



BROMPTON
ASSET MANAGEMENT

Quarterly review

for the three months to 31 December 2014



Gill Lakin
Fund manager

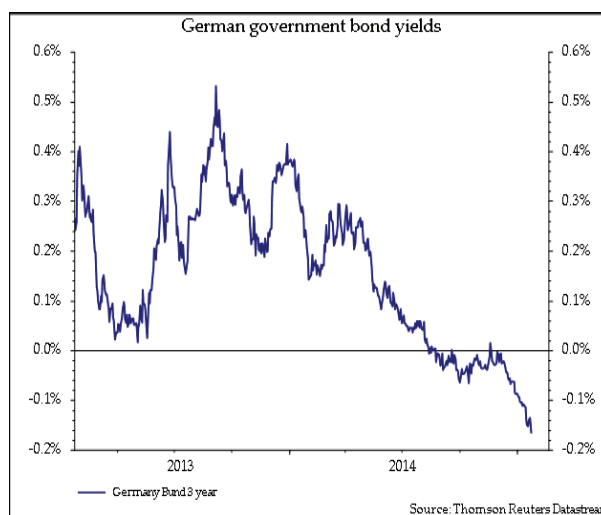
The year 2014 opened with investors in confident mood following the strong equity market gains of 2013. It ended with 10-year gilt and treasury yields close to all-time lows, the price of gold on the rise and investors more concerned about the risks of deflation than the likely timing of the first interest rate rises for many years. In October, the Federal Reserve stuck to the script and stopped quantitative easing, the extraordinary policy of monetary expansion first adopted during the credit crisis in 2008. During the subsequent six years, successive programmes of quantitative easing eventually culminated in an “open-ended” commitment to continue money-printing until unemployment fell below target. US economic data is now sufficiently robust to justify the Federal Reserve in making the first moves to normalise monetary policy. Unemployment has fallen to 5.6%, third-quarter annualised gross domestic product (GDP) growth was 5.0% and consumer confidence is high.

So what has occasioned the strong demand for defensive assets such as government bonds and gold? The answer lies in the fall in global inflation. In the UK, inflation fell to 0.5% annualised in December, the lowest level since May 2000. The chancellor, George Osborne, has celebrated this boost to real disposable incomes while warning that inflation could fall further and even turn negative in the months ahead. The prospect of a UK interest rate rise has receded in consequence. UK gilts and corporate bonds performed well during 2014, returning 13.86% and 12.31% respectively. Although I was cautious on the outlook for bond markets in 2014, client portfolios benefited from their significant holdings in UK commercial property.

Prices are now declining in the eurozone, having fallen 0.2% in December. The weakness is a result of reduced demand exacerbated by recent falls in energy and commodity prices. The oil price fell 38.85% in sterling during the last quarter of 2014. Falls of this magnitude have generally been associated with falling global demand but in this instance, it is the result of supply-side developments. Saudi Arabia has maintained supply in the face of increased production from US shale oil producers to defend its market share. The fall in energy prices is likely to be sustained because it will take some time to achieve a long-lasting reduction in supply. The share prices of global energy producers have fallen and may now offer good value but, given the impossibility of predicting policy-making

by the major oil-producing nations, I increased clients’ holdings in funds investing in the beneficiaries of lower energy costs such as global consumer companies.

Investor risk aversion is manifest in the negative yield on 3-year German government bonds. Since last summer, investors who hold these bonds to maturity are effectively paying to own this defensive investment.

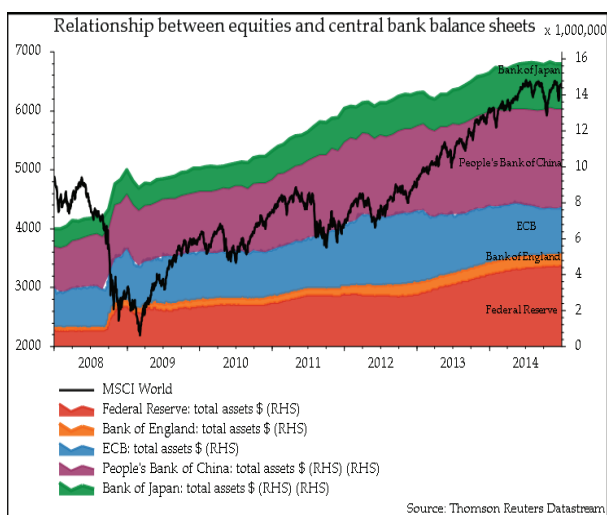


Since the year-end, the European Central Bank (ECB) has taken action to prevent short-term falling prices leading to long-term deflation, a state of affairs in which consumers defer purchases in the expectation of further falls in prices, thus causing economic activity to stall. The ECB has finally adopted quantitative easing, saying it will purchase €60 billion of assets each month from March 2015 until September 2016 and possibly beyond that date if the inflation outlook has not improved. This will lead to an increase in the monetary base of at least €1.1 trillion, which should be sufficient to reverse the decline in the ECB balance sheet since 2012. The ECB is mandated to achieve price stability whereas the Federal Reserve has an obligation to achieve full employment. It has, however, adopted a similarly “open-ended” approach, implying that quantitative easing in the eurozone will continue until inflation nears its 2% target.

Global equities rose in the wake of this announcement. The chart overleaf shows that central bank support continues to expand in aggregate despite the ending of quantitative easing in the US. This policy remains supportive for higher-risk assets such as equities.

Quarterly review (continued)

for the three months to 31 December 2014



Brompton clients have held significant investments in Europe ex-UK equity funds since early 2014 because valuations are low compared to US equities and I expected that further monetary support would be forthcoming. A portion of these investments is held in the sterling-hedged share classes of preferred funds to protect clients from the potential for significant euro weakness. The surprise decision by the Swiss National Bank to break the currency link with the euro rather than use central bank reserves to purchase euros to maintain the exchange rate confirmed my view that money-printing in the eurozone would be meaningful in scale.

It is unusual for me to make asset allocation decisions in relation to currencies but the extraordinary monetary policy of recent years has increased the importance of considering currency when making investment decisions. A significant proportion of clients' investments in Japanese equities has long been held in either sterling or more recently, in dollar-hedged share classes to protect against the fall in the yen while benefiting from strong local market returns.

Important information

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I believe the divergent monetary policies now being adopted by major central banks will lead to a further strengthening in the dollar. Brompton clients hold significant investments in US-dollar denominated assets such as US treasury bonds and global bonds in consequence. I have also taken a highly-selective approach to developing economy assets as a result of the potential for significant local currency weakness. The next few months may also witness further sterling weakness relative to the dollar given the uncertain outcome of the impending UK general election and the possible consequences for UK membership of the European Union. During the second half of 2014, the dollar rose 9.66% against sterling.

Looking ahead, the potential for negative surprises has increased as a result of falling inflation, sharp falls in commodity prices and heightened currency volatility. The stronger dollar may also prove a headwind for certain asset classes. Overall, however, I remain positive about the prospects for equities in 2015 as central banks continue to expand monetary support.