

Rathbone Multi-Asset Defensive Growth 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 built a position in the **S&P 500 Energy Sector ETF** after oil and gas prices dropped back in June and July. While we hope that the cost of energy keeps falling we believe there is a good chance of another upheaval in supply, so we have bought this to help protect us in that scenario.

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.

We added to the **Heathrow Funding 7.125% 2024** bond during the month as well, as spreads (the extra yield offered above gilts to compensate for the risk of default) widened.

We also bought the **iShares Physical Gold ETF**. It may seem a strange time to buy a non-yielding asset like gold, what with interest rates rising rapidly. However, we think gold comes into its own during times of swirling uncertainty and when people are worried about the world coming apart at the seams (war, famine, hyperinflation, that sort of thing). Given there is a risk of all of these things, we felt buying this yellow 'catastrophe insurance' made sense.

We trimmed design software developer **Cadence**. And, finally, we reduced our holdings in the **Invesco LGIM Commodity Composite** and **Legal & General All Commodities** ETFs because we believe that peak inflation should now be behind us. If we are correct, commodity prices should broadly fall from here.



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