



**UPDATE FOR CLIENTS OF
RATHBONES FINANCIAL PLANNING
Q3 2024 REPORT**

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QUARTERLY INVESTMENT UPDATE

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 DESCENT OF MONETARY POLICY

Subsiding inflation has allowed interest rates to fall – but are bond markets factoring in too much?

We've seen a significant development since our last quarterly update: the UK and US central banks have both started to cut interest rates. We anticipated this, as did many other market participants: **in July we presented five key pieces of evidence** to suggest a US rate cut was highly likely in August or September. The stage is set for rates to keep falling in the fourth quarter and beyond, but there's still much uncertainty about how fast and ultimately how far. In the US in particular, expectations of substantial further cuts all the way through 2025 may now be excessive.

The US Federal Reserve (Fed) didn't move in August, but it did cut rates by 0.5% in September, more than the more common 0.25% rate of change – a double cut, if you like. The commentariat tends to overemphasise the implication of each decision at each individual meeting of its rate-cutting committee; longer-term investors like us are much more interested in the path of interest rates over the next year or more. We don't think this outsized cut was the starting gun for an accelerated cutting cycle. We find evidence for this view in the combined projections of the future Fed rate by the committee's members. We can also cite the statements made by Fed Chair Jay Powell following the September meeting.

To some extent the Fed was playing catch up in September. The Bank of England (BoE) has already cut once, the European Central Bank and various northern European central banks twice, the Bank of Canada three times. Moreover, looking at the Fed's 10 interest rate cycles since the 1970s, there was an average of five months between the last rate increase and the first cut. This time it was 14. In other words, the Fed has kept rates at the peak longer

than it usually does. It did this because of the grave consequences of assuming that inflation was tamed from such high levels before it actually was.

Employment: the new focus

Increasing confidence in more stable prices ahead means that the Fed can now focus on jobs – it has a dual mandate to pursue both stable prices and maximum employment. The double-strength cut alters its focus decisively onto employment.

In the US, price stability and full employment are given equal importance over the long-term; however, in the UK a strong economy is an objective of the central bank, but subordinate to price stability. The Bank of England cut rates by 0.25% in August but held them steady in September. While we expect another quarter-point cut in November, the BoE is right to proceed more cautiously. At 3.6% in August, UK core inflation is much higher than the US's 2.6% (using the Fed's preferred measure). In the UK services inflation, which can be hard to suppress once it's taken hold, popped back up to 5.6% in August, well above its long-run average of 3.5%. A shorter-run measure of core services, which strips out more volatile components, rose back to 5.3%, in contrast with an easing to 2.5% in the US.

The labour market also remains tighter in the UK than in the US, as far as we can judge, though the quality of the labour market data has deteriorated significantly – the Office for National Statistics needs to hurry up and fix that problem. Meanwhile, the BoE is putting more emphasis on the surveys conducted by its agents. These point to a retreat from high wage growth to something approaching normality. This makes us confident that UK rate cuts will resume, though at a relatively slow tempo for now.

Past performance is not a reliable indicator of future performance.

Over time, we expect interest rates in the UK and the US to settle at around 3-4%, still some way below the current rates of 5% and 4.75 to 5% respectively. As late as July, we said markets were likely underestimating the pace of rate cuts over the following year. For that reason, we tactically preferred bonds with longer duration – those whose price rises more than shorter-duration bonds when interest rates fall. However, markets have since priced in an extra 0.5% of UK rate cuts between now and July 2025, while in the US they have priced in an extra 1%.

The UK repricing matches our assessment of the balance of risks. Uncertainties about government spending, higher minimum wages and the effect of public sector pay rises on inflation do warrant caution.

But the US repricing is arguably an overreaction – something bond markets have been prone to in both directions over the last two years, as we've pointed out repeatedly. Market interest rate expectations are at odds with those of the Fed rate-setting committee. They're also at variance with commonly used rules of thumb for monetary policy rules that trade off damping inflation and maintaining a strong economy. These ready reckoners have been good guides to Fed policy in the past. We therefore no longer advocate overweighting those more rate-sensitive bonds.

Interest rates could fall further than we expect if there's a deflationary recession. We discussed weaker job growth in our last video, and the risk of this has grown. That said, we still think there's a 70% chance that the US economy will keep growing. That's a slight downward revision from the 75% probability we estimated three months ago because some – though by no means all – indicators of labour market health have weakened.

