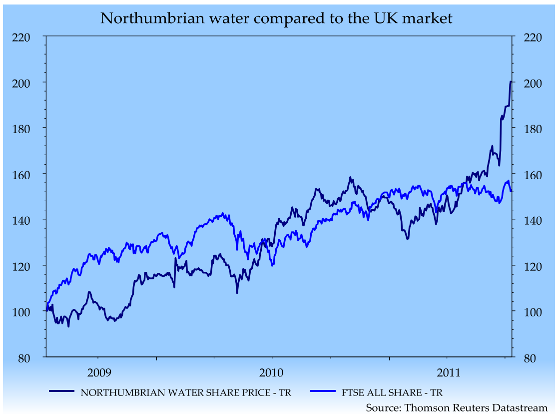
Brompton Private Clients

Quarterly review for the three months to 30th June 2011

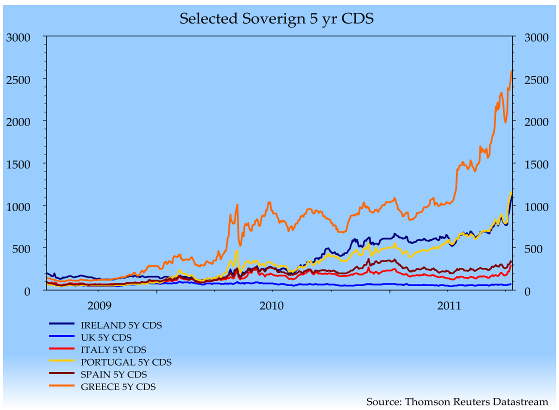
The newspaper headlines in recent days have been dominated by the unfolding events at News International and its ill-starred bid for BSkyB. Much less attention has been paid to another takeover approach, the offer made by Li Ka-shing's Hong Kong company, Cheung Kong Infrastructure, for Northumbrian Water. The chart shows the performance of Northumbrian shares compared to the UK stockmarket over the last two years. They had broadly kept pace with the stockmarket recovery until Li Ka-shing's announcement made them a clear outperformer. What is so interesting about this bid is that infrastructure assets more broadly look an attractive investment; indeed, we have been investing in the global infrastructure sector over the last quarter on behalf of clients.



We have invested in a fund which focuses on companies that own and manage such essential and predictable assets as toll-roads, railways, ports, storage terminals, pipelines and communication towers. These businesses are attractive because many of them have an explicit link to inflation through regulation or contracts or operate in less competitive markets, giving them the pricing power to maintain margins. It is likely that global inflation will remain persistently higher than central bank targets and we continue to look for investments that will provide some protection. The era of low-cost manufacturing in China and other developing economies that has contributed to low global inflation may now be coming to an end. The urbanisation of the emerging economies is commodity-intensive leaving the global economy vulnerable to further commodity price shocks and generally higher inflation. One key objective when investing on behalf of clients is to ensure that inflation does not reduce the real value of investments but maintains spending power.

The current high levels of debt relative to gross domestic product in many developed market economies also mean that governments are becoming distressed sellers of infrastructure assets, potentially creating attractive acquisition opportunities for investors. Greece is an obvious example of this as the government has just passed a further package of state-owned asset disposals and austerity measures to secure more emergency funding.

This year continues to be dominated by worries about the fragility of the economic recovery in the developed economies and the escalating sovereign debt crisis in the eurozone. No apology is needed for using this chart again showing how the cost of insuring the debt of the peripheral eurozone economies has continued to rise along with the probability of default. It first appeared in the September 2010 review. Since then, the combined policy actions of the International Monetary Fund, the European Central Bank (ECB) and European finance ministers have failed to restore confidence as the probability of default has risen further.



The euro has been remarkably resilient in the face of this crisis as the ECB has raised policy rates twice since March from the 1% low reached in May 2009 to the current 1.5%. These moves may help to restrain inflation fears in Germany but can only exacerbate problems in the over-indebted periphery.

While there is no resolution in sight to the eurozone's problems, prospects have improved in Japan. The Japanese stockmarket was on a low valuation compared to other markets before the March earthquake struck. The market fell nearly 20% in two days but it then recovered much of the fall to end the first half of this year down 4%. The earthquake hit the economy hard, with Japan's bellwether motor industry falling by about 40% in production terms. However, evidence is now beginning to emerge that recovery is occurring faster than anticipated and that the whole economy is likely to return to growth in the second half of this year.

In the current environment, Japan looks relatively attractive compared to many other developed market equity markets. It does have a high level of debt but this is mainly held by domestic savers and Japan is a wealthy country when its ownership of overseas assets is taken into consideration. These factors mean the Japanese currency is often seen as a defensive asset and investors typically buy the yen when they are concerned about risks elsewhere. This appears to be happening as the eurozone crisis worsens.

Developed market equities generally outperformed emerging market equities over the second quarter of 2011. Clients' investments in emerging market equities were reduced at the beginning of the year and we remain concerned in the short term that the combination of rising raw material prices, rising labour costs and rising interest rates will result in earnings disappointments. In the meantime, policy in the developed world continues to be highly stimulative. The Federal Reserve finished its latest programme of asset purchases and liquidity measures in June but there has been no attempt to reverse the policy adopted at the time of the credit crisis and withdraw liquidity. US macro-economic data was generally disappointing over the quarter although it is still consistent with recovery, albeit at a slow pace. Ben Bernanke, the Federal Reserve chairman, is reluctant to commit to further measures but relief came in a different form with the decision by the US to release oil reserves from its strategic petroleum reserve in unison with similar moves by other countries. This contributed to a fall in the oil price of more than 10% during the quarter giving further support to the fragile recovery. There are likely to be more policy initiatives in the months to come if the recovery appears seriously compromised.

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