Rathbone Unit Trust Management

Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Greenbank Dynamic Growth Portfolio

Monthly update April 2023

The shades of panic elicited from the banking wobbles of March receded in April, even as some American lenders continued to struggle with the aftermath.

The sudden collapse of Silicon Valley Bank and several smaller peers, followed by the shotgun merger of ailing Credit Suisse with UBS, cut roughly a tenth from the value of worldwide banks. Investors have since calmed down and refocused on inflation, the chances of recession and what the US central bank will do as a result. We agree that the chance of a big banking blow-up was — and still is — very slim. Regulation and monitoring, especially among large systemically important banks, is so much tighter than it was back in 2008 during the Credit Crunch.

However, that won't necessarily prevent people getting nervous and sparking sell-offs when more smaller banks fail. We think more small-to-medium-sized banks may need emergency mergers, takeovers and share sales to bolster confidence and keep depositors calm. The last time interest rates rose extremely rapidly at the dawn of the 1980s and that caused a wave of collapsed banks. This was known as the Saving & Loans Crisis, and it smouldered on for several years. Fewer banks should fail this time — again, because of improvements in regulation — but we should heed the fact that the effects of sharp interest rate movements can linger in the banking system.

We expect this to fade into a slow-burn that flares up every now and then as a lender comes unstuck or announces serious restructuring. Meanwhile, some banks will no doubt do quite well indeed. Take the recent results of many lenders on both sides of the Atlantic: they have reported big bumps to profits even as share prices slumped and some banks failed. This makes sense in that you expect the difference between winners and losers to widen in a period of great change, depending on their individual decisions and strategies.

The end of a steep hike?

American regional bank and wealth manager **First Republic**, which we own, was taken over by the federal government and sold to JPMorgan at the end of the month. Under the terms of the deal little if any recovery is likely from the shares. We believed First Republic was a quality operator that didn't have the same concentration of depositors as Silicon Valley Bank; however, as panicked news flew around the world its depositors withdrew funds at an unsustainable rate. We discussed First Republic in our quarterly update as well.

As soon as First Republic was sold, short sellers turned their attention to other regional banks, sending their share prices tumbling further. Like First Republic, most of these banks aren't in any danger of being unable to pay their debts — as long as their depositors stick with them. They have a mismatch between their deposits (which can be withdrawn instantly) and the value of their long-term assets (the loans they've offered to customers or the government bonds they've parked unneeded cash in). As interest rates rise, the market values of these assets fall because they pay a lower interest rate than what is on offer to investors today. But if banks don't have to sell them and crystalise the loss, and they still have the cash to pay bills, borrowers and depositors, then they are solvent. In response to the recent bank failures, until March 2024 the US central bank is offering banks one-year loans secured on those high-quality bonds and mortgages at the amounts they were issued and will mature at (i.e. not at their currently depressed market values). This helps ameliorate that asset/deposit mismatch, in the medium term at least.

These dynamics could weaken some banks' profits as they pay more in deposit rates and debt repayments to the central bank (costs) while still receiving the low rates of yesteryear from their old loans (revenue). But it shouldn't be a mortal issue. Also, banks aren't static — they make new loans every day and old ones either roll off or are refinanced at prevailing rates. In time, the gap between what they pay depositors and what they receive from lending should return and profitability should improve. American deposit rates have been extremely low for years, so there's a chance that once concerns recede from the headlines depositors will settle down. However, if depositors and investors flee, the pressure on any bank is irresistible.

In early May the US Federal Reserve (Fed) raised its benchmark interest rate by 25 basis points to the 5.00-5.25% range; a few days later US inflation dipped from 5.0% to 4.9%, continuing at downward trajectory from a peak of 9.1% in June. It seems likely that US rates have now hit their peak unless inflation reverses course. The banking failures caused by the exceedingly swift rise in rates will probably have given the Fed members a case of the willies. If we were in their unenviable position, we would want to pause and take stock.

