Quarterly review

for the three months to 30 June 2014

Gill Lakin
Chief Investment Officer

In June, the Federal Reserve stayed true to its course and tapered monetary stimulus by another $10 billion as it has done at every previous policy-setting meeting this year. The minutes of the latest Federal Open Markets Committee meeting revealed that monthly asset purchases are likely to come to a halt entirely in October. The first interest rate increase is widely expected to occur towards the middle of 2015 but even then, the Federal Reserve may continue to reinvest the proceeds of maturing assets rather than attempting to shrink its balance sheet more rapidly. The pace of interest rate rises is expected to be slow. Fed officials expect the Fed Funds Rate to reach 2.5% by the final quarter of 2016 and they recently lowered the estimate of long-run equilibrium to 3.75%. Many commentators have rejected the idea that interest rates will remain much lower than in previous cycles, a theory referred to as "the new normal", but as bond fund managers have observed, it is difficult to take an opposing view given the Fed's price-insensitivity and unlimited balance sheet.

Investors shrugged off the weather-related 2.9% annualised contraction in first quarter gross domestic product because recent macro-economic data have revealed the underlying strength of US economic growth. During the first six months of the year, the economy generated an average of more than 200,000 net new jobs per month. This is the strongest period of job creation since the credit crisis. Unemployment has fallen to 6.1%. Janet Yellen, the Fed chair, remains sanguine on the outlook for inflation although strong employment growth may ultimately result in pressure on wage-inflation, particularly if productivity growth remains weak.

The expansion in economic activity might in other circumstances have spelt good news for equity markets but returns have been lacklustre. US equities rose 2.61% during the second quarter of 2014, taking gains for the year to just 3.78% in sterling. This may be because US equities performed so well in 2013 and returns outpaced earnings' growth. Brompton clients' investments in US equity funds have been gradually reducing through profit-taking in favour of more attractively-valued opportunities elsewhere. Strong US economic growth should be supportive for equity markets generally, however, and clients' equity market allocations have not changed overall.

Over the quarter, additions were made to those investments in out-of-favour gold equities and industrial commodity funds that were introduced into clients' portfolios in the first quarter. Direct investments in physical gold were avoided as the perceived "safe-haven" attributes of this asset are inconsistent with the evidence of economic growth. The gold price was, however, strong, rising 4.09% in June as Sunni insurgents advanced through Iraq. This took year-to-date gains to 6.43% in sterling as a combination of increased geo-political risk and falling treasury yields increased gold's attractions. Gold equities appeared well supported in valuation terms at the quarter-end bullion price. Blackrock Gold & General and Investec Enhanced Natural Resources benefited, rising 5.92% and 4.87% respectively over the quarter.

Industrial commodity assets rose on tentative signs of stabilisation in China. The official Chinese purchasing managers' index, a leading indicator for economic growth, edged up to a seven-month high in June and the People's Bank of China announced small-scale, targeted measures to improve liquidity including the exclusion of loans to smaller companies from banks' loan-to-deposit ratios. This should improve access to capital for these businesses. The level of debt in the Chinese banking system remains a concern although the central bank has, so far, intervened to stop the situation escalating into a crisis.

In Japan, evidence emerged that the economy had weathered the recent consumption tax increase. Japanese retail sales recovered by 4.6% month-on-month in May after a 13.6% fall in April. The consumption tax increase contributed to the 3.7% year-on-year increase in consumer price inflation in May and increased the scope to cut corporate taxes and further stimulate capital spending, which increased 3.1% quarter on quarter in the first quarter. Machinery orders rose 4.2% over the same period. Corporate profitability has improved and, now the uncertainty surrounding the tax hike has been removed, Japanese equities may resume their outperformance.

Monetary policy remained accommodative in the eurozone. The European Central Bank (ECB) cut interest rates in June and introduced further measures to improve liquidity. Inflation remained perilously low at 0.5% compared to the central bank's 2% target. Unemployment has started to fall but recent survey data has softened. The ECB remains under pressure to do more. European corporate profitability and equity valuations were significantly lower than in the US at the quarter end and equity markets should prove highly

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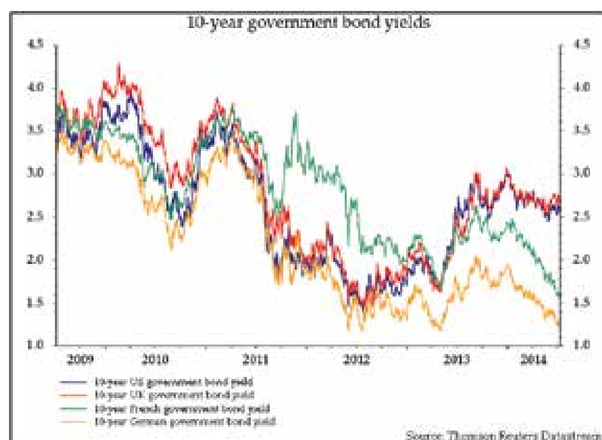
sensitive to additional stimulus.

In the UK, Mark Carney, the Bank of England's governor, used his Mansion House speech to confirm the strength of the UK economy and warn that the first rise in UK interest rates could happen sooner than investors expected. UK 10-year gilt yields ended the quarter marginally higher than US treasury yields and significantly higher than French and German yields, which fell over the first half of 2014 on expectations of further monetary stimulus from the ECB.



Rising interest rate expectations contributed to the strength of sterling. The pound rose 2.50% against the dollar and 3.14% against the euro over the quarter. The strengthening pound could prove a headwind for UK companies. UK equities delivered 2.24% and underperformed a rise of 2.60% by global equities despite the strength of the currency. Smaller companies disappointed and rose just 0.09%. Relative returns were lower as a result of the number of new issues and the absence in the small- and mid-cap tiers of the UK market of sectors such as energy and mining, which were strong over the quarter.

Overall, central bank policy remained supportive for risky assets at the quarter end. Yet equity markets made little progress over the first half of 2014 because valuations in some markets, most notably the US, appeared stretched and investors continued to debate the likely future path of interest rates in the US and UK. While US economic recovery is strengthening and there are tentative signs of improvement in China, the Brompton asset management team's preferred equity markets of Europe excluding the UK and Japan should perform well while gold equities and industrial commodities have the potential for significant gains from their depressed levels at the quarter end.

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Brompton Asset Management LLP, 1 Knightsbridge Green, London, SW1X 7QA