Some analysts dismiss the rising unemployment rate as simply down to higher supply (particularly because of surging immigration). They argue that it shouldn't be read as the end of demand growth and the prelude to recession. These analyses can cite low initial jobless claims. But on the other hand, some labour market gauges that are affected little by changes in supply have also weakened,

suggesting faltering demand for workers. These include a rise in the native-born unemployment rate and a significant increase in 'job losers' in the unemployment numbers. Moreover, business bankruptcies are up 200% to their highest level in a decade.

None of these statistics are sending clear signals of recession, and consumer spending remains robust. Meanwhile, corporate profit growth remains fine, even if we strip out the earnings of the technology giants. But we're in the 'late cycle stage', a time when equity markets tend to produce positive returns but with increased volatility. In other words, more pull-backs, even though the direction of travel is upwards.

Unstressed by systemic stress

On that note, we saw a sharp sell-off in the first week in August, caused by weak US economic data, a rate hike in Japan that caught investors by surprise, and some repositioning away from trades that had become rather overcrowded. At these moments – and there will be more – long-term investors like us must return to fundamentals and ask, are there signs of 'systemic stress' that could prevent a swift recovery?

We like to break down systemic stress into four categories: banking, debt market, macroeconomic and corporate profit stress. There have been no clear signs of any of these (outside of China), so we weren't surprised when global equities started reaching new highs again within a fortnight.

This underlines the importance of keeping a clear head. Panic selling can greatly harm long-term performance. Over the last 40 years, there have been 73 days when global equities have notched up a rolling one-month loss greater than 7.5%. A sharp pullback over a short period of time starts to make investors' palms sweaty and the ill-advised investor may sell in a panic. But in seven out of every 10 times, equities went on to beat cash over the following year – and by a median of 16%. What about slightly slower but more persistent falls over two months? We look at the 161 days when the two-month loss is greater than 5% (and things haven't turned around over the previous month). Two-thirds of the time, equities still beat cash.

Past performance is not a reliable indicator of future performance.

US equities: from large to small

Another striking feature of markets since our previous quarterly update has been the outperformance of smaller stocks. In that time, the US's fifty largest stocks have been roughly flat, while the Russell 2000 index of small stocks has gained more than 8%. This is in marked contrast to the typical pattern of the past couple of years.

We recommended adding to smaller stocks in the first quarter of this year. Their previous struggles, while larger stocks powered ahead, had left valuations looking very attractive in relative terms. On most conventional measures of valuation, the gap between small and large stocks had become about as large as it had at the peak of the dot com bubble in 2000. This period was followed by substantial outperformance from smaller stocks when the bubble burst. That suggests a significant long-term investment opportunity.

However, we always allocate to smaller stocks with a couple of caveats. First, broad indices of smaller stocks typically contain a higher share of companies with weak balance sheets or profitability. So it pays to be selective, rather than investing passively. Fund and stock selection is a crucial part of our approach here. Second, smaller stocks are typically more volatile and exposed to the economic cycle than their larger peers. In other words, they might be expected to suffer more if the economy contracts.

Japan: it pays to be cautious

While the central banks of most advanced economies have cut interest rates, there's been one notable exception: Japan. On 31 July, the Bank of Japan (BoJ) shocked markets when it raised interest rates, pledged to halve its bond purchases, and suggested that more tightening was on the way – an aggressive move away from ultra-loose monetary policy by the central bank that had pioneered it. The fallout briefly convulsed Japanese (and some other) markets, appearing to trigger the rapid unwind of some crowded trades. Japan's Topix stock market index plunged by 20% in just three days, before reclaiming nearly all the lost ground over the next three weeks.

Rapid 'flash crash' events, where markets fall

sharply and then recover in a matter of days, have been a feature of markets in recent years. And sterling-based investors in Japanese equities have lost nothing over the past quarter. Yet such volatility is concerning. It's prudent to trim our exposure in response, reallocating to highly profitable Western companies that increase the marginal risk to our portfolios in a more predictable way.

But there are still several fundamental structural reasons to favour Japanese equities. Corporate governance, once an Achilles heel, has steadily improved – but this has yet to be fully recognised in valuations. By international standards, Japanese firms also generally enjoy very low leverage, and many have lots of idle cash; there's now evidence that firms are starting to return some of this cash to shareholders with increased buybacks.

However, it makes sense to be cautious because of high uncertainty about the BoJ's policy. Although the case for continued tightening appears weak, with underlying inflation already low and clearly on a downward trajectory, monetary policymakers seem more focused on backward-looking measures of wage growth. They're also under political pressure about recent yen weakness – albeit somewhat undone by the BoJ's recent moves. With markets discounting little further tightening, the prospect of another hawkish surprise – and the possibility of an unpredictable reaction in equity markets – makes us concerned that volatility in Japanese stocks could stay high.

