Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone UK Opportunities Fund

Quarterly update September 2022

There's no shortage of things to worry about right now. Global economic data increasingly points toward a sustained slowdown, driven by concerns of high energy prices and restricted availability. Closely entwined with increases in energy and other raw materials is the war in Ukraine, which is helping inflame inflation that just won't quit. So for UK investors to contend with another mini-crisis engendered by our own government was a nasty way to end the quarter.

Falling off the wall of worry

Three months ago, stock markets had started the period with promise. Admittedly, many investors got ahead of themselves, thinking that inflation – and therefore interest rates – were topping out. They tried to front run the US Federal Reserve's (Fed) expected pivot to rate cuts in early 2023 by buying up 'growth' stocks, pushing them to optimistic levels. That trade ended nothing short of chaotic when the fantasy of the Fed loosening anytime soon was put to bed by stubbornly high and rising inflation.

Fed Chair Jay Powell wrestled markets back into monetary tightening mode in late August, reminding us all that there is more work to be done to halt the spread of price rises. So far, so orderly. UK investors then expected the Bank of England (BoE) to follow suit with another chunky raise. Instead, we got a relatively dovish 50-basis-point hike (how far we've come in so little time) to 2.25% followed not a day later by the new Chancellor announcing a bizarre collection of unfunded fiscal stimulus. With no plan in place to regain fiscal probity in the medium term, sterling and gilt markets took fright, ably aided by deep-pocketed speculators.

Record moves in gilts and sterling followed, and stocks hit new lows for the year. A week later and the Chancellor has rowed back on some of the more politically toxic (yet immaterial) parts of the stimulus, and acquiesced to having his homework properly marked by the Office for Budget Responsibility (OBR). The BoE demurred against an intra-meeting rate hike, but did have to intervene in the very long-dated gilt market, and postponed long-planned sales of gilts picked up in past quantitative easing programmes. Sterling had recovered its losses as we were writing, but yields are still very elevated. The benchmark 10-year UK government bond yield is 4%.

	3 months	6 months	1 year	3 years	5 years
Rathbone UK Opportunities Fund	-10.8%	-26.0%	-35.7%	-8.4%	-12.5%
IA UK All Companies Sector	-5.0%	-12.8%	-15.3%	-2.2%	3.2%

	30 Sep 21-30 Sep 22	30 Sep 20-30 Sep 21	30 Sep 19-30 Sep 20	30 Sep 18-30 Sep 19	30 Sep 17-30 Sep 18
Rathbone UK Opportunities Fund	-35.7%	37.2%	3.7%	-10.9%	7.3%
IA UK All Companies Sector	-15.3%	32.4%	-12.8%	0.0%	5.5%

Source: FE Analytics; data to 30 September, I-class, mid price to mid price.

These figures refer to the past, which isn't a reliable indicator 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.

Panic, overshoot

Undeniably cack-handed moves from the government and the BoE, made significantly worse by the usual bunch of speculators, ensured markets overreacted. For a time at least, only the costs are being priced, with no potential for upside.

It was badly communicated, but fiscal stimulus into the teeth of a recession is the right thing to do. Barely communicated, but there are some interesting and potentially workable supply-side policies, aimed at improving the UK's low productivity. We expect markets to start pricing those in during coming weeks. For example, halting the planned rise in corporation tax should lead to single-digit earnings upgrades for most UK companies. Medium-term spending cuts to balance the books will be forthcoming – estimates around the new OBR forecast suggest only an additional one percentage point of public sector net borrowing as a percentage of GDP by 2026.

Looking at our portfolio performance over the quarter, September will stand out for all the wrong reasons. Our sweet spot of mid-cap quality growth was hit hardest by the sell-off. Mid-cap because that's where the domestic names are, and growth because their values tend to fall by more when rates rise (and rise by more when rate fall). Positive contributions to our quarterly return came from **GB Group** and **AVEVA**, two tech names that were bid for by overseas buyers in the quarter (although post-month end the acquisition of GB has collapsed). Our worst performers were our interest-rate-sensitive real estate names.

Another unhelpful chapter in the narrative for UK assets

When the market's time horizon compresses so rapidly, we need to expand ours. The Truss-Kwarteng-inflicted scars will take some time to fade, but a level of existential confidence is returning to UK markets. We remind ourselves too that the fourth quarter is typically more favourable for equities.

A slowdown is baked into the cake, in our view. But to a large extent this is thanks to the energy crisis, not due to cyclical excesses. As previously discussed, household and corporate balance sheets are strong, so a slowdown is unlikely to morph into another financial crisis. Especially as banks are much more rigorously capitalised and regulated these days.

At the current valuation level of 9x earnings (which of course needs to come down a bit), the UK is close to its previous recession-era trough levels. This is a much-needed valuation cushion at this point in the cycle. Compared with US stocks, which are still several turns above the usual trough. More importantly, the premium that we typically pay for our top-quality names has receded. For a similar valuation we can buy cash-rich, structurally growing names like **JD Sport**, or over-spaced, over-leveraged, unnamed retail has-beens.

With some cash in our pockets, we'd be ready to buy UK equities here.

Alexandra Jackson
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.

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