Rathbone Unit Trust Management

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Look forward

Rathbone Income Fund

Monthly update October 2023

October often tests the resilience of investors, and this year has proved no different. It's always a difficult month since it inevitably stirs unwelcome memories of the crashes of yesteryear — throw in storms and high winds and the nervousness only increases. It also feels as if we might be on the cusp of a reset in investor expectations. The prevailing view is that inflation may have been tamed and that interest rates in the major economies may have peaked but could the relative composure of markets over the summer months prove to be the calm before the storm? We've yet really to see the lagged effect of rising interest rates on economies, on the decisions that consumers make, or on the investment upon which businesses elect to embark. In the UK at least, shares are already priced for a fair degree of disappointment, but in the US, there still seems to be a residual belief that earnings will come through in the final quarter to justify stocks' heady prices. We're not so sure. Fractured economies may well break.

And the global backdrop is depressing. This isn't the right place to opine upon geopolitics in general, and the events in the Middle East (and of course the Ukraine lest we forget) are truly shocking. But we do need to reflect on market reactions. Markets have a disconcerting ability to brush off the most terrible tragedies in the shortest of times. Over the last month, energy stocks have been supported by higher oil prices, while defence stocks have also strengthened. Our large positions in **Shell** and **BAE Systems** have moved ahead.

Brief reflections on Q3 results

Despite a mad flurry of news, another busy results season proved inconclusive. If short-term outcomes were all that mattered, then October generated strong relative results — put more brutally, we went down less than the market. At this juncture, we're relieved to state that, in aggregate, we got through results season relatively unscathed. Welcome news as markets have largely been punishing any disappointments harshly.

Nevertheless, companies remain downbeat, especially in their outlooks. Economic sensitivity has been a drag for many companies and their share prices. Our financial exposure, alongside businesses such as media giant **WPP** and credit services business **Experian**, and staffers like **Page Group** and **Hays**, have felt the inevitable downdraft. On the other hand, housebuilders seem to have steadied and are generally up on the year, encouraging investors to look beyond the immediate malaise. And, as mentioned, our big positions in oil, defence and pharmaceuticals have added considerable ballast.

One business that did report good Q3 results is an old name we've recently reintroduced to the fund. We admit that **Tesco** won't set pulses racing, but it is an appropriate stock to own right now. It ticks a lot of boxes in terms of what we're currently looking for — defensive revenues, a decent return on capital and an attractive valuation. Moreover, its private equity-owned competitors, Morrisons and ASDA, are distracted by their huge debt piles and soaring interest bills, meaning Tesco's competitive positioning is stronger than it's been for years. As a result, the company reported better than expected H1 results in early October, leading to upgraded full-year profit guidance.

With savings rates falling and the lagged effects of higher interest rates starting to bite, more people are opting to 'dine in' instead of eating out. This is helping Tesco sell more groceries. It seems likely this theme will continue. Management also notes that food inflation is falling, which should help support its margins. It's also performing well operationally — growing its market share, cutting costs and expanding its offering to meet changing consumer needs, with things like super-fast 30-minute home delivery.

Despite these positives, we're mindful that Tesco faces intense competition from discounters Aldi and Lidl which have also grown market share. Tesco has sought to combat this competition by reducing prices through initiatives like its 'Aldi price match', 'everyday low prices' and Clubcard prices schemes. And there's a risk that higher oil prices could stoke food production and packaging costs in the months ahead. As ever, there's no such thing as the perfect story, but in the current environment, and at its current share price, we are very happy to buy.

Breaking news!

At the start of November, we got some exciting news when UK pharmaceutical company **GSK** upgraded its earnings expectations. This is something that's rare at the moment and supports our focus on the relationship between pharmaceutical businesses and the consequences of longer lifespans (you can read more about the potential implications of a 'longevity society' here). The driver of GSK's upgrade was its outstanding launch of Arexvy in the US, the world's first Respiratory Synctial Virus vaccine (RSV is a common virus that usually causes mild, cold-like symptoms but can have a serious complications for the elderly). Combined with ongoing sales growth of Shingrix, its shingles vaccine, we have comforting evidence that our constructive stance on the business, especially in preventative medicines for the over 65s, is warranted.

Moreover, **Halfords** has just announced the sale to Bridgestone of a 5% stake in its Avayler subsidiary. Avayler is a 'software as a service' business that helps automotive companies digitalise their service offering, while Bridgestone is a global mobility business (encompassing much more than the tyres for which it's best known). This 15-year deal is a fine seal of approval that should help to recognise the value in this hitherto under-the-radar bit of the Halfords Group. We hope it will encourage further similar contracts. We bet you didn't know that Halfords has been moonlighting as a software business with global appeal, did you? Good news indeed.

Finally, once more unto the breach...

Here we go again. Yes, there's loads of doom and gloom, and yes, everyone still seems to be avoiding the UK market. There is a lot not to like, and a catalyst for change in sentiment towards UK stocks seems a long way off. But here are at least five points to consider.

1. **The overwhelming positive is valuation**. The UK market is absurdly cheap. How much more bad news can be priced in? For UK investors, with UK assets and UK liabilities, we think the UK market needs to be considered at these levels.
2. On the other hand, **US valuations remain very elevated — are they pricing in recession? Probably not**.
3. **The UK market is not the UK economy** — less than a quarter of FTSE All-Share revenues are generated within the UK. If you want to buy exposure to the global economy, why not look at the UK?
4. **Interest rates may well have peaked in the UK**. Although the cost of borrowing may remain high, fears of it rising still higher seem to have dissipated. We're very wary indeed of the lagged effect of higher rates on the economy — things could still get worse before they get better — but the economic news hasn't been dreadful. For example, the latest data from Nationwide reveal an unexpected rise in house prices; shop price inflation is falling, according to the latest British Retail Consortium report; and we've yet to see any big ramp-up in unemployment. It can't be denied that the UK still faces a cost-of-living crisis, but while people remain in work, we are avoiding the worst. If wages keep growing at a rate that doesn't scare the Bank of England, the pressures on households may ease.
5. **Policy** — in the lead-up to elections, probably in about 12 months' time, we're likely to see discussion about and the potential introduction of policy measures supportive of UK markets as well as key sectors like housing. Changes to ISA allowances to encourage more investment in the UK, changes to Capital Gains Tax, Corporation Tax, inheritance tax and pension incentives have all been mooted as potential strategies to refocus investment in the UK market.

We wouldn't say we rest our case... rather, we must keep banging the drum!

Recent trading: October was an active month. In addition to the initial purchase of **Tesco**, we have added to **BP** and **Unilever**, as well as **Computacenter**, **IG Group** and **Close Brothers**. We have trimmed our large positions in **BAE Systems** and **Relx**, and also aggressively reduced **WPP**, ahead of what turned out to be weak results.

Companies seen in October: AstraZeneca and **BP**.

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If you require further clarification on this commentary, then please contact your adviser or Rathbones at the contact details below.

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