Quarterly review

for the three months to 31 December 2020

Gill Lakin
Chief investment officer

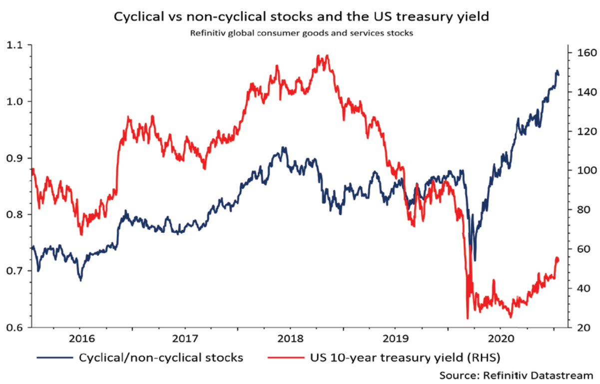
Global equities rose 8.56% over the quarter to close a turbulent year 13.22% higher in sterling. Global bonds gained 3.28% in local currencies but fell 2.32% in sterling because of currency movements.

Sterling assets rose in December as the European Union-UK trade agreement averted a hard Brexit. Sterling gained 5.74%, 3.45% and 1.34% respectively against the dollar, yen and euro. UK stocks outperformed, rising 10.61%, and small companies, which tend to be more sensitive to domestic trends, rose 20.0%. UK government bonds and sterling corporate and high-yield bonds gained 0.48%, 3.96% and 6.35% respectively as monetary policy remained supportive and income-seeking investors bought corporate bonds after companies cut their dividends.

US equities rose 12.15% in dollars but only 6.06% in sterling. Investors cheered the initial outcome to November's election, which gave the Democrats the presidency and control of the House of Representatives but not the Senate. Fears of higher taxes and more regulation eased because it appeared the Democratic policy agenda would be stymied in the Senate. In early January, however, run-off elections gave the Democrats Senate control.

Dollar weakness and stronger industrial commodity prices contributed to outperformance for equities in emerging markets and Asia excluding Japan, which gained 13.28% and 12.23% respectively in sterling.

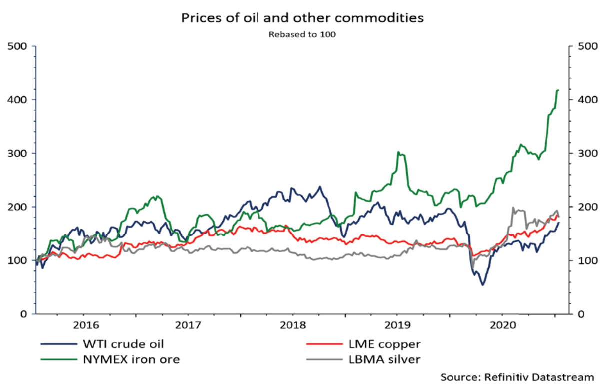
Good news on Covid-19 vaccines led to strong performance from out-of-favour cyclical stocks as investors looked beyond the American and European pandemic lockdowns and anticipated the reopening of economies. In some countries, including the US, this change in market leadership in favour of cyclical stocks was accompanied by higher government bond yields, as the chart below shows.



Inflation was stronger than anticipated, particularly in the US and UK, despite unemployment rising significantly above pre-pandemic levels. In the US, the five-year breakeven inflation rate, which measures medium-term inflation expectations, has risen, implying that inflation will exceed 2%. In 2020, the Federal Reserve shifted its inflation targeting from the fixed 2% target it adopted after the credit crisis to an average target of 2%. This change may lead to higher inflation because it implies the Fed will allow inflation to exceed 2% for some time to compensate for more than a decade of persistently below-target inflation.

