Quarterly review

for the three months to 31 March 2019

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Global equities rallied after the sell-off in late 2018, rising 9.79% in sterling over the quarter. A shift in US monetary policy and dovish rhetoric from the Federal Reserve chairman, Jerome Powell, stemmed the ebbing tide of investor confidence. US interest rates were held at the Federal Open Markets Committee's March meeting, illustrating the "patient" approach the Fed has adopted recently to monetary policy. US interest rates ended the quarter close to neutral and may not change for some time. Interest rate increases have not, however, been the only means the Fed has employed to tighten monetary policy recently. Its swollen balance sheet has been reduced as the proceeds from maturing bonds have only been partially reinvested. The Fed will slow the rate at which the run-off of bonds reduces the balance sheet from May 2019 and keep the balance sheet constant from September.

The Fed changed tack in response to evidence of slowing economic growth. US gross domestic product (GDP) rose 3.1% in 2018 as a whole but the growth rate slowed to 2.2% in the final quarter. Growth is expected to slow in 2019 because of tighter monetary policy and the fading impact of tax cuts, with the Fed cutting its 2019 US GDP growth forecast to 2% in March. Consumer spending and business investment data showed weakness and the economy ended the quarter facing headwinds from slower growth in China and Europe and the unresolved issues of Brexit and trade tariffs. The narrowing difference between short-dated and long-dated US government bond yields led some to conclude a recession might be on the horizon.

The US economy did, however, prove more resilient in the first quarter than many commentators had feared. According to the advance estimate, first quarter GDP increased 3.2%, significantly above consensus expectations. One-off factors such as inventory-building ahead of potential trade tariffs and higher public sector spending may have flattered this figure, which is also subject to revision, but this was a positive surprise for investors. Leading indicators such as the April 2019 purchasing managers' indices (PMIs) for manufacturing and services were consistent with steady growth.

The UK economy may also have proved more resilient over the quarter despite Brexit strains. GDP expanded by 2% year on year in February against 1.5% in January. Stockpiling in advance of an anticipated Brexit date of 29 March may, however, have contributed to the apparent strength of manufacturing. The manufacturing PMI rose to 55.1 in March. A PMI above 50 indicates the sector is expanding. In contrast, the PMI for the larger services sector fell to 48.9 from 51.3, suggesting contraction.

UK unemployment fell to 3.9% during the three months to January, the lowest level since January 1975, while average weekly wage growth was 3.4%. Consumer spending held up well in consequence. By contrast, there was a marked deterioration in business confidence, with investment in the final quarter of 2018 down 2.5% on the previous year. This was the fourth consecutive quarter-on-quarter fall, a sustained decline not seen since the credit crisis.

UK stocks rose 9.38% despite the Brexit impasse because investors' fears that there would be no deal with the European Union diminished. UK smaller stocks marginally lagged, rising 8.71%. The low valuation measures for UK shares at the quarter end relative to some comparable foreign markets, including relatively high dividend yields, provide an attractive buying opportunity. An end to the Brexit deadlock would provide the catalyst for additional purchases of UK equity funds.

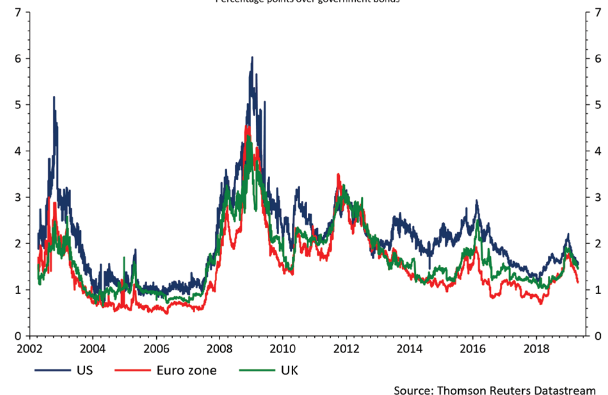
In March, the European Central Bank president, Mario Draghi, cut his eurozone GDP growth forecast for 2019 from 1.7% to 1.1% and announced measures to stimulate bank lending. Interest rates are on hold for longer, with no increase until 2020. Manufacturing has been hit hard and the eurozone manufacturing PMI in April was consistent with contraction. Germany narrowly avoided a recession in late 2018 and in April a key business survey showed current conditions and expectations were weak. Equities in Europe excluding the UK rose 8.16% in sterling over the quarter, reflecting improved Chinese data and signs of progress in Sino-US trade discussions.

Beijing government policy shifted in 2018 from reducing public and private sector debt to stimulating growth as the economy weakened and trade tariffs started to have an impact. The stimulus package of tax cuts and increased public sector spending was, however, relatively modest. China's GDP, according to Beijing, expanded 6.4% year on year in the first quarter of 2019 and leading indicators have improved. The Chinese manufacturing and services PMIs rose in

March, signalling future expansion, as shown in the chart below.

Stronger-than-anticipated Chinese growth and easier US monetary policy created a benign environment for some emerging markets. This, when combined with low valuations at the quarter end, provides an attractive buying opportunity. A positive resolution to the Sino-US trade dispute would provide a fillip to growth and a catalyst for additional purchases of emerging market equity funds. In April 2019, the rhetoric was encouraging but no agreement had yet been reached.

Bonds generated positive returns in local currencies over the quarter as yields fell in response to lower interest rate and inflation expectations, with sterling corporate bonds and UK government bonds returning 4.83% and 3.53% respectively. Global bonds, however, fell 0.11% in sterling as currency swings outweighed the impact of lower yields, with the pound strengthening 2.31% against the dollar. The Fed's loan officer surveys showed tighter lending conditions but more accommodative US monetary policy was reflected in the fall in corporate bond yields relative to government bond yields in early 2019, as the chart opposite shows.



Signs of weaker economic growth in early 2019 ushered in easier monetary policies from some central banks and more benign market conditions for investors. Stronger growth would, however, revive fears of monetary tightening. In the equity markets, Brompton favours the UK and some emerging markets because uncertainties over Brexit and trade tariffs have created potentially attractive buying opportunities. Subdued growth and inflation should also support some bond market sectors. Brompton favours strategic bond managers with a bias towards shorter-duration assets yet with the flexibility to change duration in response to changes in their economic views. Allocations to alternative funds, in particular daily-traded long/short funds, provide diversification away from long-only investments in equities and bonds.

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