



Bespoke portfolio update for clients of Saunderson House

Q4 2023 Report

RATHBONES

ASSET ALLOCATION – FIXED INTEREST

Government bonds

The inflation outlook has improved considerably since the last quarter. There is lots of evidence of further disinflation in the pipeline in the UK, where growth in producer food and goods prices has collapsed, and services price pressures have started to weaken as the labour market has begun to soften. Risk of a spike in oil prices remains amid Russia's war with Ukraine and the possibility of the Israel-Hamas war becoming a wider conflict in the Middle East.

Major central banks, including the Bank of England, have probably finished raising rates, and rate cuts could occur in the months ahead as growth and inflation slow. Historically, longer-dated government bonds have begun to outperform shorter-dated bonds in the three months before rate cuts happen (figure 1). Attractive yields also underpin the outlook for returns from longer-dated bonds in 2024.

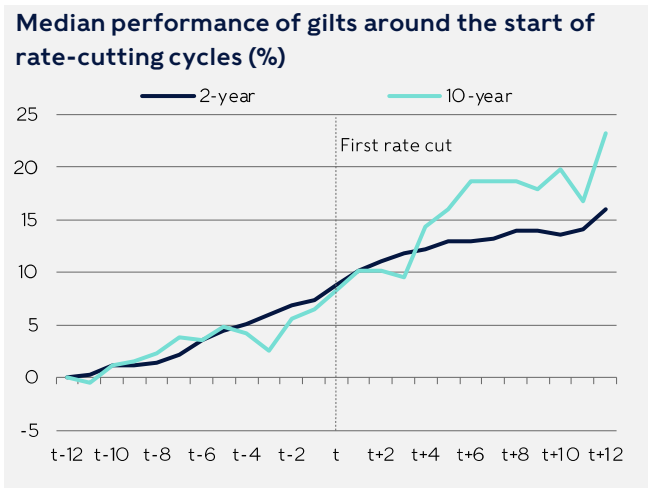


Figure 1
This chart shows the performance of 2- and 10-year UK government bonds around the start of rate-cutting cycles.

Source: Refinitiv, Rathbones

Corporate bonds

Investment grade (higher quality) corporate bonds should be less sensitive than equities to earnings downgrades since they are higher up the capital structure (higher in the queue to get their money back in the event of losses). The yields of investment grade corporate bonds are also far higher now than they were on average during the 2010s, and more attractive relative to equities.

However, the additional yield from corporate bonds compared to safer government bonds has narrowed recently (figure 2). In the US, this extra yield is now low by past standards, and around the middle of the UK range since 2010, despite the significant risk of recession.

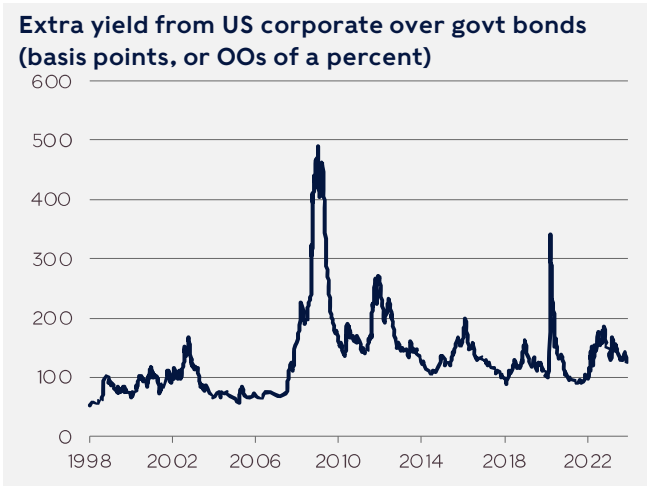


Figure 2
The extra yield from US investment-grade corporate bonds compared to safer government bonds has narrowed recently and is fairly low by past standards.

Source: Refinitiv, Rathbones



ASSET ALLOCATION – UK EQUITIES

UK Equities

Although FTSE mid- and small-cap UK equities performed strongly in the past month (figure 3), we still prefer the larger, multinational companies of the FTSE 100. This stance reflects concerns about weakness in the UK economy, to which smaller companies are more exposed. FTSE 100 firms collectively earn only about 20% of their revenues in the UK, compared with almost double that number for the mid-cap FTSE 250.

The UK economy flatlined in the third quarter of 2023, and leading indicators point to a contraction in output. One reason the UK economy has struggled more than the US is that higher interest rates have been passed on to mortgages faster. Well over one million more households will face higher mortgage rates in 2024, which will be a further drag on consumer spending.

