hurt the country's bond and stock markets.

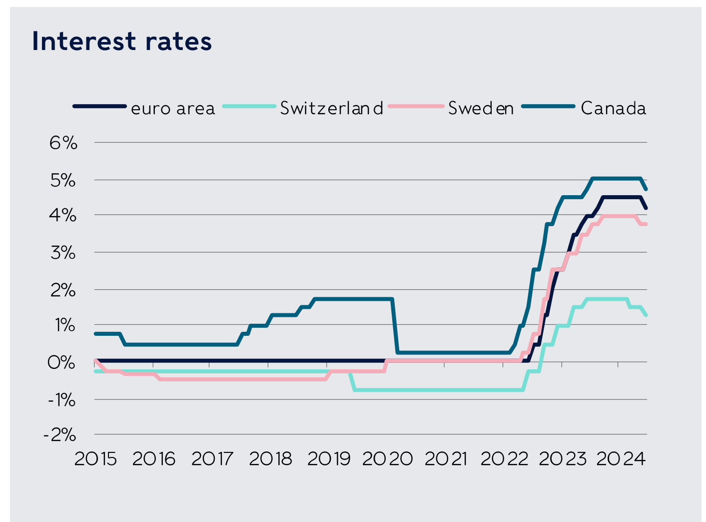

Figure 3

Some central banks have already started to cut their benchmark interest rates.

SSource: LSEG, Rathbones, 30 June 2024

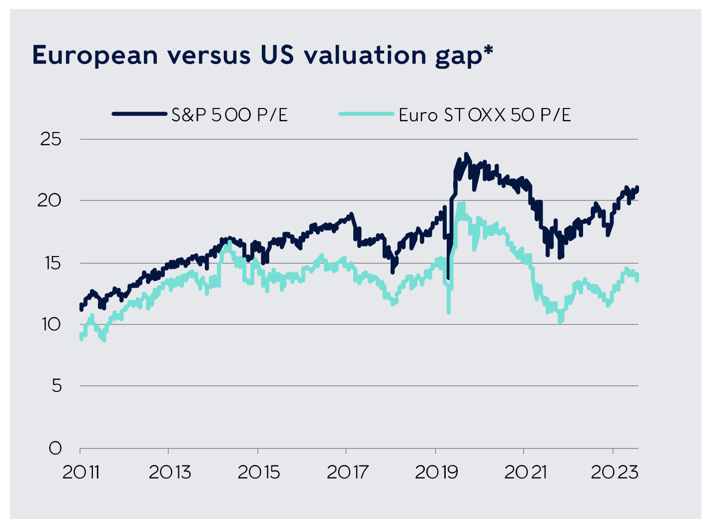

Figure 4

The valuation gap suggests European equities are cheap relative to US equities.

Source: Factset, Rathbones, 31 March 2023

*measured in terms of forward PEs, or prices relative to forecast earnings for the next 12 months

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HOLDINGS IN FOCUS

AstraZeneca

AstraZeneca is a global healthcare company, specialising in pharmaceuticals and biotechnology. The company is focused on delivering robust growth from its existing portfolio, as well as investing in its pipeline of medicines.

Share price performance has been strong this year, supported by the announcement of a 7% increase in its annual dividend in April, following consensus-beating earnings results.

AstraZeneca held an Investor Day in May in which it announced new long-term goals, with the 2030 revenue target of $80bn representing 8% annualised growth from 2023's $45.8bn, and well ahead of prevailing market expectations.

Given its solid earnings outlook, we believe that the stock is attractively priced and well positioned to add value over time.

National Grid

National Grid's share price weakened over the quarter on a surprise £7bn rights issue, in which existing shareholders were given the opportunity to buy new shares, at a discount, in the company. While there was some expectation of the potential for an equity issue to help finance future investment plans, the size and the timing were unexpected.

National Grid also announced a five-year outlook with cumulative capital expenditure of £60bn, double the level of the previous five years. The investment plans are motivated by the need to support the energy transition.

