Rathbone Unit Trust Management

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Rathbone Multi-Asset Enhanced Growth Portfolio

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One of the fun, bizarro features of our age is that the freewheeling capitalist global economy is reliant on a communist nation for much of its goods, and a punchy chunk of its GDP growth too.

Of course, China is far from Karl Marx's ideal. Workers aren't allowed to join a union (except the one that is in hock to the ruling Chinese Communist Party); the top flight of that ruling party has become fabulously wealthy somehow; and markets and free enterprise have been allowed to flourish under the hammer and sickle as long as people bow to the state whenever asked. You could argue this simply makes it authoritarian not communist. Because no matter which way you look at China, you see hustle, bustle, massive growth, innovation and huge consumption. In other words, you see a vibrant capitalist society. And yet...

Hammer time

Communism tends to have little bearing on what China gets up to during business hours. It's like some weird wallpaper in the boardroom – it prompts a comment or two but doesn't influence the discussion. Still, it pays for investors to keep it in mind! It may be wallpaper, but the guy who owns the place liked it enough to hang it. China was restored to greatness by communist leadership using capitalist tools to become wealthy. And that's the rub: China's government uses capitalism, it isn't capitalist at heart.

Recently, the Chinese leadership have been concerned that some of its more swashbuckling technology companies have been getting a little too big for their boots – that they were no longer listening carefully enough to the state's subtle hints about what was acceptable. Similarly, the authorities haven't been happy with how private tutors have fuelled the arms race of education, which has in turn become a burden on Chinese families. This came to a head last month. Chinese leaders don't need to put their solutions to a public vote; they can do it overnight. So they made some bruising changes to the technology market and effectively outlawed for-profit tutoring, both of which sent Chinese markets tumbling (along with a few domestic stocks that were listed in the US through convoluted ownership structures). This then spread to American firms that sell educational services to China as well.

Instantly the debate roared to life: is this the end of the road for Chinese capitalism? We think that's unlikely. China's leaders know that markets are pivotal to Chinese prosperity. We think they are trying to fix some problems that aren't exactly unique: data security, spiralling education costs and rising inequality. They just have a habit of bringing a hammer to the problem. We are sticking with China, but we will be extremely careful about any exposure that could be seen to aggravate inequality or that plays fast and loose with Chinese data. The risk of greater intervention has increased dramatically in these areas, we believe.

Inflation's sharp sting

Another risk that we're keeping our eye on is inflation. Central banks are adamant that the current spike in inflation is 'transitory', and the market is apt to believe them. We too think the price spikes will die down in time, but we think that it may take a year or two for that to happen. If the market's idea of 'transitory' is four to six months, there could be a few wobbles as they come to terms with that misunderstanding. We had a chat about this in episode one of our The Sharpe End podcast.

In recent months quite a few consumer staple giants warned that the cost of goods sold – raw materials, energy, packaging and transportation – had ballooned recently. They are considering price increases to offset some of this, but that tends to lag the cost inflation by a year or so. One day, we'll all be scratching our heads and wondering if our shampoo bottle isn't a little bit smaller than it used to be. In the meantime, the share price of many staples businesses have lurched lower.

Pedalling solutions

During lockdown, the number of people using bikes rocketed. For much of the lockdown it was virtually impossible to get your hands on one in the UK. This was a once-in-a-lifetime boost for cycling, but one that should help add vigour to the general upward drift in global usage over the past few years. Cycling is a remarkably efficient and very cheap way to get around. On the flipside, it can also be an invigorating and decidedly more expensive hobby for lycra-clad punters on country lanes.

With more of us hanging round the neighbourhood in the flexi-working age and lots of government money getting funnelled into cycleways, this should lend a strong global tailwind to cycle manufacturers and their suppliers. In July we bought Japanese manufacturer **Shimano**, which makes gears, brakes, cranks and other components, along with returns on equity in the mid-teens. It has a reputation for quality among cyclists and is heavily embedded in the production of most bike manufacturers (it supplies between two-thirds and three-quarters of bike gears and brakes globally). That has translated to compound earnings growth of almost 20% over the past three years.

Cycle journeys have a long way to go before they reach the 12-14 billion annual miles covered by a much-smaller British population back in the 1940s and 1950s. These days we rack up less than 4 billion a year. Just shows how much growth there could be if there is a swing to greater take-up of cycling, whether for fun, convenience or as a response to climate change.

Meanwhile, we have been adding to computer chip producer **Taiwan Semiconductor Manufacturing Company**; German warehouse machinery, forklifts and automation supplier **Kion**; and miner of iron, aluminium and copper, **Rio Tinto**. This was part of a move to tilt our portfolio toward businesses that are more sensitive to the ebb and flow of global economic growth. There was quite a bit of volatility in markets throughout July, so we used this to our advantage in making these changes.

Out of the comfort zone

As summer winds down without ever getting going, inflation remains the hot topic both here in the UK and abroad. Its path and people's reaction to it will have fundamental effects on borrowing costs, monetary policy, spending habits and businesses' bottom lines.

Inflation is extraordinarily complicated, yet it is often victim to anecdotal and emotive arguments. People paying £6 for a pint grumble about lies, damned lies and statistics. Others feel the burn of paying to get on a train again or the cost of post-pandemic airfares. Yet inflation is when the *general level* of prices is increasing, not when one or two things become very expensive. Many people forget about the generally low price of electronics, home appliances and food. In particular, the increase in quality relative to price is often not adequately accounted for by punters. The most obvious example of this is mobile phones: they are roughly the same price as 25 years ago (adjusted for inflation), but now incorporate all the tasks of a camera, GPS unit, games console, scanner, personal organiser, gardening almanac and more besides. That's a lot of stuff that people no longer need to buy. Technological progress often has this hidden deflationary effect in the background.

This longer-term phenomenon, along with the large productive capacity that exists around the world — in factories' possible output, underutilised labour and piles of savings — persuades us that inflation shouldn't stay hot for years and years. But people live in the short term, and right now inflation has hit 2.5% in the UK for the first time in three years. In the US it's 5.4%, the highest level since 2008. There could be still higher numbers in coming months as supply chains continue to untangle themselves.

In a meeting with Generac, an American manufacturer of power generators, we were told that the cost of a shipping container to get something from China to San Francisco had shot up to $20,000 from roughly $3,000 a year ago. Ships, containers and orders have been knocked completely out of sync by quarantined ports, interrupted output from factories and sporadic orders from shuttered retailers. This sort of thing will crimp some companies' profits and no doubt frighten investors, causing gyrations in bond yields that will reverberate through stock markets. Expect 'growth' companies to shoot higher at the expense of 'value' stocks, only for them to reverse a couple of weeks later. These rotations will probably zigzag like that for the rest of the year, until some feeling of normality is reached.

If markets do go on as we expect, it will be an uncomfortable time for investors. Yet all that volatility would offer opportunities as well. It sounds hackneyed, but it's true. With a greater spread of possible prices, it gives you more options to adjust your portfolio, to buy into companies at a lower price and take profits on your investments at attractive heights.

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