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In this issue, we mark 10 years since a pivotal moment of the financial crisis, when employees at Lehman Brothers gathered their belongings and filed out onto Wall Street. In today’s climate, with the UK in the midst of Brexit negotiations and escalating trade tensions between China and America, it is easy to feel apprehensive about the future.

In our lead article, we look back over the past decade and explore how the US economy has rebounded, now enjoying its second-longest period of growth in history. While we acknowledge that the recovery has been slow, we believe this bodes well for its longevity and do not see a recession on the near horizon.

Elsewhere, widely reported troubles in countries such as Turkey and Argentina have pushed yields for emerging market debt to attractive levels relative to safer developed market bonds. On page 5, we explore the challenges faced by emerging markets and whether today’s yields are worth the risk.

In the US, the dominance of the tech giants is getting some negative attention, but will Donald Trump’s pro-business attitude keep them out of the sights of US regulators? We take a look back on page 6 at how anti-trust law has evolved through past waves of great technological change in America, and how it might be applied today.

In our penultimate article on page 8, we turn to our own investment process. We believe in a multi-asset approach to effectively managing risk. Over the long run, we believe the correlation between equities and our diversifying assets should remain low. Though some strategies will perform better than others in different market conditions, we believe holding these diversifying assets is important in the long term.

Brexit poses many unanswerable questions: Can a deal be struck with the EU? Will it appeal to a majority in Parliament? Can it be done in time? Is the Irish border problem intractable? The list goes on. Our final article shows how valuable insights can be gleaned from our Brexit decision tree - even if the answer is “we don’t know” at every stage.

I hope you enjoy this edition of Investment Insights. Please visit rathbones.com to explore our latest views on the issues shaping financial markets this year and beyond.

Julian Chillingworth
Chief Investment Officer
A long road to recovery has investors wondering if the end is nigh

It’s been 10 years since the defining moment of the global financial crisis — when Lehman Brothers filed for bankruptcy and employees piled out of its headquarters on Wall Street with their personal belongings. Following a swift response and extraordinary measures from policymakers, the US economy pulled out of The Great Recession in June 2009 — and it hasn’t looked back since.

However, the recovery’s been going on for so long, that many investors are wondering if the end is nigh. This is now the second-longest period of growth in American history, having recently matched the expansion from 1961 to 1969, an era of big government spending under presidents John F. Kennedy and then Lyndon B. Johnson.

Unlike the rapid growth of the 1960s, the current expansion hasn’t been setting any records for its speed. It’s taken a long time for unemployment to get back to healthy levels and wages have only recently begun to accelerate ahead of the rate of inflation.

However, the tortoise-like nature of the recovery may help account for its longevity. The slow speed has prevented it from overheating. Despite three hikes already this year, official interest rates remain at just 2% to 2.25%. One early warning signal of an upcoming recession is a ‘flatter’ yield curve, as longer-dated government bond yields fall relative to shorter-dated yields in expectation that rising rates will lead to slowing growth and inflation down the track. Yet it’s still signalling a decent amount of GDP growth. Some economists say that forecasting the business cycle is as easy as looking at the direction of monetary policy over the past two years. But this relationship hasn’t been strong over the past decade. We prefer to look at a combination of consumer interest rates. These do suggest economic activity is slowing, but it’s not yet clear if this is another mid-cycle slowdown or something more sinister.

Meanwhile, despite some recent hand-wringing headlines to the contrary, the US housing market is buoyant. For example, new permits for building private homes are at a record high. Lumber prices have recently fallen sharply. However, they are only correcting an earlier spike related to President Donald Trump’s tariffs on Canadian imports and some unfortunately timed transportation problems north of the border. Prices for this house-building material remain a long way above the long-term average.

Stock market concentration
The strength and dominance of the US economy, and its tech sector in particular, was amply illustrated in August when Apple became the first company in history to reach a market capitalisation of one trillion dollars, followed a month later by Amazon.

Figure 1: Forecasting a slowdown
The shape of the US yield curve can be seen as an indicator of the risk that a recession is coming, but it’s not flashing red at the moment.

Source: Bloomberg, Rathbones

Slow and steady
We don’t see a recession on the near horizon, meaning the recovery could persist beyond July 2019, when it would surpass the 1991 to 2001 expansion as the longest on record. Our analysis of the economic environment suggests this is more likely than not.