UK Budget: investment is vital

October brings us the new UK government's first Budget.

The Chancellor has to ensure the health of the public finances. But Rachel Reeves also has a chance to revive investment – the weak investment numbers largely explain the UK economy's long record of slow growth over 40 years. We'd like to see three responses to this problem.

The first is preserving public sector investment. Reeves inherits spending plans that show it falling over the next five years. The second is avoiding tax changes that discourage private investment. Some Labour MPs want much higher rates of capital gains tax. But this may

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bring in scant additional revenue because people can control when they sell assets, crystallising capital gains. HMRC analysis suggests large rate increases could even reduce the total tax take. Higher rates can also discourage entrepreneurship and investment in small firms.

The third is supporting a broader pro-investment agenda. That includes reforming the sclerotic planning system, to boost housebuilding and investment in infrastructure. Changes to the pensions system, such as tax incentives, could help with the latter. The Chancellor could also sharpen the incentives for businesses to invest. That could include expanding ‘full expensing’ – where the full value of investments can be written off against tax –

to include things like training and software.

Finally, in industrial policy, we need both consistency and humility. By one count, the UK has had 11 strategies since 2010. And decentralisation, working with business and with local and devolved government, has a greater chance of success than the usual top-down model.

US election: special report

Finally, in the run-up to America’s presidential election, we’ve published a detailed report exploring the differences between the two parties’ platforms on eight policy areas that could affect our clients’ investments. These include corporate tax, geopolitics, and industrial and energy policy. **Read here.**

ASSET ALLOCATION

FIXED INCOME

Government bonds

The cooling of the US economy, and stalling of the recovery in the euro area, suggest a reasonably cautious investment stance is still justified – which has made government bonds attractive for diversified portfolios. However, bond markets are already anticipating significant interest rate cuts (figure 1). Longer-dated government bonds, which are more sensitive to changes in rate expectations, may be more vulnerable to disappointment.

Inflation-linked government bonds can provide insurance against any unexpected persistence or reacceleration of inflation. However, inflation risks are muted, and inflation-linked gilts are relatively expensive at current prices.

Corporate bonds

The difference in the yields between investment grade corporate bonds (credit and government bonds (known as credit spreads) are generally low by past standards in both the US and UK (figure 2). In other words, they offer relatively little additional return in compensation for their higher risk of default compared to government bonds.

However, higher-quality investment grade corporate bonds could still deliver positive returns. Relative to safer government bonds, they have only substantially underperformed in the most extreme economic downturns, such as the global financial crisis. Such an environment seems very unlikely at the moment.

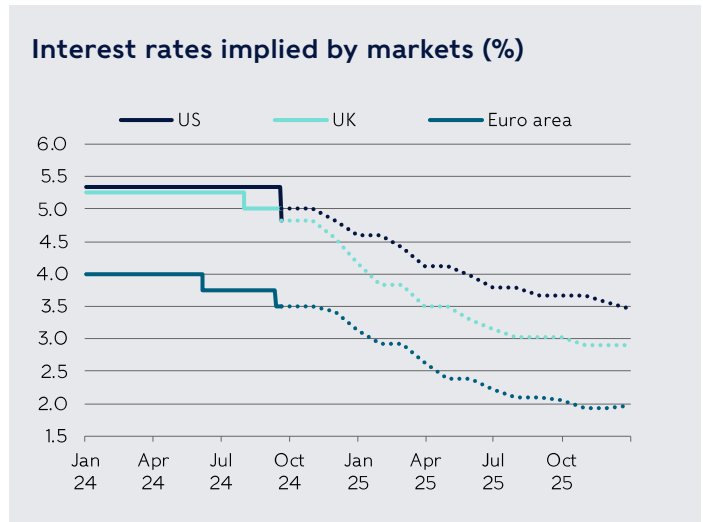


Figure 1
The pace and extent of interest rate cuts currently priced in by financial markets are closer to what would be expected for recessionary conditions; we believe the risks are skewed toward fewer rate cuts than expected.

Source: LSEG, Rathbones, as at end September 2024

Region	Percentile rank of latest spread	Rating			
		AAA	AA	A	BBB
US	Since 2010	1%	4%	11%	7%
	Since 2000	0%	8%	15%	8%
UK	Since 2010	43%	16%	11%	12%
	Since 2000*	41%	19%	15%	16%
Euro area	Since 2010	56%	55%	49%	24%
	Since 2000	68%	64%	57%	34%

Figure 2
US credit spreads are particularly low by past standards – all in the bottom quartile since 2010. UK spreads are also offering very little compensation for their additional risk compared to government bonds.

