



# CLARION plc

## Market and Portfolio Review

### Summary

- Market Volatility
- Political Uncertainty
- Japanese Crisis

### Review and Outlook

This quarter has been mired with negative news flow, which has overwhelmed the more positive economic data. Rising inflation, political unrest in the Middle East and North Africa, and the tragic events in Japan have knocked investor confidence.

Equity and bond markets have been broadly flat. However the most interesting fact, from the fund managers' point of view, has been that equities have outperformed during the period.

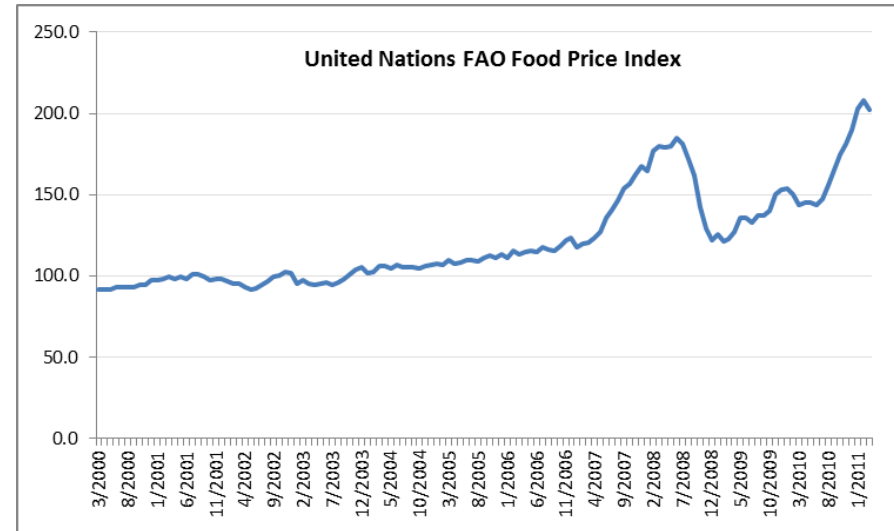
Usually in periods of uncertainty, especially news that is likely to negatively impact on markets, bonds tend to perform well as investors sell risky assets and re-invest in low risk assets, such as Government bonds. This shift is often referred to as a flight to quality.

Over the quarter UK and global equities have broadly performed in line, delivering c. 1 – 2%. Government bonds in the UK have fallen c.0.8% illustrating the lack of any flight to quality over the period, and indicating that Government debt is no longer perceived as an area of safety.

Over the last cycle investors have been increasing their exposure to emerging economies, due to their strong position relative to developed markets. The Emerging Markets have built up budget and trade surpluses due to the strong demand for cheaper exports. In addition, the high savings rates of their consumers and large populations provide an opportunity for future growth.

The strength in these markets has been evident over the last few years where Emerging Markets have contributed more to annual global growth than the developed markets.

However, very strong growth in developing economies is causing some unwanted pressure in the global economy. Demand for commodities has forced up input costs for manufacturers, and changing tastes and improving living standards has put immense pressure on food supply.



Source: Food and Agriculture Organization for the United Nations

There has been debate over whether these economies are overheating, and whether a premium for the future opportunity in their stock markets is correctly priced. Many stock markets in developing economies have moved to trade at a premium over developed markets.

Rising food prices has led to political unrest in many developing markets. However, over the quarter political unrest in North Africa and the Middle East boiled over into riots, and bloodshed in the case of Libya.

Violence in Libya has sparked further rises in oil prices, which has exacerbated concern about a bubble in commodity prices and the effect on inflation globally. In addition, worries that violence may spread to other oil rich nations, most importantly Saudi Arabia, led

to investors reducing allocations in Emerging Markets and re-allocating to developed markets, with the US being the main beneficiary.

The tragic earthquake and tsunami that hit Japan on 11<sup>th</sup> March has left tens and potentially hundreds of thousands of people dead, missing or displaced. Much of Japan shut down and supply chains have been massively disrupted across the globe, highlighting how interwoven the global economy now is.

The immediate market reaction was a sharp sell-off globally, and with a nuclear disaster in the balance markets have been fairly volatile since.

These events cannot be predicted and highlight the importance of a diversified portfolio. Although investor's portfolios have been affected during the period, the team have been confident that the level of diversification has provided the natural protection it is intended for. Following the initial falls markets have recovered quickly to levels before the crisis.

The recovery is fairly natural in markets following a natural disaster. The initial effect will be a slowdown in GDP, especially in Japan, but also globally due to supply chain disruptions. However, the longer term impact can be positive (from an economic perspective) as huge stimulus is applied to rebuild and develop the affected areas and markets price in future growth.

Japan's economy, as previously discussed, has been trapped in a debt / deflation cycle. Japanese Government debt is the highest in the world, but it is fortunately mainly financed by savers in Japan and therefore the cost of debt has remained relatively low.

The injection of liquidity required to stabilise the economy, and the efforts to rebuild affected areas, may provide a catalyst that allows the economy to change.

Under other circumstances the team may consider increasing allocations in high risk portfolios to Japanese equities. The initial reaction in the market is to sell Japan and re-allocate. However, Japanese companies have an extremely high exposure to the global economy, and significantly higher exposure to emerging economies' consumers, than the other developed stock markets. Therefore, stocks which have fallen due to investor sentiment alone

could be well placed. However, the nuclear threat is such that the team do not view the rewards as strong enough to justify the risk.

In Europe the debt crisis moved from Ireland to Portugal towards the end of the quarter. However, this appears to have been almost ignored by the market. Steps for a permanent rescue fund appear to have drawn a line under the crisis for now, as spreads (the additional return) for Spanish and Italian bonds have fallen over the quarter (Spain and Italy are the biggest and most significant peripheral European countries that have excessive levels of debt and high unemployment). We have always believed that it would be more costly for a European breakup than a rescue, and continue to monitor the situation for any change.

On a more positive note, unemployment in the US fell indicating that the recovery continues and economic growth is real. We expect that over the course of this year and next companies will start to invest more, recruiting and buying competitors as confidence grows.

Our main fear is that growth continues to apply pressure in commodity markets and speculation continues to cause higher inflation. If central banks move too quickly to dampen inflation, which we believe is not in the control of developed markets' central banks, then the recovery may be damaged.

We continue to favour larger cash generative businesses as reflected through our fund selection and overweight equity exposure. We believe that investors should be well diversified and continue to favour Emerging Markets, where appropriate, for their long term competitive advantages, wealth and inflation protection. However, we will monitor indirect exposure to commodities through Emerging Market positions, and will reduce exposure in the event that a bubble forms.

Where applicable we remain underweight in bonds and have positioned portfolios to be shorter duration (lower interest rate sensitivity). The team have been exploring inflation protection fixed interest assets, which should perform well in an inflationary environment.

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