



CLARION plc

Market and Portfolio Review

Summary

- Negative Investor Sentiment
- Increased Sovereign Risk
- A Progressive Coalition
- Sterling a safe haven?

Review and Outlook

The quarter has seen a sharp correction in equity markets with the FTSE All Share returning c. -12.8%¹ over the period and the FTSE World returning c. -11%

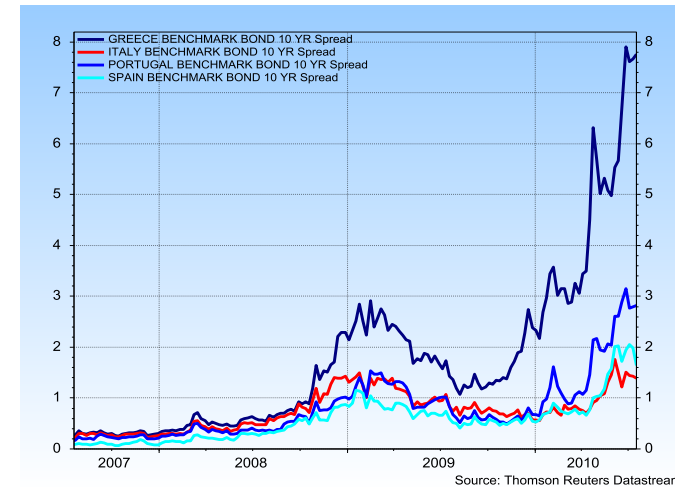
Although most economic data has continued to indicate economic growth, the rate of growth has been lower than expected, indicating that the recovery is not going to be a V shaped recovery, but is more likely to be protracted as the developed world grapples with its high level of debt.

In the previous quarter, we commented on investors focus shifting from the recovery to sovereign risk i.e. the ability of governments to manage record levels of debt. The worst offenders are the P.I.I.G.S (Portugal, Italy, Ireland, Greece and Spain).

Greece having increased its debt to over 100% of its GDP and running a budget deficit of over 10% per year was the first European member to face a debt crisis. The amount that the Greek Government has to pay to finance its debt has grown substantially since the start of the year, making it impossible for the country to maintain its debt at market interest rates, threatening default.

¹ FTSE All Share TR, FTSE World TR – 1 April 2010 to 30 June 2010. Source: Thompson Reuters Lipper

The chart below shows the additional interest demanded for 10 year government debt in the P.I.I.G.S compared to the interest rate paid by Germany.



Despite a massive bailout package put together by the European Union and the IMF, totalling €750Bn, which is additional to the €110Bn rescue package for Greece, investors have started to panic that there may be a contagion of the Greek debt crisis to other countries, with the other P.I.I.G.S being the most likely candidates. Political disagreement in Europe on how to tackle budget deficits and how to use the bailout has meant that investors have been selling European assets, benefiting Sterling, which has appreciated by c. 8%² over the period.

Governments' responses to the debt crisis have been more fractured than their joint response to the credit crisis. However, at the G20 meeting in Toronto it was generally agreed that all members should follow a policy of "growth friendly fiscal consolidation". It was agreed that members should halve their deficits by 2013 and stabilise the debt to GDP ratio by 2016. An exception was provided for Japan, as it finances its deficit from domestic borrowers (ft.com 27/6/2010).

In the UK, the result of the general election was a coalition government between the Conservatives and Liberal Democrats. A

² Euro vs £ Sterling – 1 April 2010 to 30 June 2010. Source Thompson Reuters Lipper

hung parliament was considered to be the worst outcome before the election but the two coalition parties have made every effort to unify. George Osborne, the new chancellor, gave an emergency budget at the end of June. The result of the budget was to slash Government spending by 25% in real terms by 2014, increase VAT to 20% and raise £2Bn through a new bank levy. The budget has been labelled as one of the most austere budgets in recent times.

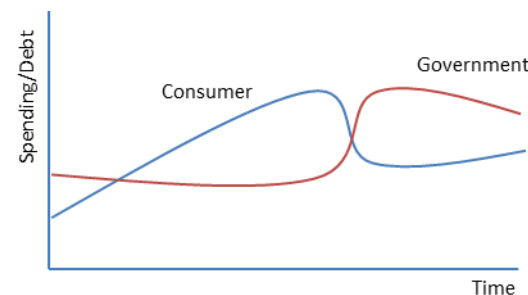
Although the market has punished overly indebted nations, by increasing the premium demanded for holding their debt to the point at which drastic budget cuts have been forced by the market, the consequence of budget tightening across developed markets has caused investors to now panic about a double dip recession.

Following the credit crunch consumers and banks, which were overleveraged in the property boom, have increased their saving and started to de-leverage. Saving rates in the UK have gone from virtually 0% in 2007/08 to over 7% at the start of 2010. In response to a dramatic change, governments went on a spending binge and central banks embarked on QE to stop the money supply shrinking and the global economy falling into depression.

In a modern democracy and according to Keynesian economic policy, governments should take up the slack from a shock to consumption to smooth the economic cycle. The debate is what happens next?

In the chart opposite we have illustrated consumers slow build-up of consumption and debt followed by a shock to the system (credit crunch). In addition, we have illustrated a hypothetical government response, which in terms of the rise has been typical in this cycle.

It is our expectation that governments will follow a gradual belt tightening policy as consumption rebuilds, the UK is currently still growing Government debt, but the new budget reduces the rate of growth until 2016 when it should balance. The concern from investors is that belt tightening will lead to a double dip recession, the previous concern of bond holders was a debt trap similar to Japan, where government debt keeps building, with the risk being that it cannot be sustained.



Source: Margetts Fund Management
Chart is for illustrative purposes only

It is our view that both views are too extreme and the most likely outcome is a protracted recovery. Whilst we believe that the risk to bonds is reduced as budget deficits are tackled, we still consider the biggest risk is future inflation from monetary policy being held too loose for too long. Any attempt to reduce the money supply early risks choking the fragile recovery. We feel that policy makers will err on the side of caution when faced with that decision and will not tighten policy until a recovery is well rooted. In addition, the real return on UK government debt is c.0%. (Yield on 10Yr Gilt - 3.3% 1/7/10, CPI – 3.2% 15/6/10. Source: Thompson Datastream)

In the last quarter, UK gilts have appreciated by c. 5% over the period³ as investors perceive the holding to be a safe haven, despite the UK being similar in terms of debt to many of the peripheral European economies. Although the UK can't default as it controls its money supply, the currency can depreciate if money is printed.

Our strategy remains the same, we favour equities in quality companies with a high level of diversification, which are priced at a relatively attractive level. We intend to take advantage of volatility as investor sentiment swings. We remain underweight bonds and favour shorter duration holdings, which are less sensitive to interest rate movements.

Matthew Jealous CFA
Fund Manager

July 2010

³ FTSE A British Gov't All Stocks TR – 1 April 2010 to 30 June 2010. Source: Thompson Reuters Lipper