Rathbone Unit Trust Management

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Rathbones
Look forward

Rathbone Greenbank Dynamic Growth Portfolio

Monthly update October 2022

The strangest thing has happened in the UK: by accident or design, centrists are back in fashion for the first time since Brexit. This is a very heartening development.

In October, Rishi Sunak and Jeremy Hunt replaced the short-lived leadership of Prime Minister Liz Truss and her Chancellor Kwasi Kwarteng and hammered home their aims of stability and living within the country's means. It brought relief to bond markets, with yields dropping sharply (prices rising) after their brief spaceflight driven by the aborted policy directions of Team Truss. The return of Sunak means professional centrists are in control of both the government and the Opposition – the first time since Brexit. When Theresa May was in charge, Jeremy Corbyn offered a radical option in the wings; while Keir Starmer's trademark boring competence has been a foil to Boris Johnson's helter skelter premiership as well as the revolutionary whirlwind that was Truss's time in office. The kooky fringes will still be tugging at the corners, but looking from Sunak to Starmer, the UK political situation looks much more grown-up. That's pretty rare in today's world!

British bond yields remain higher than they were, but that is true all over the world because investors are expecting the US Federal Reserve (Fed) and other central banks to continue increasing interest rates for a little while yet. Globally, investors are hoping for a pause or a pivot, but they may be disappointed. We think US interest rates shouldn't need to rise as much as some believe, but the Fed will feel it needs to hold its anti-inflation stance until it's beyond all doubt that inflation is sinking briskly back towards its 2% target.

Powell talks tough

Shortly after the month end Fed Chair Jay Powell punctured a mini-rally in stocks by warning that the 75-basis-point Fed Funds rate increases to the 3.75%-4.00% band would likely be followed by more hikes than investors expect.

Powell's comments were more nuanced than simply "higher", however. He said that the Fed's next rise would be a more moderate 50bps in December and then the committee would be firmly fixed on the economic data. But he thought the speed of hikes would probably slow, even as the peak in rates could be higher – the implication is that it would now be about 5%. The Fed has acknowledged the sheer scale of its moves and admitted that the economic effects come with a significant lag. We think this is very much the rub: the Fed is in danger of overtightening and sending the world into recession because of this lag, which can be between a year and two years. We hope Powell is simply trying to weaken the hopes of stock market investors to ensure the 'wealth effect' is working to reduce exuberant household demand and help alleviate inflation. That is, he's trying to keep stocks from rushing higher, making 401(k) retirement accounts comforting enough to push people to spend more.

This won't help US technology stocks in the short term. These companies have been hit hard by the rapid rise in interest rates because their values today are overwhelmingly reliant on profits coming far out in the future. We haven't been immune to this, holding **Shopify**, **Adobe** and **Microsoft** as we do, yet we had taken profits from these companies when they had looked expensive before. We have now been buying these shares back at lower prices. We think these are strong businesses that will continue to grow for years and decades to come. It shouldn't be forgotten that many of them have faced stiff headwinds to profit growth from a rampantly strong dollar this year. That makes overseas revenue worth much less when converted to dollars, yet despite that earnings expansion hasn't been terrible.

With interest rates marching higher all around the world, yields on bonds have obviously increased too. For many years bonds were often, bluntly, return-free risks. Yields were so low that there was no real return accruing to the holder. There was precious little cash flowing back to bondholders in coupons and there was a lot of risk of capital loss if interest rates rose from record lows (which came to fruition), particularly for bonds that matured in five, 10, 20 years plus. This is no longer the case. Therefore, we have been buying bonds. We added a small amount to our holding of Australian dollar-denominated **New South Wales Treasury 2.5% 2032** and the US dollar-denominated **Asian Development Bank 1.5% Senior 2031**. We have locked in the currency exchange for both overseas bonds, so we will not lose out if sterling recovers nor benefit if sterling weakens further. We also bought a small amount of the **UK Treasury 1/8% Index-Linked Gilt 2031**, whose coupons and capital value increase in line with RPI inflation, because it briefly became much cheaper relative to conventional UK government bonds during the October market ructions.

