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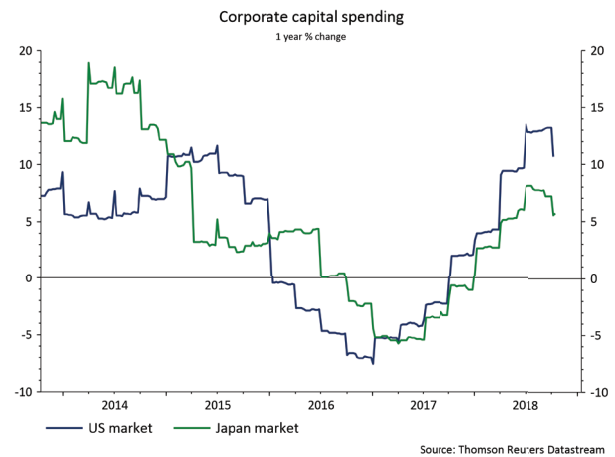
Quarterly review

for the three months to 30 September 2018

The sharp falls in equities and bonds during early October overshadowed the benign market conditions of the third quarter of 2018. In the first half of the month, global equities fell 6.40% in sterling, eradicating the 5.70% gain during the third quarter. The trigger for the retrenchment was the rise in US bond yields. The strength of the US economy encouraged the Federal Reserve to raise interest rates to 2-2.25% in September. US growth improved to an annualised 4% in the second quarter after a slow start to the year and may have accelerated in the third quarter. Strong inflation and jobs data sparked a sell-off in bond markets, pushing 10-year US Treasury yields to 3.26% on 9 October 2018. Investors have long ago abandoned the fears of deflation they experienced over the years following the credit crisis. At their historic low point on 6 July 2016, US 10-year treasury bond yields fell to 1.32%.

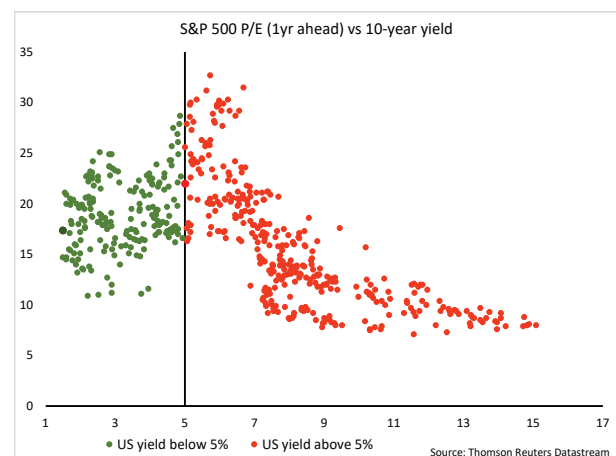
In early October, investors debated whether the price falls were the beginning of a bear market in equities or were merely the start of a shorter-term correction. On the 10th anniversary of the Lehman Brothers insolvency, media commentators reminded their audience of the origins of the crisis: the build-up of debt, regulatory failures in banking and a perceived asset price bubble in US housing. In the aftermath of the crash, the Federal Reserve chairman, Alan Greenspan, was criticised for keeping US interest rates too low for too long. Since December 2015, his successors have steadily raised rates eight times and reduced the Fed balance sheet to pre-empt a repeat of the build-up of perceived asset price bubbles.

On the evidence of its loan officer surveys, the Fed's monetary tightening has not yet become restrictive, with business access to debt remaining relatively easy. There has, during 2018 so far, been an increase in corporate capital investment in the US and Japan, as shown in the first chart. Takeover activity has also increased. These may be signs of company directors' confidence in economic prospects. The US tax cuts and jobs act reduced tax rates for businesses and consumers and relaxed restrictions governing the repatriation of US companies' overseas cash balances, freeing up funds for investment.



Elsewhere, central bank monetary policy remains easy. The European Central Bank's asset-purchase programme is drawing to a close but interest rates are not expected to increase until the second half of 2019. UK interest rates increased to 0.75% in August 2018, still an exceptionally modest level despite inflation well above the Bank of England target. Japanese monetary policy remains ultra-loose to combat deflation.

The Fed may raise interest rates significantly before conditions become restrictive and choke off growth. The chart below shows the historic relationship between US rates and Wall Street's price/earnings ratio. It shows that interest rates have typically reached 5% or more before market valuations fall.



Quarterly review (continued)

for the three months to 30 September 2018

US equity market valuations ended the quarter high relative to history and other major equity markets but such valuations may persist for some time for various reasons: the US is benefiting from fiscal stimulus at a time of relatively easy monetary policy, it is increasingly self-sufficient in energy thanks to shale oil and it dominates fast-growing sectors such as information technology.

In some countries such as Japan, valuations ended the quarter attractive and recent falls may provide a buying opportunity. Shinzō Abe fought off a leadership challenge in September, putting him on course to be Japan's longest-serving post-war prime minister. Policy continuity in government and at the Bank of Japan may lead to further gains for Japanese stocks.

When Abe became prime minister in 2012, Tokyo stocks rallied in response to his ultra-loose monetary policy. More recently, corporate reforms have gained momentum. Japan recently launched its JPX 400 index, whose constituents demonstrate good corporate behaviour through quantitative measures such as return on equity as well as by appointing independent non-executive directors and observing generally-accepted accounting principles. Such companies may gain higher valuations, increasing their access to cheaper capital than their less progressive competitors.

Takeover activity may increase as Japanese family owners put their businesses up for sale. In addition, labour shortages are forcing directors to focus resources on businesses with the greatest competitive advantages and shed non-core activities. This factor has contributed to the strength of Japanese companies in key sectors such as robotics and automation. I have been positive on the prospects for Japan since Abe

took office in 2012 and there may be further gains to come. Japanese equities rose 4.51% in the third quarter of 2018.

Equities in Asia excluding Japan and emerging markets underperformed over the quarter, with dollar strength and President Trump's trade tariffs proving powerful headwinds. Some of these equity markets ended the quarter attractively valued given the steady pace of global economic growth but there was no catalyst for an improvement in investor sentiment. In such circumstances, it may pay to remain cautious. Investments in Indian equity funds were sold on behalf of clients during the third quarter on concerns about the impact of rising US rates on India's economy. The country has fiscal and current account deficits and is a net oil importer. The oil price rose 3.87% over the quarter in sterling, taking the gain for the nine months to 30 September to 32.89%.

While remaining relatively sanguine on prospects for some equity markets, I see few opportunities in bond markets. Global bonds rose 0.31% in sterling over the quarter as the dollar gained 1.24% against the pound. UK government bonds and sterling corporate bonds fell 1.80% and 0.16% respectively. Brexit uncertainty remained elevated in early October. A "good outcome" is possible and the UK financial markets were not pricing in this possibility in October as a result of investor despondency on this issue. UK interest rates ended the quarter too low given the country's low unemployment rate and 2.7% inflation as measured by the Consumer Prices Index. Yet even a favourable outcome might result in significant falls for longer-dated sterling bonds, leaving the prospects for this asset class looking poor. Instead, I favour investments in daily-traded, long/short equity funds, which tend to be lowly correlated to both equity and bond markets, as a means of offsetting equity risk in portfolios.

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