



## Newsflash

A new month and the 44<sup>th</sup> issue of Viewpoint from FP.

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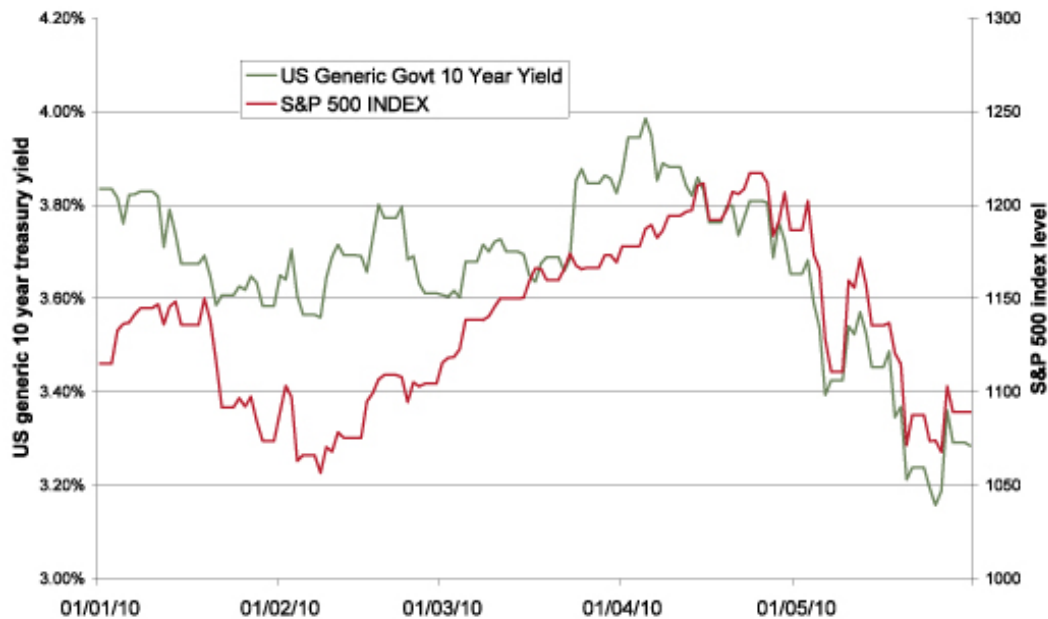
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Political events in Europe dominated news in financial markets over the past couple of weeks. At the start of May the United Kingdom had a general election and for the first time since the end of the Second World War the country is being run by a coalition government. After some deliberation Gordon Brown stepped down as prime minister and gave the leader of the Conservative Party, David Cameron, the opportunity to form a new government after the latter failed to win an outright majority. Together with the Liberal Democrats they formed a proper coalition in a move that has been welcomed by markets. Seeing that nearly 60% of the voters supported these two parties (36% Conservatives and 23% Liberal Democrats) the new government has a clear mandate to implement the changes on which the two parties agreed at the outset. It also seems as if both parties are willing to reach a sensible compromise on matters where their party policies differ in timing more than philosophy, and markets reacted well to the higher level of certainty with respect to the British parliamentary leadership. This may indeed herald a watershed moment for British politics as Cameron has undertaken to take power away from politicians and give it to the people of the UK.

