

Quarterly review

for the three months to 31 March 2014

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Geopolitical events drove financial markets during the first quarter of 2014 as the crisis in the Ukraine escalated and investors pondered the potential impact of retaliatory trade sanctions. Russian equities fell 11.79% in one day at the beginning of March before recovering to end the quarter down 16.09%. The Bank of Russia increased interest rates by 1.5 percentage points to defend the rouble and deter further capital flight but could not prevent the currency falling 7.10% against sterling during the quarter. Russia's place in the global financial system means that the power struggle over the Ukraine is being resolved as much in capital markets as it is through armed conflict. Clients in the Brompton Equity Strategy have a small allocation to Russian equities through the Neptune Russia & Greater Russia Fund. Russian equities offered good value before the crisis. Recent positive developments including some reforms of the financial system have been overshadowed by the politics but sentiment should improve in time.

Developing economy equity markets continued to disappoint during the quarter. Emerging market equities fell 1.02% and Asia-Pacific ex-Japan equities rose 0.38%, underperforming a gain of 0.73% from global equities. Valuations for these markets ended the quarter looking attractive relative to developed economy peers but there were grounds for caution because Chinese policymakers were maintaining a tight monetary policy and the extent of bad debts in the banking system remained opaque.

US equities gained 1.14% as improving macro-economic data confirmed that the weakness at the start of the year was principally weather-related. Solid US non-farm payroll numbers in March and an upwards revision to February's data allowed the Federal Reserve to continue tapering. The new Fed chair, Janet Yellen, confirmed that interest rates might start to rise six months after the end of tapering. This suggests that the first rise might occur in the middle of 2015. Yellen's focus on setting policy to help the long-term unemployed may engender wage inflation as rates stay lower for longer.

Europe ex-UK equities rose 2.98% in sterling. The European Central Bank (ECB) president, Mario Draghi, has achieved much through rhetoric since his "whatever it takes" speech in 2012 gave investors the confidence that he would defend the euro, obviating the need for intervention. At the quarter end, he stood ready to adopt radical policies, potentially including quantitative easing, to support the economy and combat deflationary forces. In March, eurozone inflation was running at just 0.5% year on year compared to the ECB target of 2%. The modest recovery in both activity and sentiment during the first quarter, particularly in the periphery, may have dissuaded the ECB from taking immediate action. Eurozone unemployment has stabilised while exports and consumer spending data have improved. During the quarter, clients' investments in Europe ex-UK equities were significantly increased through purchases of equity funds likely to benefit from economic recovery within the eurozone.

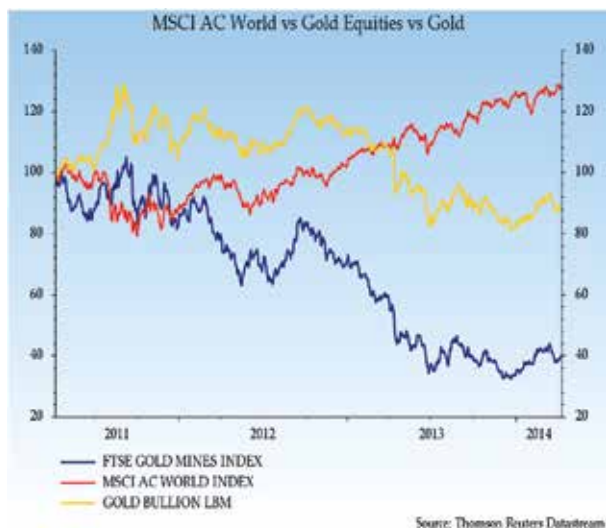
Japanese equities fell 5.44% in sterling as investors awaited the impact on spending of April's rise in consumption tax from 5% to 8%. The Bank of Japan (BoJ) maintained the current pace of quantitative easing at its early April meeting but recent survey data pointed to a significant deterioration in economic prospects. The existing commitment to achieving the stated inflation target of 2% will involve the BoJ continuing to expand the monetary base at a rapid pace throughout the rest of 2014. Although some profits were taken during the quarter, Brompton clients retain significant investments in Japanese equities. The divergent paths of monetary policy and widening interest rate differential in the US and Japan may lead to both further yen weakness and gains from Japanese equities.



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During the quarter, the prospects became more positive for gold equities. The price of gold stabilised as the pace of liquidations from physical gold exchange-traded funds slowed. Although the price of gold recovered 6.02% during the recent Ukraine crisis, the evidence of global economic recovery diminished the attractions of holding this “defensive” asset in client portfolios. Gold mining equities, however, appeared attractively valued relative to asset values on the assumption that the price of gold does not fall significantly from levels prevailing during the first quarter. An undervalued asset also needs to have a clear catalyst for change before it is considered for investment in Brompton’s private client portfolios. This can be found in the significant management changes at many of the major gold producers. New management teams are now in place with a focus on cutting costs and instilling greater discipline into the capital allocation process. As the chart below shows, gold equities have significantly underperformed global equities in recent years.



Industrial commodity assets also appeared to offer good value and many of the industry majors ended the quarter with the added attraction of supportive dividend yields. There was speculation that BHP Billiton might be considering a major programme of asset disposals, potentially selling unwanted assets or spinning these off as a separate business, to focus its remaining operations on four major commodities. There was evidence that industrial commodity miners were also focusing on improving shareholder returns.

Gilts and sterling corporate bonds returned 2.15% and 2.42% over the quarter and outperformed equities as dovish comments from the Bank of England governor, Mark Carney, reassured investors that interest rates would remain lower for longer and investors sought safe-haven assets as political tension rose. In both UK and US, wage inflation may rise more rapidly if unemployment falls and productivity gains remain disappointing. The investments of Brompton’s private clients in bond markets remained short-dated to minimise the impact of further rises in bond yields. Investments in index-linked bonds and real assets such as commercial property may provide some protection in the event that inflation rises more rapidly than anticipated.

Equity markets in early 2014 were more volatile than during much of 2013. Global equity market returns outpaced earnings growth last year and investors may require evidence of accelerating growth in corporate profits if equities are to make further significant gains. Central bank policy remains highly accommodative notwithstanding the onset of tapering by the Fed. The BoJ remains committed to quantitative easing and the ECB stands ready to take action. At the quarter end, the greatest threat to markets was the risk of capital destruction and slowing economic growth in China, where the policy agenda was far less transparent.

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