



# CLARION plc

## Market and Portfolio Review

### Summary

- Political uncertainty
- Investor Panic
- Record Low Yields

### Review and Outlook

Following last minute solutions to stalemates in Europe over Greece, and in the US where congress was held to ransom by the Tea Party over increasing the debt ceiling, investors' belief in policymakers' ability to resolve the on-going crisis has been shattered and stock markets worldwide fell sharply during this quarter.

Over the summer, Greece needed to implement new austerity measures to meet conditions so that it would receive the next phase of bailout money from other European members and the IMF. Two parliamentary votes were needed in order to pass the measures, which were only passed at the last minute, taking the country only moments away from a default on its government issued debt.

In the US there is a hard limit on the amount of debt that the Government can issue. Although this limit has been raised on numerous occasions in the past, the Tea Party opposed a lift in the limit unless cuts were made to Obama's plans, such as healthcare. Again, the problems were only solved when a default on the existing debt was in danger of shutting down congress, which would lead to the US being unable to pay civil servants or interest to the owners of US debt.

Although in both cases it was unlikely that a solution would not be found in time, in order to maximise the leverage on both sides of the argument, pressure of default was always going to be used.

However, this strategy has been costly as investors have begun to fret that leadership is lacking.

In markets it is important to step back from the short-term noise and remain focussed on the longer term cycle.

In 2008 following falls in the property market, investors were in shock at the state of financial institutions that had taken on too much debt, which had been insufficiently securitised, leading to the financial crisis.

At the time, papers described the end of capitalism, a new bartering system and a great depression on the scale of the 1930s, without considering the action of policymakers.

In the 1930s interest rates were held high to maintain the Gold Standard which, as we have seen during this crisis, soars at times of panic. In addition, Government spending was slashed in order to balance any deficit. Both these actions slow the economy through tightening fiscal and monetary policy, which pushed the economy into a deeper recession. Also, acts were passed to protect domestic industries such as the Smoot-Hawley tariff in America and Britain added import duties on non-British Empire products, leading to a catastrophic fall in global trade.

In 2008 / 2009 governments were quick to take up the slack of a failing private sector and central banks aggressively cut interest rates and then followed up with Quantitative Easing. The main economies experienced a relatively sharp recession as companies slashed inventories. However, many commentators were surprised by a quick turnaround, as having depleted inventory businesses had to increase production.

Investors were buoyed by the co-ordination of governments and central banks that were willing to work together to solve the crisis.

Asked at the time, how do you think the recovery will look? Most people would have agreed that a long, fragile, shallow recovery is most likely as the global economy rebalances away from debt in the developed markets to rely more heavily on demand from emerging markets.

Asked, what are the biggest risks to a recovery? Many people would have agreed that policy mistake would top the agenda.

These answers have been realistic, with economic data swinging by the quarter and sentiment changing with the wind. However, most data continues to support a gradual recovery despite more recent weaker than expected numbers.

It is our opinion that investors and politicians became complacent following two years from the bottom of the recession. Global and domestic co-ordination has slipped and infighting about how to repair government budget deficits has resumed.

Once the fighting increased the risk that a major government may default or that policy mistake may threaten the recovery, investors have retreated to perceived safe havens.

The main problem facing world markets continues to be European debt markets. Under normal market conditions Greece would have been forced to print its own currency to pay back its debts, which would be a default. The currency would depreciate quickly and the country would experience hyperinflation. However, without the debt it would provide the conditions that would allow it to recover in time.

As Greece is a member of the Euro it cannot print its own currency, which means that it is reliant on other members to bail them out in times of crisis. In order to provide a bailout, other members want Greece to slash its government spending, to reduce future bailouts.

There is no planned process to leave the Euro, the main issue is that other European / Global banks hold Greek debt, which pre-crisis was seen to be as safe as German, UK or US government issued debt and therefore considered virtually risk free. If Greece defaults then the banks that hold Greek debt may become insolvent, leading to another banking crisis.

It does look more likely that Greece will have to default, it is not expected that they will be able to continue to meet austerity measures. The difficult issue is that would a default by Greece lead to contagion where the other P.I.I.G.S (Portugal, Ireland, Italy and Spain) suffer from a loss of confidence and face a similar situation.

The European Financial Stability Facility is €750Bn which would be enough to support all the P.I.I.G.S with the exception of Italy, which alone has public sector debt that is higher than the other nations put together.

It is accepted that the European members may need to increase the EFSF to €2Tn in order to ensure that contagion is not spread beyond Greece. In addition, they would need to differentiate Greece from the other nations as insolvent rather than just illiquid.

Despite the high level of debt that Governments have gathered, investors in Government debt outside of the P.I.I.G.S have not been deterred, with yields falling to record lows in the UK and US. Despite the rating agencies cutting the AAA rating (the highest rating possible) given to the US Government, investors have continued to demand the asset class.

The debt markets appear to be pricing in an Armageddon scenario!

This view is not shared by the investment team. We continue to believe that the global recovery is intact; the recent falls have been a result of market confidence loss rather than a change in the fundamental economics. However it is likely that markets will remain volatile until a permanent solution is found. Investors must be prepared to hold assets and resist the temptation of turning a paper loss into a real loss.

Equities look good value on a longer term basis, with valuations in line with 2008/2009. In addition, the yield on the equities has risen above the yield on debt, which historically has indicated a good buying opportunity.

Large companies have record cash balances and are in good shape to survive a recession or capitalise on growth. In addition, companies are able to protect against long term inflation as prices adjust.

Although the current strategy has detracted from performance during recent market falls, we believe that the portfolios are well positioned to benefit from a return in confidence.

**Matthew Jealous CFA**  
Fund Manager

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