Our global leading economic indicator (LEI) has recently rolled over, with the annual rate of change turning negative. This has been driven largely by the Asian and commodity-related components, and could be bad news for more cyclical markets. Yet it’s still signalling a decent amount of GDP growth. Some economists say that forecasting the business cycle is as easy as looking at the direction of monetary policy over the past two years. But this relationship hasn’t been strong over the past decade. We prefer to look at a combination of consumer interest rates. These do suggest economic activity is slowing, but it’s not yet clear if this is another mid-cycle slowdown or something more sinister.
Indeed, the five largest US technology stocks—Facebook, Apple, Amazon, Microsoft and Alphabet (Google’s parent)—now represent over 15% of the S&P 500 index. In July they had a combined market capitalisation of just over $4 trillion, equal to the S&P 500’s smallest 282 companies combined—and this huge list of the “smallest” includes many major household names such as Ralph Lauren, Kellogg’s, Goodyear Tires and Gap. Given their large size, what happens to these tech stocks has an outsized impact on the performance of the wider index.

**A narrow focus**

This concentration in the S&P 500 is not new—for example, for most of the 1960s, General Motors was the largest US company, representing 10% of the S&P 500 at times, compared with Apple today representing just 4.4%. The top five companies were 25% of the index through much of the 1960s. What is different this time is that the largest companies are now predominantly in one sector, technology, which adds to the perception that the S&P 500 (and by extension the US economy) is becoming too narrowly focused.

However, it appears that this situation is starting to change. The performance of the dominant tech stocks is starting to diverge (figure 2). So far in 2018 we’ve seen strong performance from Amazon, good performance from Apple and Microsoft, Alphabet performing slightly better than the S&P 500 Index and Facebook actually falling, as it faced the fallout from the Cambridge Analytica scandal. Investors are being reminded that the continued rise of the technology giants is not inexorable.

Yes, they have significant positive network effects and deep competitive ‘moats’ by virtue of their large user bases (for example Facebook has 2.2 billion users across its social media platforms, while Alphabet has 1.8 billion users of its YouTube platform alone). They also generally have high profit margins, solid cash flow and strong balance sheets. But after some fairly hefty price gains, valuations in some cases are beginning to look expensive. Management teams are demonstrating that they can make mistakes. Importantly regulators are noting the network effects that these new ‘quasi-monopolies’ enjoy, and taking steps to curtail perceived market abuses. You can read more about the outlook for increasing regulation of big tech on pages 6 and 7.

**Healthy divergence**

This divergence of performance within the technology sector is healthy and, if it continues, will help investors focus on interesting investment opportunities elsewhere. The S&P 500 beyond the dominant tech stocks has been performing pretty well, and this is important, as narrow performance is one of the signs that a bull market has peaked.

This breadth comes against the backdrop of a healthy outlook for the US economy, which continues to be vibrant and entrepreneurial, with high levels of innovation and strong business models leading to solid earnings growth and superior returns. To be sure, the debt levels of the median company are at all-time highs. We’re fairly relaxed about it, though, as companies have worked to extend the maturity of their debt and therefore are not too sensitive to interest rate rises. There are relatively few companies that are at risk of not being able to cover their debt payments.

Active stock picking is key to identifying those companies with lower financial leverage, and with exposure to growing areas of the US domestic economy, particularly those likely to be insulated from the trade war with China.
Emerging market debt is attractive despite some isolated problems

Trouble in some emerging markets (EMs) has pushed yields for EM debt in general to attractive levels relative to safer developed market bonds. The crucial question for investors is whether the problems in Argentina and Turkey are localised or could spread to other regions. Investors have been spooked and EM currencies remain under pressure, but have markets over-reacted?

Government finances in Turkey and Argentina are much worse than most other EMs, which have improved significantly since the ‘taper tantrum’ in 2013, when the US Federal Reserve first announced it was tapering its bond-buying programme. Notably, Turkey has a large current account deficit, a substantial amount of external debt maturing in the next 12 months, and inadequate official reserves.

The country relies on the kindness of strangers to meet its immediate need for foreign funding (figure 3). Only two others (Pakistan and South Africa) in the 20 major EMs we follow rely on short-term foreign financing. Even the more fragile economies of Brazil, South Africa and Russia don’t.

Emerging risks
Although there has been some recovery, and EM yield spreads over those of safe-haven US Treasuries have already narrowed this year (excluding Turkey and Argentina), they are still much wider than their 2017 lows. The risk is that contagion across EM foreign exchange markets appears to be increasing, with correlations between currencies rising, and this could have knock-on effects on EM debt.

Some EM currencies have appreciated against the dollar over the past 18 months, while others have depreciated. Notably, the Brazilian real, South African rand and Russian rouble have fallen by more than 15% this year. The Indian rupee and Indonesian rupiah have also lost value. As a result, EM debt denominated in hard currencies looks more attractive than local currency bonds.

