Quarterly review

for the three months to 30 September 2017

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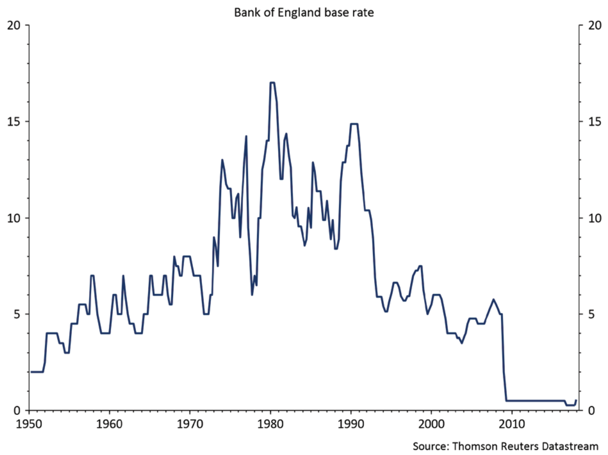
Chief investment officer

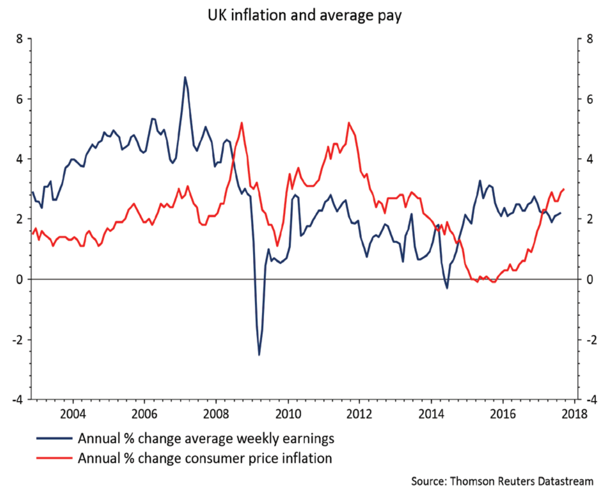
The Bank of England raised base rate shortly after the quarter end, tightening monetary policy for the first time in a decade. The rate rose to 0.5% from the historic low of 0.25% reached following the Brexit referendum in August 2016. The last rise was in July 2007, when base rate rose a quarter of a percentage point to 5.75%. In the wake of the credit crisis, successive cuts swiftly reduced the rate to 0.5%, a level hit in March 2009, and it has remained at or below this level since then.



The rate increase was flagged in September, when the Bank of England governor, Mark Carney, surprised investors by suggesting monetary tightening would begin in the "relatively near term". In response, UK bond yields rose as government bonds and sterling corporate bonds fell, leaving the negative return from gilts at 0.40% for the third quarter of 2017. Sterling rose despite stalling Brexit talks, posting a 3.29% quarterly gain against the dollar. The base rate rise reversed the cut that formed part of the monetary boost to the economy after the Brexit referendum. The UK economy has, however, proved more resilient than the Bank's monetary policy committee anticipated.

The monetary policy tightening is also a response to rising consumer price inflation, which reached 3% in September, fuelled by rising commodity prices, particularly for oil, in 2016 and sterling's fall following the Brexit vote. A further increase in inflation above 3% would necessitate a letter from Carney to the chancellor to explain why inflation had deviated by more than a percentage point from the Bank's 2% target.

The latest unemployment figures showed the percentage down at 4.3%, the lowest figure since 1975, making it harder for the Bank's policymakers to justify holding base rate close to zero when inflation was 3%. Wage inflation, however, remained subdued over the summer and autumn. In August 2017, wages excluding bonuses were increasing at 2.2% year-on-year, meaning that real wages were falling. With the economy near full employment, however, wage pressures and ultimately productivity may start to pick up.



