Quarterly review

for the three months to 30 June 2019

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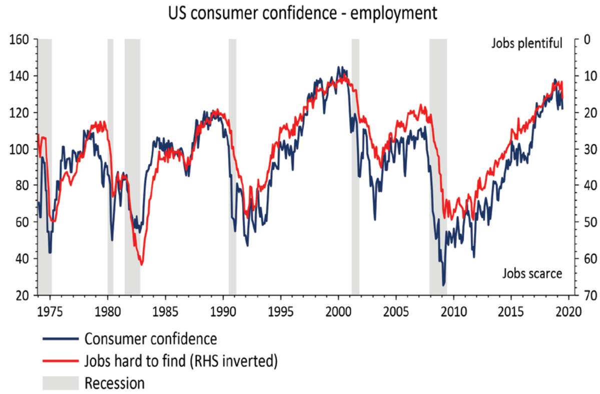
The second quarter of 2019 was a strong period for markets as global equities and bonds returned 6.28% and 5.76% respectively in sterling in response to increasing prospects of US monetary easing. The Federal Reserve left interest rates unchanged in June but the accompanying statement revealed another significant softening in the Fed's stance. Reference to the "patient" approach adopted in January was dropped, with the Fed saying it would "closely monitor" economic data and act to sustain economic expansion in light of the increased uncertainties and muted inflation pressures. At the quarter end, an interest rate cut in July was widely anticipated.

The Fed aims to maintain full employment and price stability. Inflation has, therefore, been a concern because it has been significantly below the official 2% target rate. This is a "symmetric" target, not a floor or a ceiling. The core personal consumption index, the Fed's preferred inflation measure, which excludes the prices of more volatile goods such as food and energy, stood at 1.6% year-on-year in May. It has been below target for the majority of the time since it was adopted in 2012.

Expectations of future inflation were also below target at the quarter end. The relative yields of US treasury bonds and US treasury inflation-protected securities (TIPS) with the same maturity, implied inflation would be below 2% in five and 10 years' time despite near-full employment and 3.1% year-on-year wage growth in May. This is because inflationary pressure from rising wages has been offset by increased labour productivity, which rose 3.4% annualised in the first quarter of 2019, the strongest increase since 2014.

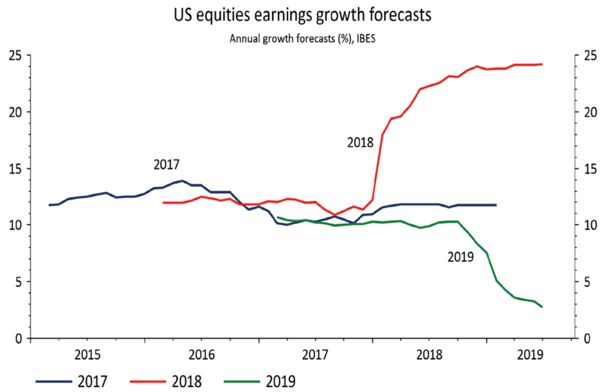
The strong June non-farm payroll employment data notwithstanding, there were signs at the quarter end of weakness in the employment data. The Conference Board's consumer confidence index declined in June, as the chart above right shows, with the percentage of respondents claiming jobs were hard to find rising from 11.8% to 16.4%.

Economic growth is expected to slow in the second half of 2019 in response to fading fiscal stimulus and tighter monetary policy although 3.1% growth in the first quarter of 2019 beat expectations and exceeded the 2.2% figure for the fourth quarter of 2018. The impact of inventory-building in advance of tariffs might, however, have masked underlying weakness.



Source: Refinitiv Datastream

US corporate earnings growth is expected to slow significantly this year relative to 2017 and 2018, as shown in the chart below.