EM debt is also vulnerable to a fall in global demand, which could be caused by a slowdown in international trade. But the larger yields offered by EM sovereign bonds make a negative total return (yield plus or minus change in price) unlikely providing the world economy does not flirt with recession over the next six months. Yet we are mindful of the cyclical risks to global trade, the possibility that the dollar could continue to strengthen and the risk of escalating tensions between America and China.

While any further appreciation of America’s currency is a concern, the relationship between EM assets and the dollar is not as strong as often assumed. There is a much tighter relationship between EM equities and a broader measure of developed market financial conditions. Providing the Fed doesn’t raise rates too aggressively, financial conditions should remain benign.

Chinese growth appears to be holding up well in the face of trade tensions. The next round of tariffs on $200 billion of exports is likely to hurt the US more, because China should offset any damage through its economic stimulus programme. Meanwhile, its government is making progress with measures to reduce the risks presented by excess debt in its shadow banking system (non-bank lending).

Risks remain. They include a possible policy mistake by the Fed, a negative demand shock in China, a broad-based trade war started by US protectionism and a loss of confidence in the technology sector. But we believe that, for longer-term investors willing to accept the risks of further volatility in the short run, the additional yield available on EM debt is looking attractive.

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**Figure 3: Foreign funding requirements**

Turkey is one of very few emerging market countries that has any immediate reliance on foreign financing.

![Graph showing foreign funding requirements](image)

Source: Datastream and Rathbones.
The revolution has been digitised, how will anti-trust laws adapt?

Apart from some fairly benign congressional hearings, America’s tech giants have faced minimal scrutiny at home. The European Union has been active, though, fining Alphabet €2.4bn in June for misusing the dominance of its Android operating system and now investigating Amazon’s possible misuse of data on sales made by its third-party merchants. What will it take for the US government to take aim at these behemoths?

Anti-trust law has never been a precise science, blowing hot and cold with the prevailing winds of time since it was first employed in the US in the late 1890s. It took the assassination of a protectionist president and the direct prodding of Teddy Roosevelt to get the US Department of Justice to bring its first successful case against the great trusts. Northern Securities, a holding company set up by John Pierpont Morgan and associates, had gained control of an array of railroads whose tracks spanned the northern half of the United States.

The battle, like so many great American tales, led all the way to the Supreme Court. In 1904, the shareholders of Northern Securities argued that Congress had no right to interfere in the buying or otherwise transferring of property. The nub of the debate was the tension between unfettered property rights and the public good. Looking back, it seems surprising that breaking up Northern Securities was decided with the slim margin of five to four.

The amount of money it could have gouged from controlling the transfer of goods from countless farms, forests and mines to market was mindboggling. If that wasn’t detrimental to commerce, what would be? But a century ago, many believed such overcharging would simply create an opportunity for another company to create a cheaper rival line. It would only be anti-competitive if Northern Securities were to pay off rivals or create contracts that prevented that from happening.

Buying or owning what already existed couldn’t be legal for some but a crime for others only because of what they already owned. If that were true, the integrity of property rights could be eroded to nothing, argued the dissenting four Justices, led by the chief of the Supreme Court back in 1904. But they lost; it was a sea change in the law.

A paradigm shift
By 1911, this new way of thinking was unanimous. In Standard Oil of New Jersey versus United States, the Supreme Court, with only partial dissent, determined that John D Rockefeller’s mob of interests in petroleum was illegal and should be broken up. The dizzying web of interconnected companies controlled 90% of the US market in shipping, refining and selling oil and its derivatives, all of it essential for the lighting and mechanisation of society.

By controlling the pipelines and refineries, it became the principal buyer and was able to set prices. It also colluded with railways to charge rivals more for transportation, allegedly sabotaged rival installations and engaged in predatory pricing (selling something for less than it costs to make in an attempt to put your opponents out of business).

This case created a new precedent and a new test: monopolies and massive businesses were not inherently bad, some may not harm the public interest. It was up to courts to use the “rule of reason” to decide in each case which were benign and which distorted the market by weighing the pros and cons. This led to some ambiguity about what was reasonable and what wasn’t. Over the decades since, a raft of anti-trust cases have built up the law. But the views of the Supreme Court Justices on the bench have been just as important as previous decisions.

Another complication has been the rise of digital technology. Hi-tech businesses, with their complexity of design, operation and business models, make anti-trust law difficult to apply. Microsoft continually clashed with the government over whether it was anti-competitive. It eventually settled in 2001, and agreed to be more open with its software and coding in return for remaining intact as a business.

