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Rathbones
Look forward

Rathbone Multi-Asset Strategic Growth Portfolio

Update, October 2017

Overview

President Donald Trump finally announced his pick for new Federal Reserve Chair. After months of prevarication, the replacement for Janet Yellen will be Jerome Powell – the most Yellen-like candidate except for Yellen herself.

This is not a bad thing. Some of the prospective nominees were downright kooky and others, particularly John Taylor (inventor of the eponymous monetary policy rule), could have presaged a lurch toward much more aggressive interest rate rises. Nominating Mr Powell offers a nice hedge: the status quo with a hint of change.

Mr Powell still needs to be confirmed by the Senate before he can take over when Mrs Yellen's term finishes on 3 February. However, we don't see this being a problem: he is a pretty uncontroversial pick and a sitting Fed governor. What is perhaps more important is who Mr Trump nominates to fill the other vacant Fed governorships. There may yet be a more hawkish tilt coming.

The Bank of England (BoE) raised rates in early November from 0.25% to 0.5%. A decent boost from the services sector helped third-quarter GDP grow by a faster than expected 0.4%, helping justify the hike. The BoE was likely feeling pressured to act on inflation which is biting consumers hard – the CBI retail sales flash survey crashed in October – but by doing so it runs the risk of increasing borrowing costs and dampening demand. Much of the rise in prices was out of the bank's hands: sterling has slumped since the Brexit vote, pushing up import costs for UK retailers.

Still, we think it will be some time before the bank hikes again. Or at least it should be, otherwise there's a strong chance that the BoE may inadvertently bring about stagflation, that insidious combination of low growth and high inflation and unemployment. Our in-house research suggests inflation should peak in October and begin to slide back down. Governor Mark Carney said as much in November's press conference, too. He also said the bank expects to raise rates just two more times in the next two years – a comment that sent sterling lower, suggesting that's a slower tightening path than the market had believed. With price levels on the decline, the BoE should be able to pander to growth and sit on its hands from here.

If we are correct and inflation does fall from here, it should lead to improving real wage growth (it's currently negative) and better consumer sentiment. The real pressing issue for Britain and the BoE is a lack of investment growth, something that Governor Mark Carney and his chief economist, Andy Haldane, have both highlighted. They say they need to see better investment spending and a boost to trade to offset consumer spending.

And that's where Chancellor Philip Hammond comes in. With the crunch year for Brexit looming, he will set out his Budget on 22 November. It will be the first autumn Budget since he dropped the convention of an autumn statement and moved the Budget announcement to the year's end. It will be a gloomy affair too. Winter is coming, both literally and metaphorically. A punchy cut to the UK's estimated productivity is expected, which will reduce tax revenues already lagging due to lower growth forecasts. Mr Hammond

doesn't have much cash to work with and it seems to be dwindling by the day. But he needs to take some of the strain from the BoE and inject some favourable fiscal policy into the economy.

It seems unlikely that he will though. He is hamstrung by his predecessor's legacy of austerity and "balancing the books", an inheritance likely to dog him throughout his time at HM Treasury. He seems as likely to hit these targets as George Osborne was. Unfortunately, we don't see Mr Hammond striking out on a different path. That's why we prefer FTSE 100 companies, with predominantly overseas earnings, rather than mid-caps that are more affected by weakness – or strength – in the British economy.

This month's trades

A new holding for the fund is **ASML**, the world's leading lithography equipment maker (machines that make computer chips for specific products and tasks). Historically, this Dutch company has enjoyed a large market share and it is firmly embedded in its customers' supply chains. Importantly, ASML occupies a monopoly position in next-generation extreme ultraviolet lithography (EUV) technology. EUV machines will become critical as semiconductor chip sophistication and volume increases in several applications – artificial intelligence and automotive markets, for example. Owning ASML means we don't need to bet which chipmaker is the ultimate winner, because it will be supplying all the contenders. We also like that 30% of ASML's revenue comes from servicing, usually a recurring income. Moreover, the company has more cash in the bank than liabilities on its books, giving it strong defensive characteristics.

We trimmed the **Tritax Big Box REIT** because its share price has soared well above the value of its net assets (this premium was 12% when we sold). This trust has done very well for us over the past few years, but we feel investors may have gotten a little ahead of themselves recently. We sold some of our shares in **Estee Lauder** because it has been straying into expensive territory and recycled that money into **Ulta Beauty**, an existing holding that has been weak lately.

We trimmed the **Ashmore Emerging Markets Short Duration Fund** because spreads – the extra return you get for investing in riskier debt than developed world government bonds – had got very low for emerging market corporate debt. We felt it was prudent to take some profits here.

Outlook

Around the world, quarterly earnings have been pretty good recently.

At the time of writing, Japan was doing exceptionally well, with more than 60% of those reporting beating earnings estimates. Earnings per share growth was a staggering 15%, while reported sales are currently around 7% higher than a year earlier, no doubt helped by a weakened yen. Europe has done similarly well: 15% earnings growth driven by energy companies. Its revenue growth is soft, however. Despite being up 5% on a year ago, most of those reporting have only matched or undershot analyst hopes for top-line growth.

About half of the S&P 500 had reported, and they have packed quite a surprise: more than three-quarters of the index beat forecasts and EPS growth was 7%, 4 percentage points higher than expected. According to FactSet, tech, materials, energy and consumer discretionary delivered most of the surprise uplift. Financials, industrials, utilities and consumer discretionary were the disappointments, with their earnings lower than they were a year ago.

A phenomenon we have talked about previously continues to affect share markets: earnings beats are not being rewarded as you would usually expect, while disappointments are being punished severely. According to Factset, positive surprises for S&P 500 firms earn just a 0.1% bump on average to the share price over the two days following the announcement (the five-year average is 1.2%). As for earnings misses, they result in an average 3.2% drop, (longer-term average is -2.4%).

We think this punishment of disappointment – the scale of which is illogical in our opinion – is likely to continue. When our businesses post short-term stumbles, we've generally been buying into the drawdowns. Where something fundamental has changed in the investment case, we have sold. But, typically, we find these sell-offs tend to be overreactions that allow us to pick up businesses we value at a discount.

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