BROMPTON
ASSET MANAGEMENT

Quarterly review

for the three months to 30 September 2019

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Global bonds and equities rose over the third quarter of 2019, returning 4.02% and 3.38% respectively in sterling as the Federal Reserve and the European Central Bank (ECB) eased monetary policy. The Fed led the way, making quarter percentage point cuts in July and September. The ECB cut its interest rate on central bank deposits by 10 basis points to -0.5% in September and said key ECB interest rates would remain at or below current levels until clear evidence emerged that inflation was closer to its 2% target. Net purchases under the ECB's asset purchase programme are resuming and will continue until shortly before any interest rate rise. The Bank of England, however, kept rates on hold in September. The path of UK monetary policy is likely to depend on the impact of Brexit on supply, demand and the currency.

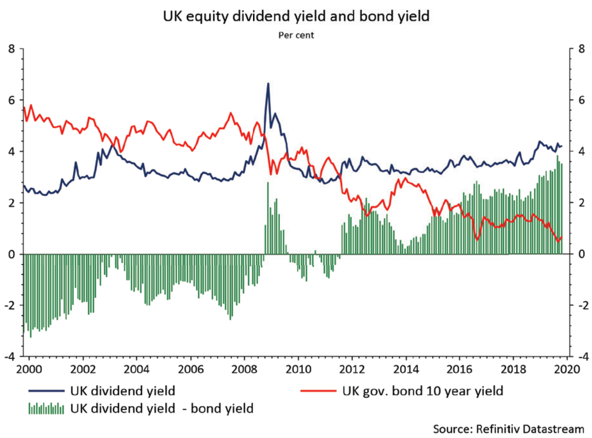
The Fed and the ECB cut interest rates because economic growth slowed and inflation fell below official targets of 2%. In the US and the eurozone, leading indicators turned down for manufacturing and services. The Sino-US trade dispute exacerbated the impact of slowing growth on manufacturing, which was hit particularly hard. American and eurozone consumer spending was resilient but there were signs of weakening consumer confidence. In response to Fed easing, US stocks outperformed, gaining 5.03%, but equities in Europe excluding the UK, where some countries rely more on exports, lagged, rising only 1.74%.

In August, the US yield curve inverted as the 10-year treasury bond yield fell below the two-year yield. This suggests a recession might be on the horizon because the US yield curve has inverted prior to every recession in the last 40 years although not every inversion has presaged a recession. The last time the yield curve inverted was in 2005, two years before the credit crisis. Steady US jobs data may suggest more favourable prospects because US unemployment fell to 3.5% in September, the lowest level since December 1969, but jobs data are typically lagging indicators, only deteriorating once a downturn is underway.

UK stocks underperformed as the risks of a no-deal Brexit increased, gaining only 0.72% as sterling fell 3.17% and 2.87% respectively against the dollar and the yen. Investors sought safety in government bonds and sterling corporate bonds, which returned 6.55% and 3.72% respectively. In September, 10-year gilt yields fell to a 0.34% historic low. In September, the Bank of England suggested that some clarity on Brexit and faster global growth would increase demand and lead to gradual interest rate rises. In such circumstances, gilts may fall.

Eurozone sovereign bond yields ended the quarter even lower than gilt yields and some turned negative. The German 10-year bond yield, for example, fell to a -0.74% historic low as investors anticipated renewed central bank asset purchases. Negative yields ensure purchasers will lose money if they hold their bonds to maturity.

After the quarter-end, the UK parliament voted in favour of an outline Brexit deal. The possibility that a UK departure from the European Union may prove smoother than feared was the catalyst for a sterling recovery and UK stock outperformance in early October. UK equities ended the quarter lowly valued on a yield basis relative to gilts. As shown in the green bars in the chart below, the gap between the yield on UK stocks and UK 10-year gilt yields stood at the quarter end at 3.65 percentage points.

