BROMPTON ASSET MANAGEMENT

# Quarterly review

for the three months to 31 December 2017

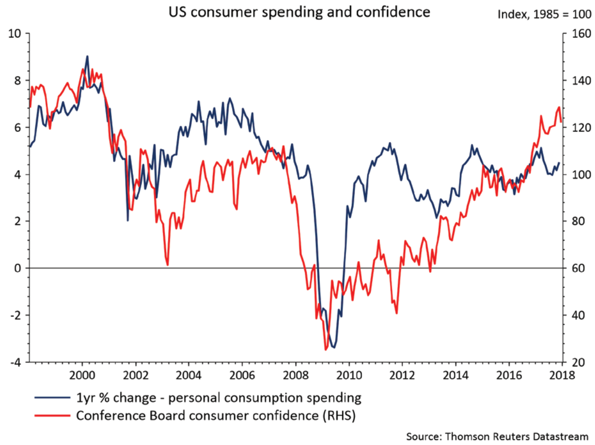
**Gill Lakin**
Chief investment officer

Global equities rose 4.97% in sterling during the final quarter of 2017, bringing the curtain down on a good year for equity investors and taking annual returns to 13.84%. Bonds recovered 0.25% but still retreated 1.90% over 2017 as the Federal Reserve raised interest rates three times and sterling rose against the dollar. Sterling bonds fared better as the Bank of England only raised rates once, taking them from a 0.25% low to 0.5%. UK government bonds and sterling corporate bonds returned 2.04% during the quarter, taking annual returns to 1.97% and 5.01% respectively.

In 2017, stronger-than-expected economic growth driven by buoyant manufacturing and a modest inflation pick-up supported equities. This was particularly evident in the eurozone. In December, the manufacturing purchasing managers' index, a key leading indicator, hit its highest level since its 1997 launch. Unemployment fell while consumer spending and business investment rose. Some political risks apparent in early 2017 receded as Dutch and French elections returned centrist candidates. In France, President Macron's programme, including €56 billion of state spending and lower corporate taxes, should soften the impact of labour market reforms.

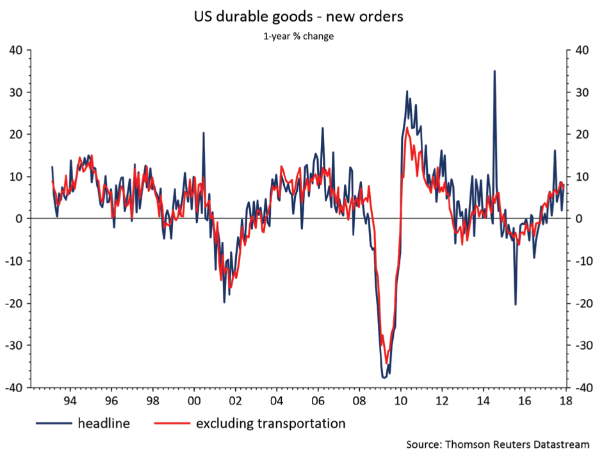
Equities in Asia excluding Japan and emerging markets outperformed, gaining 7.38% and 6.62% respectively in sterling as trade expanded and the dollar weakened. This took annual gains to 29.78% and 25.83% respectively. Indian equites shone, with quarterly gains reaching 10.91% in sterling despite the impact of the 15.03% oil price increase on this energy-importing nation. In 2017, Brompton clients benefitted from such gains through generalist emerging market funds and, in the higher-risk strategies and funds, a specialist India fund. The latest World Bank ease-of-doing-business survey lifted India 30 places thanks to Narendra Modi's reforms. It is now easier to start a company, obtain building permits and bank loans, trade across regions, enforce contracts and resolve insolvencies. During the quarter, Modi announced a road-building programme and Indian sovereign debt was upgraded.

In the US, economic growth may accelerate in 2018. The chart at the top of the right-hand column shows consumer spending strong and confidence rising. In addition, business investment, subdued since the credit crisis, has revived. The chart opposite shows rising durable goods orders, a key component of business spending.