We also believe the defensive sectoral composition of the FTSE 100 index is attractive in the current economic environment, reflecting our preference for defensive sectors across the board as the global economy slows.

What’s more, we also think that over the longer term, UK equities could be poised to do better than their counterparts elsewhere. Valuations look particularly cheap in the UK both compared to their own history, and equities in Europe and the US (figure 4). And this gap with the US in particular persists even after adjusting for sectoral composition. While valuations are a poor tool for timing short-term performance, they do tend to tell us something about likely returns over longer horizons.

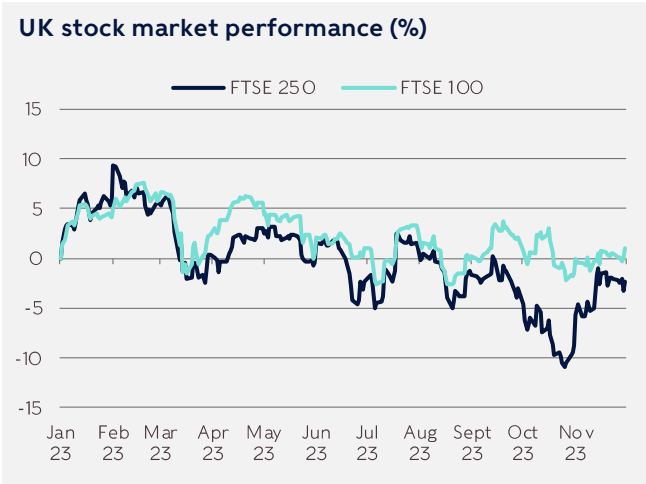


Figure 3
The FTSE 250 has made up a lot of ground on the FTSE 100 recently.
Source: Refinitiv, Rathbones; as of 15 December 2023

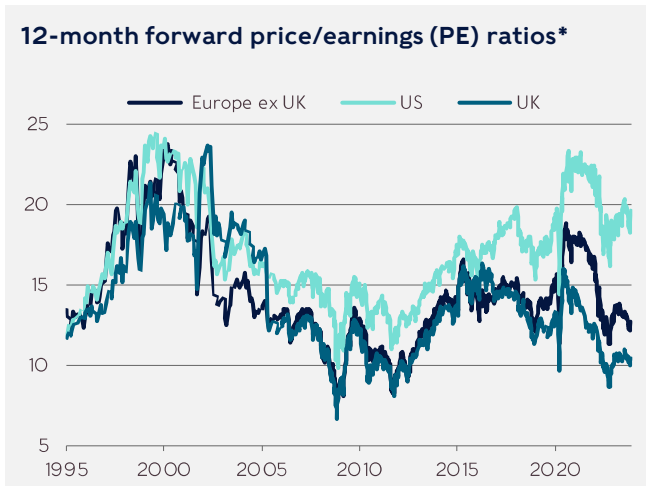


Figure 4
UK equities look cheaper than those in the US and Europe. *The chart shows prices relative to forecasted (forward) earnings (PE ratios).
Source: Refinitiv, Rathbones



HOLDINGS IN FOCUS

ASML

ASML is the world leader in the manufacture of lithography equipment, used to create semiconductors, with an 80% market share. It has 90% market share in the highest specification segment of the market, Extreme Ultraviolet Light equipment, which is used to make the fastest and most powerful computer chips, and it is the sole manufacturer of the next generation of equipment called High-NA (Numerical Aperture). Demand for its equipment is driven by increasing penetration of computer chips in devices, smartphones and cars, as well as the growth of megatrend applications such as automation, data analytics, cloud services, Internet of Things and artificial intelligence.

The semiconductor industry experiences cyclicity relating to inventory levels, and is currently going through a period of de-stocking and therefore lower than average demand which will continue in 2024.

While ASML is not immune from this, it is somewhat sheltered by the fact that it has a long order backlog (€40bn at the end of 2022, equivalent to nearly twice the 2022 level of annual sales). In addition, geopolitical tensions between the West and China have led to growth in requirements for localised semiconductor production in the US and Europe, which we believe is likely to lead to incremental demand for ASML's lithographic equipment. Given long lead times, this may lead to order intake turning up in 2024 to supply equipment that is needed in 2025 and 2026.

In a cyclical industry with large and lumpy orders there is risk around the near-term earnings outlook, but we like ASML over the long term, given its multiple structural drivers of demand growth and its commanding technology leadership position.

