BROMPTON
ASSET MANAGEMENT

Quarterly review

for the three months to 30 June 2017

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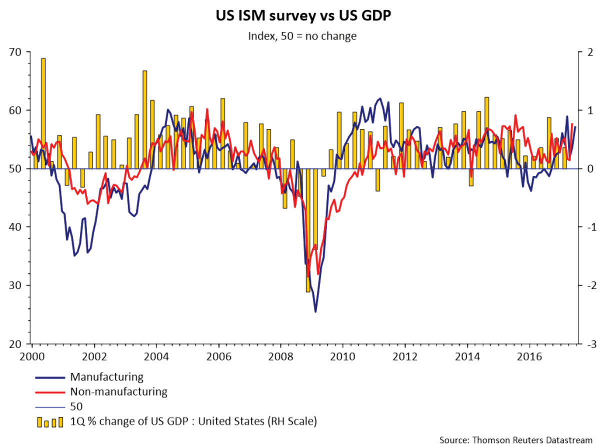
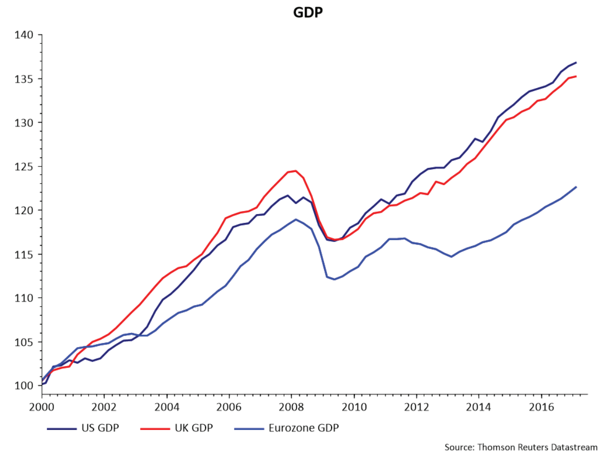
Global equities gained 0.55% and global bonds fell 1.23% in sterling over the second quarter of 2017 as investors remained sanguine about economic growth prospects. In early July, some leading indicators in the US and the eurozone signalled an acceleration in economic growth during the second half of 2017. In the US, for example, the widely-followed Institute of Supply manufacturing (ISM) and non-manufacturing surveys were consistent with economic expansion, as the chart below shows.

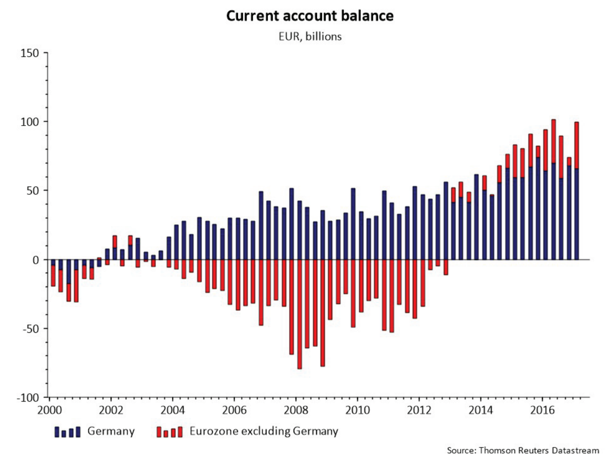


Currency movements significantly affected global equity and bond returns over the quarter as the dollar fell 3.73% against sterling while the euro gained 2.66%. Prompted by a significant change in sentiment from recent years, the euro rose sharply against the dollar despite the Federal Reserve's decision in June to raise US interest rates for the fourth time since December 2015. President Trump's failure to repeal Obamacare and deliver his promised fiscal stimulus in the form of tax cuts and infrastructure spending shook investors' confidence.

