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Rathbones
Look forward

Rathbone Multi-Asset Strategic Income Portfolio

Monthly update July 2021

One of the fun, bizarro features of our age is that the freewheeling capitalist global economy is reliant on a communist nation for much of its goods, and a punchy chunk of its GDP growth too.

Of course, China is far from Karl Marx's ideal. Workers aren't allowed to join a union (except the one that is in hock to the ruling Chinese Communist Party); the top flight of that ruling party has become fabulously wealthy somehow; and markets and free enterprise have been allowed to flourish under the hammer and sickle as long as people bow to the state whenever asked. You could argue this simply makes it authoritarian not communist. Because no matter which way you look at China, you see hustle, bustle, massive growth, innovation and huge consumption. In other words, you see a vibrant capitalist society. And yet...

Hammer time

Communism tends to have little bearing on what China gets up to during business hours. It's like some weird wallpaper in the boardroom – it prompts a comment or two but doesn't influence the discussion. Still, it pays for investors to keep it in mind! It may be wallpaper, but the guy who owns the place liked it enough to hang it. China was restored to greatness by communist leadership using capitalist tools to become wealthy. And that's the rub: China's government uses capitalism, it isn't capitalist at heart.

Recently, the Chinese leadership have been concerned that some of its more swashbuckling technology companies have been getting a little too big for their boots – that they were no longer listening carefully enough to the state's subtle hints about what was acceptable. Similarly, the authorities haven't been happy with how private tutors have fuelled the arms race of education, which has in turn become a burden on Chinese families. This came to a head last month. Chinese leaders don't need to put their solutions to a public vote; they can do it overnight. So they made some bruising changes to the technology market and effectively outlawed for-profit tutoring, both of which sent Chinese markets tumbling (along with a few domestic stocks that were listed in the US through convoluted ownership structures). This then spread to American firms that sell educational services to China as well.

Instantly the debate roared to life: is this the end of the road for Chinese capitalism? We think that's unlikely. China's leaders know that markets are pivotal to Chinese prosperity. We think they are trying to fix some problems that aren't exactly unique: data security, spiralling education costs and rising inequality. They just have a habit of bringing a hammer to the problem. We are sticking with China, but we will be extremely careful about any exposure that could be seen to aggravate inequality or that plays fast and loose with Chinese data. The risk of greater intervention has increased dramatically in these areas, we believe.

Inflation's sharp sting

Another risk that we're keeping our eye on is inflation. Central banks are adamant that the current spike in inflation is 'transitory', and the market is apt to believe them. We too think the price spikes will die down in time, but we think that it may take a year or two for that to happen. If the market's idea of 'transitory' is four to six months, there could be a few wobbles as they come to terms with that misunderstanding. We had a chat about this in episode one of our The Sharpe End podcast.

In recent months quite a few consumer staple giants warned that the cost of goods sold – raw materials, energy, packaging and transportation – had ballooned recently. They are considering price increases to offset some of this, but that tends to lag the cost inflation by a year or so. One day, we'll all be scratching our heads and wondering if our shampoo bottle isn't a little bit smaller than it used to be. In the meantime, the share price of many staples businesses have lurched lower.

It's coming home (investments, not football)

We have been increasing our exposure to the UK over 2021 as we believe the economy seems to be recovering well and stocks are still relatively cheap compared with overseas markets. As part of this move, we added British lender and investment bank **Barclays** to our portfolio. It does everything from mortgages and business banking to stockbroking, trading and mergers and acquisitions. Half of its sales are made here in the UK, a third in the US and the rest spread around the world. After being forced to slash its dividend during the lockdown, we believed the recovery in the UK (and the US) would quickly filter through Barclays' income statement and allow it to turn the taps back on. This duly happened at the end of July as a more-resilient-than-expected Britain allowed the bank to reverse about a fifth of the £3.7 billion it had previously written off the value of its loans because of the pandemic.

We added further to our investments in the UK financial sector by purchasing a spread of businesses in smaller quantities than we would normally. The combined holdings add up to about 1% of our fund — the typical size we would apportion to one of our 'positions'. These included **Jupiter Fund Management**, wealth managers **Quilter** and **Close Brothers**, and emerging market funds specialist Ashmore. All of them should benefit from a continuing recovery and they all offer decent dividends. Meanwhile, there's a good chance of consolidation in the industry — something that has already started happening with the Florida-based Raymond James's recent £279 million takeover bid for Charles Stanley.

