Contact us 020 7399 0399 rutm@rathbones.com

Rathbones
Look forward

Rathbone Multi-Asset Strategic Growth Portfolio

Monthly update January 2023

Markets have roared out of the gates in 2023. They had quickly recovered from their October lows, before dipping slightly as 2022 closed out. But they jumped almost 10% again in January alone.

The latest stock market surge has a wild, feverish feel to it. Like the dawn light after a very long night. The 'growthiest' stocks that crashed the hardest last year were also the ones that bounced the highest recently. 'Growth' stocks are most sensitive to changes in prevailing interest rates (including those that are expected in the future) because their payoffs come many years in the future, as opposed to more mature companies that increase their sales more slowly and deliver profits back to investors today.

The reason for the aggressive swing back to these growth stocks was the steady decline in American inflation from a high of 9.1%in June to 6.5% in December and a popular belief that slowing economic data would encourage the US Federal Reserve (Fed) to stop hiking interest rates early. In fact, market prices imply thatthe Fed will actually reverse course and *cut* rates. These upward moves in stocks were no doubt super-charged by a 'short squeeze' on many of the really growthy, 'speculative tech' businesses.

Caught short

Many investors had 'shorted' these companies, hoping to make money from further falls in their prices. To do this they borrow stocks from other investors and sell them immediately, hoping to buy these shares back for less money in a few months' time to deliver to the lender, leaving them with a profit. However, if prices go up instead of down, these short investors can lose money at a quicksilver pace. When prices move rapidly higher, there's a scramble to buy shares early to ensure they don't lose their shirts, which puts yet more upward pressure on the price, creating a self-propelled rocket. There were quite a few such rockets put up in January. These rapid gains then caught the eye of more and more investors with cash on the sidelines, who were spurred into a sort of FOMO (fear of missing out) rally.

European stocks also had a good start to the year. The Continent enjoyed a mild winter, avoiding the potential catastrophe of outsized demand for gas sending prices back into the stratosphere and causing blackouts and rationing for homes and businesses. With spring approaching, the European wholesale gas price is back near €50/megawatt hour (£44/MWh), compared with the €100 to €200/MWh range of 2022 (with spikes up as high as €340MWh). That's good news for households and businesses, especially energy-intensive manufacturers.

The reason for the punchy jump in European stock prices isn't completely clear. It might be because of the better-than-expected winter and economic data. But it might also have something to do with China — Europe's third-largest export destination. Many investors had sold their Chinese holdings because of the country's zero-COVID policy and concerns about increased government intervention in markets. Since the nation's rapid reopening in December, the nation has bounced back, with greater demand for goods, services and resources. Europe might be a way for investors who cooled on China to retrieve their exposure indirectly.

We have kept a decent position in European stocks for some time, so we've benefited from this uplift. While we're not cheerleaders for the European economy, some fantastic global companies can be found there, especially luxury brands, pharmaceuticals and industrial businesses that are digitising in exciting ways.

A towering opportunity

We switched our investment in US telecommunications business **Verizon** for **American Tower**, a real estate investment company that owns and operates more than 220,000 wireless, broadcast and mobile data tower sites all over the world. It also leases fibre optic networks to telco businesses. This is a big, niche business — just what we like. How it works is that American Tower buys very long leases on well-sited parcels of land, builds the tower frames and installs the electrical infrastructure to allow broadcast and wireless assets to plug in. It then leases space on its towers to telco networks — often two or three on the same tower, which adds revenue with little extra cost. This business model is an oldie but a goodie: it's selling picks and shovels to the goldrush. Mobile networks all over the world are moving from 3G to 4G and from 4G to 5G, fuelling double-digit increases in data demand. To keep up with this demand, they need to increase antennae space quickly. This is especially true for 5G, which needs higher-frequency radio bands to offer better-quality services, but higher frequencies have shorter ranges from the towers. Therefore, more towers required.

