

Rathbone Multi-Asset Strategic Growth Portfolio

Update, May 2018

Overview



Italian politics sent a shock through global markets last month. No sooner was a broad, right-wing/left-wing populist coalition stitched together than it announced spend-thrift policies and mooted creating what would amount to a parallel currency.

Bondholders panicked and started hawking Italian debt and didn't stop for several days. As Italian bond yields soared the selling spread to other markets. Corporate debt in Europe (including the UK) started to go south, with financial and subordinated bonds leading the charge. Equity markets took a small tumble as well as investors decided to exit risk wholesale. Yields on gilts, bunds and Treasuries all contracted as investors ran for cover. The contagion was relatively contained compared with the dark days of the 2011/12 debt crisis though.

These short-term moves seemed an overreaction to us; since month-end most assets have recovered most, if not all, of their losses. We took the opportunity to add to a range of investments around the world at lower prices. Still, as much as investors may have got ahead of themselves this time round it vindicates our feeling that Europe is a dangerous place to invest unless you're careful about exactly what you own. There are too many fundamental flaws with the eurozone, too many nations are in thrall to populists, and companies aren't as enticing as elsewhere.

Since month-end, the European Central Bank has hinted that it may start to reduce the amount of bonds it buys each month as part of its quantitative easing programme. Without this comfort blanket dampening yields in the eurozone, borrowing costs may start to spike in the more concerning areas of currency bloc. That would likely aggravate the already testy politics of the region.

Before this Italian whirlwind ripped through May, I (David) visited the US to meet with 14 companies – some that we own and some that we've had our eye on. For years we've believed that the US is the great growth engine of the world and the place that sports many of the very best companies. I went to the US with a positive outlook. I returned, somehow, even more confident and with a number of promising candidates for our portfolios. There was a definite buzz in the air: companies are using the recent tax-cuts to invest in their businesses and raise pay for their workers. The business cycle doesn't seem to be about to turn down to me. The main risk is probably a monetary policy misstep by the Federal Reserve; however, company managers were relaxed about the gradual path currently set out.

I'm used to US companies' dogged focus on shareholder value, but what struck me during this visit was the greater emphasis on creating value for the customer as well. When done well this gives businesses tremendous pricing power. When you become a major source of efficiency for your customers, it costs customers more to go with the cheaper option.

Since my return we have already bought some of the companies that impressed me.

This month's trades

Emerging market debt had a wobbly month in May. Worries have surfaced in many different developing nations: Argentina had to go cap in hand to the IMF after the bottom fell out of its currency; Brazil was hit by strikes and its 10-year yield flew above 10% as investors took flight; and Turkey's President failed economics 101. Overall, however, we think pockets of emerging market debt offer decent returns and so we added to the **Ashmore Emerging Markets Short Duration Fund** on the weakness.

We trimmed our holding in pest control business **Rentokil Initial** after its shares have soared more than 25% since the end of March. We also sold some of our shares in the Tritax Big Box REIT to take advantage of an increase in its premium (the shares are worth more than the assets the fund actually holds).

We sold rolling stock manufacturer **Wabtec** because we are worried about the tie-up with GE's transportation division that was announced in May. We think the pair may struggle to execute the merger well – either way, we feel the risks for this company have increased to the point where we think it's prudent to sell.

We continued to build a position in **Tencent**, the Chinese internet giant. Meanwhile, we took profits in information and analytics company **RELX** after a strong year.

Following David's trip to America, we bought **US Bancorp**, the fifth-largest lender in the US. Its place at the top of the second stratum of the American financial world is actually quite positive. It doesn't have any of the investment banking divisions that make the large firms so volatile, but Bancorp still has the scale to serve both the people and the businesses on Main Streets across the Midwest (the mix is 50/50) while delivering a best-in-class return on equity of 13.4%. Over the past few years it has built a strong corporate services and lending business for larger enterprises across the country, but the mainstay of its operation is Middle America, both geographically and socially. You have probably realised that we are more upbeat on working class America than the average manager. We bought US Bancorp soon after our meeting because we felt it was in a great position to capitalise on this grass-roots improvement in the US economy.

Still, we are aware that financial markets have come a long way and there is a potential for disappointment – or panic. We topped up our defensive holdings during the month, including a put contract on the S&P 500 that expires in January.

Outlook

Ignore the gloomy talk of “late-cycle capitalism”, the US is booming right now.

To be blunt, no-one has a clue about when the current business cycle – or any business cycle for that matter – will end. What we do know is that US business and consumer confidence surveys are near all-time highs and investors aren't buying assets at silly prices (what we call irrational exuberance).

Pessimistic people are hanging their hats on the flatness of the US Treasury curve. The difference between the yield on a 1-year bond and a 10-year bond is just 65 basis points. That means investors are getting just 0.65% more a year to lock in their money for 10 years, than they do for one year. This “spread” is very close to going negative, and it has only once gone below zero without a recession coming close behind.

However, we have never been in the extraordinary situation we now find ourselves in. Interest rates remain extremely low, compared with history. Wages haven't risen meaningfully over the last decade. Global inflation is also pretty well contained given these conditions. We think the reason the yield curve is so flat is because the bond market expects US Federal Reserve (Fed) interest rates to peak at a much lower level than in the past. That could mean that this will be a very long business cycle indeed, if it is not punctured by central bankers raising rates faster than the economy can handle.

Look at it this way: the Fed has averaged just 2.3 25bps hikes a year for the past three years. At that pace, rates would be just 3.75% in June 2021. That's well below any previous peak in the rate. So the bull market in equities could have a few more years in it yet. That's why we believe we should stick to our overweight to equities and avoid corporate debt. While we have a relatively small amount of sovereign debt, we continue to buy US and UK bonds when yields rise. That, combined with our extensive holdings of diversifiers, should help us protect the portfolio in the event that we're wrong.

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