BROMPTON
ASSET MANAGEMENT

Quarterly review

for the three months to 31 March 2022

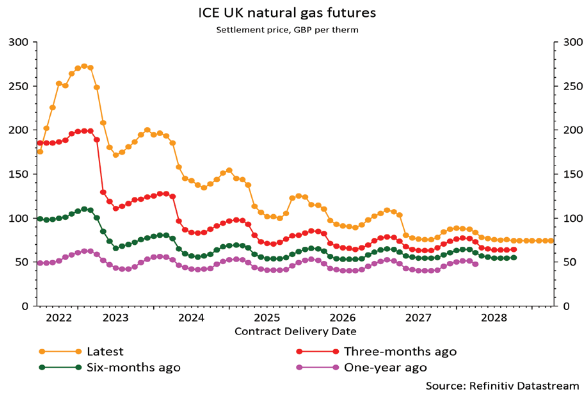
Gill Lakin
Chief investment officer

Global bonds fell 3.47% in sterling over the first quarter of 2022 in response to rising inflation and interest rates, with the pound's weakness masking greater losses in some overseas markets. UK government bonds fared worse, falling 7.46%, while sterling investment-grade corporate and high-yield bonds lost 6.63% and 3.39% respectively.

Global equities proved more resilient despite Russia's Ukraine invasion, falling 2.54% in sterling. The rotation in equity markets extended, with value stocks rising 2.06% in sterling whereas growth stocks fell 7.08%. US technology stocks were particularly badly affected, falling 7.35% in sterling, but UK equities outperformed, rising 4.75% because of the London market's bias towards sectors such as energy and natural resources. Gold equities and gold also generated gains, rising 17.10% and 9.65% respectively in sterling. In the currency markets, the dollar proved a safe haven, rising 2.87% against sterling, but the yen fell 2.40%.

The Bank of England has been in the vanguard in tightening monetary policy to combat high inflation. In December, the Bank's monetary policy committee (MPC) Raised Bank rate to 0.25%. This was the first rate increase since rates were cut to almost zero in March 2020 to combat the Covid-19 pandemic. Bank Rate rose twice over the quarter, with quarter percentage point rises in February and March. In May Bank Rate rose by a further quarter point, taking it to 1%. A minority of MPC members favoured a larger half-point rise. The Bank ceased asset purchases in December 2021 and may sell bonds later this year. UK inflation may top 10% later this year because of rising household energy prices, with Ofgem likely to sanction a big price increase in October. The Bank governor, Andrew Bailey, said further monetary tightening might be appropriate but the economy is expected to slow sharply because of the impact of higher prices on inflation-adjusted incomes.

Prices are rising because strong demand for energy has been exacerbated by Russia's Ukraine invasion plus subsequent sanctions and restrictions placed on Russia, including the German refusal to open the Nord Stream 2 gas pipeline linking the two countries. European energy policy over recent decades has led to the closure of coal-fired and nuclear power stations and left the region dependent on Russian gas. In the short term, liquid natural gas may be purchased from the US but it will take time to reduce dependence on Russia by accelerating the transfer to renewable energy sources and by classifying some natural gas and nuclear developments as "green investments". The UK natural gas futures shown in the chart below imply that investors anticipate prices will fall over the coming months as countries take action to diversify energy supply away from Russia.



Supply disruption stemming from China's zero-Covid policy, which resulted in major cities such as Shanghai going into lockdown, is also contributing to higher prices for imported goods and fuelling inflation. Inflation caused by higher prices, so-called "cost-push" inflation, may be relatively impervious to higher interest rates. Christine Lagarde, the European Central Bank president, has referred to the limited influence monetary policy may have on energy prices.

In the US, the Federal Reserve raised rates by a quarter point to a 0.25%-0.50% range in March and by half a point to 0.75%-1.00% in May. US inflation was at 8.3% in April, slightly below March's 8.5% figure. The energy crisis is not as acute in the US as in Europe because the US is close to energy self-sufficiency. A further half-point increase in rates is on the table for the Fed policy-setting meeting in June. The Fed has been criticised for moving too slowly to combat high inflation but may now be tightening monetary policy too aggressively in an environment of rising living costs and slowing economic growth as consumers rein in spending. Janet Yellen, the US Treasury secretary and previous Fed chair, said the Fed would need "luck and skill" to maintain a strong labour market and bring inflation down, implying that the risk of a monetary policy error and subsequent recession has risen. In early May, there were no clear indicators that a recession was on the way. When, however, the yield on longer-dated bonds falls below that of shorter-dated

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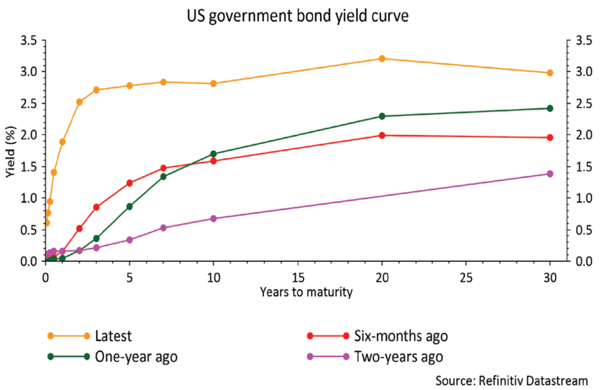
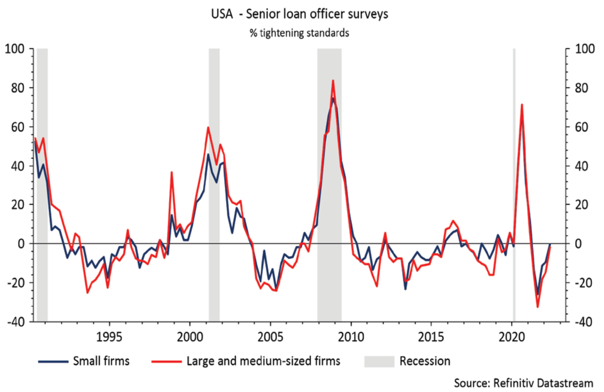
bonds, known as an inverted yield curve, a recession may be on the horizon. As the chart below shows, the US yield curve has flattened but not yet inverted.



Brompton's investment team also monitors the Fed's loan officer surveys because lending conditions tend to tighten prior to recessions as shown in the chart below.



The risk of a recession has increased but I remain positive on the prospects for equities overall despite the shocks to the economy from higher prices, supply disruption and the Ukraine war because equities may provide some inflation-protection as companies pass on higher costs through price increases to customers and reward investors through higher dividends. As appropriate to the investment strategy, Brompton has bought funds investing in energy, mining and agricultural commodity-related equities, which may benefit from higher energy and commodity prices. Agricultural commodity prices have risen because of the importance of Russia and Ukraine to global wheat production.

Brompton has also made insurance and healthcare investments as appropriate because the essential nature of the products and services provided by some businesses in these sectors means prices are typically resilient in the face of slowing growth. Insurance companies may also benefit from investing customers' premiums received at higher interest rates.

A bias towards shorter-dated and inflation-linked bonds provided some protection in falling bond markets but, with 10-year US government bond yields close to 3%, longer-dated conventional bonds offer an attractive buying opportunity. Gold and gold equities provided diversification, making gains during a quarter in which broader equity markets and bonds fell.

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