We added a new diversifier, which takes advantage of an idiosyncratic feature of European equity option markets. Large Continental insurers are pressured by regulation to each week buy very short-dated put options — a kind of insurance contract on the stock index. This is to make sure that a big drop in stock markets doesn't wipe out the assets required to pay out their customers' insurance claims. As you can imagine, that creates a huge amount of demand for short-dated put options, which (like anything) pushes up their price. The **Bank of America European Catapult** structured product sells these structurally overpriced put options and then uses half of the money it receives to simultaneously buy slightly longer-dated puts at keener prices. This strategy therefore makes money regardless of whether stock markets rise or fall because it simply pockets the difference between the two put prices. It should also make money if market volatility increases because it is 'long' the slightly-longer-dated put, and its value is more sensitive to changes in volatility because of its longer life. We could lose out, however, if markets fall gracefully — i.e. even as volatility *drops* (this can happen).

We used big moves in stock markets to take profits from credit card and payments network **Discover** and pan-Asian insurer **AIA**. We used that cash to buy more shares in some of our existing holdings, including landfill and recycling company **Waste Management**, derivatives exchange **CME** and digitisation consultant **Accenture**.

Labour is a battlefield

The hope that interest rates may peak at a lower level and start falling sooner also boosted the value of bonds, as you would expect. Bond prices leapt higher as their yields fell. US 10-year government bonds fell from 3.9% at the start of January to about 3.5%, while UK treasuries dropped from 3.7% to 3.3%. Following month-end, the 10-year UK treasury plummeted even further, briefly slipping below 3.0% before racing back to almost 3.5% in just a couple of weeks. The US government bond yield has retraced itself too, and was trading near 3.7% by-mid-February.

Sorry to throw all these numbers at you, but these big moves show just how uncertain investors are about the path of inflation, GDP growth and interest rates. Bond markets are the bedrock of all these market fluctuations. And when bondholders don't know what's going on, it's best to hunker down.

Economic data has been all over the place. Lots of business surveys, like PMIs, and gauges of household confidence have deteriorated to levels that tend to warn of recession. Two-year government bonds have yielded more than their 10-year counterparts — a solid sign of trouble sometime in the coming year — since June. This 'inversion' of the yield curve has increased dramatically this year to -0.8%, an extreme level. However, hiring and employment are holding up well, and wage growth is cooling, at least in real terms (adjusted for inflation). Spending in shops and by businesses is holding up too — cooling from recent months but higher than the previous year. As long as inflation continues to decrease in line with investors' expectations and employment holds up, markets will have a sunny disposition. But any wobbles in these numbers could cause more wild swings in the prices of stocks and bonds.

The much-watched nonfarm payrolls data release reported that the US created a massive 517,000 jobs in January, double both December's number and what economists were expecting. However, the ADP Employment measure showed just 106,000 new jobs, with smaller companies, construction, trade, and transportation firms shedding jobs. As clear as mud then. The labour market is really shaping up to be the Fed's chosen field of battle. What happens here will determine whether rates continue to rise or if a reprieve will be offered.

One Goldilocks, three bears

Everyone is praying that the Fed can pull off a 'soft landing' for the economy — that it will get inflation back under control without having to hike rates so high that it causes a recession.

This has rarely been achieved in the last 60 years. It happened in the late 1960s/early 1970s and again in the early 1990s. The other 10 times were somewhere between a bumpy landing and a flaming wreckage, sometimes by the Fed's design and other times because of 'events', like wars and energy shocks…

So, while we all dream for a Goldilocks scenario — not too hot, not too cold — we must remember that in the children's tale our heroine was outnumbered three to one by bears. And given the Fed's record, as discussed above, we think it's prudent to be cautious and balanced in how we position ourselves for the year ahead. Hope for sun, plan for rain, that sort of thing.

The thread running through all markets in 2023 is whether or not Fed can pull off this soft landing. Anything that suggests the probabilities on the answer to this question are changing will move markets considerably. There's one other market inconsistency that we've noticed: market prices imply that there will be both a soft landing *and* that the Fed will cut its interest rates before the end of the year. We think it's nigh-on impossible that both happen this year. For the Fed to cut rates that early, the economy must have gone pop, which would mean the soft landing didn't come off. Either that, or inflation would need to take a swan dive towards zero, scaring the Fed with the spectre of deflation (falling prices). Given the state of labour markets, GDP growth and current inflation, that seems extraordinarily unlikely.

David Coombs
Head of Multi-Asset Investments

Will McIntosh-Whyte
Fund Manager

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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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