Berkshire Hathaway

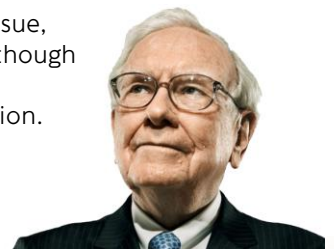
Investment conglomerate Berkshire Hathaway's vice chairman Charlie Munger passed away in November at the age of 99. The company issued a short press release in which Warren Buffett said that "Berkshire Hathaway could not have been built to its present status without Charlie's inspiration, wisdom and participation". This will clearly be a loss for Berkshire and for Warren Buffett given Charlie Munger had been his right-hand man and confidante for the last 45 years. Buffett credited Munger for encouraging him to shift towards a more quality approach – away from buying 'fair businesses at wonderful prices' and towards buying 'wonderful businesses at fair prices'.

While Warren Buffett and Charlie Munger have not had any involvement in running or managing the businesses within Berkshire, they have been responsible for investment decisions and capital allocation across their holdings. That said, Greg Abel, currently head of the non-insurance businesses, was named as Warren Buffett's successor a few years ago, so a succession plan is in place, while there are also a number of other experienced lieutenants in the business including Ajit Jain who runs the insurance businesses and Todd Combs and Ted Weschler who help Warren Buffett manage the company's equity investments.

In the short-term there is unlikely to be any change to the investment case and Munger's shareholding is worth c. \$2.4bn so only c. 0.3% of the company's shares outstanding, meaning there is not a share overhang. However, it could be that Warren Buffett considers stepping aside now that his friend and confidante is no longer around, and given that he is 93 years old himself. We could also see renewed speculation around the longer-term prospects for the business and its direction once Mr Buffett is no longer in charge. In the past it has been speculated that the business could potentially be broken up from its conglomerate structure, although this has been refuted by the company.

We continue to like Berkshire Hathaway as a well-managed and diversified investment in corporate America, with disciplined capital allocation and a strong focus on shareholders' long-term interests.

Its lack of focus on ESG is an issue, for which we rate it Lagging, though it remains a major investor in Renewable electricity generation.



Eastspring Japan Dynamic Equity Fund

Eastspring Japan Dynamic Equity fund invests in Japanese companies, both large and small considered to offering attractive valuations to shareholders. The funds investments are actively rebalanced based on a range of value factors such as Dividend Yield, Price-to-Book and Price-to-Earnings. Factors are analysed on an absolute and relative basis over multiple time periods. Further analysis is also carried out on sentiment and deep qualitative factors to find mispricing at the sub-industry level.

The fund remains overweight in its exposure to Financials and Autos stocks, though less so than the

beginning of 2023. The management have adhered to the value principles and continued to take profit in such areas. One of the key trims was the strong performing, credit card issuer Credit Saison for example. As per their disciplined portfolio construction process, the managers have rotated capital towards names with higher upside to their intrinsic valuation share price targets.

We continue to have conviction in the strategy owing to the managers experience and focus on bottom-up fundamental analysis. We feel the strategy components compliment other quality-growth funds for longer-term balanced allocations to Japan.

QUARTERLY INVESTMENT UPDATE

READY, SET, GO INTO THE NEW YEAR
Q1 2024

The fits and starts may not be over, but we're looking forward to a more sustainable recovery beginning in 2024.

Investors have much to cheer as we near the year's end. Following a terrible October, in which most of the year's gains were eradicated, global equities have rallied strongly. Returns through the year have been unusually concentrated, with the majority of companies underperforming the benchmark, but large technology leaders doing well.

We've been cautious through 2023, and remain so, but can look ahead to 2024 with a more confident hope. A fundamentally weak profit environment may challenge all but the highest-quality companies in the first half of 2024, and another one or two large dips wouldn't be surprising. However, the outlook for inflation – a huge source of uncertainty for investors last year – is much improved, especially outside of the US. With many market segments offering very attractively priced opportunities, there's much to look forward to.

Where have we come from?

This time last year we said that what happens in 2023 would be determined by the answer to two questions: will the world's major economies fall into recession? And how far will central banks continue to raise rates? That second question was, of course, conditional on a third, how quickly will inflation recede? Before looking ahead to 2024 and beyond, let's take stock of 2023.

