RATHBONES

SELECT
CORE STRATEGIES
INVESTMENT UPDATE FOR CLIENTS OF RATHBONES FINANCIAL PLANNING

Q4 2024 REPORT

CONTENTS

KEY PERFORMANCE DRIVERS

SELECT OFFERS SIX CORE STRATEGIES AND FIVE GREENBANK STRATEGIES, EACH INVESTING EXCLUSIVELY IN ONE OF OUR IN-HOUSE FUNDS MANAGED BY RATHBONES ASSET MANAGEMENT. THE LATEST QUARTERLY UPDATE FOR EACH OF THE SELECT PORTFOLIO FUNDS IS NOW AVAILABLE IN THE DEDICATED MULTI ASSET PORTFOLIO SECTION OF THE RATHBONE ASSET MANAGEMENT WEBSITE, OR BY CLICKING HERE.

Government bonds

In contrast to the third quarter, government bonds held back our returns in the final quarter of the year as yields in the US, Europe and UK surged. While the US Federal Reserve (Fed) cut its benchmark interest rate as expected by a quarter of a percentage point to the range of 4.25-4.50% in December, investors felt a mood change. The Fed's rate-setting committee signalled it expects to make just over half a percentage point of cuts in 2025; in September, it thought it would make almost double that. If benchmark rates remain higher for longer, it reduces the value of bonds because their fixed returns become less attractive compared with cash in the bank that can be withdrawn at any time. In contrast to some other investors, we are comfortable buying a spread of US and European bonds at their current prices. We think they offer an attractive yield along with providing portfolio insurance should stock markets and economic growth falter.

Here in the UK, government bond yields rose markedly before and after the October Budget, partly in sympathy with US bonds and partly because investors took the announcements poorly. In particular, the government's decision to issue more gilts than expected sent prices lower (and therefore pushed yields higher). We think the risk of a British recession has risen, which makes bonds a more attractive prospect, especially given yields are back near multi-decade highs. We bought and sold throughout the quarter as yields fluctuated. Like US and European government bonds, they should offer portfolio protection if there's a material downturn.

Stock contributors

A number of our companies reported strong results during the quarter and rallied into the end of the year. These included e-commerce platform Shopify, American lender and investment bank Morgan Stanley, sales tool Salesforce, search giant Alphabet and e-commerce titan Amazon. It wasn't just American names either, with good performance coming from Japanese media and electronics creator Sony, computer chip manufacturer Taiwan Semiconductor Manufacturing Company, Singaporean bank DBS Group and London Stock Exchange.

A key detractor from our performance was US-listed cosmetics company Estée Lauder. Investors were already very negative on the company due to slowing Chinese economic growth (about a quarter of the business's sales are made there). Tepid results and cautious forecasts for 2025 sales drove a further sell-off. We think they – along with other names in our portfolio which have exposure to China – should benefit from a stabilisation in Chinese markets. While this may not be imminent, we now feel valuations have overly discounted this weakness. It's interesting to note that mainland-listed Chinese stocks posted the third-highest return of any major stock market in 2024 (behind the US and Japan) after a huge rally in the fourth quarter. So the locals are optimistic.

Diversifiers add value

Our Diversifiers did a useful job for us in the quarter. These are investments whose prices tend to move very differently to stock markets yet are less easily traded than government and very high-quality corporate bonds (what we call Liquidity assets). One of these Diversifiers is the Société Générale US Rates Volatility structured product, a contract with an investment bank that benefits from increased price movement in US government bond yields. This perfectly summed up the quarter: big moves in both directions (mostly up). This meant we made good returns on this investment.

MARKET HOT TOPICS (MACROECONOMIC)

Coming up Trump

Donald Trump's electoral win triggered a surge in American stocks, bonds and the currency as investors bought into the prospect for lower taxes, lessened regulation and a pro-growth agenda. This moderated somewhat in the final days of the year, likely because of people cashing in profits after another year of 25% gains in US stocks, but also as inflation concerns rose to the fore once again and government bond yields rebounded sharply.

There's a risk that Trump's touted policies (big tariffs on trade, big tax cuts for households and businesses, and a clampdown on both legal and illegal immigration) will send inflation higher. However, we think people are putting too much weight on these areas and ignoring his ambitions on slashing government spending. Trump often talks big at the outset, only to negotiate a compromise at the end. As such, some of the tariffs may be much smaller or not happen at all. Similarly, tax cuts may not be as large as some hope. But if he and "First Buddy" Elon Musk's Department of Government Efficiency manage to slash a significant amount of federal spending, the tax-cuts' net effect on inflation may be negligible.