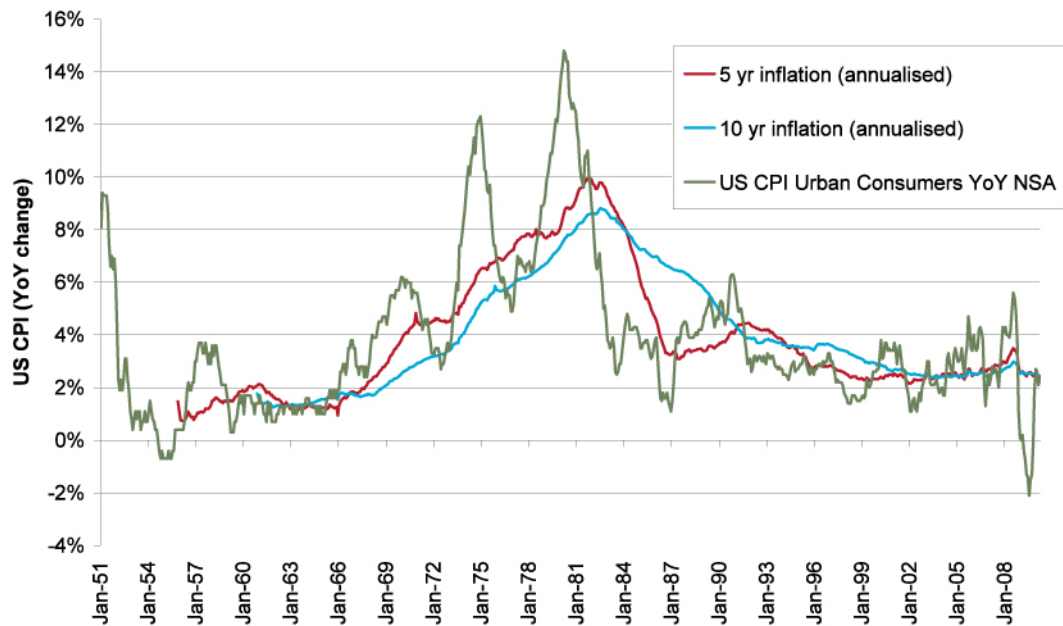
In continental Europe the European Central Bank (ECB) and European Union came to the rescue of Greece when it undertook to provide a near trillion euro rescue package in an attempt to prevent the Greek (and other) governments from defaulting on their debt, and ultimately trying to keep



their financial system from collapsing. The proposals include, amongst others, a EUR750 billion European Financial Stabilisation mechanism and government bond purchases by the ECB. In contrast to the new government in the United Kingdom markets did not react kindly to this plan as it seems more and more likely that Greece will have to eventually restructure some of their near term debt. It is likely that the actual impact could be contained as the biggest losers in such a restructure would be the European banks who hold the majority of Greek debt. The expectation of a debt restructuring could potentially weigh heavily on global market sentiment and would have a subsequent knock-on effect on risk asset prices. A restructuring is in many ways similar to default, with the exception that it happens in a more orderly way and losses are possibly not as pronounced.

During May equity markets gave back all of the gains (and then some) from the start of this year. Across the globe markets fell by around 5% to 10% in local currency terms, with the general weakness in pan European currencies further crippling global returns measured in US Dollars. The chart alongside clearly illustrates the inverse relationship between Treasuries and equities (in the US, from the start of the year) when the decline in equity markets was mirrored by a reduction in government bond yields as investors fled to the safe haven

known as the US government. How long Uncle Sam will retain this title of borrower of last resort will be anyone's guess, as Obama's administration still needs to make a start with respect to cutting their fiscal deficit and addressing the high levels of government debt that the Americans have amassed in the last two years. It seemed as if during May equity and bond markets were in agreement that it was a time to look for safety rather than to add risk within investment portfolios. Whereas many assets at the start of the year seemed to be fairly priced, or even somewhat expensive, the recent pullback has perhaps created a buying opportunity for the brave. With sovereign risk being identified across more and more regions it is hard to argue holding anything but the best quality governments' bonds in portfolios, but this is countered from a valuation point of view as German bunds and US Treasuries already seem to be priced on the expensive side. The one scenario where the current yield (circa 3.2%) on the benchmark 10 year Treasury may look attractive is if the world moved into a state of prolonged deflation. Under most other (more likely) scenarios it does not seem like the best investment to lend money to the US Government for 10 years at a rate which is barely higher than the long term average inflation rate in the States. The chart alongside shows the US Consumer Price Index dating as far back as 1950, with the 5 and 10-year moving averages staying above 2% since the 60's.



