

Rathbone Multi-Asset Total Return Portfolio

Update, January 2019

Overview

Well, it's certainly all eyes to the east at the moment. As China's economic growth has slowed, its lower demand has flowed through to weaken two of its large suppliers: Japan and Europe. Both make their way in the world by making things, much of which they sell to China, so they are more sensitive to less demand from the Asian powerhouse.

We are happy with the long-term outlook for China, although we expect a few wobbles along the way as it moves from being a giant factory nation to a more services and tech-led economy, and one driven increasingly by household spending. Essentially, as it transforms from an industrial to a developed market economy in the space of only a few decades. However, for us, the real weaknesses are these second links on the chain. Europe and Japan both flirted with recession at the turn of 2019 as China's economy hiccupped, but it's only Europe that makes us nervous.

Japan should be able to shrug off the recent drop in trade, we believe. It's closer to China than Europe is, and therefore sends a larger proportion of its exports to the Middle Kingdom. However, we think its politicians – while not perfect – are doing the right things to try to improve the country, its labour market and its economy. Important reforms to Japanese businesses over the last few years have made them leaner, more profitable and generally better able to roll with the punches. Also, we think the nation will keep benefiting from the growing Chinese middle classes who are increasingly travelling to the island on holidays.

Europe, on the other hand, looks exceptionally fragile to us. And not just short-term fragile, but fundamentally broken in a “back to the drawing board” kind of way. And if Europe goes down for a moderate to deep recession at the same time as China slows noticeably and the US Federal Reserve plods on with tightening monetary policy, would that be enough to tip the whole world into recession? Is that why the Fed conducted such a screeching U-turn this year, slashing its rate hikes to a standstill and all but calling time on running down the trillions of dollars' worth of bonds and mortgage-backed securities racked up during quantitative easing?

This month's trades

When markets bottomed out in early January we sold our S&P 500 put contract, which mitigated losses in the American stock market. By selling this contract, we collected a chunk of cash which we used to buy more equities on the weakness. The stocks we added to included web search king **Alphabet**, defence contractor **Lockheed Martin** and **ASML Holdings**, a manufacturer of the machines that write computer chips.

Mid-month, when markets were still rocky, we switched our **iShares Core FTSE 100 ETF** for the **JPMorgan 1243 FTSE Defensive Autocall** structured product. We did this because the heightened volatility gave the JPMorgan contract an attractive return as long as the FTSE 100 is flat to higher over the next seven years. We would lag a soaring market and lose capital if the market falls 35% over that time.

Towards the end of the month, we added to our **US Treasury 2.25% 2027** bonds because of the Fed's screeching halt on its monetary tightening policy. It now seems highly unlikely that there will be *any* interest rate hikes this year – and subsequently published Fed minutes the “normalisation” of its balance sheet may be wound up years ahead of schedule. This development, along with decelerating inflation, should help US government bond returns. We bought the **UK Treasury 1.625% 2028** for similar reasons. UK GDP has slowed significantly and inflation has receded well below the Bank of England's target; with Brexit confusion still clouding Westminster and the economy, it seems improbable that the central bank will increase rates any time soon.

While we're still cautiously optimistic for the year ahead, we expected volatility would remain elevated (and we've been proved right so far!) so we have topped up our position in the **iShares Physical Gold ETC** to increase our protective basket of assets.

We trimmed the **BH Macro Fund** because its share price rose above its net asset value per share during January.

Outlook

Historically, the Fed has had scant regard for the rest of the world when setting its monetary policy. In the 1970s, President Richard Nixon's envoy to Europe said the dollar "is our currency and your problem," after severing the currency's gold standard. In the 1990s, with inflation running at a fairly muted 2.75% the Fed hiked rates so aggressively that it sent emerging market currencies into a tailspin, contributing to the Asian Financial Crisis. But the scales may now have shifted: if America is more susceptible to recessions overseas perhaps the Fed is taking account of what's happening beyond the US borders.

Whether this is the case or not, the Fed has unequivocally put the brakes on its rate tightening agenda. This is good for capital markets, as lower-than-expected interest rates mean upcoming cash flows are worth more today. It should also release some of the upward pressure that was brought to bear on US sovereign bond yields last year. This reversal in the fortunes of bond markets led us to buy both gilts and US Treasuries, at roughly eight to 10-year maturities. We're cautiously optimistic for the year ahead but we are aware that volatility has picked up noticeably as well. We expected this and feel market prices are likely to continue jerking around violently. Having a few more safe-haven bonds in our portfolios should help to offset some of these movements.

As for the UK, things could get very dicey as Prime Minister Theresa May takes the Brexit yacht very close to the rocks in high winds. Who knows what will happen now. We've increased the currency hedge of our overseas assets, reducing exposure to the dollar, because we're worried that there's a considerable chance that sterling will shoot higher if Mrs May is sidelined, the Article 50 deadline is extended and a categorical departure from the EU is thrown overboard. A sudden rise in sterling would lead to foreign currency losses on UK investors' overseas assets.

Don't let our safe-haven purchases get you thinking that we're expecting the worst. When markets took a tumble late last year and in early January we have steadily rebalanced our equity positions. We sold our put contracts, which had protected us from some of the falls, and we spread the lump of cash between equities and cash.

To us, investors are sliding between absolute panic and eager optimism too quickly and on too little information. We don't mind a jot though, as it gives us lots of opportunities to trim positions at higher prices and buy things we like at lower prices. We've been sticking assiduously to companies with strong balance sheets, high return on assets and a true edge on their competitors. These businesses are in no way immune to a recession, if one comes (they are nigh on impossible to predict), but we believe they should fare best.



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