We're particularly impressed with nomination of billionaire hedge fund CEO and one-time Democrat Scott Bessent as Treasury Secretary (the job currently held by former US Federal Reserve Chair Janet Yellen). He's eminently qualified for the top finance job and many investors see him as a restraining force for the administration, one that could smooth the sharp edges of other members. Bessent has spoken of a "3-3-3" strategy: halving the federal budget deficit to 3% of GDP by 2028, growing the economy by 3% a year through deregulation and privatisation, and increasing US oil production by 3 million barrels a day.

Hitting these targets could be a tough ask, but the strategy seems positive for the US economy: a focus on growth, tighter finances, less bureaucracy, more private enterprise and cheaper energy. We think US inflation is likely to remain in its current band: between 2% and 3%. Not quite low enough for the central bank to claim victory and not high enough to cause serious panic. Just constant low-level anxiety throughout the year. But that would leave room for the Fed to cut rates.

We think this sort of situation should allow a broadening of American stock market performance beyond the handful of massive technology companies at the top of the index. Solid economic growth, steadily falling rates and a reduction in regulation should boost smaller US companies as well.

Bond yields

Right now, however, bond investors around the world are definitely rattled. After a short-lived and aggressive drop for most major government bond yields in November, a swift reversal sent prices lower and yields rocketing again. The concerns appear to centre on the spendthrift ways of most advanced nation governments, but particularly the US, which is the bellwether bond market. The rampant American economy, which continues to outdo forecasts, and stickier inflation of late, also haven't been good for bondholders' nerves.

The US and UK 10-year yields were 4.6% by the end of the year, up roughly a full percentage point from their recent lows. Even Germany, which shares none of its peers' fiscal imprudence, has suffered a substantial rise in its bond yields.

The big question for 2025 is the same as it was in 2024: how much will central banks be able to cut interest rates in the face of strong economic growth in the US and stubborn inflation virtually everywhere? As 2025 dawns, the prevailing answer is just one quarter-percentage-point reduction by July – if that.

As Trump's inauguration has approached, hopes have steadily faded for cuts to the Fed's overnight interest rate. One thing to note is that this isn't a new thing: yields were very volatile for all of 2024 as expectations for rate cuts ebbed and flowed. They surged higher in the first half of the year on concerns that the Fed's rate-cut plans would be upended by strong economic growth and rising inflation. They then sunk back significantly when the panic subsided. Sound familiar?

Indexes are unmanaged, and it is not possible to invest directly in an index.

MARKET HOT TOPICS (MACROECONOMIC)

British exceptionalism

The UK wasn't the only country to suffer a bond market sell-off in the past few months, but it was by far the hardest hit. Very long-dated 30-year government bonds jumped to heights not seen since the 1990s. The increased borrowing costs across all maturities may have vaporised the headroom between what the government expects to receive in taxes and how much it will spend. Yield spikes have caused angst about UK government finances several times over the past five years, only for the problem to melt away when panic and yields subsided.

If US central bank interest rates fall back, as most investors expect, then you would expect UK yields to recede with them. Let's hope the same happens this time as well. If not, greater borrowing costs may force the government to tighten policy to meet its fiscal rules. It's got until 26 March when the Office for Budget Responsibility gives its verdict on the rules – bond yields could easily move another half of a percentage point (in either direction!) between now and then.

Yet that's only one of Britain's pressing concerns: the other is a distinct lack of GDP growth. The economy has ebbed relentlessly since Labour took power, hitting 0% in the third quarter. We had been concerned about the increasing chance of a UK recession for some time and now it seems the chorus is growing broader. The major risk, as we see it, is stagnant economic growth and above target inflation and high unemployment. Some may call that stagflation. Inflation climbed back up to 2.6% in November as housing costs, utility bills and prices for package holidays, cinema tickets and pets all rose. The December figure, released after year-end, eased to 2.5%. Most helpful, however, was that it showed a big drop in services inflation – essentially anything that isn't a physical product. Persistently between 5% and 6%, the problem child is now closer to 4% than it is to 5%. If that trend continues it will help dampen those UK stagflation fears.

If inflation does remain above target despite an economic contraction, it would make it extremely difficult for the Bank of England to cut interest rates in support of the economy, because that would worsen inflation. It would also send government bond prices lower (so yields higher) because higher inflation would mean investors demanding a greater return to offset that reduction in the value of their coupons. This would make it even harder for the already cash-strapped government to boost the ailing economy too.

INVESTMENT OUTLOOK

This information reflects our general views and should not be taken as a recommendation or advice as to how any specific market is likely to perform.

