BROMPTON
ASSET MANAGEMENT

Quarterly review

for the three months to 31 December 2022

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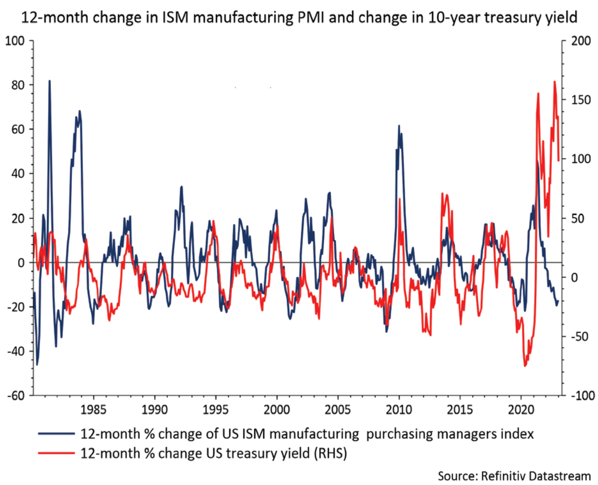
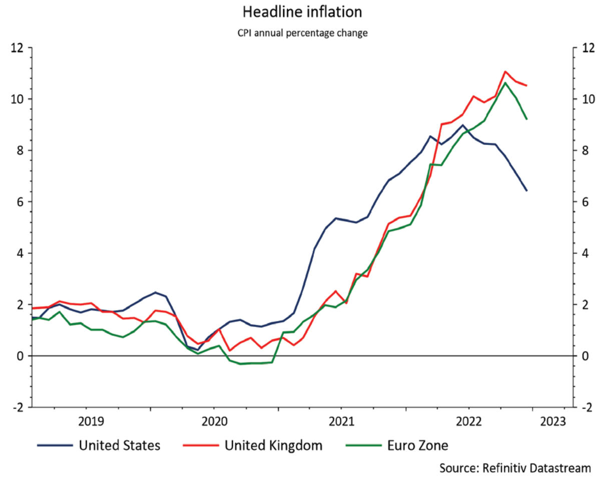
The Federal Reserve, European Central Bank (ECB) and Bank of England all tightened monetary policy on two occasions over the final quarter of 2022, with one rise in their official interest rates of three quarters of a percentage point followed by an increase of half a point. These measures followed previous rate rises earlier in the year aimed at combating persistent inflation. In December 2021, the Fed abandoned its suggestion that inflation was merely "temporary". It then raised rates on seven occasions over 2022 as a whole, taking them from their ultra-low, post-pandemic levels of 0-0.25% to 4.25-4.50%. The Fed was widely criticised for belatedly taking action to combat price increases at a time when economic growth was slowing. UK Bank Rate increased to 3.5% and ECB policy rates on its main refinancing operations, its marginal lending facility and its deposit facility rose to 2.5%, 2.75% and 2% respectively by the year-end. All three central banks warned investors of further rises to come to return inflation to 2% over time.

Global equities rose 9.88% in dollar terms over the quarter despite monetary tightening although the gain was only 1.97% in sterling because the dollar fell 7.20% against the pound. Global bonds, meanwhile, fell 2.98% in sterling despite making gains in dollars. UK government bonds and sterling investment-grade and high-yield bonds rose 2.20%, 7.16% and 6.49% respectively over the quarter. Financial markets rallied because, as the chart below shows, deteriorating economic prospects as evidenced by a key manufacturing leading indicator have historically been accompanied by lower interest rates.



US headline inflation peaked at 9.1% in June and declined every month thereafter, falling to 6.5% in December. Eurozone and UK headline inflation proved more obdurate, standing at 10.6% and 11.1% respectively in November before falling modestly to 9.2% and 10.5% respectively in December.



UK and eurozone inflation may have peaked later partly because of the impact of elevated European gas prices in the wake of Russia's invasion of Ukraine. The oil price has been a major contributor to inflation. Brent crude peaked at $133.18 per barrel on 8 March 2022 but fell to $82.82 at 31 December.