An argument that may support the case for deflation over the longer term is that US growth (and inflation) has been fuelled by the extension of credit and increasing real wages over the last half a century, and that the age of austerity may severely impact the availability of debt, employment and wage levels and subsequently consumer demand.

Apart from government bonds (and even then only in local currency terms) and gold (+2.4%) most major asset classes produced negative returns in May. Investment grade corporate bonds posted slight losses for the month in both the United States (-0.6%) and in Europe (-0.5%), but high yield and convertible bonds were not spared as their higher correlation with equity markets sent them south as well. Most currencies struggled against the US Dollar during the month, and in fact



G-10 currencies against the US Dollar - 2010 year to date (Source: Bloomberg). June 2010

it is only the Japanese yen (amongst the major currencies) that has gained against the greenback so far this year, as clearly illustrated by the chart below. It is this volatility, more than asset class performance, that has greatly detracted from multi-currency, multi asset class fund performance in 2010.

## Asset Class Performances

Asset Class/Region	Index	Currency	May 2010	YTD 2010
<b>Equities</b>				
United States	S&P 500 NR	USD	-8.1	-1.7
United Kingdom	FTSE All Share TR	GBP	-6.2	-1.6
Continental Europe	MSCI Europe ex UK NR	EUR	-5.5	-3.9
Japan	Topix TR	JPY	-10.8	-2.1
Australia	S&P/ASX 300 TR	AUD	-7.5	-7.6
Global	MSCI World NR	USD	-9.6	-6.6
Global Emerging Markets	MSCI World Emerging Markets TR	USD	-8.8	-5.5
<b>Bonds</b>				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.8	4.0
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.0	2.9
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	-0.6	3.6
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	-3.6	3.2
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	2.4	4.3
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	0.0	4.8
Euro Government Bonds	Citigroup EMU GBI TR	EUR	1.5	3.1
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.5	3.3
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	-4.5	5.7
Australian Government	JP Morgan Japan Government Bond Index TR	AUD	0.3	1.0
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	2.1	3.4
Global Government Bonds	JP Morgan Global GBI	USD	-0.7	-1.7
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	-1.4	-2.3
Global Convertible Bonds	UBS Global Convertible Bond	USD	-6.6	-3.8
Global Emerging Market Bonds	JP Morgan Global EMBI+	USD	-1.2	3.0

Asset Class/Region	Index	Currency	May 2010	YTD 2010
<b>Property</b>				
US Property securities	MSCI US REIT TR	USD	-5.5	11.0
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	-6.8	-9.2
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	-5.5	-4.8
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	-10.0	-8.1
Australian Property securities	FTSE EPRA/NAREIT Australia TR	AUD	-13.4	-8.0
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	-8.8	-4.0
<b>Currencies</b>				
Euro		USD	-7.7	-14.5
Sterling		USD	-5.1	-10.0
Yen		USD	3.3	2.3
Australian Dollar		USD	-9.9	-6.7
Rand		USD	-4.3	-4.2
<b>Commodities</b>				
Commodities	RICI TR	USD	-10.3	-9.9
Agricultural Commodities	RICI Agriculture TR	USD	-6.0	-12.5
Oil	ICE Crude Oil CR	USD	-14.3	-3.9
Gold	Gold index	USD	2.4	7.3
<b>Interest rates</b>				
	Last meeting		Current rate	Change at meeting
United States	28 April 2010	USD	0.25%	No change
United Kingdom	10 May 2010	GBP	0.50%	No change
Eurozone	6 May 2010	EUR	1.00%	No change
Japan	30 April 2010	JPY	0.10%	No change
Australia	1 June 2010	AUD	4.50%	No change
South Africa	13 May 2010	ZAR	6.50%	No change

