

Rathbone Greenbank Defensive Growth Portfolio

Monthly update November 2022

In normal times, central bankers try to be as clear as possible about the likely path of interest rates. These are not normal times.

Inflation is sky-high although it looks to be rolling over. Parts of the American economy are cooling swiftly, parts are still rolling along no problem. In 2022, the US Federal Reserve (Fed) has hiked interest rates by 375 basis points, from 0.25% to 4.00%. Typically, the Fed raises rates by about 3% over two years in the course of a tightening cycle, but they had been getting much shallower and shorter in recent decades. Until now, that is. If the Fed cleaves to expectations and delivers another 50bps rise in December, rates will have increased by 425bps in a year with more to come in 2023.

As a backdrop to all this, comments from Fed policymakers have been all over the place. Some of them argue that many more stiff rate hikes are required to firmly tamp down inflation. Others suggest that tightening must soon end to avoid overtightening and strangling the economy in the coming months and years. And then the policymakers swap scripts and repeat.

Running down the clock

The Fed seems to be trying to manage markets as it approaches the point where it will pause its tightening. We think inflation has now peaked in the US and that it will continue to fall over the coming year toward its 2% target (but it won't get there for a few years yet). If the Fed adds many more rate increases next year, it's likely that it will puncture GDP growth and create an unnecessarily deep recession. That's our view, anyway, and we have a feeling that the Fed is, broadly, in the same camp as us on this. However, investors have been excessively giddy about monetary policy inflection points in the last few years. When they get a sniff of any sort of slowdown in tightening or divine the potential for future cuts to interest rates they buy stocks and bonds like it's Black Friday. And that ruins the Fed's buzz because a market resurgence makes households and businesses feel better about their situation and may encourage them to splurge again. That would dull the Fed's efforts to rein in consumption and inflation.

All this inflation, pandemic hangovers and monetary tightening has created a maelstrom of effects on financial markets and – crucially, with a lag – the real economy. This lag is the reason for the Fed's head-fake strategy, in our opinion. It's trying to run down the clock, not tightening too much further but also trying to avoid investors getting ahead of themselves as it waits for the medicine to hit the economy's bloodstream.

Investors have mostly cottoned on to this though, sending bond yields sharply lower and stock prices sharply higher in the past couple of months. What drives the market's mood now is the balance of US economic data. Poor numbers get investors excited about the Fed relenting on hikes; evidence of economic strength sends markets tumbling on concerns of rates marching much higher. Most American economic data has been weakening lately, with the stubborn exception of employment. We expect this to continue into 2023, with jobs growth beginning to melt away as companies refinance borrowing at higher rates, increasing their costs and reducing the number of profitable projects they have to embark on.

Letting the bandwagon pass

The belief that a Fed pause is just over the rainbow has weakened the dollar considerably as many investors have moved their money out of the US and into riskier assets and nations. From its peak in late September, the greenback has sunk about 7% relative to a basket of major currencies. Against the pound specifically, the dollar has dropped by 13% over the same period.

Emerging market stocks rallied significantly over November, Europe has had a stonking run and even the UK has recovered. This is, effectively, a 'risk-on' trade. It comes at a strange time, in our view, and we're not leaping on to this bandwagon. Meanwhile, there was also a marked buying of gold, which becomes more attractive if interest rates are lower than expected in the future. Because gold doesn't yield anything, lower interest rates reduce the 'opportunity cost' – the potential return you can get elsewhere – of holding it. While about 10% higher over November, the gold price is still well below the peak of \$2,050 from March this year at \$1,770.

We added to our dollar-denominated 'safe haven' bonds: the **Asian Development Bank 1.5% Senior 2031** and **European Investment Bank 0.75% 2030**.

We traded one US main street lender for another in November. We sold down long-time holding **US Bancorp** and bought the smaller (but still very big) **Huntington Bancshares**. Based in Ohio, it has 1,000 branches spread across the Midwest, with Colorado and some eastern states in the mix as well. Its retail banking pitch is skewed to those who prefer in-person banking, and it scores highly in customer satisfaction. It is trying to parlay that into cross-selling, especially of investment products. Huntington also has a strong business and commercial banking operation, with a growing speciality in supporting vets and dentists. Despite its down-home feel, Huntington is no luddite, sporting the top-rated mobile app among its regional bank

peers. Less than 1% of its loans are to oil and gas businesses and it has a strong community spirit. Huntington has earmarked \$40 billion over five years for lower-cost loans and mortgages to disadvantaged people with poor credit ratings, as well as to invest in underserved communities. The plan is to boost the wealth and vibrancy of poorer areas by offering a helping hand to get businesses off the ground and help people get a secure home. If they are successful it's good for the economy, good for the neighbourhood and good for a lender's business. It just makes sense.

We trimmed **ASML**, the Dutch designer of high-end commercial computer chip printers, after a recent rally. We used the cash to add to wastewater pipe manufacturer (and the largest plastics recycler in North America) **Advanced Drainage Systems** and American high-end wealth manager and private bank **First Republic**, whose share prices have been weaker.

We bought Illinois-based inventory management business **Zebra Technologies** in November. The company combines RFID (radio frequency identification) technology with cloud-based computing to help its customers better track and monitor stock and equipment. This could be knowing exactly how many widgets are in a retailer's warehouse, or letting a doctor swiftly know what has been administered to a hospital patient in the last 24 hours. Zebra sells to many different industries, from utilities and energy through to manufacturers and hotels. Where it really comes into its own though is in the analytics tools that it has developed. The insights gleaned from RFID tracking can save businesses vast amounts of money and spot inefficiencies and opportunities. We often talk about how much digital investment we believe is coming in the next decade or more as companies drag themselves into the 21st Century. Zebra should benefit.

We added to our **Put Spread** structured product, which protects us against the first 25% of any fall in the US stock market. These options are effectively an insurance policy on our US stock portfolio. We pay an upfront premium in return for the right to 'sell' a given value of the S&P 500 Index at a pre-agreed level.



Lockdown anger boils over

Chinese President Xi Jinping's third term has got off to a rocky start. Going into his second decade at the head of the Politburo, Xi culled the last perceived market-friendly members of the ruling committee, filling the spots with loyalists. Investors took that very poorly and Chinese stocks sold off during the 20th Party Congress in October. It appeared to herald more of the same for the world's largest exporter, which had cracked down on technology and education companies earlier in the year, and was continuing with its extremely strident and disruptive zero-COVID strategy and was suffering from a slow-motion implosion of its property market.

Yet in November simmering tensions boiled over in rare widespread protests against the government. Thousands of people took to the streets of cities and towns across the country complaining of rolling lockdowns that have been going on for three years now. The state appears rattled and has since relaxed some of its policies. China is still in a bind though. The reasons for its attempts to avoid widespread infection of COVID-19 remain: it has a very large, old population that has been cautious in its uptake of the homegrown Sinopharm vaccine, which is also less efficacious than Western varieties. Reducing restrictions will mean more infections and it's unclear how the country will be able to deal with the waves without either locking down again or accepting high casualties. Chinese scientists have developed an mRNA vaccine, but it hasn't been approved for the mainland. The government has refused to use Western options and it seems unlikely to change course this late in the day.

We were heartened by the meeting between Xi and US President Joe Biden, which seemed to cool tensions over Taiwan, Hong Kong and the disputed islands of the South China Sea. Hopefully this is the beginning of the end of recent sabre rattling in the Pacific. For the time being at least.



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