A pause in US rates will be welcomed by both banks and investors alike. According to markets for locking in future interest rates, many investors expect the Fed to cut rates before the end of the year. We think that's unlikely, given inflation is still more than double the Fed's target. The economy would need to be seriously disintegrating for the Fed to reduce rates if inflation is still above its target.

Weaker economic data has slowly started to eclipse stronger data, creating a fade in the health of the global economy. The information coming from companies has started to follow suit. Earnings held up pretty well in the first quarter, but a few businesses have disappointed overoptimistic analyst expectations and have been slapped with double-digit falls in their share prices. We've increasingly noticed more companies reducing their forecasts for 2023 profits, obviously hoping to avoid undershooting expectations, which is heavily punished these days.

Stock markets have ground higher in 2023 despite continued rate hikes, shocks to the banking system, persistently above-target inflation and rising chances of recession. We think it's prudent to take out portfolio insurance, given our uncertainty about the future and the potential for investor disappointment to drag markets sharply lower at some point this year. To do this, we buy put options, which give us the right to 'sell' a large proportion of our American stock market exposure at a set level. This protects us when stock markets fall by creating a floor for our losses. The latest was the **Bank of America October 95% S&P 500 Put**. This means it kicks in 5% below the S&P's level at the time of purchase and it expires in October.

We added to dollar-denominated safe-haven bonds which offer better yields now that their prevailing interest rates are much higher than previous years. We did this by purchasing the **European Investment Bank 1.25% 2031**, as America spends too much on its military and isn't doing enough to fight climate change for us to be comfortable using sustainable investors' money to buy US government bonds. We also added to our **UK Treasury 4.25% 2032**, again because yields are now much more attractive.

We added to tractor maker **Deere**, laboratory instrument and testing substances supplier **Thermo Fisher Scientific** and **Merck**, a pharmaceutical, veterinary medicine and vaccine manufacturer.

We completely sold our holding in smartgrid operator **Alfen** because the market for electric vehicle charge points – which is a large part of Alfen's business model – is becoming more competitive even as costs rise. We felt there were better places to invest, so we sold.

A different world, different results

We think the yawning gap between banking winners and losers is something that will flow through to other industries in the coming year or two.

The world is waking up from a strange decade when money and energy were cheap and plentiful and inflation dormant. Costs rarely moved significantly, wages went nowhere and even fell for many once you factored in inflation, and it was relatively easy to get a bargain loan to paper over any short-term cracks between income and costs.

Those days are well and truly over, both for people and for businesses. Households, companies and governments are now having to roll over their debts at much higher interest rates. Everyone is paying more for energy as well, both because of much greater market prices and because of the need to invest heavily in developing the technology and infrastructure for low-carbon alternative technologies. The spurt of double-digit inflation roused workers, too, encouraging significant wage demands that companies and governments are struggling to settle, leading to strikes and dramatic increases in staff turnover.

Virtually all costs are much higher now than a couple of years back. People have less left to spend after paying bills and that means they will start to become much pickier about what they keep buying and what they can dispense with. Governments, too, will no doubt need to review their programmes and contracts to see what they can cut to save money. Businesses are at risk of being caught in the middle: paying higher costs like everyone else, while losing sales at the same time.

We've been reviewing our investments using this litmus test: are they the best value option? And are they making solid profit margins that allow them the flexibility to reinvest in themselves and ride out difficult times? We want to own resilient businesses as we navigate what could be a bumpy 2023. Companies must make it very difficult for their customers to switch to a cheaper rival or dispense with their products all together. Otherwise they will be toast.

Will McIntosh-Whyte
Fund Manager

David Coombs
Head of Multi-Asset Investments

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Rathbone Unit Trust Management Limited
8 Finsbury Circus, London EC2M 7AZ
Tel 020 7399 0000

Information line
020 7399 0399
rutm@rathbones.com
rathbonefunds.com

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