



# CLARION plc

## Market and Portfolio Review

### Summary

- Continued Market Volatility
- Eurozone Uncertainty
- Commodity Price Falls

### Review and Outlook

Over the quarter the market has grown more anxious about the economic recovery. A potential default in Greece as well as tightening monetary policy in Asia has taken its toll on investor nerves.

UK markets grew slightly over the quarter adding c. 1.5%<sup>1</sup>, however the return was not evenly distributed, with falls registering for the majority of the time followed by a rapid recovery in the last week of the quarter.

Nervousness has caused a 'flight to quality', a term that is used to describe investors selling risk assets such as emerging market equities and buying government issued debt. The 'flight to quality' has pushed yields on government debt back to extremely low levels, and has caused emerging markets to suffer losses in the period. The most notable losses occurred in commodities.

We have previously commented on the issue surrounding the P.I.I.G.S (the peripheral European nations – Portugal, Italy, Ireland, Greece and Spain), where they have built excessive debt in the last economic cycle, which has become unsustainable with lower economic growth.

In the June 2010 review, we discussed the European Bailout package of €750Bn plus €110Bn specifically for Greece. This

package was subsequently made a permanent feature of the Euro area, in an attempt to draw a line under the sovereign crisis.

However, there continues to be political wrangling over using the facility. Politicians in the developed economies want Greece to implement tougher fiscal cuts and align issues like retirement ages with Germany. However Greece, aware that cuts will be extremely unpopular, argues that implementing the cuts will devastate the economy and be potentially worse than default.

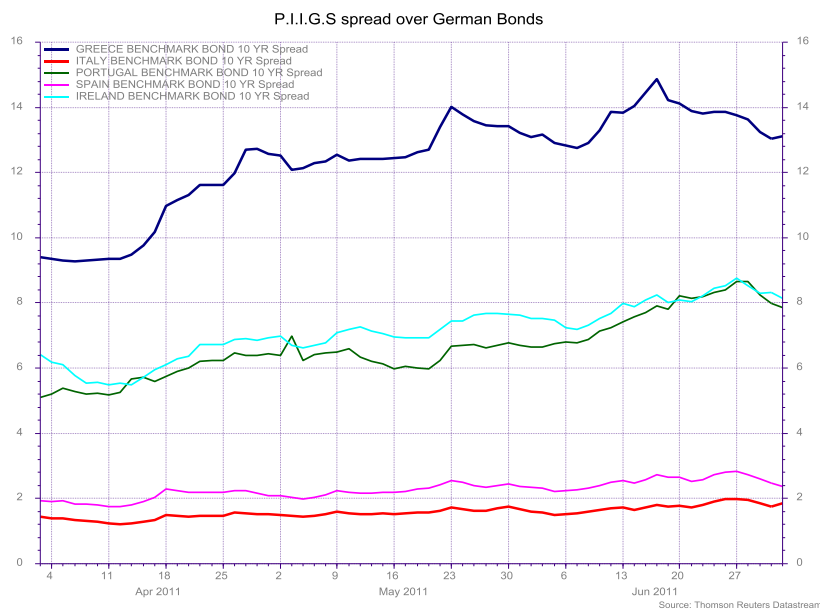
It is our opinion that the cost of seeing through the bailout will provide more certainty and will be ultimately less costly than default. Although Greece is relatively small, a default will weaken the global banking sector, which has exposure to Greek bonds and failure may lead to a second banking crisis, which the world experienced in 2008. In addition, if one country is allowed to leave the Euro area in default then it brings into question the sustainability of the Euro area in general. A default is likely to cause a contagion through the other peripheral countries, of which Italy and Spain are the biggest, and the cost of default in these areas would be difficult to predict.

Should Greece default then they would be shut off from raising capital in global markets, the likely affects would lead them to print money to pay for the public sector and in turn causing hyperinflation. The economy would be devastated and it would take years/decades to recover. Argentina is a good example of what can happen when a country defaults on its debt.

Therefore, we believe that it is everyone's interests to find a way to solve the issues, however for politicians to remain popular, both sides of the argument need to show their voters that they are extracting the most value from any deal. Unfortunately this means that stalemates are likely to occur regularly and a solution is only likely to be agreed when close to the final deadline.

The following chart shows the feeling in markets. It shows the yield on 10 year debt (the cost to the government of issuing debt) above the 10 year yield on German debt. Over the period the spread rises as investors sold bonds issued by the P.I.I.G.S, as they became more concerned that a resolution would not be found.

<sup>1</sup> Source: Morningstar Direct – FTSE 100 TR 1 Apr 2011 to 31<sup>st</sup> June 2011



At the end of June, the Greek Government had to pass a vote of confidence. The market worried that if the vote was unsuccessful then the necessary deficit cuts would not be put in place. The vote was successful, leading to a fall in the spread of Greek debt. This was the first of two key votes and its success caused a relief rally in stock markets.

We believe that although relief was experienced in the last week of the quarter the issue remains that Europe is not showing a strong union in defiance of the markets. Although we feel that sentiment will continue to oscillate, we remain convinced that these issues will be resolved, and that Europe will be stronger following this crisis than it was before.

In addition to the European crisis, investors have become concerned that global growth may slow as the Chinese Government tighten monetary policy to fight inflation. High levels of growth in the emerging markets coupled with recovery in the developed markets was discussed in the last review and our concern was that if not tackled a bottle neck would form, which would jeopardise future growth.

Although markets have taken the policy shift as negative, our view is that it provides a more sustainable future. We feel that in order to fix the global imbalances that have been built up through borrowing and spending in the West and saving and producing in the East, the developed markets need to remain near recession for a prolonged period of time to allow consumption to grow in the developing markets and rebalance the global economy. This shift is going to take years and the strategy must be able to cope with the uncertainty that is likely to prevail.

Within our cautious portfolios we remain under weight fixed interest and have maintained our skew to shorter duration bond funds. Although this strategy has not added significant value in the short term, the team remain convinced that short of a global depression, yields are far too low. The timing of any strategy is extremely difficult to predict and therefore we will remain underweight whilst we do not find support for another strategy.

Within equities, our overweight position is being maintained as we feel the core scenario remains unchanged and equities represent the best value. We have generally favoured larger cash generative income producing companies, which offer more protection should the economy deteriorate.

Our overweight emerging market and Asia Pacific position has detracted from performance recently. The team are constantly re-appraising our asset allocation and remain of the view that whilst there is some merit to decreasing positions, the short term sell off earlier in the year reduced any relative benefit. In the long term we firmly believe that these areas offer the most opportunity and do not pose the same sovereign risk that investors have been used to in previous cycles.

For balanced portfolios the managers are considering a small reduction in the allocation to emerging markets in favour of developed markets to protect against further sell offs. The change will rebalance the portfolios towards their benchmark allocation.

For higher risk portfolios the position in Asia and emerging markets will be maintained and any deterioration in liquidity monitored.

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