Last January, interest rate futures were pricing in rate cuts for 2023, quite substantial ones in the US. We expected inflation pressures to recede enough to bring a halt to both US and UK rate hikes, but our research suggested that rate cuts were unlikely to come that soon, and we thought that the market was too optimistic about the path of inflation. That kept us cautious on bonds, and we saw particular risk for longer-dated debt, which is more sensitive to changes in interest rate expectations. As the year went on, the market came around to our way of thinking. As those rate cuts were priced out, bond yields soared: 10-year UK government bonds (gilts) peaked just shy of 4.7% in August; 10-year US Treasuries peaked just shy of 5% in October.

By September we had a more constructive view on longer-dated government bonds, particularly east of the Atlantic, and indeed bond markets have rallied strongly as they look ahead to rate cuts in 2024 following a plunge in key measures of inflation in the UK and Eurozone.

The three-month rate of change of both headline and service sector prices (usually a stickier category of prices) has turned negative in both regions – i.e. deflation. While we had flagged more heightened risks in the UK, weak demand has brought inflation tumbling down and concerns that inflation may linger at higher levels are now greater for the US.

Resilience underestimated

While we got those second and third deterministic questions correct, we were incorrect about economic growth. This time last year, the consensus forecast was for a developed-market recession to start in 2023, and we were part of that consensus. By the middle of the year the consensus had split, and many market participants now think that a recession will be avoided next year too.

With hindsight, we underestimated the potential for economic resilience in 2023, and we could have advocated taking more risk. We issued our *mea culpa* in August. We care about recessions because they are invariably accompanied by sizeable equity market falls. It is popular to dismiss economic cycles as irrelevant for market outcomes. At a national level this is often correct – a nation's GDP is often very different to the profits made by its companies who make many sales overseas. But at a global level – and we are global investors – this is completely wrong. There is a very strong correlation between global GDP and global profits.

And in 2023 global profits stagnated, alongside European economies, contracting global trade, and a significant slowdown in China. The US was an outlier among the largest economies, but even there profits weakened. With real interest rates (interest rates minus inflation) rising to a 14-year high, equity markets were largely driven by sentiment. Trying to time every ebb and flow of investor sentiment is not our business and we're sceptical of anyone's ability to do so consistently.

Instead, we set a strategic asset allocation, find companies that we can believe in over the long-term, preferably aligned to the *major* themes of a changing world, and tactically tilt towards or away from certain risk factors in response to the major turning points of the economic cycle – that's when the dispersion of returns both within and across asset classes are at their widest, presenting the greatest opportunities for active investors.

Where are we going from here?

The various goldilocks scenarios, to which many investors subscribe, could be summed up as “it’s different this time.” For sure, we only have eleven US business cycles to analyse since the Second World War, and even if we multiply that by building a panel of other region’s business cycles, our dataset is not that much richer because of the degree of interconnection between Western countries’ cycles. Statistically, it is important to acknowledge that it *could* be different this time and that’s why our investment committees consider the probabilities of a range of scenarios.

But the aggressive rise in interest rates, tighter bank lending conditions, falling real sales and profit growth, an inverted yield curve (yields for longer-dated bonds being lower than shorter dated ones due to expectations of weaker future growth), contracting money supply and rising unemployment have almost invariably signalled a recession in the past. When they are *all* flashing at the same time, it is bold to say definitively that they can be ignored. So-called ‘soft landings’ – whereby central banks calm inflation without derailing economic growth and corporate profits – have never occurred when all of these gauges are flashing warning signs.

Of course, much like the effects of monetary policy, the lags between these warning signals and the start of a downturn are long and variable. US recessions have tended to arrive 18-27 months after the first Federal Reserve (Fed) rate hike. That covers most of 2024. Similarly, recessions tend to arrive 14-24 months following the inversion of the yield curve (bond investors demanding more compensation for short term debt than long-term debt). That too covers most of 2024. We could go on.

Tighter financing is already weighing on businesses. Company bankruptcy filings are on the rise (they’ve never been higher since data began in 1996, outside of the global financial crisis period). It isn’t surprising that business investment intentions are on the floor and spending on equipment is contracting year over year, even in the US, with borrowing costs for companies having surpassed revenue growth. This is particularly true when you strip out the supercharged profits of the so-called Magnificent Seven (watch out for the lead article on these tech titans in our next Investment Insights publication in early January). Firms’ interest expense is also likely to grow in 2024 and 2025, with lots of debt maturing that was taken out at ultra-low rates during the pandemic.

