BROMPTON ASSET MANAGEMENT

Quarterly review

for the three months to 30 September 2023

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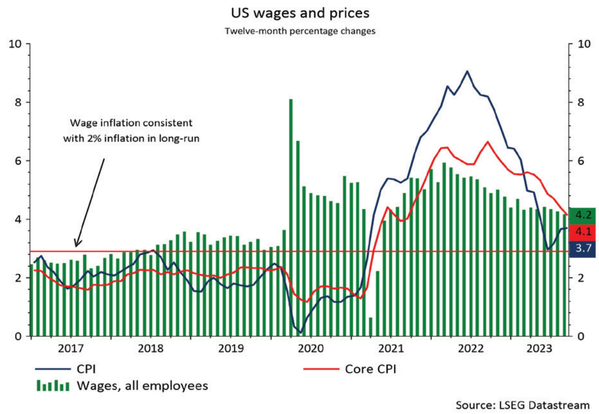
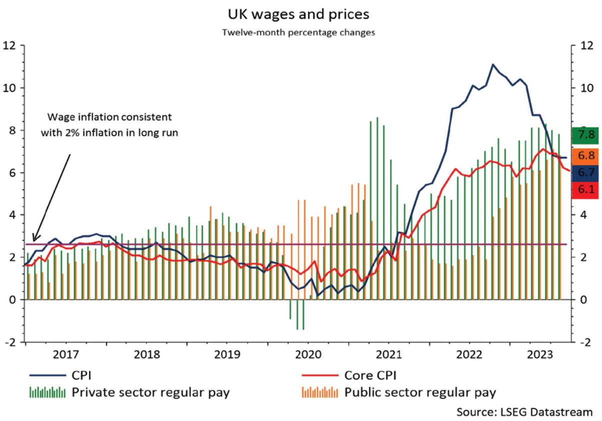
Inflation has fallen from recent highs and central banks have paused their interest rate hikes for now. Investors, however, ended the quarter concerned that rates might have to stay higher for longer to reduce inflation to the leading central banks' 2% targets. Global equities and global bonds rose 0.73% and 0.43% respectively in sterling over the quarter but the returns would have been negative but for sterling's weakness against other major currencies.

In July, the Federal Reserve increased its official rate by a quarter percentage point to 5.25-5.5%. In August, Jerome Powell, the chairman, told the annual Jackson Hole symposium the Fed was prepared to raise rates depending on economic data but said the uncertain outlook meant his task resembled "navigating by the stars under cloudy skies". In September, the Fed kept rates on hold although monetary policy will tighten through the reduction of bonds on its balance sheet, so-called quantitative tightening. The European Central Bank raised its policy rate a quarter point in September to 4%, a level the ECB considered might be sufficient to reduce inflation to 2%. The Bank of England lifted its Bank Rate a quarter point to 5.25% in August but kept rates on hold in September, with five monetary policy committee members voting in favour and four voting for a quarter-point hike. UK monetary policy will, however, tighten as the Bank shrinks its balance sheet by £100 billion to £658 billion over the year to next September.

US inflation rose from a 3% low in June to 3.2% in July and 3.7% in August and September but eurozone inflation fell to 4.3% in September, down from 5.3% in July and 5.2% in August. UK inflation has proved stickier than expected, with inflation figures for July, August and September being 6.8%, 6.7% and 6.7% respectively. Core inflation, which excludes energy, food, alcohol and tobacco and owner occupiers' housing costs, was 6.1% in September, far above the Bank's 2% target. Oil prices gained 37.84% in sterling over the quarter in response to resilient economic growth and production cuts by some oil exporters.

Resilient economies maintained demand for workers. US non-farm payrolls increased by 336,000 in September. UK unemployment for the three months to July was estimated at 4.3%, up just half a percentage point on the previous quarter. Although salaries had previously not kept pace with inflation, strong jobs markets have recently enabled US and UK workers to achieve pay increases above headline inflation, as shown in the charts below.





