

Rathbone Multi-Asset Total Return Portfolio

Update, January 2018

Overview



We have highlighted for a while now that with central banks beginning to reverse the process of quantitative easing and tighten rates that a pickup in volatility was likely. This process began towards the end of the month, and then accelerated as stock markets sank sharply lower in early February.

Equities and bond yields had been rising steadily over the past few months due to a mixture of better growth prospects and higher expectations of inflation. Company earnings have largely been strong, with tax cuts helping to boost forward earnings. However, casting its shadow over this sharp drawdown is that grim raven of yesteryear: “good news is bad news.” Back in the early years of US quantitative easing (QE), risk assets were driven higher by a flood of Federal Reserve-driven liquidity – beyond what could be justified by earnings. Because of that, we had a topsy-turvy few years where any threat to QE purchases – i.e. stronger economic data and higher inflation – was met by a wave of selling. Over time, continued earnings growth helped justify higher prices and this phenomenon seemed to fade into the background.

And then, this year Main Street got a pay rise: in January, US wages were 2.9% higher than a year earlier. That was 30 basis points greater than expected and the highest rate since 2009. Albeit somewhat glossed over was the fact that hours worked actually fell. But it was enough to concern some investors that higher inflation was finally coming down the pipe, which would mean faster interest rate hikes by the Fed. Higher assumptions of future interest rates means cash flow in coming years is worth less, and so share prices adjusted. This appears to have been amplified by the squeeze on investors who were short volatility (highlighted above), and then as markets sold off people (and machines) sold because other people (and machines) were selling and the market tripped over itself in a flurry of worry.

Volatility is always bracing, but given the move up in equities and length of time since the last material pull-back, any correction was always going to be fast, of reasonable magnitude and, as ever, impossible to time. We’ve been building up our fund’s defensive assets for some months now, including cash, gold and more recently a put option on the S&P 500 index for 25% of the value of our equities. Our cash would be particularly useful in a ‘taper tantrum’ type scenario where almost all assets are falling.

This month’s trades

With the spread between 10-year and five-year US treasury yields falling to an extremely flat 20bps in January, we took the opportunity to wager that it would rise from here. Yield inversion – when longer-term debt yields less than short-term – almost always signals a recession; however, we think the world is not on the verge of a downturn. Economic growth (UK excepted) is strong and improving, while business and consumer sentiment is buoyant. Therefore, we bought the **RBC Leveraged three Year Yield Spread Steepener**. This structured product is capital protected and pays a multiple of the change in yield spread between the 5-year and 10-year US treasury. We will benefit from any “steepening” in the US yield curve.

Footwear and sports clothes manufacturer **Nike** has been increasing its direct retail presence around the world for a few years now. By vertically integrating its supply chain, it hopes to boost its profit margin by giving away less value to retailers in what is a pretty competitive market. This strategy has been paying off, with profitability steadily ticking upwards over the past few years. In recent months, some analysts have forecasted easing pricing pressure for Nike, too, which helped boost the stock. We decided to take profits as the price was looking pretty full.

Late last year, we bought Australian government bonds, while hedging the Australian dollar exposure to sterling. This is portfolio defence against faltering global growth, if it materialises. Because the natural resources-heavy Australian economy is highly sensitive to global growth – particularly China – sovereign yields and the Australian dollar should fall as soon as growth worries began to rise. Our hedge eliminates the currency risk, so we would be left with the benefit of falling yields. We added to this trade in January by buying the **Australia Government 4.75% 2017** and **5.5% 2023** bonds, again with the currency hedged back to sterling.

We have added **ASML** to the fund. This is the leading lithography equipment maker (machines that make computer chips for specific products and tasks). Historically, ASML 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 sold US-based **BankUnited** last month, swapping it for **Danske Bank**. BankUnited has been a great holding for us, but we feel the best may be past it. Its extremely experienced chief executive, John Kanas, retired on the first day of 2017 and the new managers, while competent, are not him. BankUnited did well in past years by exploiting the big banks' retreat from commercial property lending in New York and Florida. Lately, the behemoths have been returning, meaning the niche is no longer as cosy and lucrative as it once was. Danske Bank is a Danish bank with one of the strongest balance sheets of any lender in Europe. The company recently increased its (well-covered) dividend by almost 10% more than analysts had expected. We think it's a well-managed company with a solid outlook and a focus on returning capital to shareholders.

Outlook

It was a rude welcome for new Federal Reserve (Fed) Chair Jerome Powell, whose first day was the Monday of the 4% sell-off in America.

Many investors will be watching to see how he responds. He is widely regarded to be similar in temperament and strategy to his predecessor, Janet Yellen. However, if we really are moving into a new economic paradigm that is pretty moot now anyhow. Who knows how Mrs Yellen would have responded to a new situation and if that would be any different to Mr Powell?

In some ways, it's the market that dictates to the central banker. If inflation climbs higher and investors violently sell equities (and bonds for that matter), the Fed Chair is less likely to tighten policy rapidly in case they set off a capital markets rout and damage economic growth. Mr Powell appears a cautious man

who worked closely with Mrs Yellen, herself plainly cautious, for many years. We will have a chance to see this interchange this month, with an inflation print due on Valentine's Day. US CPI has been hovering around 2.1% for several months, if it breaks significantly higher investors may get worried once again.

As for us, we are comfortable with gently rising interest rates in the US, particularly as they are still very low in absolute terms. Less so in the UK, though, where the economy feels more fragile. We think February's ructions were a foretaste of more volatility ahead as investors come to terms with the Fed's normalisation of interest rates. The exaggerated market movements caused by quantitative traders and passive flows should create opportunities for longer-term investors who buy on fundamental value. We have already used some of our cash to add to equities on this sell-off and will continue to do so in a careful and disciplined manner, should we see further drawdowns in equities or higher yields on bonds.

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