America’s CHIPS and Inflation Reduction Acts, focussed on microelectronics and the green transition respectively, may have provided some offsetting support to investment in manufacturing facilities, but this has been small compared to the overall size of US investment. And there are growing anecdotal reports of associated projects, especially in the renewable energy

sector, now being delayed or renegotiated due to higher interest rates. Moreover, fiscal policy, burdened with high government borrowing expenses, is likely to shave some 0.6 percentage points off headline US real GDP growth, according to a Brookings Institution measure, in stark contrast to 2023.

Recessionary foreshocks are often felt first among smaller companies, which collectively employ half the US workforce and the most people per unit of sales. In the latest survey by the NFIB small business association, the proportion of smaller companies with shrinking revenues in the prior three months outweighed those enjoying gains by 17 percentage points. This level of deterioration has only been exceeded twice in the survey’s 49-year history: during the financial crisis and COVID. The forward-looking gauge of sales expectations in this survey is similarly poor.

Household spending has stagnated across much of Europe, but it still strong in the US. It is certainly possible that US households continue to spend next year. Investment spending tends to be the key swing factor for business cycles, and it tends to correlate with corporate profits. In five of the 11 US recessions since the Second World War, household consumption didn’t contract at all.

Tying it all together, the long leading indicators, such as the yield curve, change in rates, or bank lending conditions have continued to signal recession. Some of the shorter-term indicators such as housebuilder confidence or business surveys have stabilised, though at levels consistent with stagnation, if not recession, while some indicators are dropping significantly again.

Investing in 2024

On many measures 2023 was the narrowest year in equity markets since the late 1980s, as far back as we have records for, with returns concentrated in the hands of a few tech titans. One of those measures is the proportion of companies in the S&P 500 rising by more than the US equity index. It’s around 25%. Until this year the low was just under 35% during the dot com bubble. In Europe, there’s been more breadth, and the largest 10 stocks have actually underperformed. But, like 2022, leadership has still been very concentrated, and it is also the narrowest two years in Europe apart from the late 1990s dot com era.

While the economic environment is weak, we expect leadership to continue to be narrow, with large companies that have a track record of sector-beating profitability and plenty of cash to cover their interest payments likely to do well. These factors have been outperforming since the summer in all geographies except the UK. In the UK, sector laggards have outperformed their stronger peers, something that is highly unusual and not something we expect to continue.

On their own, valuations are a terrible market timing tool – when something is cheap it tells you nothing about the likelihood of it getting cheaper over the next year. But there is a strong link between valuations and longer-term returns, and as long-term investors we are looking at the valuations in many areas of the market with great excitement, particularly among smaller and mid-market companies. In a forthcoming article in *Investment Insights* we'll set out some of the more cyclical and higher beta investments (i.e. investments that tend to rise by more than the broader market when the broader market is going up and vice versa) that are on our buy lists ready for when the economic environment becomes a little more certain and these factors tend to do well. Inflation uncertainty is much reduced, which brings us much closer to that point compared to last year. We just need a surer outlook for corporate profits.

UK equities: cheap for a reason, or good value?

Long gone are the days when UK equities made up the majority of the average UK wealth management portfolio. We firmly believe that a global mindset is important for delivering superior risk-adjusted returns. In 2022 the UK equity market had its best year relative to the global benchmark since the early 1990s, but the FTSE 100 has underperformed for most of the last ten years. Some commentators suggest UK equities should be ignored entirely. There are certainly some stocks that deserve to be cast aside. But is that right for the market as a whole?

When the gap between the valuations of UK relative to global equities (which is wider on some measures than it has been since the 1970s) is mentioned, we often hear the rejoinder that the UK market deserves to trade at a significant discount, because it is weighted towards old-economy sectors and has fewer fast-growing and high-quality firms than the US. There's certainly an element of truth to that view. The UK clearly has no direct equivalent to the US tech giants. But what it doesn't tell us is how much of the valuation gap is due to the composition of the UK market, and how much (if any) is a genuine discount. Or in other words, cheap for a reason or good value.

Using regression analysis allows us to control for all kinds of relevant characteristics which can affect valuations. Doing so means we can account for differences in composition between markets, helping us compare valuations on an apples-to-apples basis. We've done just that, using a universe of more than 1,000 global stocks (of which 140 are listed in the UK).

