BROMPTON
ASSET MANAGEMENT

Quarterly review

for the three months to 30 June 2022

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Chief investment officer

Global equities and global bonds fell 15.53% and 8.26% respectively in dollar terms over the second quarter of 2022 but only 8.42% and 0.54% respectively in sterling because of currency movements. UK government bonds, sterling investment-grade corporate bonds and sterling high-yield bonds fell 7.86%, 7.83% and 9.10% respectively. Equities and bonds fell in tandem because of higher inflation and interest rates. In June, headline inflation rates in US, eurozone and UK were 9.1%, 8.6% and 9.4%, far above the central banks' 2% targets.

US and European monetary policy tightened over the quarter. The US's Fed Funds Rate increased in May by half a percentage point and in June and July by two three-quarter point rises, taking them to 2.25-2.5%. UK Bank Rate rose a quarter point in May and in June, taking it to 1.25%, and it rose a further half point to 1.75% in August. The BoE said UK inflation could top 13% in the fourth quarter of 2022 because of the planned Ofgem energy price increase and other factors. Sterling-weakness may also contribute to higher inflation as imported goods cost more. Meanwhile, the European Central Bank (ECB) abandoned negative interest rates and increased rates by half a point in July. In addition, the Fed and BoE tightened monetary policy through balance sheet reductions but the ECB maintained its policy of reinvesting the principal from maturing securities.

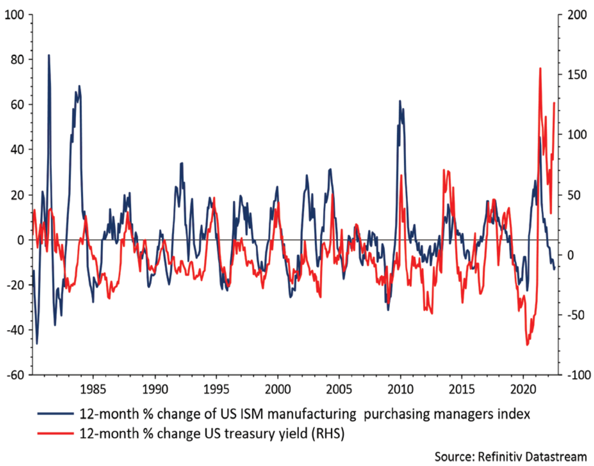
Sterling fell 7.76% against the dollar because of the increasing differential between short-term US and UK interest rates and deteriorating UK economic prospects. UK equities, however, proved resilient, down only 4.60% because of the London stockmarket's heavy weighting in the energy sector, which was buoyed by the 19.29% oil price rise in sterling, and its underweight position in technology during a quarter in which US technology stocks fell 15.91%.

By contrast, the Chinese and Japanese central banks maintained easier monetary policy. As a result, Chinese stocks gained 12.21% in sterling while Japanese stocks fell only 6.68%.

Central banks tightened policy despite weak economic growth and even contraction in some countries. US gross domestic product (GDP) fell 1.6% in the first quarter of 2022 and, according to the first estimate, 0.9% in the second quarter. A second consecutive quarter of falling GDP meets the accepted definition of a recession. Covid-related supply-chain disruption may, however, have distorted the data to some extent because the declines were in part due to rising imports and growth was expected to resume in the third quarter. First-quarter UK GDP rose 0.8% but may have slowed in the second quarter, with the BoE predicting 0.3%. Despite growing recessionary risks, central banks tightened policy to counter inflation but rising rates may prove ineffectual in combatting cost-push inflation caused by higher energy and goods prices as opposed to demand-led inflation.

Employment data remained robust. US unemployment was 3.6% in June, eurozone unemployment was 6.6% in May and UK unemployment was 3.8% in the three months to April. Unemployment is, however, typically a lagging indicator and is more likely to peak at the end, not the start of a recession, or even during a recovery. By contrast, purchasing managers indices (PMIs) are forward-looking indicators. The chart below shows the relationship between US manufacturing PMIs and bond yields. When US manufacturing PMIs fall, bond prices rise, reducing yields, as investors anticipate interest rate cuts to combat slower growth. The US manufacturing PMI weakened to 52.2 in July, a level implying modest expansion, but the US services PMI fell from 52.7 to 47 in June, and in consequence, the composite PMI fell to 47.5, a level consistent with economic contraction. The eurozone composite PMI also fell below 50, the level below which an economy may shrink, reaching 49.4 in July. Consumer confidence, another leading indicator, fell in the US and Europe as rising prices outstripped wage increases.

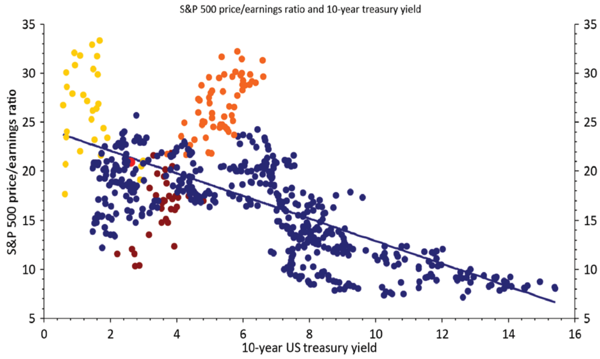
12-month change in ISM manufacturing PMI and change in 10-year treasury yield



Quarterly review (continued)

for the three months to 30 June 2022

During the first half of 2022, equities fell 19.97% in dollar terms and 10.74% in sterling. The chart below shows the relationship between equity valuations and bond yields. The line-of-best-fit suggests that US stock valuations are likely to fall as bond yields rise. The price/earnings (PE) ratio of US stocks has fallen in response to rising interest rates as investors allow for the impact of tighter monetary policy and slower growth on forecast profits. At the quarter end, the US PE ratio was 20.9 and the 10-year US sovereign bond yield was 2.64%, as shown by the red dot in the chart below. The red dot is below the line of best fit and may imply that the impact of higher interest rates has been fully discounted in the recent market falls although recent periods of historically-high valuations such as during the 2000 technology bubble and the 2020 Covid-19 pandemic may have distorted the data.



Source: Refinitiv Datastream

At the time of July's US interest rate rise, Jerome Powell, the Fed chairman, said future interest rate rises would be data dependent. In such circumstances, central banks may not raise interest rates as much as many investors expect because of the growing risk of recession. As a result, there appears to be a buying opportunity for some longer-dated government bonds, with 10-year US treasury yields near 3%. Assets that are not correlated with bond and equity markets are important diversifiers, particularly at times when equities and bonds fall together. Gold, for example, rose 0.15% in sterling over the quarter although gold equities fell 22.22%.

The prospects for equities overall appeared positive at the start of the third quarter of 2022 because some companies have the ability to pass on higher inflation through higher prices and reward investors through higher dividends. The Brompton portfolios and strategies were focused on equity market areas most likely to benefit from higher inflation. They include sectors that benefit from higher commodity prices, the healthcare and infrastructure sectors, where companies have pricing power because of the low substitutability of their products and services, and commercial insurance, where some companies may gain from higher interest rates.

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