Quarterly review

for the three months to 31 December 2016

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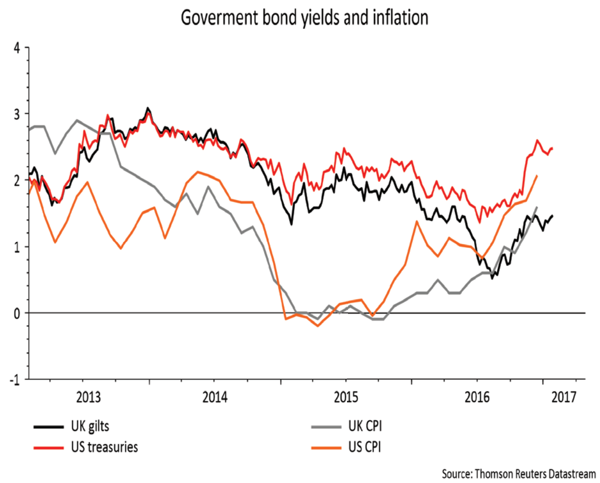
Chief investment officer

The year 2016 was one in which political events loomed large on the investment horizon as investors faced uncertainty around June's UK European Union referendum and the US presidential election in November. Investors' worst fears appear to have been realised when UK voters chose Brexit and the vagaries of the US electoral system put Donald Trump in the White House. The great irony of 2016 was the positive market reaction to these events. Global equities and bonds closed the year having returned 29.40% and 21.77% respectively in sterling terms. Admittedly, much of these sterling returns can be attributed to currency movements as the pound fell following Brexit. The dollar, euro and yen gained 19.28%, 15.82% and 23.02% respectively against the pound in 2016. In local currency terms, it was, nevertheless, still a good year for investors.

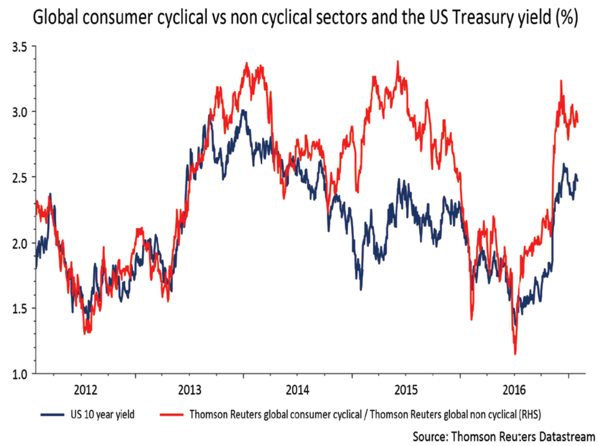
So why was the market reaction so different from expectations? First, bonds and equities were buoyed by the slower-than-anticipated pace of US monetary tightening. At the start of 2016, many commentators expected the Federal Reserve to raise interest rates four times during the course of the year. In the event, the Fed increased US interest rates only once and then only in December. Investors were also heartened by the steady pace of global economic growth, a recovery in the prices of oil and other industrial commodities and rising inflation.



In the US, Trump's election win rapidly switched from being bad news for equity markets to good news once investors weighed the reflationary impact of tax cuts, increased infrastructure spending and "putting America first". Inflationary pressures were already building prior to Trump's victory as a result of near-full employment and rising commodity prices but his election success focused investor attention on the recovery in inflation data and the likely impact of his policies on a strong economy. This prompted one commentator to coin the term "Trumpflation" (see graph above).

In the UK, the economy proved resilient over the third quarter of 2016 and into the fourth and consumer spending remained strong. This was so different from Mark Carney's pessimistic warnings ahead of the Brexit vote. The Bank's chief economist, Andy Haldane, recently referred to the Bank's pre-referendum gloom as its "Michael Fish moment", drawing a parallel between Carney's gloomy prognosis for Brexit Britain and the BBC weatherman's sanguine forecast before the great October 1987 storm. The robust growth may result from the Bank's swift action in cutting interest rates, increasing quantitative easing and fostering bank lending. I do, however, believe UK monetary conditions may have eased too much given the powerful stimulus from the weaker pound and I remain negative on prospects for UK and US longer-dated bonds.

The change in inflation expectations sparked a change in equity market leadership. So-called "bond proxies", those dependable, cash-generative companies with strong brand protection and high barriers to entry, generally outperformed more cyclical or "value" stocks after the credit crisis. The recovery in inflation expectations and rising bond yields has led to a reversal in this trend. The chart below shows the outperformance of cyclical sectors relative to less cyclical peers since the middle of last year. This trend



Quarterly review (continued)

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is likely continue and this has been reflected in some changes in Brompton's preferred third-party fund managers. At such major inflection points in markets, it may be difficult for active managers to outperform and I have, therefore, also included a significant number of index-tracking funds in client portfolios.

Currencies played a big role in determining sterling investment returns last year and Brompton's clients benefited from their relatively-high holdings in foreign currency investments. Brexit uncertainty may continue to depress sterling, particularly relative to the dollar, which could strengthen as Trump's expansionist policies result in accelerating US economic growth and the Fed raises rates to combat inflation more aggressively than investors currently expect. I have, however, increased Brompton clients' sterling assets because I believe UK inflation and gilt yields may also rise more rapidly than investors expect. Unlike his predecessor, Trump has put the UK "at the front of the queue" when it comes to a trade deal, strengthening the UK's hand at the EU negotiating table and steadying sterling.

Market returns will continue to be influenced by political risk in 2017. Trump's protectionism may benefit US companies but could prove a headwind for emerging market assets as investors assess the impact of his planned renegotiation of, or withdrawal from, trade deals. The US has benefited from globalisation and the gains from sourcing goods more cheaply from abroad. A reversal in this trend might boost US output in the short term but could prove inflationary and result in slower growth in the longer term as a result of the inefficient allocation of resources.

Political risk is arguably at its most acute in the eurozone. From an economic perspective, the outlook for equities in Europe excluding the UK has brightened. Economic leading indicators, employment and inflation data have all improved but the region is confronted this year by a raft of unpredictable political events. The UK government plans to trigger Brexit by the end of March. In addition, presidential elections are due to take place in France and Germany and there will also be a general election in Holland. Italy, meanwhile, could face a snap election at any time in the wake of Matteo Renzi's referendum defeat. Trump's more conciliatory approach to Russia and his criticism of Nato may also allow Russia to expand its sphere of influence in Western Europe.

Over the coming months, the recovery in inflation, particularly in the US and UK, is likely to remain an important theme. Equities and other real assets should benefit but longer-duration bonds could post losses in this environment. I have positioned our clients' portfolios for such conditions. If 2016 showed anything, however, it was how difficult it is to predict accurately the impact of political events on markets. I continue to avoid building in a bias to any specific political outcome in client portfolios but my stance is more cautious than might otherwise be the case given the significant political uncertainty currently facing financial markets.

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