Recent congressional hearings about today’s tech giants are echoes of the sparring matches between Microsoft and the government back in the 1990s – even down to Microsoft founder Bill Gates’ surly responses and Google’s empty chair. Is a slew of anti-trust cases possible? Just as it took the prodding
of a president to get the government to move on the trusts of yesteryear, so it could work in reverse. Donald Trump has shown himself to be dismissive of consumer protection and supportive of reducing impediments to business. This bears out when you look at the Department of Justice’s anti-trust actions. Between 2011 and 2016, it averaged 75 suits a year. In 2017 it undertook 34. As of September 2018, the number stands at just 25.

**Economic genius or monopolistic manipulation?**
Monopolies that have been broken up have all tended to underpin the pivotal technology of the time. Railways were overwhelmingly important to America in the 1800s to early 1900s. They brought jobs, mail and all manner of supplies to fuel expansion to the West. Similarly, America in 1911 was waking up to the tremendous freedom and opportunity provided by the internal combustion engine.

Oil was the lifeblood of this new economy and it was increasingly controlled by one gigantic octopus of a company. Up to the early 1980s, AT&T controlled American communication through owning all of America’s telephone lines. This network was the foundation for fax machines and electronic information transfers, the internet and eventually the digital age. AT&T was busted up because it was stifling innovation in the sector.

So where does all this leave today’s internet titans? Some of them chime closely with the trusts of the 20th century. But there are pivotal differences. First, consumers haven’t been the victims of tech companies’ hefty pricing power. Instead, they have benefited from free access to the greatest repository of knowledge and entertainment ever seen. They can contact friends and family instantly, whatever the distance, for nothing. They can keep a virtual record of their lives, they can search for anything in the world from the back of a bus and have it delivered to their doorstep in days, and they can create a business out of thin air and an idea.

The price of the tech companies’ dominance is actually borne by businesses that aren’t large enough, smart enough or cool enough to compete. A century ago, Standard Oil was mistrusted and widely despised by Americans. But it can be argued that the company’s dominance was driven by economic genius and an operational tenacity that saw the distribution of a new technology explode across the continent at much lower prices for customers.

Tech giants have revolutionised this model by changing consumers nothing at all. Well, nothing in cash. Consumers are paying for new-age wonders with their information. When consumers saw how fast and loose social media companies were with this data, it created a backlash. Less so for other tech companies, such as Netflix, Amazon, Alphabet, Microsoft and Apple.

Still, unease reigns over their market power, their vast stacks of personal data and the voluntary nature of their tax payments. It seems like the Trump administration is likely to ease anti-trust restraints on businesses generally, but it could launch lawsuits against particular companies that raise the president’s ire. In the next issue of Investment Insights we will look at how Mr Trump’s Supreme Court nominations could work against any attempts to rein in big tech, why busting US champions might be counterproductive and — if it comes to it — how break-ups may look.

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**Figure 5: Mapping the market**
Over the past 20 years, the share of the largest five companies in the S&P 500 Index by market value has changed frequently.

Source: Datastream and Rathbones.
Managing expectations

Diversifying assets are important but don’t necessarily look for a big payoff

At Rathbones, we take a multi-asset approach to investing, which provides us with the flexibility to meet individual needs. In order to construct portfolios effectively and manage risk, we divide assets into three building blocks, which play different roles – liquidity (mostly safe-haven government bonds and cash), equity-type (such as shares, corporate bonds and emerging market debt) and diversifiers.

This third category comprises assets that demonstrate a low or negative correlation to equities, particularly during periods of market stress. They include precious metals, non-directional alternative strategies, targeted return strategies and unleveraged commercial property.

Although these assets tend to exhibit diversifying characteristics across a range of environments over the long term, the performance of the different types of strategies can vary significantly over shorter periods. From a tactical perspective, it can be helpful to consider which diversifiers are most suited to the current investment climate.

**Actively managed strategies**

We believe the environment for some strategies has become less favourable. For example, returns within equity markets have become less dispersed, M&A activity remains subdued and common factors (such as value and growth) are starting to drive the return of a wider spread of equity-type assets.

However, we continue to believe that overweighting these assets is still important for generating attractive risk-adjusted returns in a balanced portfolio. Although over the past three years our diversifiers have not beaten US equities, they are not supposed to. Indeed, we would be highly concerned if they had.

Instead, most of the strategies we invest in have delivered steady, small, uncorrelated returns, which is what we would expect from assets that are meant to provide a form of protection against periods of market stress. However, we acknowledge that some of these strategies have struggled over the past year.

The correlation between equities and many of our diversifying assets remained low or even negative during the difficult markets in the first half of the year. This is likely to be more important than ever over the next year or two, when we believe markets are likely to suffer recurring bouts of volatility, driven by rising bond yields.