The Fed justified its hawkishness by citing the strength of the labour market and the resilience of consumer spending. US unemployment in December was 3.5% having remained in a narrow range between 3.5% and 3.7% since March. Employment is, however, a lagging indicator and is typically high at the beginning of a recession. Inflation is widely regarded as "sticky" when it becomes entrenched in pay increases. This was not the case in 2022 because wages fell in real terms in 2022, with wage growth being only 5.1% for the year to 31 December. As the chart overleaf shows, wage increases fell below recent highs and the percentage of firms planning to increase wages stabilised.

Unemployment is expected to increase in 2023 as economic growth slows under the cumulative weight of interest rate increases and higher living costs. US gross domestic product (GDP) growth slowed from 3.2% year-on-year in the third quarter to 2.9% in the fourth quarter, taking growth for 2022 overall to 2.1%, down from 5.9% in 2021. The strength of the US

Quarterly review (continued)

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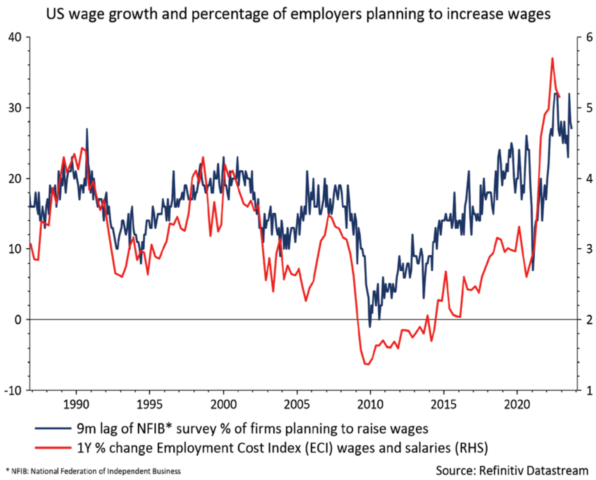

economy has defied expectations so far but it is expected to show a fall into recession during the first half of 2023.

In the UK, the Bank of England's monetary policy committee expects GDP to fall throughout 2023 and the first half of 2024 because of the impact of higher energy costs and tighter monetary policy on spending. Inflation is, however, expected to fall significantly from mid-2023. In the eurozone, the ECB expects growth to slow from 3.4% in 2022 to 0.5% in 2023 before recovering to 1.9% in 2024.

I have become more positive on the prospects for equities and longer-dated conventional bonds despite gloomy economic forecasts because interest rates may be close to their cyclical highs. Equity investors are typically forward-looking and may already be discounting near-term weakness in anticipation of stronger growth in 2024. UK equities outperformed over the quarter, rising 8.80%, and smaller companies did even better, rising 9.95%. I believe there may be further gains for UK smaller companies, which underperformed larger stocks, falling 17.87% over 2022 as a whole even after the fourth-quarter rally.

Despite its fourth-quarter weakness, the dollar gained 12.60% against sterling over the year while its gain against the euro was 6.55%, driven by the widening differential between shorter-dated interest rates. A stronger dollar is typically associated with outflows from emerging market equities, which fell significantly over the first nine months of 2022. This created a buying opportunity because emerging market equities were trading on low valuations relative to some developed markets. As the dollar retreated against sterling in the final quarter, equities in Asia excluding Japan and emerging markets rose 3.40% and 1.89% respectively in sterling. Gold proved a good diversifier, rising 9.45% in dollars over the quarter and 1.57% in sterling. This strength was magnified in the returns from gold equities, which gained 12.90% in sterling.

In fixed income markets, I favour holdings giving clients exposure to longer-dated conventional sovereign bonds, which may make gains as inflation eases and investors anticipate a peak in the interest-rate cycle, at the expense of shorter-dated and inflation-linked bonds.

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