Commentators are divided on the long-term impact on inflation of the monetary and fiscal stimulus in response to Covid-19. Successive waves of quantitative easing failed to stoke inflation after the credit crisis, possibly because capital was needed to recapitalise commercial banks. This time, bank balance sheets are stronger. In December, the Prudential Regulatory Authority said UK banks were strong enough to resume paying "prudent" dividends. Central banks' calls for governments to support monetary stimulus with fiscal easing went largely unheeded after the credit crisis. By contrast, the response to the pandemic was swift and large-scale, with more easing to come. In December, the US enacted a $900 billion fiscal package and in January the new president, Joe Biden, called for a $1.9 trillion rescue plan.

Higher commodity prices are inflationary and the prices of oil and industrial commodities such as copper and iron ore rose sharply in late 2020, as the chart below shows.



China is the world's largest buyer of commodities such as iron ore and copper. Chinese demand rose as Beijing increased infrastructure investment after issuing $581 billion of special bonds to help revive

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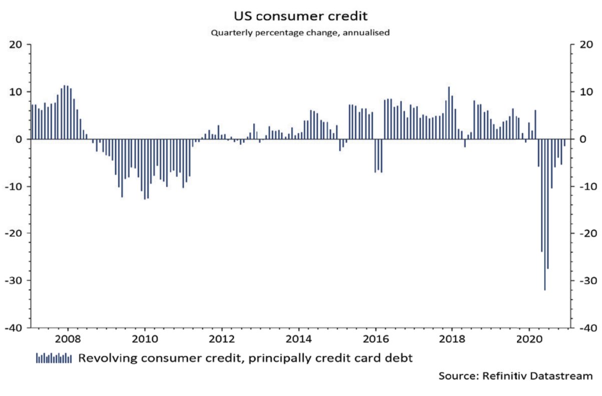
China's economy. Strong global demand in second-wave lockdowns for Chinese products, particularly electronic goods, contributed to a record $78 billion trade surplus.

Prices may rise because some commodities are in short supply as a result of lockdown-related mine closures. Industrial commodity stocks typically rise during recessions because mines stay open despite lower demand but this was not the case in 2020. The relatively long lead times for reopening mines may lead to demand outstripping supply for some time.

Decarbonisation targets will increase longer-term demand for commodities such as copper, which is used more intensively in electric vehicles than in vehicles powered by internal combustion engines, as well as for other electric battery-related commodities. The UK and EU aim to be carbon neutral by 2050; China is targeting carbon neutrality by 2060 and President Biden has outlined a $2 trillion renewable energy investment plan.

Pent-up consumer demand may also fuel short-term inflation because people in work during the lockdowns saved more of their income and reduced their debts, as the chart below shows.



Covid-19-related supply chain disruptions may result in higher costs for companies. Companies may increase their numbers of suppliers and stocks of raw materials and finished goods to make their operations more resilient. The costs associated with such changes may be passed on to customers through higher prices.

The overall prospects for equities at the turn of the year appeared positive because monetary and fiscal policies are likely to remain accommodative for some time and equities typically perform well in an environment of mild inflation.

Asia ex-Japan and emerging market equities appeared particularly attractive because they were trading on lower valuations while public sector debt levels were lower than in many developed economies. Dollar weakness and stronger oil and commodity prices would also prove tailwinds for these markets.

The change in equity market leadership in favour of cyclical companies may prove persistent given the divergence in the valuations of growth and value companies. This trend may also favour the lowly-valued UK market, which has relatively-heavy weightings in cyclical sectors such as financials, industrials, mining and energy. UK smaller companies also may benefit from reviving domestic demand and increasing takeover activity because the EU-UK trade deal ended Brexit-uncertainty and may lead to a further recovery in sterling.

Higher-than-anticipated inflation could lead to weakness among some longer-dated bonds while index-linked bonds may provide some inflation protection. Breakeven inflation, the level of inflation implicit in the prices of inflation-linked bonds, implies inflation will remain low compared to history and may provide a good buying opportunity for inflation-linked bonds. Gold and gold equities may also prove effective diversifiers and perform well in an environment of negative real yields, where inflation is higher than interest rates.

Brompton Asset Management LLP, 1 Knightsbridge Green, London, SW1X 7QA