**Hedging your hedge**

Over the quarter, gold has struggled in a strong dollar environment (figure 6). Any weakness in the dollar may strengthen gold prices, but non-dollar investors need to be aware of the currency impact of holding gold (a dollar-denominated asset). If this currency exposure is unhedged, any gain in gold prices from dollar weakness would be eroded when translated back to sterling.

There are three parts to the argument for owning gold. First, it looks oversold on a short-term basis with a substantial number of speculators betting on prices falling further. Second, on a longer-term basis, the dollar looks overvalued and any weakening from here could benefit gold. Third, historically it is one of the best hedges against mistakes in government policy, be that monetary (such as interest rates) or fiscal (such as spending or taxation) and any economic turbulence they may unleash.

At the moment, we believe the biggest argument against holding gold is the potential for a continued rise in US real rates (interest rates less inflation), given forecasts of further Federal Reserve rate hikes. That would be kryptonite for gold, given the opportunity cost of holding an asset with no income. Although seen as a geopolitical risk hedge, it has also been weak in the face of escalating trade tensions between the US and China.

Gold has historically been weak when the dollar has been strong and vice versa. But UK investors should be aware of the currency impact and hedge accordingly if they are concerned about protecting their gold exposure from the vagaries of currency fluctuations.

**Figure 6: Gold price (dollars per troy ounce)**

Gold prices have not performed as expected against a background of economic and political uncertainty, with dollar strength weighing on the precious metal.

Source: FactSet and Rathbones. Past performance is not a reliable indicator of future performance.
With six months to go, investors are still wondering what might happen

To help us filter out the day-to-day nonsense and make sense of how Brexit could develop over the coming year, we’ve created a simple decision tree.

It starts with the overarching question: can the government strike a plausible deal with the EU? We believe there is a strong probability that it can – there’s just too much at stake on both sides of the Channel. As for whether they can do it in a timely manner, we think the chances are a coin toss (mathematics for don’t know). And if the government does arrange a deal before 29 March 2019, would it pass Parliament? That’s another don’t know. But if it were to, we think it would be with the agreement of the Tory hardliners (the “European Research Group”) led by Jacob Rees-Mogg. We call that a “sandstone Brexit” — the softest rock (or hard Brexit) you can find. If the government and the EU cannot come to terms at all, there are two choices as we see it: a hard Brexit or a second referendum. The probability here is another coin toss.

When we calculate the probabilities, we find that by far the most likely result is a ‘never ending story’. The politicians agree on principles but not the details. In short, they keep kicking the can down the road. Sterling would probably rise, potentially benefiting investors who own domestically focused UK assets and hurting those with foreign investments and the FTSE 100, which tend to do poorly when the pound strengthens. A hard Brexit has the second-highest probability. A no-deal break with the EU would send sterling tumbling as low as $1.20 or less, we believe. Again, holders of overseas assets and the FTSE 100 would probably do best.

Then comes our sandstone option, followed by no Brexit. A sandstone agreement would probably make sterling amble lower, as the greater barriers to cross-border business will hamper the UK’s future prospects. However, a continued trading relationship would mitigate the pound’s fall.

Figure 7: Which way next?
Exploring the potential terms of the UK’s divorce settlement with the EU

Source: Rathbones
America’s bull market in equities is approaching its 10-year anniversary and is already one of the longest in history by some measures. Since March 2009 the S&P 500 has increased more than four-fold, driven by strong profits, low inflation and stable economic growth. Despite five corrections of at least 10%, it has never entered bear territory, defined as a drop of at least 20%, in that time.

Technology stocks and growth sectors continued to outperform over the quarter, with a select number of companies propelling the US stock market to record highs. Notably, Apple beat Amazon to become the world’s first trillion-dollar public company at the start of August. It means Apple’s stock market value is now larger than the GDP of Switzerland.

Brexit negotiations have continued to dominate UK financial markets and investors remain nervous because there is still no clear solution in sight. After reaching new highs earlier in the year, the FTSE 100 was more volatile over the summer, with sterling also experiencing some ups and downs.

Trading tensions
China’s stock market has had a difficult year so far, with the Shanghai Composite Index down by around 20% since the start of 2018 and dropping to its lowest level since 2014. Trade tensions with the US have been increasing investor concerns, with President Trump recently imposing further tariffs on Chinese goods and China retaliating.

The rising interest rate environment continued to have a negative impact on government bonds in both the US and UK. Following US interest rate rises, investors remained positive about the outlook for the US economy and yields continued to rise. Yet UK gilts remained popular with investors as a hedge against an unexpected fall in the pace of economic growth.
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