By contrast, the eurozone's position improved in the first half of 2017 both politically following the elections of centrist candidates in Holland and France and economically. Eurozone gross domestic product (GDP) grew 0.6% in the first quarter of 2017, outperforming the UK's 0.2% rise. Equities in Europe excluding the UK benefited from euro-strength, rising 4.85% in sterling over the second quarter. As the chart below shows, eurozone economic growth has lagged the US and the UK since the credit crisis. This is partly because the eurozone's federal structure made it difficult for the European Central Bank (ECB) to achieve a consensus in favour of quantitative easing until several years after the US and UK central banks adopted such policies.



Eurozone unemployment has, however, fallen overall and the region has a current account surplus and, encouragingly, it would do so even if the German contribution were excluded from the numbers, as the chart below illustrates. This should prove supportive for the euro and may lead to falls for longer-dated eurozone bonds.



All Brompton's investment strategies ended the quarter with significant allocations in Europe ex-UK equity funds such as Schroder European. Investments in Fidelity Germany in higher-risk strategies should benefit from the strong performance of German manufacturers. The German Ifo business climate index reached a high in June, heralding an acceleration in Germany's manufacturing growth.

In the UK, the extent of Theresa May's miscalculation, if not in seeking an increased parliamentary majority then in the management of her election campaign, was laid bare by the loss of the Conservative majority.

Quarterly review (continued)

for the three months to 30 June 2017

Voters' austerity-fatigue came to the fore and took precedence over the issues of Brexit and the economy. UK fiscal policy had been set to tighten under current government plans but the election result may now occasion some reassessment. Political expediency dictated the terms of the subsequent "confidence and supply" agreement with the Democratic Unionist Party (DUP). This includes a commitment to increase Ulster public spending by £1 billion in return for the support of the DUP's 10 MPs on matters relating to the budget, defence and Brexit. The deal ends in May 2019 when the government may have to accede to further DUP demands to avoid a general election. The prime minister's great gamble has ended not with a bang but a whimper.

Brexit negotiations are now underway. The UK's opening position is more amenable than expected. The Brexit secretary, David Davis, has agreed to discuss citizens' rights and financial obligations before trade talks. The chancellor, Phillip Hammond, has confirmed that the UK will leave the single market but the likelihood of a deal may have increased.

In both the UK and the eurozone, the stronger manufacturing performance has, however, been offset to an extent by a consumer spending squeeze as a result of higher inflation. Wage growth remains weak but import prices have risen as a result of rising prices for oil and other commodities. In the UK, the falling pound has added to the pressure on real wages. At this stage, consumers have not significantly reined in their spending, leading to a fall in the savings ratio.

The consumption growth slowdown may prevent overall economic growth from accelerating but this may not deter central banks from raising interest rates. The ECB ended the half year committed to its asset-purchase programme until 2018 and to maintaining the current interest rate until sometime thereafter but opinions are changing amongst members of the Bank of England's interest rate-setting committee. In his delayed Mansion House speech, the governor, Mark Carney, said "now is not yet the time" for a UK interest rate rise but three members of the Bank's monetary policy committee voted at their June meeting for a rise. Andy Haldane, the Bank's chief economist, was not one of them, but he expects to vote for a rise later this year.

UK interest rates may rise sooner than many commentators expect but the impact of higher inflation on consumers may mean the rate of increase is slow. This should support sterling, which may prove to have been oversold if the impact of Brexit on growth proves more modest than feared. By contrast, longer-dated UK government bonds may fall if the Bank raises rates sooner than anticipated.

Looking ahead, the prospects for equities appear broadly positive although valuations in early July were high compared to history particularly in the US. This has encouraged Brompton's investment team to look for better value in equity markets in Europe and Asia and in specific sectors such as US financials on behalf of clients. I believe equities offer better value than longer-dated bonds in an environment where inflation is rising slowly from subdued levels and central bank policy remains supportive. Equities may also provide investors with some protection in real terms. The current environment of higher valuations, modest economic growth and low inflation may persist – the "joyless recovery" continues.

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