Source: Lipper Hindsight, June 2010

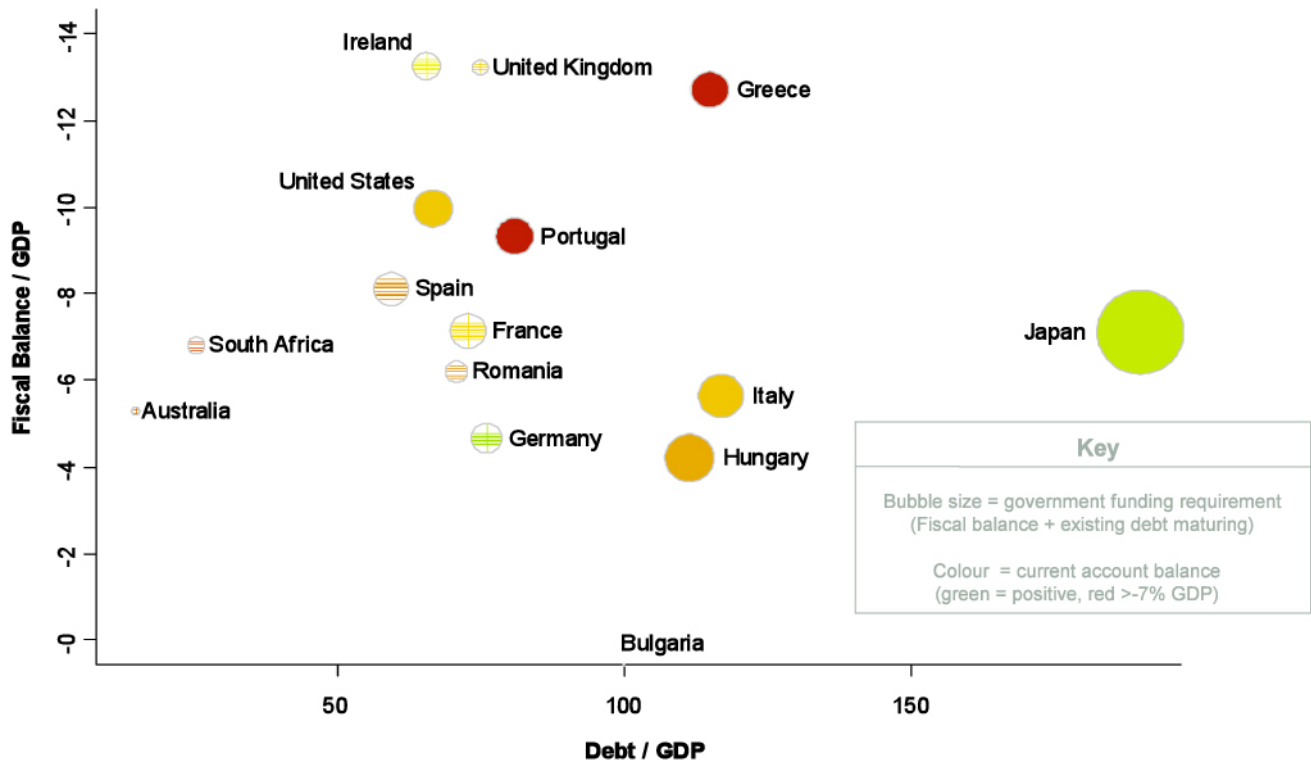
## FOCUS – An update on Europe

With European sovereign risk dominating financial headlines since the end of 2009 we thought it appropriate to focus on Europe and the effect that sovereign fiscal policies may have on the region and its trading partners. In the FOCUS section of November 2009's Viewpoint we highlighted the risks contained in Greece and similar governments within the European Union. It now seems largely inevitable that the Greeks will have to restructure their debt, and this is largely priced into Greek government bond prices at the moment. This edition of FOCUS concentrates on the economic and fiscal situation that politicians in Europe will have to face in months and years to come.

