Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Greenbank Total Return Portfolio

Monthly update July 2022

July was a reprieve for most markets after a roundly awful year so far. 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.

Things to watch

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.

While 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.

Bolstering defences

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 $110. 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 swapped out our **Landesbank Baden-Wurttemberg 1.5% Senior Non-Preferred Unsecured 2025** bond for the **AXA 5.453% Subordinated Perpetual-2026**. We made this shift because of concerns about the vulnerability of the 'Mittelstand' (small to medium-sized German businesses) to an energy shock on the Continent. Landesbank Baden-Wurttemberg's loan book is heavily invested in the Mittelstand. Much of the Mittelstand is linked to energy-intensive pursuits, like manufacturing and industry, so higher oil and gas prices caused by the Ukraine war will already be biting. If Russia shuts off supply of gas even sooner, then there could be blackouts and power rationing, along with yet higher costs. AXA is a French insurer with business all over the world. It has a strong credit rating, great cash flow and modest debts relative to its assets, with an attractive yield.

We received consumer health business **Haleon** as a spin-off from **GlaxoSmithKline**. We bought more of it once it started trading lower on the stock exchange as well. Haleon owns many strong consumer health brands, including Sensodyne toothpaste and pain relief medicines Panadol, Voltaren and Advil. We believe there's a great opportunity for global growth, and unlike mainstream consumer goods, the pills business is less sensitive to commodities, too, which should reduce any pressure on profit margins if inflation stays high.

With bond yields much higher than they have been for a long time, we have continued to buy more of the **New South Wales Treasury 2.5% 2032** bond.

Finally, we sold Danish wind turbine manufacturer **Vestas Wind Systems** because we felt there were better places to invest, given the increased competition in the wind power industry and higher costs of materials, labour and transport.

Will McIntosh-Whyte
Fund Manager

David Coombs
Head of Multi-Asset Investments

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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