We also bought UK retailer **Next** because we believe it should get through the pandemic and general decline in high street shopping, more or less, in one piece. The industry has been mauled over the past couple of years, yet Next has a good online shopping channel — not something that all its rivals can boast. We think that Next could be the last man standing in the premium economy area of UK retail, which should be an attractive place to be over the coming years. Meanwhile, in the shorter term there's also the chance that the company will boost its dividend if the recovery continues to outshoot expectations.

We added to the **Invesco High Yield Fallen Angels ETF** as US high yield credit spreads — the extra return above US treasuries for taking on the risk of default — bounced higher. We bought **European Investment Bank 5.5% 2025** bonds to pick up some lower-duration, high-coupon assets to help secure our monthly cash flows.

To add a bit of growth to the portfolio, we bought **Taiwan Semiconductor Manufacturing Company** (TSMC) and **Ansys**. TSMC is one of a handful of businesses that dominate production of the computer chips that seem to go into everything. The technology in this industry — and its progress from year to year — is blistering. Ansys develops engineering simulation software that not only reduces consumption in the automotive and aerospace industries, but also helps consumer cosmetics manufacturers bring products to market more quickly by reducing the amount of time needed for physical testing. Ansys's programs can recreate the physics of real-world situations and show how designs will react to different forces. Using this software can save companies buckets of money in design costs and get products to market much faster.

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To make way for all these purchases, we sold a few of our holdings in an array of industries and regions. We sold the **Schroder Asian Income Maximiser** because we felt the recovery is looking tougher for the East over the coming couple of years. We exited the **M&G Global Macro Bond Fund** as low yields and coupled with the drag management fees make for an upward battle. We sold distributer **DCC** because we felt its share price didn't account for the risk that its profit margins may be squeezed by higher costs. Finally, we sold the **M&G 3.875% 2049** bond to take profits after the fall in government bond yields.

Out of the comfort zone

As summer winds down without ever getting going, inflation remains the hot topic both here in the UK and abroad. Its path and people's reaction to it will have fundamental effects on borrowing costs, monetary policy, spending habits and businesses' bottom lines.

Inflation is extraordinarily complicated, yet it is often victim to anecdotal and emotive arguments. People paying £6 for a pint grumble about lies, damned lies and statistics. Others feel the burn of paying to get on a train again or the cost of post-pandemic airfares. Yet inflation is when the *general level* of prices is increasing, not when one or two things become very expensive. Many people forget about the generally low price of electronics, home appliances and food. In particular, the increase in quality relative to price is often not adequately accounted for by punters. The most obvious example of this is mobile phones: they are roughly the same price as 25 years ago (adjusted for inflation), but now incorporate all the tasks of a camera, GPS unit, games console, scanner, personal organiser, gardening almanac and more besides. That's a lot of stuff that people no longer need to buy. Technological progress often has this hidden deflationary effect in the background.

This longer-term phenomenon, along with the large productive capacity that exists around the world — in factories' possible output, underutilised labour and piles of savings — persuades us that inflation shouldn't stay hot for years and years. But people live in the short term, and right now inflation has hit 2.5% in the UK for the first time in three years. In the US it's 5.4%, the highest level since 2008. There could be still higher numbers in coming months as supply chains continue to untangle themselves.

In a meeting with Generac, an American manufacturer of power generators, we were told that the cost of a shipping container to get something from China to San Francisco had shot up to $20,000 from roughly $3,000 a year ago. Ships, containers and orders have been knocked completely out of sync by quarantined ports, interrupted output from factories and sporadic orders from shuttered retailers. This sort of thing will crimp some companies' profits and no doubt frighten investors, causing gyrations in bond yields that will reverberate through stock markets. Expect 'growth' companies to shoot higher at the expense of 'value' stocks, only for them to reverse a couple of weeks later. These rotations will probably zigzag like that for the rest of the year, until some feeling of normality is reached.

If markets do go on as we expect, it will be an uncomfortable time for investors. Yet all that volatility would offer opportunities as well. It sounds hackneyed, but it's true. With a greater spread of possible prices, it gives you more options to adjust your portfolio, to buy into companies at a lower price and take profits on your investments at attractive heights.

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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 your original investment.

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