Rathbone Unit Trust Management
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Rathbones
Look forward

Rathbone Multi-Asset Total Return Portfolio

Update, August 2018

Overview

August was a classic summer lull. Well, for three-quarters of it at least. Markets were quite directionless until investors increasingly worked themselves into a panic about the state of emerging markets and how they can deal with a stronger dollar.

We think they can deal with it just fine. Following the relatively sharp rise in the dollar over the past quarter, it's still much lower today than it was at its peak in late 2016. Emerging market equities do tend to do worse as the dollar rises, but we've been here before – just last year – and the developing world didn't explode then. We see no reason why it should now, particularly as most of the countries' economic metrics are just as healthy today as they were then.

Some of them are basket cases, sure. Turkey's leader failed economics 101 by saying higher interest rates are behind the nation's inflation rate; the central bank ended up having to more than double rates in a vain attempt to protect the currency. Argentina had to go cap in hand to the IMF because it failed to rein in its currency, regardless of how high it jacked up rates.

Both nations were beset by massive budget and trade deficits. These outflows forced them to depend on the kindness of foreign investors to fund themselves. So when a few of those foreigners got nervous and sold, it didn't take long for virtually all the other holders to sell too. The weight of this selling has hit other emerging markets too, but we believe that's most likely due to index investing and knee-jerk reactions. All emerging markets are different, but many investors and indices don't make that distinction. For us, that's how opportunities are made.

Brexit caused a bit of excitement for some, but not for us. You know it's grim when a soundbite from EU negotiator Michel Barnier reiterating that there's still a possibility of a Brexit deal sends sterling soaring. No detail, no facts, just hope. Still, like emerging markets, this creates opportunities. When everyone expects only the worst, it doesn't take much to get prices moving higher.

This month's trades

We added to our holdings of **Australia 5.5% 2023 Bonds**, hedging the Australian dollar exposure to sterling. We have held this trade as portfolio defence against faltering worldwide growth (if it materialises) since late last year. 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 switched the rest of our **ETF Securities Daily Hedged Physical Gold ETF** for the **iShares Physical Gold ETF (Unhedged)**, a process we started last quarter. This should protect us against a bad Brexit because if sterling weakens, creating inflationary pressures, owning gold in dollars should be a safeguard.
We bought the **London Stock Exchange Group** last month. We think the key to this business is its data: it licences the rights to use thousands of indices, like FTSE, that funds and ETFs use to benchmark themselves.

We switched our commodity exposure from the **Invesco Bloomberg Commodities ETF** to the **L&G All Commodities ETF** which is virtually the same except cheaper.

Outlook

It seems almost inevitable that the US Federal Reserve will hike rates at the end of September to 2.00-2.25%. That will be the central bank's third rate rise of the year, at a quicker pace than 2017, and yet it hasn't done much to dent the American economy. GDP grew 2.9% in the year to 30 June; it roared ahead in the second quarter, with the annualised rate jumping 2 percentage points to 4.2%. The second-quarter rip was driven by consumption, business investment and exports. Small business optimism is at multi-decade highs, retail sales growth is north of 6% and personal income growth is running at roughly 5%. That's why we like US companies so much.

Everyone is trying to decide whether the US is "late-cycle" (whatever that means) or not. Some people are fixated on the flattening yield curve: the difference between the 2-year and 10-year Treasury fell to a cycle low of 18.8 basis points in August. When this difference goes negative, i.e. when the 10-year yields less than that 2-year, it almost always signals recession, so it's a decent measure to keep an eye on. However, just because it's close to inversion doesn't mean it will go negative. In the '90s, this spread remained below 100bps for three and a half years without going below zero. It dipped below for a month or so before heading positive again, and then went for another 18 months before recession. That's a long time to be wrong.

Other investors are no doubt focused on the US midterm elections, set for early November. Our research shows the S&P 500 tends to drift before these hustings, before rising afterward. The actual result didn't ever seem to matter much, the event just seemed to give investors pause. Markets are odd like that. President Donald Trump's trade exploits have been brusque and prolonged, but we think it will take something exceptionally radical for him to derail world trade.

For now, we're comfortable remaining in equities and keeping our significant US holdings as they are.

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