



CLARION plc

Market and Portfolio Review

Summary

- The End of Recession?
- Strong Equity Growth
- Risks in Bonds Build

Review and Outlook

The quarter has continued to provide strong equity returns, with the FTSE All Share returning c. 7%¹ over the period. However, UK Gilts produced a negative return of c. 3%¹ as the yield curve started to steepen, affecting most bond holders.

Evidence to support a recovery has continued to build with most economic indicators showing improvement. In addition, consumer spending appeared to be robust with record levels of sales growth reported by some major retailers over the Christmas period.

Most major economies around the world returned to positive economic growth in the third quarter of 2009, with only the UK, Greece and Spain remaining in recession.

It would appear that the worst of the financial crisis is now behind us. Market confidence has increased and liquidity has been restored in financial markets. News that Dubai had requested to restructure its high level of debt caused some shock to markets in December, but markets quickly resumed the rally after the oil rich Abu Dhabi agreed it would lend its neighbour additional funds.

As stronger economic data builds, policy makers have started to turn their attention to repaying the massive levels of debt that has been acquired through stimulus efforts. Government deficits in the developed markets have reached levels only normally associated with major war time periods.

Politicians have been keen to focus on bankers' bonuses, which will have popular appeal, but is unlikely to make a significant difference to the overall level of debt. Rating agencies and overseas lenders will be keen to see that policy makers in indebted countries have a plan to repay their borrowings in order to sustain growth and not devalue their currency. Procrastination by politicians in the UK, where a general election looms, has caused concern about the UK's AAA credit rating, which is currently the top rating. Part of the concern lies in a hung parliament, where neither party will be able to push through legislation to help manage the debt.

The Bank of England is starting to consider an exit strategy for their Quantitative Easing [QE] programme. QE and other coordinated action by central banks is likely to have been one of the most significant stimulus policies to have helped the world avoid depression. Combined with record low interest rates, QE has helped to restore liquidity and bring down the cost of maintaining debt.

QE brings down the cost of debt by printing money to buy government issued bonds (gilts), and other corporate bonds. The Bank of England has been a massive price insensitive buyer which has purchased c. 25% of all UK Government debt causing the price of debt to rise and yields fall. The yield on government bonds in the 5 -10 year range is generally used by banks to set interest rates on loans, including mortgages. Therefore, by artificially reducing the yield on these bonds the debt becomes cheaper.

¹ FTSE All Share TR, FTSE A Brit Gov't All Stocks TR – 1 Oct 2009 to 31 Dec 2009.
Source: Lipper Hindsight

The reversal of policies to stimulate the global economy is akin to driving a large oil tanker through a narrow strait. The path is likely to be tricky with very fine balances and the tools available to steer are blunt and have a lagged effect.

On one hand, policy makers must be seen to be providing a plan to repay the unsustainable level of debt. If they do not then the risk is that inflation pressures mount and credit ratings are cut. Both of these consequences are likely to lead to currency depreciation, which will make government bonds in certain markets unattractive and therefore, yields should rise. Ultimately, this can create a cycle which is difficult to break. However, if policy is tightened too aggressively, then it may choke the fragile recovery. An example from history would be Japan's recession in the 1990s, where policy was reversed too quickly and led to the 'lost decade'.

Central banks also face a difficult period. QE has helped to restore liquidity to the financial market. Over extended banks were quick to write off bad debt and shrink their balance sheets by not lending. This removed the liquidity from markets and could have led to a more severe recession, had central bank policy not been to support the market and force cash into the economy. Initially this has led to companies having to go to equity and corporate bond markets to raise finance as banks have not been willing to lend.

If QE is unwound too quickly then liquidity may dry and yields are likely to rise. This could be harmful to a recovery and is likely to be especially painful in the UK, where most mortgages are variable rate. However, if monetary policy is too loose for too long, then there is a risk of inflation and currency depreciation.

We believe that although the navigation of the hypothetical oil tanker will be tough, lessons from history and a coordinated approach will lead to more sustainable growth in the future.

As an investment team we are looking for signs that the recovery has moved from a centrally planned recovery to a free market

recovery. In addition, we are keeping our eyes on the action of policy makers.

The recovery is likely to be slow and protracted, however equities look to be fairly valued and therefore we believe will offer investors the best level of return. Although we expect returns to be volatile as economic data both beats and misses forecasts, we expect reasonable returns over the next cycle. We continue to be neutrally weighted, but are looking to increase diversification from the UK, in order to protect investors against a devaluation in Sterling.

The team has spent most of its time analysing the bond position in lower risk portfolios, which we believe will be key to the investment strategy. We expect yields to rise as exit strategies are discussed, monetary policy tightened and future inflation expectations increase. Over the period we have shortened the duration, which is the sensitivity to interest rates, of portfolios in order to protect investors from rising yields. In addition, we have avoided government issued debt in favour of corporate debt. Whilst the risk of default is higher in corporate debt, the level of interest paid reflects an uncertain period and the spread between government and corporate debt remains elevated. The drivers that will cause yields to rise are more likely to be in line with an improved economic picture and therefore, whilst yields may rise on government debt, spreads could narrow as the risk of default falls, protecting corporate bond holders from a rise in the yield curve.

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