Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Income Fund

Monthly update October 2020

Some reflections

Despite a few yet-to-be-negotiated hurdles, Joe Biden will be the next President of the United States, and the initial response from equity markets was unequivocal. Shares went up. Even though, ahead of time, the combination of a contested Biden win and a Republican Senate was regarded as the worst possible outcome, after the event investors piled in. They just changed the narrative. A Biden presidency means less unpredictability, the possibility of a meaningful stimulus bill, more conciliatory trade talks; a Republican Senate, if confirmed, would limit the scope of tax hikes and maintain the likelihood of pro-business policy. There are wins all round. The 'value' rally that had accompanied expectations of a 'blue wave' didn't reverse too much, but 'growth', led by the FAANGs, revived with a vengeance.

On the assumption that there is an eventual transfer of power, one big source of uncertainty is now behind us. However, when you consider how divided the US is, how confrontational their tribal politics has become, sorely in need of reconciliation, it is troubling that markets surge on the promise of further gridlock, on nothing getting done to rock the boat. From an investment point of view, it is unwise to stand in the way of the 'momentum' trade. But also, taking a longer view, it seems dangerous to ignore the widening gap between what drives markets and what drives the wider economy. What happens if we do not get gridlock, but an American government that does get things done? Is this dangerous territory for investors for whom gridlock has been the backdrop to over a decade of gains?

Certainly, global markets responded positively to the election results. Investors are betting that the new administration will seek to ease trade tensions. They wager that Mr Biden is unlikely to want a trade war with China. The UK markets participated in the rally, with the commodity-heavy FTSE 100 benefiting from the constructive vibe. Financials were also catching bids. The 'risk-on' character of the week was reflected in a weakening dollar, which is in itself a risk for large dollar-earners in the UK market. Talking heads on the financial channels even discussed shifting asset allocation towards emerging markets. We are not sure where the UK ranks in this view, but any change in allocation can only be an improvement.

For a few days, the US election relegated COVID-19 lower down the news cycle, but it remains the dominant global issue. Lockdowns have been re-introduced across Europe, and hospital admissions are ramping up worryingly in the US. It remains to be seen how American policy changes, but we think a robust and disciplined response is guaranteed from the task force that Mr Biden establishes.

Our position on the UK economy has become marginally more constructive. Our nation's big news last week was lost in the noise. The Bank of England announced a further £150 billion of monetary stimulus through purchases of government bonds, and later the same day, Chancellor Rishi Sunak extended the furlough scheme through to March 2021, a clear demonstration of co-ordinated action between government and central bank, something which does not avail the US. This is a major response, and notwithstanding the real economic travails that have necessitated the action, it is a positive.

The Brexit saga has been rumbling along too long, and it now pales into insignificance alongside the global, social and economic impact of the pandemic. However, we think a deal is more likely than not. A Biden presidency may even precipitate a deal, because Prime Minister Boris Johnson has lost Donald Trump as an ally and he may need to tack; it will be interesting to see if there is a change of rhetoric out of Number 10.

The Fund

We balance risk in our portfolios because we cannot predict the future. In this extraordinary year, companies themselves are unable to give meaningful guidance because they also have limited visibility. They do not know how COVID will impact their businesses, or how policy and behaviour will change. There is no such thing as a meaningful consensus view in today's environment, because forecasts are wild guesses. This is one reason why the structural growth stories in the technology sector have been so attractive, because they offer some semblance of certainty. And to be fair, have generally exceeded expectations. For the rest, 2020 has been tumultuous.

All we can do is speak to our companies and listen to them. They are our best sources of data. The market has its own agenda, and too often it forgets what has been said. Investors have understandably avoided the banks, but they have largely ignored the positive data coming from these businesses. In the recent round of trading updates, the banks beat, and beat well, because expectations were so low. We were not betting on this outcome, but we felt that investors were ignoring the margins of safety afforded the sector through their strong balance sheets. The point is, for all the fear that is out there, we must not forget to look at the facts.