Source: Refinitiv Datastream

The flattening US yield curve may be a sign that a recession is on the horizon. A flatter yield curve hurts banks' profits because they typically borrow at short-term rates and lend at higher long-term rates. When rates are similar across the yield curve, banks' profit margins are squeezed and they may tighten lending criteria. The fund management team monitors the Fed loan officers' surveys for signs that lending conditions have tightened.

Trade disputes and tariffs have weighed on growth and contributed to the decline in the manufacturing purchasing managers' indices (PMIs), leading indicators of economic growth, as shown in the chart below. Among the four largest global economies, the latest US PMI implied manufacturing output would expand modestly, whereas the PMIs for China, Germany and Japan were below 50, implying a contraction. Non-manufacturing PMIs have, however, proved more resilient.

Quarterly review (continued)

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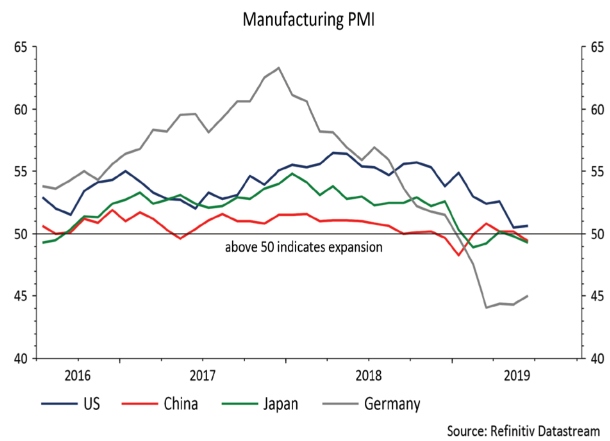

The US imposed the first tariffs on China more than a year ago and equities in Asia excluding Japan and emerging markets have lagged since then. During the quarter, they rose 1.81% and 3.14% respectively in sterling. Chinese equities were particularly vulnerable, falling 1.63% in sterling. Chinese producer price inflation fell to zero in June as a result of tariffs and weak domestic demand. This may lead to earnings' downgrades for Chinese manufacturers although investors were cheered by the resumption of Sino-US trade talks in June. Whatever the outcome, Trump's protectionist approach to trade has won bipartisan support and is likely to become an established feature of US trade policy. Chinese growth has slowed and further policy support may be forthcoming if trade talks stall.

Equities in Europe excluding the UK outperformed, rising 8.96% in sterling as the European Central Bank implied in June that more monetary support would be forthcoming. Bank of England monetary policy remained accommodative because of Brexit. UK first quarter economic growth of 0.5% may have been swelled by inventory-building ahead of the original Brexit deadline of 31 March to the detriment of growth in the second quarter.

Safe-haven assets performed well over the quarter. Gold rose 11.61% in sterling while the dollar and yen, regarded as defensive currencies, appreciated 2.38% and 5.18%. UK government bonds and sterling corporate bonds returned 1.40% and 2.31% respectively.

Dovish central bank monetary policies may support risky assets such as equities over the coming months. Slower global economic growth, subdued inflation and a flattening yield curve are, however, reasons to be cautious alongside trade disputes and the potential of Brexit to damage UK economic confidence. These factors were reflected in the modest scale of the overweight allocations to equities in Brompton's multi-asset portfolios at the quarter end and in fund selections.

I have bought funds that should prove defensive if economic growth slows more rapidly than anticipated. Funds such as Fundsmith Equity, Newton Global Income, Lindsell Train Global Equity and the First State Global Listed Infrastructure focus on companies with high cash flow visibility operating in sectors with high entry barriers. The "bond-like" characteristics of such companies continue to be sought by investors in a low-growth, low-inflation environment.

Within the fixed income allocations, I have typically bought strategic bond funds whose managers may move duration and alter credit risk. The alternative investments include daily-traded long/short equity funds capable of delivering modest incremental gains irrespective of underlying market movements. In the light of Brexit uncertainty, I have maintained a spread of currencies to provide some protection against sterling weakness in the event of a no-deal Brexit.

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