



BROMPTON
ASSET MANAGEMENT

Quarterly review

for the three months to 31 December 2018



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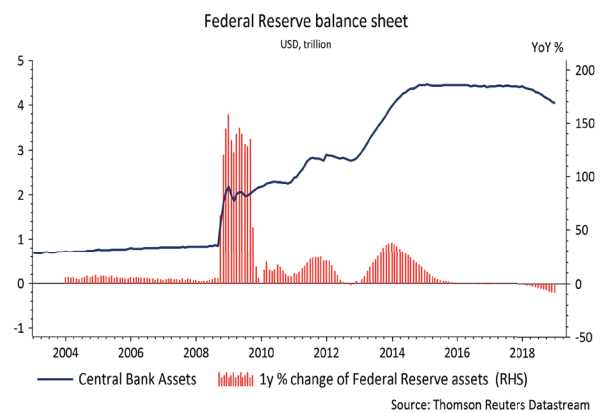
The year 2019 opened to a world of worry, contrasting with the investor optimism prevailing in January 2018. Global equities fell 10.57% in sterling terms over the final quarter of 2018, erasing most of the previous two quarters' gains and leaving the loss for the year at 3.27% in sterling. As equities fell, investors sought safety in defensive assets. Aided by the weaker pound, global bonds rose 3.62% in sterling over the quarter while UK government bonds gained 2.08%. The yen and dollar rose 6.00% and 2.39% respectively against sterling while gold rose 9.80%.

US equities underperformed, falling 11.45% in sterling over the quarter. Losses were concentrated in December when US stocks lost 8.86% in sterling. At the beginning of December, earlier optimism regarding Sino-US trade talks evaporated when negotiations proved inconclusive. In late December, the Federal Reserve, impervious to presidential criticism, responded to strong employment data by raising the Fed Funds Target Rate to 2.25-2.50%. Investors feared interest rates might rapidly become restrictive and choke off economic growth. The Fed chairman, Jerome Powell, however, retreated from earlier hawkish comments that interest rates were "a long way" from neutral. In a significant volte-face, Powell revised his guidance as equities fell, describing interest rates as "close to" neutral.

Interest rate rises are, however, not the only means by which the Fed has been tightening monetary conditions. As the chart opposite shows, the process of shrinking the Fed's outside balance sheet is underway. In October 2014, the previous Fed chairman, Janet Yellen, halted quantitative easing – the waves of bond buying that had inflated the US central bank's balance sheet to \$4.5 trillion, up from less than \$1 billion before the crisis. In addition, the proceeds from maturing bonds had been reinvested, thus maintaining the size of the balance sheet.

In October 2017, however, Yellen announced the start of "balance sheet normalisation". From then, the proceeds from maturing bonds were not wholly reinvested in further bond purchases, allowing the balance sheet to shrink steadily. Yellen sought to deflect investor concerns by likening the process to watching paint dry. This is monetary tightening by another means and investors are rightly concerned about the impact of this policy on asset prices not least because it coincides with an increase in the US budget

deficit, which will require funding from investors. Yields may have to rise to attract buyers and lead to a withdrawal of capital from other assets. The Fed may slow the pace of interest rate rises in 2019 but the process of shrinking the balance sheet is set to continue.



US growth is expected to slow in 2019 as monetary policy tightens and the impact of President Trump's fiscal stimulus fades. Some leading indicators such as the Institute of Purchasing Managers US manufacturing and non-manufacturing indices fell in December although they remain above recessionary levels. The impact of the US government shutdown on consumer confidence and stock-piling ahead of potential tariff increases should Sino-US trade discussions break down may have adversely affected the data in the short term. More bearish forecasters have, however, highlighted the flattening in the US yield curve as a sign that a recession may be on the horizon. The yield differential between US 10-year and two-year government bonds has narrowed and would invert should shorter-dated bond yields exceed the yields on longer-dated bonds. When this happens, investors are more concerned about short-term risks to the economy and require compensating accordingly. As the chart overleaf illustrates, an inverted yield curve has prefigured all the recessions of the last 40 years although on some occasions there has been a period of months between the yield curve inverting and the start of a recession.

With growth slowing and monetary policy tightening, highly-rated growth companies may underperform value stocks because earnings disappointments may lead to falls in both earnings expectations and the valuation multiples investors are prepared to pay for those earnings. This may lead to a change in equity

Quarterly review (continued)

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market leadership. Growth companies have outperformed value stocks since the financial crisis but a number of successful bellwether companies have issued profit warnings. In January 2019, Apple and Caterpillar said earnings would fall short of expectations because of slowing economic growth in China. Some of this news has already been reflected in share prices. Apple shares ended 2018 32% down on their October peak.

Beijing policymakers responded to slowing growth by cutting China's required reserve ratio, a key policy measure governing lending. Further policy support may be on the way, particularly if Sino-US trade tensions deteriorate further. China's official growth figure slowed to 6.4% for 2018's final quarter, reducing the full-year year-on-year figure to 6.6%. Many commentators believe the actual growth rate may be lower but it is unclear how much stimulus will be delivered given the government's aim to reduce private and public sector indebtedness.

Equities in Europe excluding the UK also lagged, falling 10.94% in sterling during the quarter as growth in some eurozone countries slowed. Germany narrowly avoided falling into recession during the second half of 2018, with its powerful export sector hurt by trade

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disputes and slowing Chinese demand. The European Central Bank stopped buying bonds in December although its policy will remain accommodative, with interest rates not expected to rise until late 2019. By contrast, equities in Asia excluding Japan and emerging markets were relatively resilient, falling only 6.42% and 5.19% respectively in sterling over the quarter.

Brexit uncertainty hurt UK equities, which fell 9.66%, with smaller companies, down 13.64%, most affected by increased nervousness. UK stocks ended 2018 on lower valuations than some other markets. The chart below shows the UK equity market's price-to-book ratio, which ended the year close to the lows reached during the 2008-09 credit crisis.



Global corporate earnings rose during 2018 and this, when combined with the falls in share prices, left stocks trading on lower earnings multiples at the start of 2019. Global growth is likely to slow in 2019, however, putting earnings under further pressure. The fall in valuations may not have fully reflected the deterioration in prospects and I remain somewhat cautious on the outlook for equities overall. A successful resolution to Sino-US trade negotiations and the Brexit impasse may, however, provide buying opportunities for equities in the UK and emerging markets.