

BROMPTON PRIVATE CLIENTS

Quarterly review for the three months to 31st March 2011

The returns from most major asset classes were modest for the quarter as a whole, with the UK equity market and global equity market delivering gains of 1.0%* and 2.1% respectively. Fixed income market returns were also subdued, with UK corporate bonds and UK gilts returning +1.6% and -0.8% respectively. These modest movements, however, masked a turbulent quarter that encompassed regime change in the Middle East and natural disaster in Japan.

Since the quarter end, we have witnessed the widely-flagged first increase in interest rates by a major developed market central bank since the onset of the credit crisis, with the European Central Bank (ECB) increasing its policy rate from 1% to 1.25% to combat growing inflationary pressure. In the UK, the Bank of England's monetary policy committee is also concerned about inflation as the key Consumer Price Index rate has now been running above its 2% target since December 2009 and in excess of 4% throughout the first quarter of this year. In the UK, the prospect of a rate rise may have receded in the wake of a surprise 0.5% contraction in gross domestic product (GDP) in the last quarter of 2010 and the government's downwards revision in 2011 forecast GDP in the recent budget.

In any event, it is difficult to assess how effective rate increases would prove given that inflation is not being fuelled by rising wage pressure or consumer demand but by price shocks in certain major commodities, notably oil and food. These two sectors are largely responsible for the 9.0% increase in the DJ Goldman Sachs commodity index during the quarter. Brompton Asset Management continues to favour an exposure to commodities, particularly the energy sector as prices are supported by conflict in the Middle East and a recovery in the global economy. The oil price is currently above US\$120 per barrel, a level not seen since 2008, the year in which the oil price almost reached US\$150. Investors may soon begin to turn their attention to the substitution effects of a high

oil price as users seek out alternative sources of energy. Companies operating in the alternative and renewable energy sectors may come back in to favour as they did in 2008.

In our last quarterly review, the valuation attractions of developed economy equities compared to their emerging market peers were highlighted along with the fact that investors' preference for emerging markets was a well-established and highly consensual view. Emerging market economies are generating higher levels of GDP growth and enjoy lower levels of debt relative to GDP than the US, Japan, Continental Europe and the UK. Companies in the developing world, however, are facing significant headwinds in the form of rising wage pressure and commodity prices and a resultant tightening in economic policy including higher interest costs and increased restrictions on bank lending. During the quarter, we increased our clients' investments in the US equity market, which performed relatively well, rising by 3.5% over the period.

The US equity market has a relatively high exposure to the technology sector, which currently appears attractive. Technology companies remained generally unloved following the bursting of the technology bubble at the start of the last decade. The current environment seems favourable to this area of the market. While banks remain focussed on reducing the size of their balance sheets and building up capital to meet regulatory requirements and consumers are reducing borrowing, the corporate sector is beginning to increase levels of investment spending and the technology sector is a beneficiary of increasing business to business spending. Product innovation is a constant theme in the sector but Apple's iPhone and iPad have spawned whole new sub-sectors within the consumer market.

Japanese equities were also looking attractive prior to the tragedy of earthquake, tsunami and radiation leakage that struck in March. The Japanese stock market fell by almost 20%

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in two days before rebounding, with the Topix down only 6.5% by the quarter end. Initially, the yen strengthened just as it did in the aftermath of the Kobe earthquake in 1995. This time, central banks led by the US Federal Reserve, were swift to intervene in currency markets in a concerted attempt to weaken the yen.

In the euro zone, the theory that the single currency could continue to “muddle through” gained some currency with the bailout of Portugal, admittedly only after the resignation of the prime minister. It is worth noting that the bailout plans acceded to by Ireland, Greece and now Portugal take the form of high-interest bearing loans rather than debt relief. The fundamental problem these economies are facing is not one of liquidity but one of solvency and this has yet to be addressed. The increase in the ECB policy rate has resulted in a strengthening of the euro and this can only hinder economic recovery in the peripheral countries. The currency move suggests that investors are currently more

attracted by the investment opportunity provided by the widening in the interest rate differential between the euro zone and other major economies such as the US rather than concerned by the risk of default. The conflict between these two factors is likely to continue to dominate the region throughout 2011.

One of the most striking features of markets since the credit crisis has been the high level of correlation between the major asset classes. It is rare to observe such a sustained period in which equities, commodities and bonds have all performed well and in such a synchronised fashion. As the chart below shows, the returns delivered by the different asset classes have begun to diverge in recent months and this may set the scene for 2011. The current year may prove to be one in which the impact of asset allocation between the asset classes becomes a far more significant driver of returns than it was in 2009 and 2010, when the major differentiator of returns was the extent to which investors decided to invest in risk assets rather than the specific risk assets they selected.



**All returns Lipper Hindsight sterling total return basis.*

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