Source: LSEG, Rathbones, as at end September 2024

* Since 2006

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ASSET ALLOCATION

EQUITIES

US

The valuation of the S&P 500 index of America's largest companies is high relative to the rest of the world. Although the index usually trades at a premium, the gap is larger than the long-term average. What's known as the equity risk premium, the compensation stock investors expect for the risk they are taking on, is also well below its long-term average in the US, in contrast to other major markets.

However, several other factors favour investing in the US stock market. The momentum of price and earnings gains is strong relative to other markets. The US also contains many more companies with high-quality characteristics (high returns on investment and strong balance sheets) than any other major market. Smaller US stocks also look more attractively valued than their large peers (figure 3).

Meanwhile, the presidential election race remains extremely close, with betting and prediction markets giving Donald Trump and Kamala Harris a similar chance of winning. Neither party's policy proposals appear unambiguously positive or negative for markets.

On corporate tax, the Republican plan to cut the corporate tax rate to 15% would probably be positive for equities compared with the Democrat alternative to raise it, with the headline rate increasing to 28% (figure 4). On trade, the Republicans have floated much more aggressive plans to raise tariffs, which could be negative for equities if implemented.

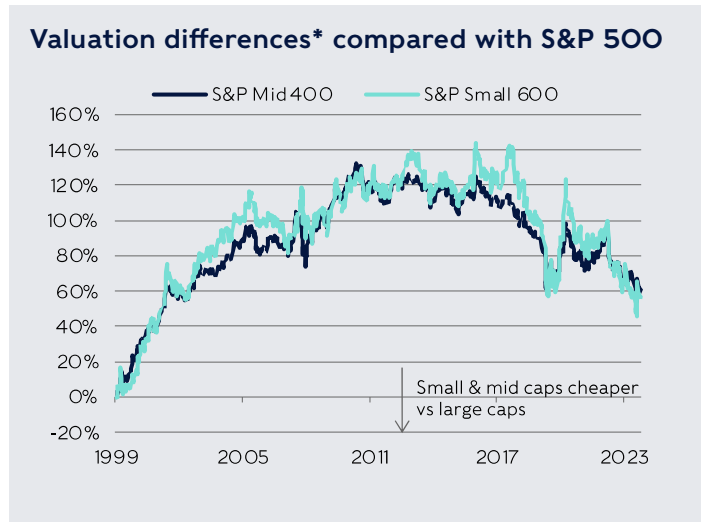


Figure 3

While the S&P 500 looks overvalued, this is not the case for smaller and mid-sized US firms. Relative to the S&P 500, they are at their cheapest in over 20 years.

Source: LSEG, Rathbones; as at end September 2024; *valuations measured by prices relative to earnings forecasts for the next 12 months

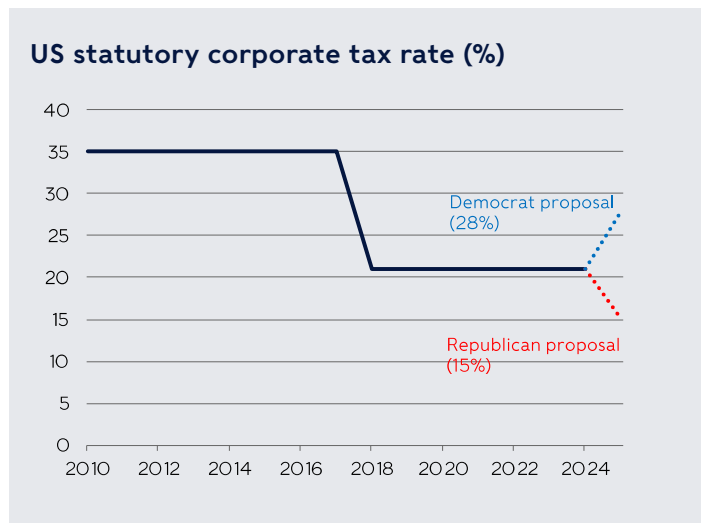


Figure 4

Corporate tax policy is key example of the divergence between Trump and Harris on an issue that matters for investors. As this chart shows, the election result could take corporate taxes in one of two opposite directions.

Source: LSEG, Rathbones, as at end September 2024

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HOLDINGS IN FOCUS

Accenture

Accenture is the leading provider of IT services to Fortune 500 companies with a broad and deep set of capabilities enabling it to provide its customers with the best advice and tools with which to navigate a fast changing and increasingly complex technology landscape.