In this universe, the price/earnings ratio of the average UK stock is 32% lower than that of the average US stock (and 16% lower than the average stock listed elsewhere in Europe). If we control for sectoral composition, the gap narrows only marginally – to 28% versus the US – meaning UK stocks trade at a discount to their US counterparts within the same sector. When we also

control for various other factors (including sales growth, profitability and balance sheet strength), the gap once more remains large, at about 22%. Essentially, this means that firms in the same sector with identical growth and quality characteristics trade at a lower multiple if they're listed in the UK rather than the US. That's very hard to justify.

The UK discount emerged after the 2016 Brexit referendum. There's no evidence of any gap whatsoever when we repeat the exercise with 2015 data. The vote to leave the EU arguably increased the uncertainty around the UK's long-term economic outlook. However, even if you're very pessimistic about the economic consequences of Brexit, the discount described above still doesn't look logical. UK-listed firms trade at a discount regardless of whether they generate much revenue in the UK. We found that multinationals face the same discount as purely domestic plays. Again, that doesn't really make sense, suggesting that an investment opportunity exists. There's little reason for high quality global firms to have been penalised just because they are UK-listed.

A year of elections, and opportunity

One risk that we expect will get over exaggerated next year is the general election. Indeed, more than half of the world's population is set to go to the ballot box in 76 elections around the world in 2024, which will make it the biggest election year in history according to *The Economist*.

Our analysis suggests that elections rarely change pre-existing market trends, which are typically determined by factors outside of a government's direct control, unless they bring in a radically different economic model, which is not something we see happening in major economies next year. In other words, we shouldn't lose sight of the bigger picture. We'll have much more to say as elections approach and we learn more about policy plans, and we make a few preliminary observations in another forthcoming article in *Investment Insights*.

To sum up, after taking a sober look at the challenges that still lie ahead, we believe investors do have good reasons to ring in the New Year with a toast to the opportunities it will bring.

End of year videos

Co-CIO Edward Smith's end of year videos are now live on our website:

[2023 – A year in review](#)

[Looking ahead to 2024](#)

KEEPING YOU UPDATED



Investment Insights – The Magnificent Seven

Our latest **Insights** publication starts the year with a look at the incredible concentration of returns in the 'Magnificent Seven' US tech giants, and what their influence might be like over the coming year. Topics covered in this quarter's edition include:

1. Will the tech superheroes ride to the rescue in 2024?
2. Bonds should benefit from the new 'higher-for-longer' rate regime
3. Why markets may be unmoved by a busy year for elections
4. Planning ahead for when economic recovery becomes more certain
5. How the transition to clean energy depends on market reforms

Investment Insight Webinars – 2024 Series

The Investment Insights webinars will be held from 12:00 – 12:30 on the following dates:
16 January / 16 April / 2 July / 8 October

You can register for the January Webinar using the following link

[Register here](#)

If you would like more information or if you haven't received an invitation to the Investment Insight webinars from us already, please do let your adviser or a member of your investment team know.

Financial awareness course for young people

3 April 2024 – 6.00pm – 7.30pm - Virtual event

[Register here](#)

8 August 2024 – 6.00pm – 7.30pm - Virtual event

[Register here](#)

17 December 2024 – 6.00pm – 7.30pm - Virtual event

[Register here](#)

Financial awareness course for women

to enquire about future dates please email [Sharon Ryan](#).

Financial awareness course for all adults

to enquire about future dates please email [Sharon Ryan](#).



Rathbones Inspired Minds

We are delighted to announce our brand new podcast series, **Rathbones Inspired Minds**, which will launch in January 2024.

The Rathbones Inspired Minds podcast series, hosted by Daniel Norcross, features acclaimed writers, scientists, entrepreneurs and thinkers talking about what inspired them to follow their chosen careers and what continues to inspire them in their lives.



Rathbones Investment Management Limited

8 Finsbury Circus, London EC2M 7AZ

020 7399 0399 | ifaservices@rathbones.com | rathbones.com

Management of strategies is provided by Rathbones Investment Management. Funds are managed by Rathbone Unit Trust Management Limited.

Rathbones Investment Management is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

Registered office: Port of Liverpool Building, Pier Head, Liverpool L3 1NW, Registered in England No. 01448919.

Rathbone Unit Trust Management is authorised and regulated by the Financial Conduct Authority and is a member of the Investment Association and a member of the Rathbones Group. Registered no. 0236568.

Basis of use: You should not rely on this information in making an investment decision and it does not constitute a recommendation or advice of a specific investment or class of investments. The information does not indicate a promise, forecast or illustration of future ratings. The information has been provided independently to Rathbones by the listed third party providers.

RATHBONES