Brompton Asset Management

Quarterly review

for the three months to 30 September 2014

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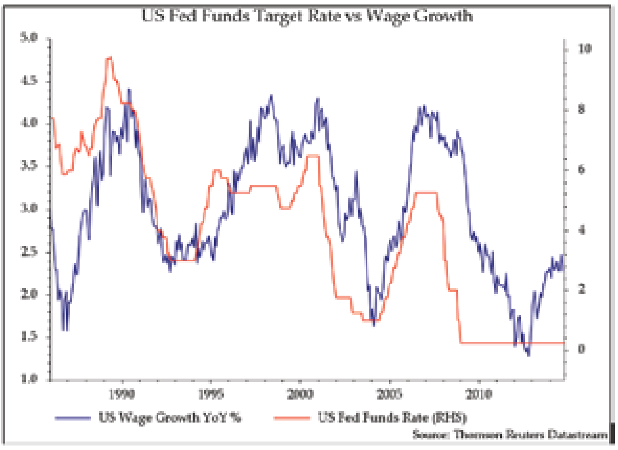
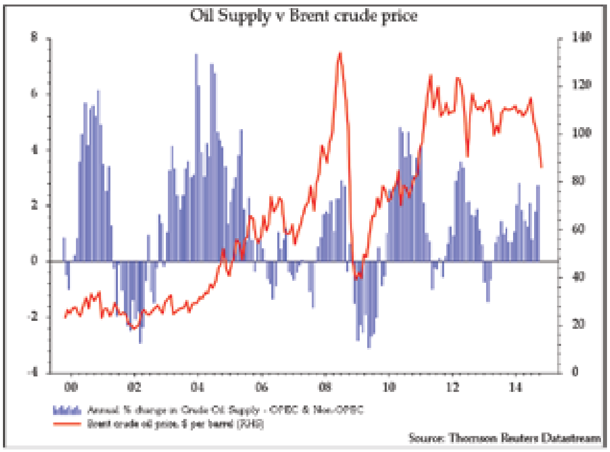
The third quarter of 2014 was marked by major moves in currency markets. Sterling weakened ahead of the Scottish independent referendum but failed to rally in the aftermath of the "no" vote, leaving it down 5.47% against the dollar over the quarter. Politics played a part but currency markets were also affected by weak UK inflation data and diminishing expectations of an earlier rise in UK interest rates relative to US rates. In the US, economic data remained robust. Unemployment fell to 5.9% and key leading indicators stayed strong. The data were supportive of Federal Reserve plans to draw to a close the extraordinary policy of quantitative easing or money printing that it adopted in the wake of the credit crisis. At the quarter end, US interest rates were widely expected to start rising from the middle of 2015 although the pace of increase was predicted to be slow. These factors proved positive for the dollar. The strength of the currency helped US equities post a gain of 6.66% in sterling terms, significantly ahead of the overall rise of 3.15% in sterling from global equities. In time, the strength of the currency may prove a headwind for the US economy, a point confirmed by Janet Yellen, the Federal Reserve chairman, who regards a stronger currency, economic weakness in the eurozone and increased geopolitical risk as reasons for keeping monetary policy exceptionally accommodative for longer than some observers had expected. The chart below shows the extent to which US interest rates have remained low compared to previous cycles, when the timing of the first interest rate rise was more closely linked to improvements in the labour market.



The dollar's strength, however, had significant consequences for other asset classes including equities in Asia Pacific ex-Japan and emerging markets. These equity markets lagged equities as a whole over the quarter, rising just 2.13% and 1.93% respectively in sterling.

Commodity markets were even more severely affected. Gold and copper fell by 8.44% and 4.67% respectively in dollar terms but the 11.50% fall in the oil price in dollar terms was the most significant drop. The oil price fell further after the quarter end, dropping almost 4% in one day in early October. The fall in the oil price is a concern because it may reflect weaker global demand and be a harbinger of deflation. The International Monetary Fund added to investor unease when it downgraded its forecast for global economic growth to 3.3% for 2014. Growth in supply, however, has also been a factor because US production of shale oil has increased and Libyan volumes have recovered strongly following the civil war in the spring. As long as economic recovery is robust enough to prevent the onset of deflation, then cheaper oil should ultimately stimulate global economic growth.



Europe ex-UK equities fell 2.35% during the quarter as economic data worsened. German industrial production may have been affected over the early summer by the conflict in the Ukraine but August's 4.0% decline confirmed the deterioration. Further substantive European Central Bank policy action was expected at the quarter end but an announcement appeared unlikely before the announcement of results of a financial health-check on eurozone banks after quarter end.

Immediately after the quarter end, there was a sea change in markets. In early October, volatility increased after a long period of relative calm. Global equity markets fell sharply and UK and US sovereign bonds

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rose. A number of factors conspired to cause investors to sell equities and seek safety in lower-risk assets such as bonds, gold and cash.

Most significantly, a major change in US monetary policy has been in progress throughout 2014 as the Federal Reserve gradually brings to a close the exceptional policy of quantitative easing and prepares the market for rate rises next year. Investors are concerned about what these changes will mean for equity markets, which have been buoyed by the huge increase in liquidity.

The recent weakness in the eurozone economy has, therefore, come at a difficult time. The weak oil price and easing economic growth in China have also added to fears of slowing global growth and possible deflation. This year has also been marked by a series of disturbing geopolitical issues ranging from armed conflict in the Ukraine and the Middle East to student protests in Hong Kong and the Ebola outbreak.

So what changes have been made to clients' portfolios? I decided to reduce investment in equities at the start of October and this went some way to protecting the value of clients' investments. I had thought for some time that US equities were expensive. Thus client portfolios had relatively low holdings in US equity funds at the start of October. Portfolios were, however, hurt by falls in other equity markets, particularly Europe ex-UK, where I believe valuations are attractive despite the bad news, not least because the European Central Bank stands ready to do more to support the economy. I continue to hold these investments for the longer term. Experience shows that it is rarely right to sell equities after a sudden market correction such as this unless it marks the beginning of a bear market, which I do not believe to be the case.

I also believe that longer-dated bonds are expensive. The yield on 10-year UK government bonds temporarily fell below 2% in early October, leaving them looking poor value given the risks. These bonds have, however, performed well as investors have become more risk averse. The low level of investment in these bonds benefited clients in 2013 but was a drag on relative performance over the first nine months of this year. That said, I have invested in UK direct commercial property funds in preference long-dated fixed income funds and this has benefited client portfolios because UK real estate has performed well so far this year.

Looking forward, the US economy appears in good shape and changes in monetary policy are likely to be slow and dependent on the continuing strength of the economy. The recent falls may give rise to some attractive investment opportunities.

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