In addition to the rights issue, there was some disappointment related to the dividend which, although it has been maintained in absolute terms, is effectively rebased due to the rights issue. Despite this, the dividend yield remains higher than the market average at 5%.

With a crucial position in enabling the energy transition, coupled with robust earnings growth, we believe that the stock offers good value. As such, where possible, we participated in the rights issue for clients to maintain our exposure within portfolios.

Schroder Asian Total Return Fund

Schroder Asian Total Return is an Asia Pacific (ex-Japan) fund which aims to invest in around 40-60 high quality companies, seeking to provide capital growth over the long term, but doing so with an absolute return mindset. The large team of 'on-the-ground' analysts is a key differentiator compared with its peers, and this is complemented by the managers' ability to use tactical hedging strategies to provide a degree of downside protection, which can be extremely beneficial given the more volatile markets in which it invests.

The strategy is led by experienced portfolio managers King Fuei Lee & Robin Parbrook. They are primarily looking for companies that exhibit high returns on invested capital, which tend to be present in more growth-oriented business and therefore typically command a higher price, although valuation and the price paid is a consideration for the managers. The fund does not take large sector positions and instead seeks to deliver outperformance through successful stock selection.

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the portfolio, and no assumptions should be made that the securities identified and discussed were or will be profitable.

The team believe that there are a lot of opportunities for investors in Asian markets and that valuations of the stocks in their investment universe are attractive. They are currently underweight China and Hong Kong, believing that both are structurally unattractive and that, despite being home to some good companies, valuations are not as attractive as the headline suggests. Conversely, they are finding a number of opportunities in Korea and Taiwan, where they are able to find companies with strong intellectual property and high barriers to entry.

We have a strong focus on negotiating with fund managers to get access to the best possible share classes for our clients. With that in mind, we have recently negotiated access to a cheaper share class, resulting in a reduction of around 0.3% in the ongoing charge for this fund.

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for the portfolio, and no assumptions should be made that the securities identified and discussed were or will be profitable.

KEEPING YOU UPDATED

PLANNING FOR LATER LIFE

Thursday 12 September, 12.00pm – 1.00pm

As you go through retirement and into later life, you often move from having more free time to enjoy yourself doing what you love, to things slowing down, downsizing or relocating. Seeking help in the form of care is an important area to plan for financially, and this session will provide an overview of issues to be aware of. The webinar will be led by Paul Sayers, senior financial planner, who is an accredited member of the Society of Later Life Advisers.

REGISTER HERE

INVESTMENT INSIGHTS WEBINAR

Rathbones' co-chief investment officer, Edward Smith and head of asset allocation, Oliver Jones discuss the key themes shaping the investment outlook and some of the principles of long-term investing through the lens of UK equities. **Watch here**

GENERAL FINANCIAL AWARENESS COURSE

Understanding investments can be like learning a different language. At Rathbones, we believe in education to enhance your understanding of the wealth management environment. Once you understand your money, you are better equipped to make informed decisions. **Register here**

16-25 FINANCIAL AWARENESS COURSESS

Our financial awareness courses, delivered by Rathbones' investment managers, are designed to help young people take control of their finances, providing them with the knowledge and skills to build a secure financial future. **Register here**

RATHBONES INSPIRED MINDS

What does inspiration mean to you? Do you need it? Where does it come from?

To find out, we invited some truly inspired minds to join broadcaster, cricket commentator and classics buff Daniel Norcross, on the Rathbones Inspired Minds podcast. Daniel talks to acclaimed writers, scientists, thinkers and entrepreneurs and asks what inspired them to pursue their fields of expertise. Listen to historians Tom and James Holland, Peter Frankopan, former England cricketer Ebony Rainford-Brent, comedian Andy Zaltzman and many more inspired minds in our fascinating new podcast series. **Listen here**

ADDITIONAL INFORMATION

Rathbones Investment Management Limited

30 Gresham Street, London EC2V 7QN

020 7399 0399
ifaservices@rathbones.com
rathbones.com

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