



CLARION plc

Market and Portfolio Review

Summary

- Strong Equity Growth
- Risky Bonds
- A Hung Parliament?
- Sterling Weakness

Review and Outlook

The quarter has continued to provide strong equity returns, with the FTSE All Share returning c. 6.5%¹ over the period and the FTSE World returning c. 10%¹.

The economic recovery has continued to build as most major economies, including Britain with its revised figures, exit recession.

With an improving backdrop the markets have started to focus on sovereign risk. In order to bail out their economies from the financial crisis and severe recessions, governments around the world have been on a spending binge.

In addition to bail outs, some governments had already been spending excessively, and in a similar manner to the banks before the financial crisis, they have been making use of off balance sheet financing.

¹ FTSE All Share TR, FTSE World TR – 1 January 2010 to 31 March 2010. Source: Lipper Hindsight

The worst offenders have been the countries labelled the P.I.G.S (Portugal, Ireland/Italy, Greece and Spain). These economies benefitted from joining the Euro, which provided cheap financing during the last cycle.

Following Dubai's rescue late last year by Abu Dhabi, sovereign risk has increased and eyes have turned to the P.I.G.S. Greece has been the first casualty, with total debt to GDP of 112% at the end of 2009, which is predicted to exceed 120% in 2010. The Greek Government's budget deficit was 12.7% of GDP in 2009. Maastricht Criteria, which is part of a treaty entered into by the

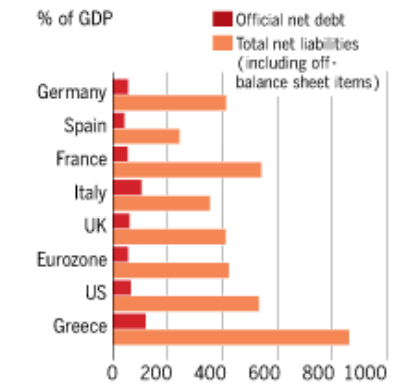
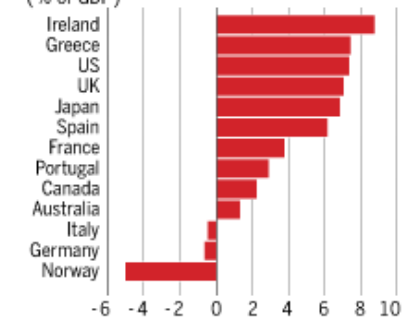
European countries, states that budget deficits should not exceed 3% of GDP and overall debt to GDP must not exceed 60%.

As can be seen from the chart on the left, taken from the Financial Times (16 February 2010), Greece's total net liability, including off balance sheet items, is in excess of 800% of its GDP, and the country would require a cut in the budget balance of over 8% to stabilise the debt at this level.

The cost of insuring Greece's debt has increased dramatically and the spread over German bunds, the interest the Greek Government pays on its debt compared to the German Government, widened to over 3% in March.

A big question has been put over Greece's ability to sustainably finance its debt and the

A taxing affair
Required change in cyclically adjusted budget balance to keep debt/GDP stable at 2009 levels (% of GDP)



Sources: Credit Suisse; SG Cross Asset Research

International Monetary Fund (IMF) and member European partners have had to put together a rescue package to calm investor fears.

Greece is a small global economy and yet the heightened Sovereign risk has caused investors to shy away from Europe and question whether the Euro will hold. It has been widely assumed that the stronger European countries would create a backstop for Greece, however, as events have unfolded the IMF have also been called in. Usually, the IMF would provide finance on the basis that a government puts in significant cuts, which are likely to cause a deeper recession and offset this effect with currency devaluation. For European countries this secondary step is not possible.

Whilst it is unlikely in our opinion that the Euro will split or that a rescue package will not be put in place for the troubled Greece, a much bigger problem would occur if the issue spreads to bigger economies like Spain.

The UK is also vulnerable, where debt may exceed 100% of GDP in the next few years and the budget deficit is running at 13.5% pa. Whilst this is similar to the USA, Sterling is not a major reserve currency and there are signs that overseas holders of UK debt have been moving elsewhere.

One of the major issues for the UK is that there maybe a hung parliament in the general election this year. Whilst both major parties realise that the deficit must be cut, they do not agree on how it should be achieved. The Labour party is leaning towards higher taxes to pay for the large public sector, whilst Conservatives are more likely to cut spending. The risk is that with a hung parliament neither party will be able to effectively implement changes and Sovereign risk is therefore increased.

In order to protect investors from rising yields (the cost of debt), the investment team has continued to reduce exposure to bonds over the quarter and have focussed on corporate debt with a short duration (duration is the sensitivity of debt to interest rates). It is

expected that bonds will continue to be gradually reduced over the next quarter as the cycle develops.

In addition to rising yields, Sterling has been under pressure. The team has been gradually increasing overseas holdings over the last twelve months in order to diversify from Sterling, which has added value to portfolios.

Although the next twelve months is likely to be volatile as markets react to changing economic data, the team remains confident about the prospects for equities over the medium term. Whilst they have rallied significantly over the last year, they remain below previous peaks and the valuation of most developed stock markets remains reasonable as things stand, and could look attractive if the recovery continues at a faster pace than expected. Whilst the returns we have experienced so far are unlikely to be repeated, we believe that equities remain the most attractive asset class.

Many investors are still holding high levels of cash, which is providing support to the market. Whilst in previous cycles attractive rates of interest have been possible, making an attractive alternative, in the current cycle cash is costing investors real returns. If inflation remains stubbornly high, then the real cost increases with time.

The team continues to favour Emerging Markets and Asia Pacific equities, where the long term economic power is shifting. However, in the short term, these areas demand a premium and the US looks attractive. Therefore, we have been building the US weightings and this area is likely to attract top ups over the next quarter.

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