We picked up the **NatWest Group 5.125% Perpetual** corporate bond as well. The price we paid was well below the face value that will be paid back at maturity, so there should be a capital uplift over the coming years as long as the business doesn't disintegrate.

We rebalanced our stocks over the month, adding to existing holdings whose prices have fallen to realign them with the proportion of the portfolio we want them to represent. Our largest purchases included simulation software developer **Ansys**, veterinary diagnostic and software business **Idexx** Laboratories and manufacturer of high-end computer chip printers **ASML**.

Sharing the cost of climate change

Following month end, the COP27 climate conference got underway in Sharm El-Sheikh, Egypt. An African host is fitting for an important and difficult discussion about the global response to the perils of climate change. Africa emits less than 4% of the world's greenhouse gases, yet it is home to about 16% of the world's people and growing rapidly. And those people are disproportionately affected by the effects of global warming, with widespread drought, famine and extreme weather across the continent.

Undernourished people in sub-Saharan Africa have increased by almost 50% since 2012 because of extreme drought. About 250 million Africans don't have enough water today; by 2030 changing weather patterns are expected to make the homes of roughly 700m uninhabitable. Floods are a massive problem too, as more rain is dumped at once, causing flash floods, ruining crops and exacerbating illness. Fully 80% of African countries are unlikely to have sustainably managed water resources in a decade if action isn't taken, according to the World Meteorological Organization.

African nations aren't the only countries who are bearing most of the cost of climate change while contributing next to nothing to the problem, either. Small island nations in the Pacific are another egregious collective example, yet there is unfairness on this front all over the world. This is why the main thrust of COP27 is an attempt by the Group of 77, a negotiating bloc of developing world countries, to press developed nations, which have burned the most carbon and affected less by the effects of climate change, to give financial aid to developing countries that are struggling with existential crises. These 'loss and damage' payments were denied at last year's COP in Glasgow, yet they have returned to the agenda with greater momentum.

The Group of 77 is supported by China in its pursuit of financial assistance for developing nations. Indeed, part of the reason China, alongside India, refused to agree to 'phase out' coal at last year's COP was because of the West's refusal to agree to financial aid. Much has changed in China since that meeting. Lately, evidence of dissents and conflicts have started popping up in China. Most directly, it could be seen a few months back with protests about ordinary people losing their money in banking failures linked to the rocky national property market. Slightly more obliquely, you can see the ruling party making some stiff changes, which must be reactions to things going on behind the curtain. GDP growth has been rockier than normal (albeit it seems to be recovering recently), its property market seems to be slowly imploding, and a whopping 20% of 16 to 24-year-old urban Chinese are unemployed.

Abroad, China has been getting into scraps with the US and several neighbours, while its $1-trillion Belt and Road Initiative to help finance development of the developing world appears to have hit difficulties because of slower global growth and higher inflation and interest rates. Many client states are now struggling to repay massive debts they have racked up with China. The Wall Street Journal estimates some 60% of China's overseas loans are held by distressed nations. President Xi Jinping recently secured a third term as leader, which was a shoo-in, yet his Cabinet choices shocked investors so badly that Chinese stocks slumped almost 10% in a day. Xi had removed the only remaining men who were considered 'pro-market' and replaced them with loyalists who seem less likely to challenge some of Xi's less business-friendly policies.

Cynically you can see how a Western-backed loss and damage climate fund would be good for China, in that it would support many of its creditor nations. On the other hand, some would certainly argue that a fund is necessary and may go some way to balancing the scales of climate change impacts and shouldn't become caught in the geopolitical antagonism between America and China. The world is in a very sticky situation and it will require compromise from the rich as well as the poor to get out of it.

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