

Rathbone Multi-Asset Enhanced Growth Portfolio

Update, January 2018

Overview



We have highlighted for a while now that with central banks beginning to reverse the process of quantitative easing and tighten rates that a pickup in volatility was likely. This process began towards the end of the month, and then accelerated as stock markets sank sharply lower in early February.

Equities and bond yields had been rising steadily over the past few months due to a mixture of better growth prospects and higher expectations of inflation. Company earnings have largely been strong, with tax cuts helping to boost forward earnings. However, casting its shadow over this sharp drawdown is that grim raven of yesteryear: “good news is bad news.” Back in the early years of US quantitative easing (QE), risk assets were driven higher by a flood of Federal Reserve-driven liquidity – beyond what could be justified by earnings. Because of that, we had a topsy-turvy few years where any threat to QE purchases – i.e. stronger economic data and higher inflation – was met by a wave of selling. Over time, continued earnings growth helped justify higher prices and this phenomenon seemed to fade into the background.

And then, this year Main Street got a pay rise: in January, US wages were 2.9% higher than a year earlier. That was 30 basis points greater than expected and the highest rate since 2009. Albeit somewhat glossed over was the fact that hours worked actually fell. But it was enough to concern some investors that higher inflation was finally coming down the pipe, which would mean faster interest rate hikes by the Fed. Higher assumptions of future interest rates means cash flow in coming years is worth less, and so share prices adjusted. This appears to have been amplified by the squeeze on investors who were short volatility (highlighted above), and then as markets sold off people (and machines) sold because other people (and machines) were selling and the market tripped over itself in a flurry of worry.

Volatility is always bracing, but given the move up in equities and length of time since the last material pull-back, any correction was always going to be fast, of reasonable magnitude and, as ever, impossible to time. We’ve been building up our fund’s defensive assets for some months now, including cash, gold and more recently a put option on the S&P 500 index for 25% of the value of our equities. Our cash would be particularly useful in a ‘taper tantrum’ type scenario where almost all assets are falling.

This month’s trades

Footwear and sports clothes manufacturer **Nike** has been increasing its direct retail presence around the world for a few years now. By vertically integrating its supply chain, it hopes to boost its profit margin by giving away less value to retailers in what is a pretty competitive market. This strategy has been paying off, with profitability steadily ticking upwards over the past few years. In recent months, some analysts have forecasted easing pricing pressure for Nike, too, which helped boost the stock. We decided to take profits as the price was looking pretty full.

We sold some of our shares in the closed-ended **Schroder Japan Growth Fund** after its discount to net asset value narrowed. We used that cash to buy more of the **JPMorgan Japanese Investment Trust**.

We added to our holding of **Aptiv**, previously Delphi Automotive. We sold our shares of the parts and powertrain business that was recently spun out of the company, as we are much more interested in the structural growth of active safety, autonomous cars and the electrification of vehicles. By buying more of Aptiv this month, we have returned to roughly the same size holding as we had in the original Delphi company.

Outlook

It was a rude welcome for new Federal Reserve (Fed) Chair Jerome Powell, whose first day was the Monday of the 4% sell-off in America.

Many investors will be watching to see how he responds. He is widely regarded to be similar in temperament and strategy to his predecessor, Janet Yellen. However, if we really are moving into a new economic paradigm that is pretty moot now anyhow. Who knows how Mrs Yellen would have responded to a new situation and if that would be any different to Mr Powell?

In some ways, it's the market that dictates to the central banker. If inflation climbs higher and investors violently sell equities (and bonds for that matter), the Fed Chair is less likely to tighten policy rapidly in case they set off a capital markets rout and damage economic growth. Mr Powell appears a cautious man who worked closely with Mrs Yellen, herself plainly cautious, for many years. We will have a chance to see this interchange this month, with an inflation print due on Valentine's Day. US CPI has been hovering around 2.1% for several months, if it breaks significantly higher investors may get worried once again.

As for us, we are comfortable with gently rising interest rates in the US, particularly as they are still very low in absolute terms. Less so in the UK, though, where the economy feels more fragile. We think February's ructions were a foretaste of more volatility ahead as investors come to terms with the Fed's normalisation of interest rates. The exaggerated market movements caused by quantitative traders and passive flows should create opportunities for longer-term investors who buy on fundamental value. We have already used some of our cash to add to equities on this sell-off and will continue to do so in a careful and disciplined manner, should we see further drawdowns in equities or higher yields on bonds.

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