Against this back-drop, Donald Trump's tax cuts and jobs act should stimulate an already strong economy, leading to higher 2018 growth forecasts. Consumers benefit from rationalised tax brackets, lower business income taxes and changes to benefits and allowances. These measures should sustain consumer spending, which may otherwise have faced pressure. In November, the savings ratio fell to 2.9%, the lowest level since the credit crisis, as consumers saved less to maintain living standards as inflation and interest rates rose. The corporation tax cut from a 35% maximum to a flat 20% should encourage companies to invest. The cut lowers the hurdle return rate for capital spending, increasing the number and value of viable investment opportunities.

Fiscal stimulus so late in the cycle, with unemployment down at 4.1%, may, however, prove inflationary and generate speedier interest rate rises. The link between unemployment and inflation has historically been strong. The Fed forecasts the



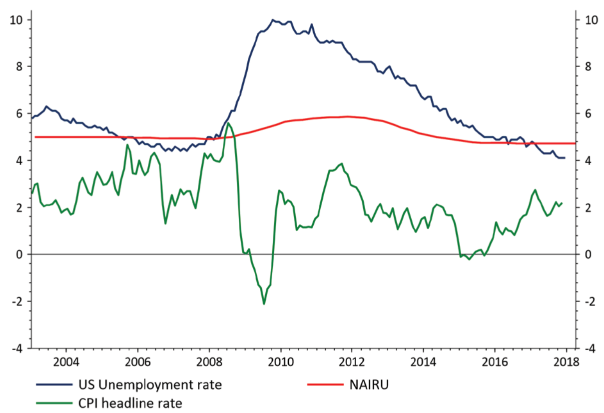
BROMPTON ASSET MANAGEMENT

# Quarterly review (continued)

for the three months to 31 December 2017

unemployment rate at which the economy and labour market are in equilibrium. This is called the non-accelerating inflation rate of unemployment (NAIRU). Real wage declines and low productivity have been hallmarks of the post-crisis US economy. Some analysts believe secular trends such as technological progress and falling unionisation explain workers' lack of bargaining power. Janet Yellen, the outgoing Fed chair, believes, however, that low inflation will prove transitory. As the chart below shows, unemployment is below NAIRU, implying that inflation will rise.

US Unemployment, NAIRU and inflation (%)




Source: Thomson Reuters Datastream

Relatively-high US valuations are a concern as interest rates rise. In isolation, high valuations may not generate a fall given the lack of immediate signs of economic or market stress. Fed loan officer surveys show lending conditions remain easy while the VIX market volatility index ended 2017 at low levels. When fundamental circumstances do, however, deteriorate, Wall Street may fall substantially before cheaper valuations support share prices. US equity allocations in Brompton's strategies and funds ended 2017 relatively low and biased towards financial companies, which should benefit from higher long-term interest rates and Trump's deregulation plans. US equities rose 5.77% in sterling over the quarter as the tax cuts and jobs act became law, taking the annual rise to 11.29%.

UK equities marginally underperformed, with the 4.87% quarterly return taking the annual rise to 11.78%. Returns were buoyed by progress in the Brexit talks, which moved forward to issues such as trade. The Bank maintained its ultra-loose monetary policy amid fears of a damaging "hard" Brexit, merely reversing the emergency quarter-point cut after the Brexit vote. Unemployment fell to historic lows and inflation rose to 3.1%, more than percentage point above the Bank's 2% target, necessitating an explanatory letter from the governor to the chancellor.

Stronger commodity prices and imported inflation driven by sterling's fall in 2016 generated higher retail price pressures. Wage growth was weak but may accelerate in response to near-full employment, minimum wage increases and the removal of the 1% public sector wage rise cap. I remain cautious about prospects for UK equities and longer-dated gilts because inflation and interest rates may rise more rapidly than anticipated and sterling may recover further having risen 0.83% against the dollar over the quarter, taking its annual rise to 9.48%.

Despite my caution about the UK, equities were my preferred asset class at the quarter end, with global growth steady and interest rates and inflation only likely to rise modestly from subdued levels. Manufacturing growth and lower valuations made Europe excluding the UK and emerging markets look most attractive. In the bond markets, longer-dated developed world sovereign bonds appeared expensive in absolute terms and relative to some emerging market bonds. In response to the general scarcity of bond market opportunities and high equity valuations, particular in the US, the Brompton investment team has devoted time to researching absolute return funds that aim to deliver positive returns irrespective of bond and equity market trends.



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