BROMPTON
ASSET MANAGEMENT

Quarterly review

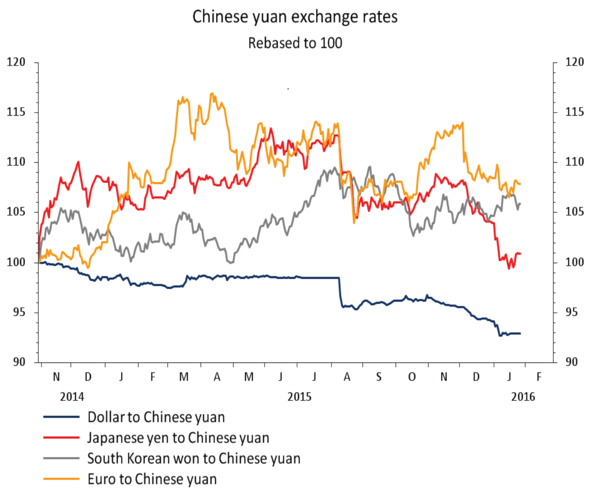
for the three months to 31 December 2015

Gill Lakin
Fund manager

Global equity markets seemingly took December's US interest rate rise in their stride and closed 2015 up 3.84% in sterling terms. There was, however, a reversal of sentiment in January, with shares falling sharply in the early days of trading. So why did investors take fright?

Recently-released minutes of December's Federal Reserve meeting, when members voted unanimously for the first rate rise since 2006, reveal their view that the US economy would grow at a moderate pace. The labour market slack had diminished, with unemployment down at 5%. Headline inflation was weak but members expected it to approach the 2% target as "transitory factors" such as the oil price fall in late 2014 dropped out of the annualised figures. Members also recognised there were "downside risks" to the US from global economic and financial developments but these were considered to be "balanced" by the stronger domestic picture.

Fed members acted in the interests of the US economy but one far-reaching consequence of this monetary policy change has been a stronger dollar. The dollar gained 5.79% against sterling in 2015 as investors anticipated the rate rise and rose further in early January. Unfortunately, the dollar's strength has exacerbated some of those global risks recognised by the Fed. The link between the dollar and the Chinese currency in recent years has produced a strong renminbi at a time when Chinese growth has slowed. As the chart below shows, this has substantially reduced China's export competitiveness.



Source: Thomson Reuters Datastream

This all changed last August, when the People's Bank of China's (PBOC) loosened the ties between the two currencies. The renminbi fell sharply in subsequent days, causing a fall in global equity markets as investors reacted to the potentially deflationary consequences of a weaker renminbi. There was another bout of renminbi weakness in early January 2016, as the chart below shows.

Source: Thomson Reuters Datastream

There were also double-digit falls in oil prices in early January, primarily as a result of a supply-side shock rather than the global economic slowdown. In the stand-off between the Organisation of the Petroleum Exporting Countries and US shale oil producers, neither side showed signs of blinking first although the increasing financial distress of US producers was shown in the elevated yields demanded by holders of their bonds. The prospect of increased supply from Iran following last year's nuclear accord may lead to a further oil price decline.

The risks of global deflation have clearly risen and, in consequence, safe-haven assets have outperformed, with gilts rising as oil prices fell. In a recent speech, the Bank of England governor, Mark Carney, said UK growth was slowing. Unsurprisingly, investor expectations of a UK rate rise receded further, with some commentators saying rates would not rise until 2017. The approaching Brexit vote only adds to the uncertainty and may have contributed to recent sterling weakness.

In January's monetary policy statement, the European Central Bank (ECB) president, Mario Draghi, said downside risks had increased again, adding that eurozone monetary policy would be reconsidered in March. The euro's rise against sterling in early January was another indication that December's ECB decision to prolong its asset purchases to March 2017 was not sufficient to counteract the heightened risk of deflation. The Japanese yen also rebounded against sterling and the Bank of Japan may also review its monetary policy given the yen's strength.

After a fourth-quarter recovery, China's stockmarket resumed its decline in early January, generating double-digit losses in sterling. Chinese stocks were hit by a relaxation in share dealing rules imposed in August to stem market losses and capital flight. The PBOC now faces a delicate balancing act to help China's domestic economy, which would benefit from a weaker currency, without precipitating capital outflows.

Chinese policy makers may ultimately increase growth. They are certainly deploying all the policy tools in the toolbox to tackle the growth slowdown. Currency depreciation is only the latest is a series of measures including interest rate cuts, a relaxation in bank lending restrictions and increased infrastructure spending. China also is a net energy importer and thus benefits from cheaper oil.

Until there is clear evidence, however, of an improvement in Chinese data, global equities may suffer bouts of weakness. I continue to focus clients' equity investments in developed economy markets in preference to Asia excluding Japan and emerging markets, which are more vulnerable to continued dollar strength. My focus is on funds that invest heavily in global consumer companies that benefit from weak oil prices so should perform well over the longer term.

In the press conference that followed December's rate rise, the Fed chair, Janet Yellen said she was surprised by the magnitude of the oil price fall. The decision to raise rates may have been finely balanced given the weakness of headline inflation at the time. Since then, the stronger dollar has produced a tightening of US monetary conditions while the fall in commodity prices has dampened inflation expectations. As a result, the Fed may re-examine its plans for future interest rate changes and adopt a more dovish stance. This would be positive for risky assets in general and, more specifically, would reduce pressure on China to weaken the renminbi. Given the near-universal gloom among investors and the magnitude of recent falls, equity markets would recover strongly on any signs of good news.

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