BROMPTON ASSET MANAGEMENT

Quarterly review

for the three months to 30 September 2016

Gill Lakin
Chief investment officer

Ahead of June's UK referendum on European Union (EU) membership, I decided that increasing the allocation to sterling cash within the Brompton portfolios would not prove to be the most effective way to reduce risk for clients. Although sterling investments ensure that clients with sterling spending needs have matched the currency of their assets and liabilities, I was concerned that a vote to leave would precipitate a sharp fall in the pound.

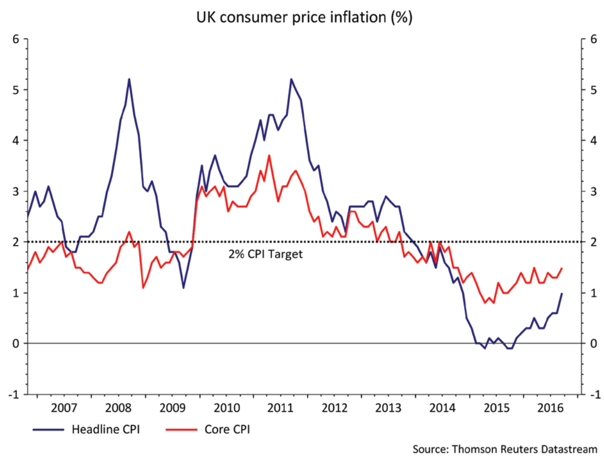
In consequence, we invested a significant proportion of clients' portfolios in foreign currency investments. Clients' sterling investments were focused on UK equity funds that I believed would do well irrespective of the outcome of the referendum outcome because UK equities would rise in response to the fall in sterling following a vote to "leave" and, conversely, UK equities would benefit from a stronger pound and a "relief rally" in the event that voters chose "remain".

Since the credit crisis, which ushered in the extraordinary monetary policies adopted by the world's major central banks, I believe it has been important to consider the currency exposure of clients' portfolios independently of the allocation to asset classes. During the third quarter of 2016, I continued to have heavy weightings in foreign-currency denominated investments and to UK equities to ensure that clients' portfolios continued to benefit in sterling terms as a result of the weakness of the pound. See chart below.

Before the referendum, Mark Carney, the Bank of England governor, warned of the negative impact that Brexit would have on the UK economy. In August, the Bank took action and cut interest rates, renewed quantitative easing and introduced further measures aimed at encouraging bank lending. The pound fell, leaving the dollar, euro and yen up 2.91%, 4.10% and 4.26% respectively against sterling over the third quarter and taking the gains against sterling for the first nine months of the year to 13.46%, 17.38% and 34.79% respectively. UK government bonds and sterling corporate bonds gained 2.34% and 6.77% respectively over the third quarter as gilt yields fell to historic lows. This provided an opportunity to take profits from clients' investments in gilt funds.

In the event, UK economic leading indicators rebounded strongly in August and consumer spending proved resilient but there was no respite for the pound and the weakness continued after the quarter end as more information on Brexit emerged at the Conservative Party conference. In particular, Theresa May confirmed that the UK would formally trigger its departure from the EU no later than the end of March 2017.

In recent weeks I have concluded that it may be time to reduce clients' foreign-exchange exposure in favour of sterling because a fall in the pound of this magnitude may prove inflationary and ultimately lead to higher gilt yields and a rise in UK interest rates. UK inflation data released in October revealed that headline inflation rose to 1% year on year in September, a significant increase from the 0.6% rate reported in August. Core inflation increased to 1.5% year on year in September. The fuel component reversed trend and rose 1.4% year on year in September compared to a fall of 2.6% in August as the recent recovery in the oil price started to affect the data. This is the biggest monthly rise since July 2013.



Quarterly review (continued)

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The full inflationary impact of the fall in sterling and rising energy costs have not yet shown up in UK inflation data. On an anecdotal level, the recent high-profile dispute between Tesco and Unilever allegedly relating to a proposed 10% price hike across a range of well-known consumer brands, may indicate the inflationary forces building up as a result of the fall in the pound.

In recent weeks, I have sold clients' investments in UK commercial property funds. The fall in the pound may benefit the sector in two ways. In the short term, the price of UK properties has fallen for non-sterling investors; in the longer term, it may spur UK economic growth and lead to increased demand for rental space. I am, however, more concerned that the unquantifiable impact of Brexit negotiations on the UK financial services sector will result in falling demand for City offices, which constitute a significant proportion of many UK property funds' portfolios.

I have also taken profits from clients' investments in equity funds. Equity markets could prove vulnerable to the uncertainties of US electoral politics and a US interest rate rise. In the longer term, however, I am positive about the prospects for equities because, in aggregate, central bank monetary policy remains expansionary and supportive of risky assets. Alongside the Bank of England, the European Central Bank and Bank of Japan are still actively seeking to stimulate growth through the expansion of their respective monetary bases. The Federal Reserve is pursuing a different path of monetary policy but the pace of further increases will remain slow and dependent on economic data. Contrary to expectations at the beginning of 2016, when some commentators expected US interest rates to increase four times this year, the Fed has, so far, remained on hold although interest rates are widely expected to increase in December.

Since the crisis, central bankers have persistently called on politicians to support their monetary measures with tax cuts and spending increases, so-called fiscal easing. Governments have been slow to respond but there are now signs that this is changing. Japan recently announced a programme of fiscal easing, the UK has softened its approach to eliminating its budget deficit and both candidates for the US presidency have advocated an increase in infrastructure spending.

I continue to believe that emerging market assets, both equities and bonds, are attractive relative to developed markets. Equities in Asia excluding Japan and emerging markets rose 13.46% and 12.33% respectively in sterling over the quarter, significantly outperforming the 8.50% sterling gain by global equity markets. Asia ex-Japan and emerging markets benefited from a recovery in commodity prices and some respite from dollar strength. Emerging market bonds also performed well as yields fell. A number of Asia ex-Japan and emerging market central banks have the capacity to cut interest rates further in contrast to their developed market peers. India's central bank, for example, cut interest rates shortly after the end of the third quarter in response to falling inflation.

My approach is to take both tactical and longer-term strategic investment decisions on behalf of Brompton clients. I believe equity markets may suffer from the uncertainties of US electoral politics and the expected rise in US interest rates. A market correction could, however, provide a buying opportunity in the light of the generally supportive monetary and fiscal policy.

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