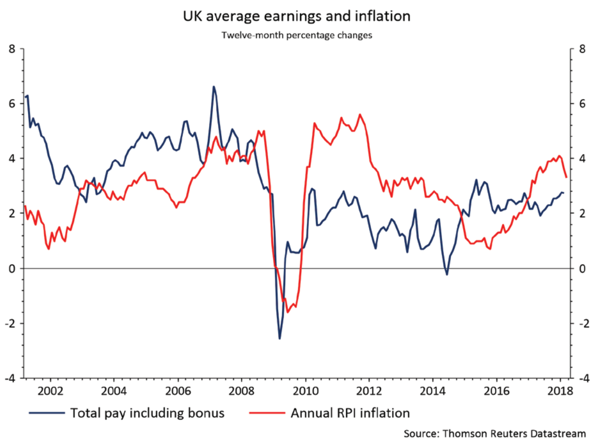
# Quarterly review

for the three months to 31 March 2018


**Gill Lakin**
Chief investment officer

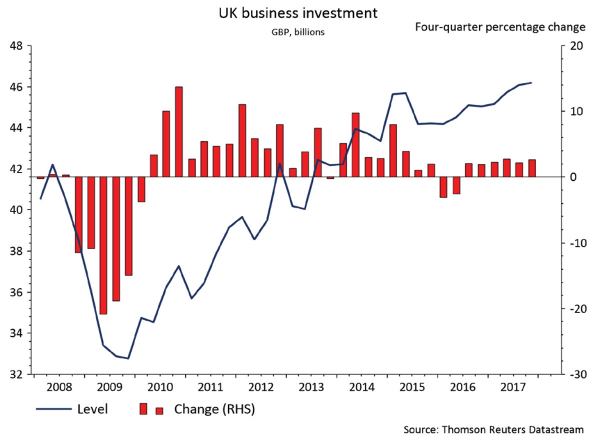

January's investor optimism moderated in February in the face of stronger-than-anticipated US wage growth and evanesced in March on fears that President Trump's trade tariffs might prove to be the opening salvo of a trade war. The dollar fell 3.57% against sterling over the quarter, contributing to falls for global equities and bonds of 4.38% and 2.25% respectively in sterling. UK government bonds, however, rose 0.20% although sterling corporate bonds fell 1.48%.

UK equities underperformed, falling 7.29%. Investors may have been deterred by fears about the impact of Brexit on the economy or the leftward shift in domestic politics shown at the last election. The economy grew steadily, however, expanding 1.7% in 2017. This surpassed the worst predictions made during the Brexit referendum and was only marginally below the 1.9% growth in 2016. Economic data released in the first quarter of 2018 suggested a further slowdown but this may prove temporary. Poor weather left March retail sales lower yet consumer confidence rose. Consumers were more optimistic because unemployment had fallen to 4.2%, its lowest level for more than 40 years, and wage growth was picking up (see chart below).

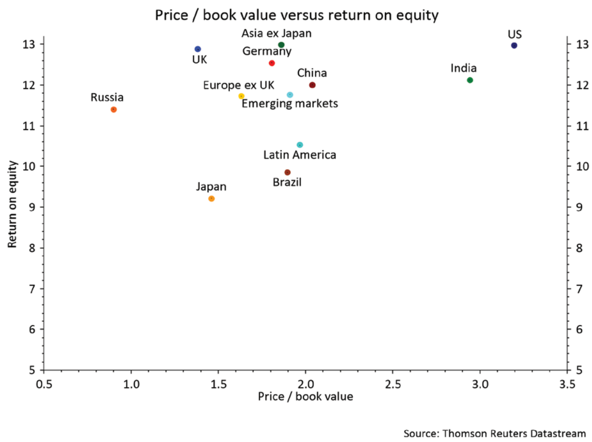



UK businesses shrugged off the Brexit gloom and increased investment spending, as the chart at the top of the right-hand column shows.

At the quarter end, UK equity valuations appeared attractive relative to overseas markets. This is illustrated in the second chart opposite. This shows the return on equity against the price-to-book value of a sample of overseas markets. The chart shows US and Indian companies as the most expensive. This is not surprising because of the returns on equity delivered by these




companies. UK companies' returns on equity are similar but UK equities measured by price-to-book were valued at less than half US and Indian equities. This discount appears excessive in light of the global nature of many UK companies.




Corporate buyers appear to share this view. In recent months, takeover bids have been made for major UK companies such as Hammerson, GKN, NEX and Sky.

The recent weakness in UK economic data and the headline inflation fall from 3% in January to 2.5% in March led some commentators to conclude that the Bank of England would keep interest rates on hold at its policy-setting meeting in May. This view may prove too sanguine despite recent dovish comments by Mark Carney, the Bank governor. Inflationary pressure is building as a result of the 20.38% oil price rise in sterling over the six months to 31 March 2018 and real wage growth resulting from low unemployment. I believe UK interest rates may rise more rapidly than anticipated, lifting the pound and generating falls for

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# Quarterly review (continued)

for the three months to 31 March 2018

longer-dated gilts and sterling corporate bonds. A more inflationary environment may also lead to a change in equity market leadership, with hitherto out-of-favour "value" companies outperforming "growth" stocks.

In March, US interest rates rose for the sixth time since 2015 and the Federal Reserve balance sheet has been contracting, with the proceeds of maturing bonds no longer being re-invested in asset purchases. In April, US 10-year bond yields rose above 3% for the first time since December 2013 having risen from a 1.36% low in July 2016. The Brompton investment team has devoted resources to seeking out daily-traded long/short equity funds that have a low correlation to bond and equity markets and the potential to deliver positive returns through stock selection. Funds of this nature may prove more attractive diversifiers than longer-dated bonds in multi-asset portfolios.

At the quarter end, US equities appeared expensive and, although there were few signs that monetary policy had become restrictive, the risk of a policy error is high. Equities in Europe, Japan and some emerging markets appeared more attractive because valuations were lower, monetary policy was supportive and some of these economies had significant excess economic capacity, which may ensure that inflationary pressure remains subdued for some time. Eurozone unemployment was 8.5% in February 2018. By contrast, there was little excess capacity in the US, with unemployment in March 2018 at an historically-low level of 4.1%.

Equities in Asia excluding Japan and emerging markets were more resilient than global equities over the quarter, falling 2.90% and 2.15% respectively in sterling. President Trump's announcement of trade tariffs swiftly followed by retaliatory measures by China is a concern. The emphasis from both sides on the importance of dialogue, however, implies that it may be possible to reach a compromise. If talks are unsuccessful, the rise in protectionism could add to inflationary pressures.

An increase in volatility is likely now that the Fed has commenced the process of reversing the extraordinary monetary measures adopted in the aftermath of the credit crisis. The withdrawal of stimulus does not, however, mean that both equity and bond markets will fall although the Brompton team has reflected this as a possibility in its selection of alternative funds. In 2008, Mervyn King, then Bank governor, was initially sceptical of quantitative easing and argued that it defeated the principle of moral hazard and encouraged the misallocation of capital. Now that the process of reversing these policies has commenced, the opportunities available to active multi-asset managers to differentiate through performance is likely to increase in relation to both asset allocation and investment selection. This view is reflected in Brompton team's choice of assets and funds.




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