Its capabilities include migration to the cloud, cyber security, data analytics and AI. Accenture is technology vendor agnostic, and therefore it is a lower risk way to play the structural increase in technology investment. Its expertise is global both at the strategy consultancy level, with deep relationships at C-Suite (senior executive) level with its customers, and at the technology implementation level. It also provides business process outsourcing.

AI is a major focus of investment. The biggest near-term opportunity is to support its customers in developing their digital data core, with cloud Enterprise Resource Planning and security, to scale their generative AI projects. This should spur further growth in cloud migration revenues.

Accenture aims to grow revenue at twice the level of IT budgets, which typically grow in line with GDP, by taking market share. Near term business momentum has been fairly flat as customers have digested heavier technology spending in the aftermath of Covid and prioritised large-scale programmes that take longer to convert into revenue. However, recently the business has seen an improvement in revenue and a significant step-up in orders, which suggests business momentum may be picking up.

While the valuation of the stock is somewhat full, it reflects the company's quality compounder characteristics and broad-based growth drivers.

Shell

Shell is one of the largest listed major oil companies. It underperformed during the third quarter as oil prices weakened, with the Brent crude oil price falling 17% to \$71.77 per barrel. Weaker economic data in both the US and China, two of the largest oil consumers in the world, led to reduced expectations for future demand, while on the supply side there were concerns that OPEC's discipline on restricting supply could soften, exacerbating weakness.

However, since the end of September, the oil price and Shell's share price have rebounded as stronger US macroeconomic data and a significant Chinese stimulus programme improved oil demand prospects. Meanwhile, escalating Middle East tensions, particularly between Iran and Israel, raised the risk of oil supply constraints.

In the long term, the role of the oil majors in the transition to net zero remains uncertain, with opportunities from their energy system expertise, but also risks from the potential for them to be left with stranded assets which could prove uneconomic in a low carbon world. Shell trades on an inexpensive valuation of 8.7x forward price to earnings ratio and a free cash flow yield of 12.5%, a substantial element of which is returned to shareholders through a share buyback programme and a 4.2% dividend yield.

BlackRock European Absolute Return

The 'long/short' fund aims to generate a positive return each year by buying European stocks and derivatives (going 'long') and selling others (going 'short'). Because it both buys some stocks and 'shorts' others (where it makes money from falling prices), this fund can make a positive return regardless of whether markets are rising or falling; it aims for a modest return

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.

that isn't tied to the overall market direction, so it's unlikely to keep up with a strong rally in stock markets, but should provide protection in periods of volatility.

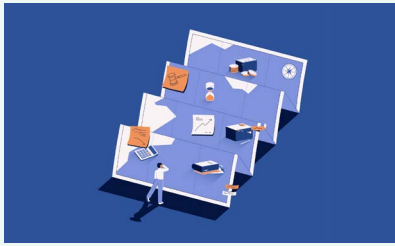
The portfolio is diversified across approximately 35 long ideas and 75 short ideas, which are picked on the merits of the stocks; it buys companies with experienced management

teams, focusing on return on invested capital (a measure of the profitability of capital investments) and strong free cashflow (cash from operations less cash expenditures) at a reasonable valuation; it shorts businesses in difficult industries with limited or no pricing power, highly indebted companies, and those with low returns, and/or the potential for earnings disappointment.

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KEEPING YOU UPDATED



INVESTMENT INSIGHTS Q4 2024

Looking ahead to Labour's first Budget

The new Labour government will be setting out its agenda in more detail soon with its first Budget. There may be big changes coming that affect your finances, or it may be an opportunity for a much-needed reset to encourage investment and boost economic productivity. [Read here](#)



INVESTING FOR THE NEXT DECADE: MEET THE NEW NORMAL, SAME AS THE OLD NORMAL

The first few years of the 2020s have been characterised by huge shocks to the global economy – from the pandemic to the Ukraine war. When the dust settles, we think the global economy will have changed in significant ways, and the investment strategies that fared best over the past decade won't be the ones that serve us best for the next one. If the 2010s are gone for good, we'll need a different approach. [Read here](#)



KEEPING A LEVEL HEAD LATE IN THE ECONOMIC CYCLE

In his latest video update, Rathbones co-CIO Ed Smith warns against excessive expectations for US interest rate cuts – and against over-reacting to stock market volatility. [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](#)

FEMALE FINANCIAL AWARENESS COURSESS

Our female financial awareness courses are designed to show women how to fulfil their financial goals through the power of investing, to better understand their money and to be better equipped to make informed decisions. To book your place please email [Sharon Ryan](mailto:sharon.ryan@rathbones.com) at sharon.ryan@rathbones.com.



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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