RATHBONES

# RATHBONE INCOME FUND

MONTHLY UPDATE FEBRUARY 2025

**Last year, we asked whether we were too early or just plain wrong with our positioning in two key areas. First, quality growth stocks (think bond proxies, 'safe havens' that would benefit from lower interest rates and also offer defensiveness in an uncertain world). Secondly, UK domestic earners (in expectations of a post-election pick-up in the UK economic mood). In 2024, we underperformed our benchmark index (and our peers) by a wide margin. Our uncomfortable conclusion was that we were wrong. Things are starkly different in 2025.**

Global financial markets are much more volatile this year. American 'leadership' is uncertain and chaotic. Europe seems in the midst of an existential crisis. And the UK appears to be carving out a new role for itself within Europe. Cynics may claim that all we've had so far are words in the form of ineffectual political posturing. What really matters is action to back up the talk.

**New geopolitical realities**

We've certainly had decisive action from the current incumbent of the Oval Office as he's catalysed seismic tremors in the geopolitical world order. Trump may believe he's leveraging US economic and military strength, but the most immediate winners seem to be those traditional adversaries of the West – Russia and China. Europe can only conclude that the US is no longer a reliable ally. Some may yet applaud Trump for shaking things up. He's undoubtedly galvanised a strong response from right across Europe. But we fear that we've not yet felt the unintended consequences of shooting policy and diplomacy (AND TARIFFS) from the hip…

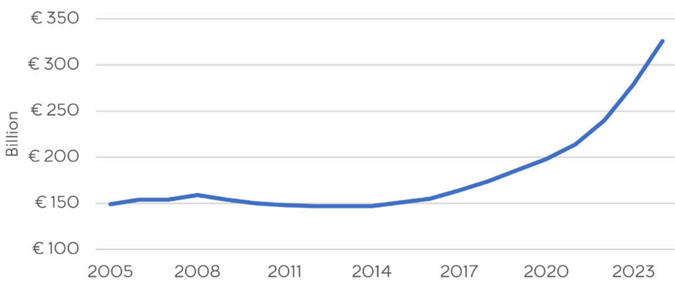
The new German administration is promising change. The coalition of the CDU/CSU and the SPD has announced a 'whatever it takes' plan. It intends to establish a €500bn infrastructure fund and an exemption to Germany's strict debt brake that would allow defence spending above 1% of GDP. There are implementation challenges ahead, but the potential fillip to Germany's economy is meaningful. Analysts are predicting this boost to expenditure could drive up Germany's admittedly sluggish GDP growth.

Meanwhile, the British Government is facing up to an awkward truth. Chancellor Rachel Reeves will need to raise taxes or make spending cuts, or both, if the UK is to increase defence spending meaningfully. That would have unhappy consequences for those who need help from the state. Yet it could also turn out to be a very powerful pro-growth lever. In government, as in life, there are always difficult choices to be made. Having spent weeks trying to scramble out of the hole she dug for herself with the Autumn Statement, the extraordinary reversal of decades of reliable transatlantic co-operation may have handed Reeves the kind of exogenous shock that would allow for an alternative approach to managing the country's finances.

More spending on defence across Europe will be expansionary. For all the UK Government's worthy pronouncements on its pro-growth agenda and investment in infrastructure, planning deregulation and the like, financial markets need to see this spurring growth. It's easier for them to grasp the implications of the government's commitment to increase investment in defence spending, which should drive up GDP growth more immediately.

Based on the most optimistic predictions about how long Ukraine can hold out without a ceasefire, most of Europe has a narrow two-year window to ramp up its defence spending further. (As the chart below shows, it's already increased that spending sizably over the last few years.)

## EUROPE HAS INCREASED DEFENCE SPENDING BY 30% SINCE 2021




Source: European Defence Agency; data to 2024

And the two-year timeframe assumes that there isn't any dramatic withdrawal of US military assistance, or of technology platforms that can't be replicated or easily replaced.

By necessity, war is the mother of invention. Recently published academic papers argue that increased research and development (R&D) in the defence industries feeds through to the private sector: a 10% increase in public sector R&D catalyses a further 4% increase in the private sphere. Major innovations such as the jet engine, radar, semi-conductors, GPS and the ubiquitous internet, were all born from military necessity. Europe, with the UK at the forefront, may be compelled to lead the way in a new wave of innovations. The human cost of any conflict must override any economic considerations. But markets have moved the way that they have over the last few weeks for a reason. More spending on defence has the potential to revive industrial growth in the UK and Europe.

**Banging the drum, again**

The argument for UK equities has its foundations in two principal arguments.

1. UK equities are attractively valued and there are now new economic and political catalysts that could narrow their discount to other markets. The Labour administration has a fresh opportunity to demonstrate stable and pragmatic leadership. How do you navigate the stormy seas of random political noise? You seek shelter in stability and undemanding valuations. We hope this presents a further argument for investors to re-visit the UK market.
2. Too much global money is allocated to the US, resulting in expensive and over-crowded trades. Recent events amplify both themes. US exceptionalism, manifest in technological leadership, a lucrative nexus of entrepreneurialism and de-regulation, resulting in world-beating productivity and growth, has elevated its stock market. But the valuations afforded to the US depend on confidence in the country's leadership. Trump's unpredictability is verging on being a liability rather than a strength. What happens if the US lurches into a recession whose severity could have been avoided by more considered and conventional politics? The combination of high prices and crowded trades is a combustible mix. The contrast with Europe is stark. For decades, that contrast has been one way, in favour of the US, but the tide may be turning.

It is beyond our remit here to try to unravel the myriad complexities ahead; our humble mandate is to invest money on behalf of our clients, and to achieve both capital and income growth. There are always challenges and opportunities. UK equity income stocks could be both a safe port in the current storm and a route to tap into a rebound in growth this side of the Atlantic.

**A brief review**

Fund performance, driven by improved UK market fundamentals, has been supported by strong corporate news: the results season has been positive. But the biggest contributor so far this year has almost inevitably been **BAE Systems**, reflecting the ramp-up in predicted defence spending. We'll tell you more about performance in the quarterly review.

The next key test, though, will be the Chancellor's Spring Statement on 26 March. Our UK domestic exposure – the banks, housebuilders, property stocks and retailers – has held up relatively well in operational terms; results have gone our way. But the mood music needs to continue to improve: we cannot rely on attractive value alone. Nevertheless, this year has started well for the fund.

**Recent Trading**: Our trading in February reflects a more aggressive shift towards economic dynamism. We have trimmed some more defensive holdings, such as **British American Tobacco**, pharmaceutical giant **AstraZeneca**, and household good businesses **Reckitt Benckiser** and **Unilever**. We have used the funds to increase energy service provider and distributor **DCC** and German and UK-based industrial property company **Sirius Real Estate**.

Companies seen in February: **Assura Group**, **Dunelm**, **Novartis**, **Unilever** and **Smith & Nephew**.

**CARL STICK**
Fund Manager

**ALAN DOBBIE**
Fund Manager

For more info on our fund, including factsheets, performance and fund manager views, please click here.

If you require further clarification on this commentary, then please contact your adviser or Rathbones at the contact details below.

Any views and opinions are those of the investment manager, and coverage of any assets held must be taken in context of the constitution of the fund and in no way reflect an investment recommendation. Past performance should not be seen as an indication of future performance. The value of investments and the income from them may go down as well as up and you may not get back what you originally invested.

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