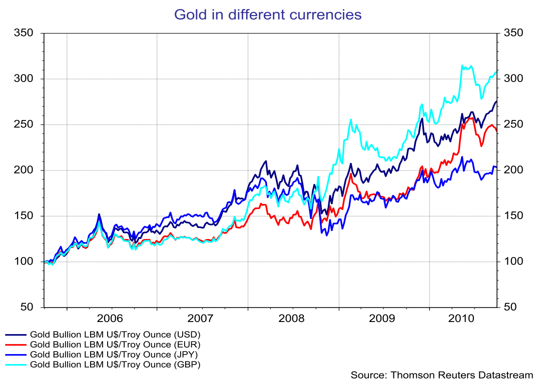
BROMPTON PRIVATE CLIENTS

Quarterly review for the three months to 30th September 2010

In 2009, following the unprecedented policy action taken by the world's leading governments and central banks to mitigate the effects of the credit crisis, global leading indicators surged, presaging a strong recovery in global trade and attendant inventory restocking. Recent macro-economic data releases have been less positive, making it hard to determine whether global economic growth is merely slowing to an anaemic rate or whether the world is heading into a "double dip" recession." The recent polarisation of opinion is illustrated by gains made by two of Brompton Asset Management's preferred asset classes, emerging market equities and precious metals.

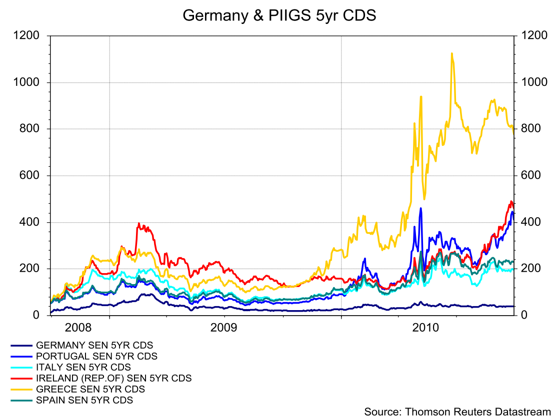
Equities in the developing world have generally outperformed developed world equities since the credit crisis. This story of emerging market economies, with their higher growth rates and lower debt-to-gross domestic product (GDP) ratios, is well known. Brazil is a good example of the positive trends that have attracted foreign investors. Brazil featured widely in the media recently as the country went to the polls and President Lula stepped down after eight years in office. In 2010, the country is expected to deliver high single-digit GDP growth driven by strong commodity prices, recovering exports and rising domestic consumption. An estimated 30 million people, some 15% of the population, left poverty and joined the emerging middle class during Lula's term of office. Inflation is less than 5% and Brazil received its first investment grade credit rating in 2008.

Emerging market equities are currently a preferred asset class but it is clear this has been a consensus view amongst fund managers for some time. They are now similarly priced to developed market equities and investors should be wary of complacency. As recently as 2000, emerging market equities traded at discounts of more than 50% to their developed market peers while at the height of the market in 2007 valuations briefly moved to a premium. Current valuations appear sustainable given the superior growth prospects and the many market-friendly policies adopted by emerging market economies but in uncertain times, a healthy regard for the theory that market valuations 'revert to the mean' should help investors avoid the next market bubble.



One strong challenge to market optimists is the rise in the prices of precious metals, in particular gold and silver. Forecasting the gold price is a challenge given that it has relatively few industrial applications and the lion's share of production is destined for jewellery buyers in India and the Middle East. At the start of 2010, George Soros said he had increased his gold investments while conceding it could prove 'the ultimate bubble'. Brompton favours investing in gold because sentiment is likely to remain supportive under both inflationary and deflationary scenarios; if growth falters and deflation risks grow, gold is likely to prove a better store of value than many risk assets such as equities and property. If the medium-term effect of exceptionally loose monetary policies is higher inflation, then gold is likely to offer some protection. It is fair to conclude that investors have become more creative in their search for stores of value.

It may pay to be cautious about the euro and eurozone equities. In early 2010, Greece became the poster child for market fears regarding the high budget deficits and debt levels in a number of peripheral eurozone economies. Investors' risk appetites gradually returned after European Union finance ministers and the International Monetary Fund approved a rescue package. Although the issue of sovereign default risk slipped out of the headlines for a while, the cost of insuring the bonds of a number of these countries against default has continued to rise as illustrated by the graph below, indicating that for the markets, this issue has not been resolved. At the end of the third quarter, the Irish government announced another package of measures aimed at rescuing its financial system, including underwriting a €3 billion equity issue by Allied Irish Banks. Irish government bond yields fell afterwards but this is a case of a problem deferred rather than a problem solved. Sovereign default risk is likely to remain a central concern for some time and it seems difficult to believe the euro can survive in its current form given voter opposition to public spending cuts in some eurozone countries.



Outlook

The most likely prospect for the global economy is a sustained period of low growth rather than a 'double dip'. The general policy environment remains supportive, with little prospect of interest rate increases in major developed markets and possibly further quantitative easing. Gilts have been supported by investors' growing perception that in the UK these policies will have to remain in place for longer than thought as the government implements its austerity measures and the private sector reduces debt.

In a low-growth but not no-growth environment, equities appear reasonably priced, particularly relative to gilts, and should make further progress. Companies are in good health with low levels of debt while increased takeover activity supports the valuation case. Brompton's private client team continues to favour emerging market equities but recognises that this is now a consensus view and that valuations may in time justify a more contrarian stance if emerging market equities become the next market 'bubble'. The 'low-growth but not no-growth' scenario may be vulnerable to policy error given the fragility of the recovery. Thus, the team continues to favour gold holdings while recognising that the price is supported by momentum buying on the part of safe-haven investors and central banks rather than by solid valuation criteria.

Important information

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