

Rathbone Multi-Asset Defensive Growth Portfolio

Monthly update February 2021

The momentum in markets has well and truly shifted. The US 10-year government bond yield has been rising steadily for months, yet it went into overdrive in late February and early March as investors prepare for a GDP growth slingshot when economies reopen.

The benchmark US borrowing rate jumped more than 50 basis points to 1.60% between January 31 and its peak in early March. To put last month's move into context, however, the yield is only now approaching the 1.60% to 2.00% band where it traded before the pandemic hit. Still, it's a big move in a small month and it has rattled markets.

Rising yields shake out stocks

The effect on stocks was as you would expect: 'growth' companies have generally tumbled because higher interest rates reduce the value of cash flows that are expected to arrive far out in the future. Growth companies tend to reinvest most of their profits in pursuit of becoming much bigger, dominant and valuable in five, 10, 20 years' time. This makes their share prices much more sensitive to changes in interest rates. As bond yields slumped during the pandemic, the values of many growth businesses were pumped up at the same time as many were enjoying increased earnings on top. Recent falls in growth company shares are simply the reversal of this phenomenon. Meanwhile, 'cyclical' companies – those that are heavily geared into wider economic growth – have enjoyed a sharp revival. This makes sense too, because investors are expecting them to make hay as economies reopen.

Now, as we've mentioned before, we're a little less sure about the longevity of any rebound in economic growth than other investors appear to be right now. While a few months of huge jumps in GDP and inflation are on the cards because of [the 'base effect'](#), we believe there's still a whole bunch of long-term economic forces that should keep a lid on growth and inflation. Older demographics, way more debt and an ongoing technological revolution that is laser focused on reducing costs. Then add a significant increase in unemployment, which is likely the moment governments remove their pandemic support policies.

Yet markets are heavily influenced by emotion. People freak out and markets reflect that. Sometimes, if enough people worry enough about a thing happening, it can actually cause that thing to come about. What we're trying to get at is that we could be wrong so, as always, we try to hedge our portfolio against that risk. Typically, that involves buying when others are selling and selling when others are buying.

For example, we have been taking profits in many of our growth companies over past months as markets and share prices kept hitting new highs. We have used that cash to add to companies we call 'quality cyclicals'. These businesses have the characteristics of growth companies (strong underlying customer bases, quality cash flow and advantageous market dominance) yet they should also benefit from economies reopening and recovering. This shift helped blunt the effect on our portfolio from the aggressive market rotation from growth to cyclicals.

As US Treasury yields shot higher, dragging gilts and other government bonds with them, we took the opportunity to buy **US Treasury 1.5% 2030** and **UK Treasury 7/8% 2029** bonds at lower prices. We had reduced our holdings of US and UK sovereign debt over the past year as yields fell to record levels (and prices rose to record levels). We still believe that they offer valuable portfolio protection – as long as you buy at a reasonable price.

Mid-month we took profits in **ASML**, a European manufacturer of industrial machines that print the computer chips that go in everything these days. The share price had risen a long way and we felt it was prudent to recycle that cash into other investments. We also took some profit from mining giant **Rio Tinto**, as its share price has soared significantly above pre-pandemic levels in anticipation of a reopening boom.

We bought Canadian ecommerce platform **Shopify** for the first time. This business is popular among small and mid-sized businesses, offering them a full white-labelled digital sales system, from website design and hosting to payment, shipping and after-sales care. Shopify's services are so good that even larger brands use them too. There has been a clear acceleration in ecommerce over the past year, yet online sales in many countries still make up a small proportion of overall retail sales. We think there's plenty more growth to come in this trend that pre-dates the pandemic.



We added to our holding in **Edwards Lifesciences**, an American manufacturer of artificial heart valves and monitoring devices. Elective surgeries haven't been so hot during the pandemic, for obvious reasons. However, they should jump back once COVID-19 fades. It should come back faster for heart surgery than rhinoplasty, at least. People tend not to mess around when it comes to recommended or required procedures for their heart.

As part of our hunt for portfolio diversifiers we purchased the **iShares China CNY Bond ETF**. This tracks a basket of investment-grade bonds issued by the Chinese government and state-run development banks. Long-term, we believe the renminbi could become a global reserve currency; shorter-term, we think these bonds should hedge us against disappointing Chinese GDP. Lower than expected growth would mean lower inflation and the effect of both would be a drop in Chinese yields, increasing the price of the bonds.

Due to inflows, we added to our holding in the **JPMorgan Emerging Markets FX Momentum** structured product. This contract gives us exposure to a 'momentum' index of emerging market currencies. It uses price trend data to anticipate whether the basket of currencies will rise or fall against the dollar. This should enable us to generate positive returns in benign markets, and historically it has provided some protection in times of crisis as emerging market currencies typically sell off against the dollar, and the index model has picked up on this trend and moved to a long dollar position.

We have also added carefully across our existing holdings where the price warrants it.

Make sure to know what you don't know

So where from here? We really don't know. As we said earlier, we have a hunch that inflation will be kept tamped down by strong economic forces, but we don't have a crystal ball.

The reopening surge could be explosive indeed. Take the UK: something like 90% of all self-catered holiday accommodation in the UK has been booked out for this summer. And that's before we know whether anyone will be able to travel further than the end of the drive! Restaurants and bars are similarly booked out months ahead despite the lack of certainty. At least in these sorts of sectors, such hefty demand coupled with reduced supply means short-term prices are headed one way: up. One of the major influences on longer-term inflation is people's expectations of inflation. If they think inflation will rise, they tend to agitate for greater wages, which has a significant effect on inflation. Who knows how people here in the UK – and those abroad who will be experiencing similar scenarios – will react. There is one impediment to widespread wage growth,

which we mentioned earlier: it's hard to argue for a pay rise if unemployment is high. That is, unless your particular set of skills is in high demand (to paraphrase Liam Neeson).

Over in the US, which tends to create the global economic winds that blow through all other nations, lockdowns have been less total and commerce seems to be sharply rebounding already. This, combined with a humungous \$1.9 trillion stimulus package that appears imminent, could redraw the economic landscape. It will do three things in particular: 1. Vastly increase households' ability to spend; 2. Massively increase the issuance of US government bonds (pushing yields even higher); 3. Boost unemployment benefits (potentially reducing people's desire to take a job paying less).

There's a lot of secondary and tertiary impacts that flow from just those three major phenomena. Over the coming months, as markets reopen and another round of stimulus kicks in, we feel like there's a reasonable chance of a rerun akin to the 'taper tantrum' of 2013 when the US Federal Reserve hinted that it couldn't Hoover up bonds forever. Investors worried about rising yields, so started selling bonds aggressively, while the US Federal Reserve stepped in to buy them and calm things down. Another bout of this sort of thing wouldn't be great for any sort of asset in the short term, so we're sitting on a little more cash than usual as we wait to see how the first stages of the global reopening go.

Longer-term, we're optimistic about markets and the investments we hold, however we just feel like the reopening months could get a bit erratic as people's expectations mix with reality and evolving economic conditions. Like any transition! So we're keeping some of our powder dry to take advantage if it comes.



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