RATHBONES

RATHBONE MULTI-ASSET STRATEGIC INCOME PORTFOLIO

MONTHLY UPDATE JANUARY 2024

They say mathematics is the universal language. No matter what they speak, two people should be able to communicate through sums. Yet there's poetry and mystery in maths too.

Take the asymptote: a curve that constantly approaches an axis yet never reaches it. It doesn't seem possible, but it is. Continuously halve a number and you'll get that result. In literature, Kafka made a living on this geometric principle: endless bureaucratic progress without definitive action. In art, there's that square staircase that somehow goes up and down at the same time. In finance, we have forecasts of US Federal Reserve (Fed) cuts.

Fed-watching is an artform for the connoisseurs, to be sure. In the summer of 2022, a reasonably sized minority of investors expected interest rates to fall in 2023. They expected rates to peak at 3% in December 2022 and then fall to 1.5% by the dawn of 2024. Instead, rates hit 4.25% by the end of 2022 and kept rising, plateauing at 5.5%, where we remain today.

This strain of hope has lingered in many investors' psyches, with regular, overly optimistic, forecasts for imminent rate cuts pitched virtually every month or so since. And the longer we go without any cuts, the more swingeing the forecasts seems to be.

Today, markets expect five 25-basis-point cuts in 2024, which would take the US benchmark overnight interest rate to 4.25%. Yet economic growth, job creation and wage growth continue to overshoot expectations. And while inflation does seem to be on a downward trajectory, it has popped higher in recent months, to the surprise of most. How long will the rate cut asymptote run?

Don't swing for the fences

At first, back in the summer of 2022, we too were sceptical that interest rates would go much above 3%. We thought a fragile global economy wouldn't be able to take it. Having said that, we were also wary of hopes that rates would quickly plummet, because the risk of resurgent inflation seemed too dangerous to central bankers' credibility for such a swift reversal. Yet as the months rolled by, the continued power of US GDP — and the resilience of the UK and the Continent — changed our minds about just what the global economy could withstand. For a good while, at least.

Today, we think rates have long peaked in the US as inflation — while bumpy — continues to fall back toward the 2% target. We think this will be accompanied by a slowing US economy. There's the possibility of global recession in 2024. There's also a chance that inflation and/or the economy resurge and rate cuts don't come to pass for a while yet. We discuss some of these risks in our latest 'In conversation' video.

Because we don't know what tomorrow holds, we try to avoid making big sweeping calls. Instead, we try to balance our portfolio for the most likely of the possible futures. There are parts of our portfolio that should do well if the Fed begins to cut rates and there are other bits that would benefit from rates staying higher for longer.

This month we added more government bonds to our portfolio as yields rose. Because we expect rates (and therefore bond yields) to fall over 2024, we have added to these sorts of bonds whose values are more sensitive to such moves. The specific bonds we bought were the **US Treasury 5.25% 2028** and **4.5% 2036** and **UK Treasury 3.75% 2036**.

Speaking of interest rate disappointments, we bought a new diversifier to protect against exactly this. The **BNP Paribas 10-Year US Rates Swaption May 2024** covers half the value of our US bond portfolio and makes money if 10-year yields rise. Usually, a swaption gives you the option to swap your fixed rate interest payments for floating ones; however, rather than giving us a series of floating cashflows into the future, ours is set up to simply pay us a lump sum when it's exercised. If rates remain flat or fall, all we lose is the small premium payment we made to buy the swaption.

Apart from these, the order of the day was topping up existing holdings whose prices fell back during the month. These included pan-Asian insurer **AIA**, infrastructure investment company **International Public Partnerships** and Chinese internet giant **Tencent**.

A risky world

Here in the UK — and in Europe to be fair — the economic picture looks darker than in America. That means the path of interest rates could deviate somewhat. Essentially, if the US economy stays strong and Europe (including the UK) slides into recession, we would expect rates to fall faster on this side of the Atlantic.

That could cause some fluctuation in the value of the pound. Sterling usually does well when global economic growth is accelerating or better than expected, which is probably why it has gained about 5% against the dollar since the lows of October last year. At $1.26, the pound has come a long way since the near-parity plummet sparked by the Truss-Kwarteng minibudget of October 2022. Recession could cause weakness, as lower rates here would make the currency less attractive to foreign investors. Yet the pound still seems undervalued on a very long-term view. Added to that, Labour appears to be more Eurocentric than the current government. Better (and smoother) commerce with our largest trading partner would be good for the pound. In a nutshell, we see the risks as balanced.

Another bubbling risk is the Middle Eastern conflict between Israel and Hamas. After four months of fighting, a cessation looks extremely unlikely. Instead, the conflict has spread across the region, with border clashes and rocket attacks crisscrossing the region, as far afield as Pakistan. The most-watched flashpoint is attacks on container ships in the Red Sea. An Iranian-backed rebel Yemeni army called the Houthis has been firing missiles at ships and boarding others in solidarity with Palestine. American and British forces have moved to prevent these attacks, yet major shipping companies have already stopped using the dangerous route typically taken by 15% of worldwide seaborne trade. The alternative means going the long way around the southern coast of Africa, adding time and costs.

This is a fluid situation, which could develop yet further. But as it stands we think the current situation won't encourage the Fed to change course on monetary policy. The other factor to bear in mind is that in 2021 we had a triple whammy of impacts which drove goods inflation higher: supply chain issues for semiconductors, reduced shipping capacity due to the COVID-19 overhang, and excess demand driven by the helicopter-money fiscal stimulus from government pandemic support — at a time when interest rates were on the floor. Today we're only dealing with an impact on shipping and therefore we don't see this causing a return to the 2021 inflationary impacts.

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For more info on our fund, including factsheets, performance and fund manager views, please click here.

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