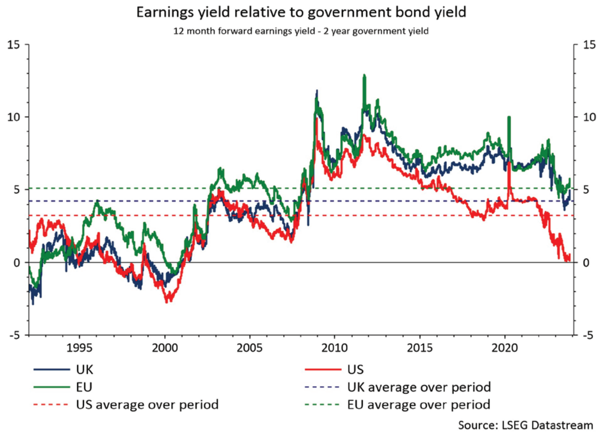
Unemployment is a lagging indicator because joblessness typically increases after economies slow. Any weakness in employment data may confirm that central banks have tightened policy sufficiently to bring down inflation. Yet, if workers continue to achieve real pay rises, high inflation may become entrenched. This may lead central banks to tighten monetary policy more than anticipated, potentially precipitating a deep recession.

A number of economic indicators are signalling that a recession is on the horizon. The US 10-year government bond yield ended the quarter lower than the two-year yield because investors think the Fed needs to cut rates to support growth. The Fed surveys of commercial bank loan officers show that lending conditions have tightened as has been the case prior to every recession since the surveys began in 1964. These two measures are widely regarded as the most reliable indicators of an impending recession.

Quarterly review (continued)

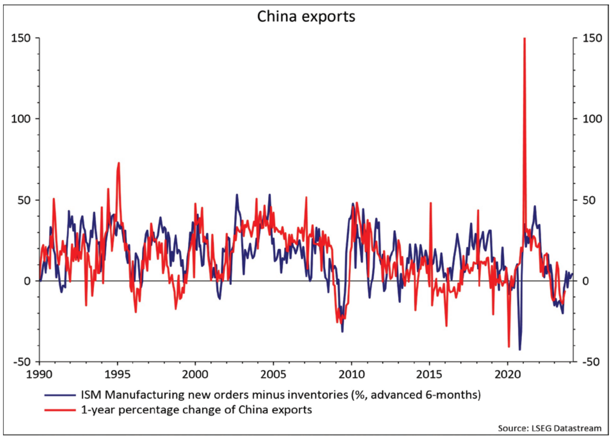
for the three months to 30 September 2023

US corporate profit margins and equity valuations ended the quarter relatively high. The chart below shows the equity market "risk premium" for some major markets. This is a measure of the earnings generated by companies expressed as a percentage of their share prices in excess of a so-called risk-free rate such as the two-year government bond yield. On this measure, US equities ended the quarter relatively expensive compared to history, as shown by the solid red line in the chart being below the dash line representing the long-term US average. Eurozone and UK equity valuations, meanwhile, were closer to their long-term average.



By contrast, valuations for some developing economies appear cheap relative to history. Equities in emerging markets and Asia excluding Japan outperformed, gaining 1.25% and 0.81% respectively in sterling. China's stockmarket, the largest component in both indices, did even better, up 2.25% in sterling. Chinese equities have been lowly valued because of government interventions in pursuit of "common prosperity" such as increased regulation of technology companies and the ban on some education businesses making profits. Sino-US trade tensions and financial distress in China's over-indebted commercial property sector have also deterred investors while the boost from the end of zero-Covid policies proved short-lived.

There are, however, signs that stimulus measures are taking effect. As the chart below shows, manufacturing new orders less inventories are picking up and may indicate manufacturing activity is improving.



Equity market prospects overall appeared positive at the quarter end. Equity funds with an income mandate may perform well because dividends from well-financed, cash-generative businesses with the potential for capital growth may prove attractive relative to cash during an inflationary period. Special situations funds invested in companies with the potential to increase shareholder value through self-help initiatives such as restructuring and cost cutting may also do well as they depend less on underlying economic trends to improve returns. The prospects for smaller companies in economically-sensitive sectors, however, appear more uncertain. There are also grounds to be cautious, in particular, about UK stocks and government bonds because UK inflation remains stubbornly high. Cash and global bonds, particularly US government bonds, appear attractive because some of these investments offer a positive real return while gold and gold equities provide diversification and may offer some protection to capital in the event of a central bank policy mis-step or other event that reduces investors' risk appetites.

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