And when it comes to facts, let us write once more about dividends. We reiterate the fact that we have rebased our dividend down 20.5%, vastly better than the drop registered by the market. We are reallocating capital to businesses that *can* pay a dividend (in some cases these companies are choosing to not pay one so they can invest in the future or have been instructed to defer by regulators). News on dividends this reporting season has surprised on the upside as far as we are concerned. And the reward to you, as an investor, is a fund yielding over 4%, in an environment where income returns on cash are very low and the savings rate is very high. There is a lot of cash out there wanting income, and just not getting it.

As we write, you do not know what is around the corner…

9 November

After month-end, US pharmaceutical giant Pfizer announced positive data on final trials of its COVID vaccine, a joint project with Germany's BioNTech. A 90% reduction in severe infections was streets ahead of the most optimistic market estimates. As one commentator wrote, everyone had been watching the election, no one had been thinking about the vaccine data. The market reaction was rapid, with 'cyclical' stocks (those most geared to the economy) finally catching a bid and safe havens getting sold. These moves were perhaps exacerbated by a smattering of short closing. Bond yields rose, reflecting a more aggressive attitude to risk, facilitating a market rotation into value businesses. Airlines and crude oil jumped higher, technology lagged or even went into retreat.

Now, this is just one day, but it shows what can happen when the news changes.

So, why support our fund? Why buy UK Equity Income?

A lot of bad news is priced in, but recent results coming from value stocks have improved: banks reminded investors that they are able to pay dividends; housebuilders continue to trade well; and oil stocks, after a dreadful nine months, are returning to profitability.

Dividends have been hit, but that's last year's news — we must get over it. Current news flow is a lot more positive and we are forecasting meaningful growth over the next two years, with a starting yield in excess of 4%. So much cash is sitting on the side-lines, earning little to no income. We expect this to make its way into the traditionally higher-yield UK market once some of the uncertainties of the past few years melt away.

Meanwhile, we think a change in American leadership should improve the mood of global trade discussions. A more structured, transparent and logical US trade strategy would be a fillip to the global economy. Many UK companies — both household names and lesser-known enterprises — are heavily enmeshed in global supply chains.

As optimism has rebounded, taking markets with it, the dollar weakened rapidly. If this turn of mood holds, we expect the dollar should fall further as global investors sell safe-haven American assets and look to make riskier investments elsewhere. That would lend support to commodity prices, which tend to run counter to the dollar, and the commodity-heavy FTSE 100 in turn.

Brexit is the running sore for the UK — and missteps could blow the benefits mentioned above. However, for all the bluster, a deal does look more likely as the clock ticks down. Both the UK and Europe are struggling to deal with the pandemic and its economic consequences, it would be madness for them to spite each other at the last gasp.

When it comes down to it, the UK market is very cheap and under-owned. The UK's combined government and central bank action was — and still is — a very substantial, well-timed and necessary boost. Now, with a vaccine in the offing, the UK may be able to drag itself out of a five-year funk. One helpful sign: overseas bargain hunters have started sniffing around. There is tremendous value here in the UK. The recent bid for RSA Insurance is just the latest in a run of proposed acquisitions. More M&A activity could be right around the corner, which would heighten interest in UK assets.

THE NEWS OF A VACCINE COULD BE A GAME CHANGER. It totally changes the market dynamic. A viable vaccine will be analogous to massive global fiscal stimulus. It's arguably more important than government policy at this juncture.

If investors start searching for more risk, the UK will be on the menu, and companies generating high free cash flow yields supportive of dividends are very attractive in a low interest rate world.

Recent trading: We have trimmed **Halfords** and **Bunzl**, taking profit after strong performances this year. We have also reduced our position in **Anheuser-Busch InBev**. We have sought to increase 'economic' leverage by adding to **DCC**, **Ferguson** and **Jupiter Fund Management**. Finally, we have sold all of our small holding in **Headlam**.

Companies seen (virtually) this month: British American Tobacco, Royal Dutch Shell and **Bunzl**.

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This is a financial promotion relating to the Rathbone Income Fund. Any views and opinions are those of the managers, 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 may go down as well as up and you may not get back your original investment. Performance data is sourced from Financial Express, mid to mid, net income re-invested.

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