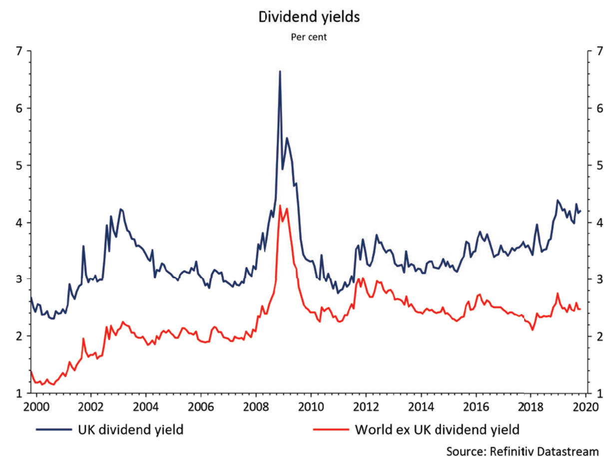


The yield on UK stocks was also looking attractive relative to the yields of some overseas equity markets, with the chart overleaf showing UK stocks at the quarter end yielding 4.13% while the yield for global equities excluding the UK was 2.50%.

UK stocks that are particularly sensitive to domestic economic conditions ended the quarter looking attractive to value managers. I believe UK equity funds with a value-orientation may, therefore, outperform if investors' worst Brexit fears prove unfounded while attractive dividend yields may provide some support for share prices in less favourable outcomes.

Quarterly review (continued)

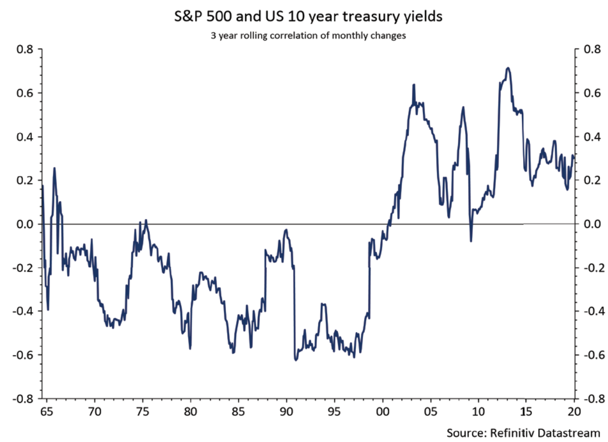
for the three months to 30 September 2019



Chinese third-quarter economic growth slowed to 6% year-on-year and equities in Asia excluding Japan and emerging markets underperformed, falling 1.25% and 0.96% respectively in sterling. Sino-US trade tension contributed to underperformance. US bipartisan support for tariffs may mean no return to the free trade era that preceded the Trump presidency. The trade imbalance between China and US may narrow through increased Chinese purchases of US agricultural products but there may be no compromise on issues of technological supremacy and national security. These concerns led to the US blacklisting some Chinese companies and may potentially result in restrictions governing the investment of US funds in Chinese markets.

Falling bond yields and slowing growth proved a favourable environment for gold over the quarter, with this nil-yielding, safe-haven commodity rising 7.22% in sterling. Gold equities are sensitive to movements in the gold price and rose 8.74%.

Among alternative funds, which typically aim to provide steady incremental returns, the Brompton team has favoured daily-traded long/short equity funds. These may provide some protection if bond and equity markets fall. The long-term negative correlation between equities and bonds is one of the central premises for fund managers when they construct diversified portfolios. This relationship has, however, been broken down in recent years as the correlation between some bond and equity markets such as in the US has turned positive, as the chart below shows.



Over the coming months, accommodative monetary policy from the Fed, ECB and some other central banks may support risky assets such as equities and mitigate the impact of slowing growth and recessionary fears. Positive developments in relation to trade disputes and Brexit may also boost share prices, particularly in the UK, where a smooth Brexit may prove a catalyst for outperformance by cheap UK stocks. Longer-dated bonds, particularly gilts, appeared expensive at the quarter end and may fall in the event that global growth strengthens and stronger wage growth fuels inflation. In such circumstances, gold equities and alternative funds may provide useful diversification.

Important information

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