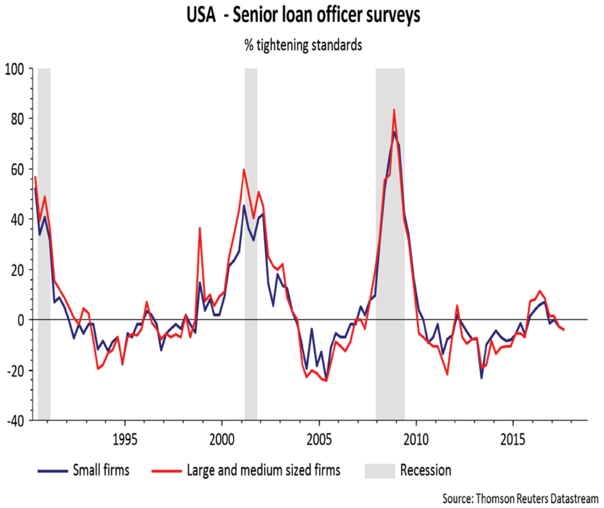
In the US, interest rates had by the quarter end increased four times since December 2015, reaching a range of 1-1.25%, and investors were expecting a further rise in December. The Federal Reserve is closing the gap between core inflation, which stood at 1.7% in September, and interest rates in view of near-full employment. President Trump has nominated Jerome Powell to succeed Janet Yellen as Federal Reserve chair when her term of office expires in 2018. Powell's appointment is unlikely to herald a significant change in monetary policy although he may favour greater financial deregulation than Yellen.

US gross domestic product exceeded consensus expectations over the quarter, showing 3% year-on-year growth, and growth may strengthen in 2018. US equities rose 1.16% in sterling. There were few signs that the Fed rate rises had significantly tightened monetary conditions in the broader economy. The chart overleaf, depicting the behaviour of US senior loan officers, shows, for example, no significant tightening in bank lending conditions for companies, a trend that might contribute to reduced confidence and ultimately presage a recession. Although US equities ended the quarter trading on relatively high valuations compared to history and some other markets, they may make further gains. I

Quarterly review (continued)

for the three months to 30 September 2017

have continued, however, to bias our clients' US equity investments towards financial companies, which should benefit from rising interest rates and, potentially, deregulation.



In contrast to the UK and US, there were no moves to tighten monetary policy in Japan. Shinzo Abe, the prime minister, won a snap general election in October 2017, with Japanese voters endorsing his policy agenda comprising monetary easing, fiscal stimulus, structural reform and strengthened national security in response to North Korean sabre-rattling and Chinese territorial ambitions. The Bank of Japan continued to anchor 10-year government bond yields close to zero to weaken the yen and foster inflation. With interest rates rising elsewhere, the yen may come under pressure as investors borrow at low yen rates to invest in higher-yielding currencies such as the dollar, the so-called "carry trade". Yen weakness improves Japan's export competitiveness and may generate gains for Japanese equities, which ended the quarter supported by low valuations. The Tokyo market rose 1.22% over the quarter in sterling and rose a further 5.54% in October following Abe's election victory.

At the quarter end, the portfolios remained focussed on equities in Europe excluding the UK and emerging markets at the expense of US equities on valuation grounds. These regions outperformed the 1.96% gain in sterling from global equities over the quarter. Europe ex-UK equities rose 3.58% in sterling and equities in Asia excluding Japan and emerging markets rose 3.35% and 4.60% respectively in sterling. All three regions continued to generate positive returns in October.

The global economic strength over the summer and autumn surprised some commentators. The rise in inflation from subdued levels accompanied by the slow pace of interest rate increases created a benign environment for equities and some other higher-risk assets. The strength of consumer confidence and the increase in corporate investment in some regions are positive factors looking ahead.

The recent low inflation levels may appear anomalous, with near-full employment in some economies, notably the US, UK, Japan and Germany, although some secular trends may be counteracting the strong jobs figures such as technological change and greater self-employment at a time of weakening trade unionism. If traditional economic relationships hold true, however, investors may soon have to contend with faster-than-anticipated rises in inflation and interest rates, potentially leading to falls for equities and bonds.

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