BROMPTON
ASSET MANAGEMENT

Quarterly review

for the three months to 30 September 2020

Gill Lakin
Chief investment officer

Global equities rose 8.25% in local currencies over the quarter but currency swings reduced the gain to 3.46% in sterling. Global bonds gained 2.66% in local currencies but fell 1.88% in sterling.

The pound gained 4.63% and 2.35% respectively against the dollar and yen but just 0.21% against the euro as investors remained sanguine on European Union-UK trade talks despite the seeming lack of progress. The stronger pound contributed to underperformance by UK stocks, which fell 4.64%. UK equities were affected by factors such as Brexit and the London stockmarket's relatively-high weightings in cyclical sectors such as financials, energy and industrials, and its correspondingly-low technology weighting.

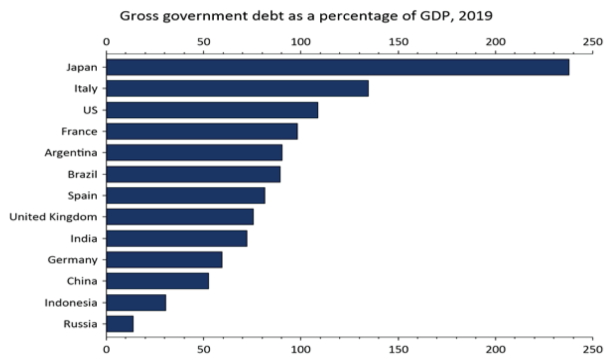
Smaller UK companies did better, gaining 6.30% because they tend to be more sensitive to the domestic economy, which appeared to have recovered strongly as a result of the exceptional monetary and fiscal stimulus in place. In its latest monetary policy committee (MPC) minutes, the Bank of England estimated that gross domestic product (GDP), which fell 19.8% in the second quarter, had recovered 18.5% from its April trough by July yet was still 11% below its start-of-year level. Growth may, however, slow in the fourth quarter because a less generous job support scheme has replaced the original furlough scheme and a growing number of regional lockdown restrictions have been imposed in response to the revival in reported Covid-19 infections.

As second-wave infections rise across Europe, more policy support may be forthcoming. In September, the MPC voted to leave policy unchanged but the Prudential Regulation Authority, which regulates banks, asked chief executives in October to assess their readiness for zero or negative interest rates. Further quantitative easing may be preferable, however, because negative interest rates could hurt bank profits should lenders prove reluctant to pass on negative rates to retail depositors.

The European Central Bank also held interest rates in September despite core inflation of 0.2%, far below its 2% official target. In October, the eurozone's composite purchasing managers index (PMI), a key leading indicator, fell below 50 into territory that implies economic contraction although there is significant disparity at the country level, with Germany's PMI signalling expansion and France's PMI implying contraction. Equities in Europe excluding the UK lagged, rising only 1.29% in sterling.

The Covid-19 pandemic appeared to be more effectively contained in Asia than in Europe, allowing restrictions to be lifted in some countries. In China, September's purchasing managers indices implied expansion was on the horizon. The Chinese labour market recovered strongly after the lockdown, with unemployment 5.4% in September, close to the start-of-year level. Equities in Asia excluding Japan and emerging markets outperformed, rising 5.89% and 4.85% respectively in sterling, with Chinese stocks, up 7.59%, particularly strong.

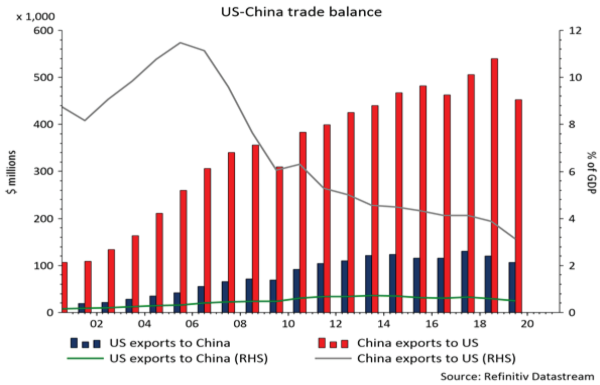
Emerging market equities may continue to outperform because quarter-end valuations were typically lower and growth rates higher than for some developed economies. Exceptional US monetary and fiscal stimulus may also lead to dollar-weakness, increasing demand for emerging market assets, while lower public sector debt levels may provide tailwinds for some emerging market economies such as China and India, as the chart below shows.



Source: Refinitiv Datastream

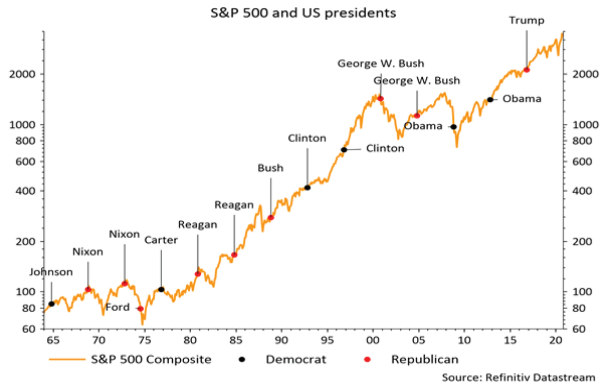
Worsening Sino-US trade relations are a threat but, as the first chart overleaf shows, exports to the US account now for only about 3% of Chinese GDP, having fallen as a percentage over the last decade as China invested in technology and domestic consumer demand increased relative to export demand.

US stocks outperformed, gaining 4.11% in sterling, with technology stocks particularly strong, up 6.91% even after weakness in early September as investors took profits. In August, the Federal Reserve shifted monetary policy, loosening its inflation target to an average of 2% over time. After more than a decade of below-target inflation, monetary policy is unlikely to tighten unless inflation exceeds 2%. This suggests that US interest rates are likely to remain near zero until 2023 at the earliest.



In late October, US politicians had yet to agree a new fiscal stimulus to cushion the impact of the pandemic on businesses and households. More fiscal easing would support risky assets such as equities but negotiations were caught up in political rivalry ahead of November's presidential election. The Democratic candidate, Joe Biden, is widely expected to win the presidency and the Democrats could potentially control both the Senate and House of Representatives after the election, paving the way for major policy changes, including increased taxes. Although financial markets may be volatile around election day, there is little clear evidence that they perform worse under Democratic presidents than Republican ones, as the chart opposite shows.

In Japan, the prime minister, Yoshihide Suga took office as Shinzo Abe, Japan's longest-serving premier, stepped down due to ill health. A high degree of policy continuity is expected because the Liberal Democratic Party remains in power and Haruhiko Kuroda continues in office as governor of the Bank of Japan. Japanese equities rose 2.76% in sterling over the quarter.



The rising rate of Covid-19 infections and attendant restrictions on economic activity may lead to market weakness over the coming months. Central banks and governments, however, stand ready to do more and a new fiscal stimulus in the US appeared imminent in late October. Good news relating to treatments and a potential vaccine would lift markets and could prove the catalyst for a period of stronger performance by unloved and more cyclical value stocks relative to growth stocks, which have been in vogue since the global financial crisis more than a decade ago.

Although I took some profits from equity fund holdings over the quarter, the longer-term prospects for equities and corporate investment-grade and high-yield bonds looked positive at the quarter end because these asset classes appeared most likely to reward investors with positive real returns. In an environment of near-zero interest rates, gold and gold equities provide diversification and may prove defensive should markets fall.

Important information

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