Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Multi-Asset Strategic Income Portfolio

Monthly update July 2022

So far, 2022 has been like Chris de Burgh's Spanish Train: a roundly awful refrain with building dread about what could ever come next. Carriage after carriage of war, worry and fear, snaking through the year covered by a hazy layer of inflation.

Yet July was a reprieve for most markets. Bond yields dropped back sharply, leading to a bounce-back in 'growth' stocks. Of course, the reason bond yields fell was because an American recession seemed more likely. The world's largest economy shrank again in the second quarter, and two consecutive declines in GDP are shorthand for the start of a recession. Unlike most other nations that call a recession as soon as real GDP falls for two quarters in a row, the US has a shadowy council of eight economists which uses a whole range of measures to decide and it takes them ages. But with a range of iffy data, it wasn't looking good.

Worsening economic performance leads many to suspect that the US Federal Reserve (Fed) will ease up on its interest rate hikes. The 'Fed Put' was replaced with hopes for a 'Fed Pause'. This was swiftly pooh-poohed by the Fed, which increased rates by another 75 basis points to 2.50% in late July and reinforced its intention to keep on hiking.

The Bank of England Governor Andrew Bailey caused a stir by predicting that the UK economy is about to slump into five straight quarters of contraction and that household income will be squeezed harder than at any time since the early 1960s. To be fair, most of the concern was because the bank was aggressively increasing rates regardless. But Mr Bailey said policymakers were adamant that it was necessary to rein in inflation, which they now expect to surpass 13% by New Year because of ever increasing energy prices. The latest prediction is for a typical household's dual-tariff power bill to jump from roughly £2,000 to £3,500 when OFGEM resets the price cap in October. It's going to be a tough winter.

Approaching the junction

There are three main branches of attention for global investors at the moment: the first is the continual obsession with inflation. It has risen higher than most people expected for much longer than we all hoped. The ballooning oil, commodity and food prices that drove the initial jump in inflation have dropped back considerably. Yet the torch has been passed to other areas, such as cars, rent and airfares.

The second is the financial resilience of US households, which drive arguably the most important economy in the world. They are sitting on more cash than usual and are benefiting from rising wages and lots of job opportunities, yet sky-high inflation worries them and erodes their ability to spend. Typically, you can get some idea about the path of household spending by looking at consumer confidence surveys, as people worried about the future tend to cut spending (and increase spending when they feel more confident). However, this has not really been the case in 2022. People tell surveyors that they are very concerned about the wider economy and the future, yet they continue to spend money at a clip. Exactly when this disconnect will reset is anyone's guess.

Company earnings is the third. Overall, companies have been holding up ok considering, but there is some big dispersion in there. According to data provider FactSet, three quarters of S&P large US-listed companies posted higher-than-expected profits in the three months to 30 June. The average year-on-year increase in profit was 6.7%. But this is because the energy sector has gone bananas. If you strip out the 300% increase in energy sector earnings, company profits actually *fell* 3.7% on average. Industrials, miners, property and healthcare did well; investment banks and flashy consumer stocks didn't.

We have no more insight into what the future holds for these three phenomena than anyone else. But we have been pondering some scenarios and what that would mean for markets, economies and our investments specifically.

Inflation is a whirlwind at the moment, yet we find it hard to believe that wages will continue on the recent upward trajectory. There are just too many options for technology to replace expensive workers or drive efficiencies without adding substantially to payroll. Not only that, but in the US especially, there are so many people floating at the edge of the workforce. Famously, the US has an employment rate of just 60% (in the UK it's 76%). These people could be enticed back if wages get much higher (if some of them haven't been already — where did July's 500,000 new workers come from?), which should subvert a wage-price spiral. We think we should have hit peak inflation now, with lower commodity prices and easing shipping costs starting to weigh down prints in the second half of the year. That said, we are putting much thought to whether inflation may settle at a significantly higher level than people expect. Prices for interest rate contracts imply investors expect inflation to go back to 2.5% — roughly what we have been used to over the past 20 years. But what if they stick somewhere near 4% for several years? That would mean a big repricing of assets (downward).

As for the resilience of the American Main Street, well, it's one of our mantras not to underestimate the raw power and optimism of the US consumer. And lest we forget, these households are sitting on much more cash than usual because of saved COVID-19 stimulus and recent boosts to wages and bonuses. Companies we think have to be assessed on a case-by-case basis. It's going to be a very tough year for businesses that can't control costs and can't increase sales. We can't promise that none of our holdings will fail this test, but we can say that this is top of our mind every time we talk about companies we own or think about buying.

Changing points

We bought a lot of bonds over the month, taking advantage of rising spreads (the extra yield offered above gilts to compensate for the risk of default) to boost our yield. These included the **Nationwide Building Society 5.875% Perpetual-2024**, **Lloyds Banking Group 7.875% Variable Subordinated Perpetual-2029** and **NatWest 5.125% Perpetual** bonds and the **Invesco US High Yield Fallen Angels ETF**. We added to our holding of **Australian Government 4.75% 2027** bonds as well, taking advantage of the higher yields down under while locking in the exchange rate to avoid any currency losses.

We added to our positions in oil majors **BP** and **Shell** because their extraordinary cash flow increases the chance of greater payouts in the future and their prices dipped during the month.

We sold consumer health business **Haleon** as soon as it was spun out of **GlaxoSmithKline** because we felt it was likely to have a lower yield than we would like. We also took profits in e-commerce and cloud computing giant **Amazon**.

We added to our **UBS Put Spread** structured product, which protects us if markets drop between 5% and 25% (we are exposed to any fall greater than 25%). Given how far markets had already fallen, we felt this was a reasonable risk to take. Another cost-effective option we purchased was the **CitiGroup Put Option Contingent on Brent**. This does what it says on the tin: in return for a cheaper premium, this insurance policy on the S&P 500 only kicks in if the Brent Oil price is over $100. This protects us against a slowdown caused by rising energy costs, yet if markets tank and oil goes with it this hedge won't help.

Finally, we sold the **JPMorgan Emerging Markets Investment Trust** because we were concerned about the effect of the stronger dollar on developing nations' economies. With recession risks growing, greater investment in safer assets could turn the screw further.

David Coombs
Head of Multi-Asset Investments

Will McIntosh-Whyte
Fund Manager

Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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