

# BROMPTON PRIVATE CLIENTS

## Quarterly review for the three months to 31st December 2010

Equity markets closed the year in buoyant mood, with a strong December performance delivering much of the increase over the quarter. 2010 proved to be a good year for risk assets, with commodities and equities, particularly emerging market equities, making strong gains. Mid-year concerns that the economic recovery would falter proved overly pessimistic. The announcement of a second round of stimulative measures by the Federal Reserve, dubbed 'QE2', coupled with improving economic news in the US spurred equity markets to make further gains.

The gold price was particularly strong, rising by more than 30% in sterling terms over the year. While the jury is still out on the ultimate success of quantitative easing and the inflation outlook remains uncertain, investors continue to be attracted to gold in the hope that it will prove a store of value in either deflationary or inflationary outcomes. Brompton's private client team is maintaining the exposure to gold and gold equities in client portfolios on the grounds that the escalating eurozone sovereign debt crisis will continue to lead the world's central banks and financial investors alike to seek protection from the instability of some fiat currencies, particularly the euro.

There appears to be no silver bullet that will solve the eurozone's woes. The birth of the single currency effectively removed the possibility of devaluation for eurozone members but only at the expense of increased default risk. The 2010 rally in stockmarkets faltered in May in the face of fears that Greece would default on its sovereign debt and only recovered when eurozone finance ministers and the International Monetary Fund put in place a rescue financing. In November, it was Ireland's turn to need rescuing coupled with another refinancing of its major banks. These measures have not satisfied investors. The cost, therefore, of insuring the sovereign debt of the other peripheral eurozone countries, notably Portugal, Spain and Italy, against default has kept on rising. As yet, private sector bondholders have been protected from

loss. Germany's chancellor, Angela Merkel, faces increasing problems justifying this position to taxpayers and controversially said as much at October's European Union summit. Her difficulty is that making bondholders share the pain could spark further rises in financing costs for weaker eurozone members. Commentators have speculated that breaking apart the euro and allowing peripheral members to devalue is the only solution but such a course of action would most likely spark another eurozone banking crisis.

Bailouts have gone hand in hand with austerity measures and it is perhaps surprising that there has not been more political fallout as a result. This may yet happen as efforts to reduce public sector costs bite. These measures may ultimately prove ineffectual because reducing the size of the public sector may simply reduce the size of the overall economy rather having the desired effect of reducing the ratio of public sector debt to gross domestic product (GDP). Ireland's economy is a case in point because GDP is now estimated to be nearly 20% below its 2007 peak so public spending cuts have failed either to reduce the size of the budget deficit relative to GDP or cut interest rate costs.

The euro's future is called into question by these unfolding events and it is possible that the political will to preserve the single currency in its current form may not withstand the political repercussions of austerity. As Chancellor Merkel put it: "Everything is at stake – if the euro fails, then Europe will fail." This issue is likely to dominate currency markets during 2011. It may, therefore, pay to be cautious about investing in euro-denominated assets even though the euro's weakness benefits the region's manufacturing industry. It has already contributed to the strength of German industrial recovery in particular.

Equities remain a preferred asset class in Brompton's private client portfolios despite

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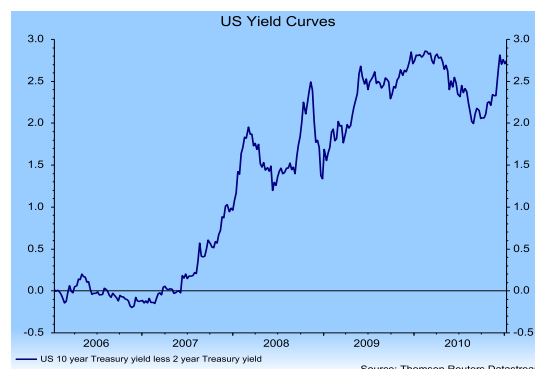
their strong performance in 2010, with the emphasis continuing on developing markets given their generally stronger economic growth and lower levels of public sector debt compared to developed economies. This is a well-rehearsed theme amongst asset managers as the developing world is undoubtedly growing faster than the major developed market economies. Many emerging market economies, however, are now facing growing headwinds from policy tightening aimed at controlling inflation and halting currency appreciation. China has progressively raised its bank reserve requirements and also announced an interest rate rise at the year end. Brazil has introduced exchange controls in an attempt to stem money inflows and halt the rise in the Brazilian real. Companies face increasing cost pressures, which may ultimately hurt profit margins as wage pressure and commodity prices rise further.

The growing signs of US economic recovery may lead to company profits exceeding expectations and result in a stronger performance from US equities than anticipated. After all, the distinction between developed and developing markets can be an arbitrary one as many US multinationals generate a significant share of profits in the developing world. Bond markets are beginning to reflect growing confidence in economic recovery, with US 10-year Treasury yields rising from 2.4% in October to 3.4% now. The rise in US inflation expectations and the steepening in the yield curve will also have reassured the Fed that QE2 was justified.

## *Important information*

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The VIX index, sometimes regarded as the market's fear gauge, has fallen as investors have bought risk assets in the face of growing confidence in the global economic recovery and negative real returns from cash. The eurozone crisis remains the biggest threat and may result in a market correction in 2011. On balance, Brompton Asset Management's private client team continues to favour real assets such as equities, industrial commodities and gold on valuation grounds and also for protection in the face of rising inflation.