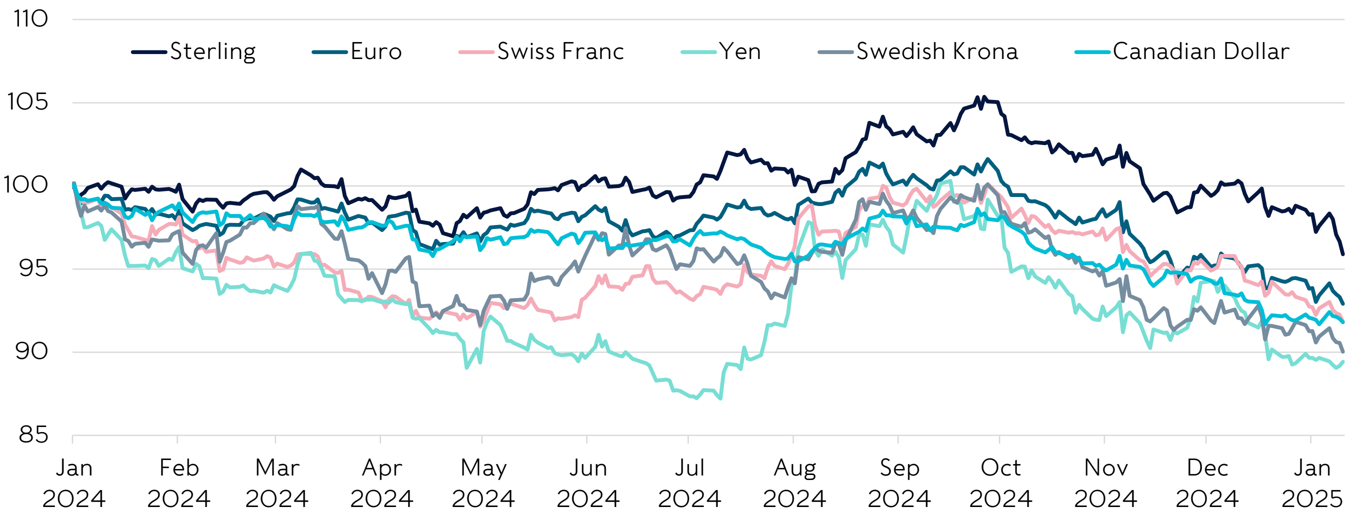
The US economy is steaming ahead and this seems likely to continue into 2025, although it may start to cool as the year wears on. The big question is whether inflation will remain low enough for the US central bank to cut its benchmark overnight interest rate by the half percentage point or so that investors want to see by the end of the year (which would take it to 4.0%).

As for everywhere else, the economic situation is far from rosy. This divergence in economic strength has already led to big shifts in currencies: a strong dollar versus virtually all other currencies. One outlier in 2024 was the pound, which actually held its own as investors became sceptical about the Bank of England's ability to cut rates as much as it suggested (see chart). But that strength unravelled quickly in the final quarter and continued in the early days of 2025, as sterling fell along with other big, advanced currencies. Will this dollar strength continue?

The dollar should remain strong if investors continue to assume that US interest rates will stay higher and fall more slowly than other major countries. That's because money tends to flow to places where the rate of return is highest for a given risk. At the moment, the US has a high risk-free rate and the strongest economy with the most opportunities for profits. That attracts cash from around the world, meaning people sell euros, pesos and pounds to buy dollars so they can get in on the action.

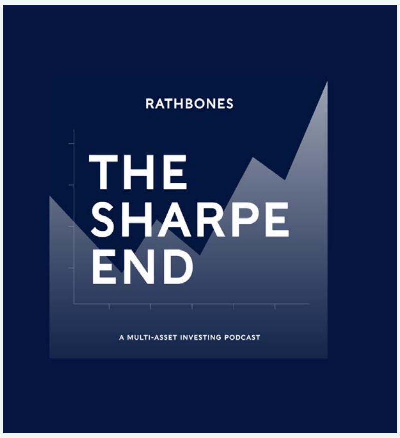
For the US, the big risk is that resurgent inflation and an economy that keeps growing at a pace that could be unsustainably fast prevents the Fed from cutting rates at all. Or, even worse, pushes the Fed to resume increasing rates. That would likely send the prices of bonds and stocks alike slumping – and not just in America – as investors decide that it's better to sell assets and keep their money in cash. But we are confident that inflation will remain in check without the Fed needing to step in with rate hikes.

STERLING HELD ITS OWN AGAINST THE DOLLAR IN 2024, UNLIKE ITS PEERS
G-10 currencies against the US dollar



Source: FactSet; currencies' exchange rates against the US dollar, indexed to 100 at 31 Dec 2023, data to 10 Jan 2025

KEEPING YOU UPDATED



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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**

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