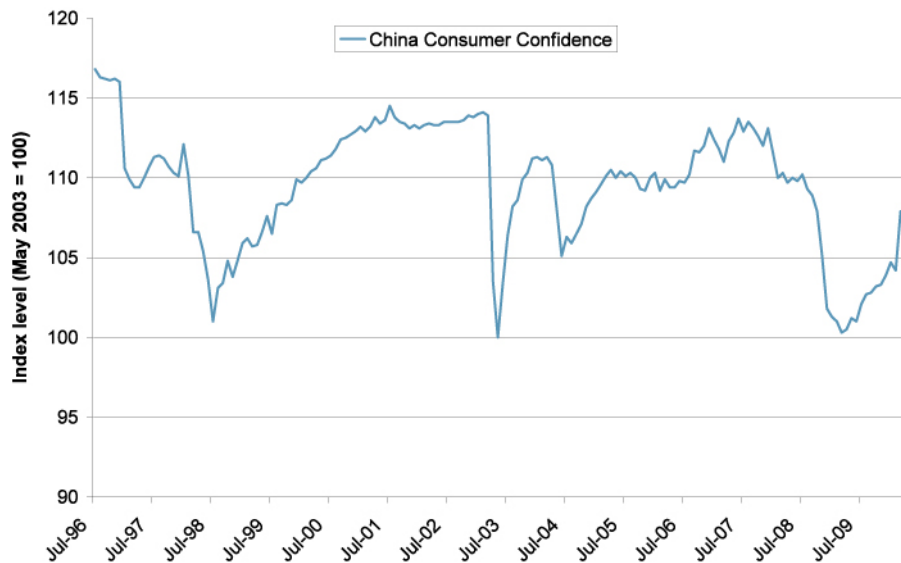
In order to appreciate the extent of Europe's sovereign risk issues it is perhaps best to compare and contrast a number of European Union members' fiscal positions to other countries around the world. The chart below show sovereign risk on four metrics:

- Fiscal deficit as a % of GDP (vertical axis) – the ability to service debt from current accounts
- Total debt as a % of GDP (horizontal axis) – the total quantum of debt that needs to be repaid
- Government funding requirement (bubble size) – indication of the total fiscal deficit and maturing debt that needs to be repaid
- Current account balance (colour of bubble) – indication of whether the country is a net borrower or lender of foreign currency

**Bubble map of Sovereign risks**







Based on the four criteria above Europe (with the exception of Greece and perhaps Portugal) is in no worse a fiscal position than many of the major governments around the world. What is missing in each individual European country's arsenal of monetary policy instruments is the ability to try and influence their currencies' exchange rate to appreciate / depreciate on the back of central bank interest rate changes. With the assumption that one monetary policy will prevail for all members of the European Monetary Union, it stands to reason that a very similar fiscal policy will have to be implemented as well. This was of course the intention of the Maastricht treaty, but in the good times when economies were booming and it was cheap to finance fiscal deficits in bond markets this requirement was conveniently brushed aside. It is now that the chickens have come home to roost that not only the peripheral European states but also the main members such as Germany and France will have to bear the brunt of the rescue packages required to stabilise the system.

Economists forecast that European budget deficits would become steadily less expansionary through the course of this year, but would only start to contract in 2011. By then the euro could have weakened significantly enough to support European exporters and the broader European economy. From the Sovereign Risk bubble map above it is clear that Europe's fiscal deficits as a percentage of GDP are at

much lower levels than in the United States and the United Kingdom, so the need for draconian cuts outside of Portugal and Spain is not evident. There should also not be funding requirements for eurozone bonds, as the debt maturity profile is not onerous when viewed against current debt levels.

The health of the European banking system is coming more and more under the spotlight with the news in the latest ECB Financial Stability Review that banks in the eurozone could be forced to write off nearly 200 billion euros in the next two years on top of the almost 240 billion euros already accounted for. This has caused a severe spike in European interbank rates, with some regulators suspending the mark to market accounting requirements on government debt holdings. European banks would also be the main recipients of any haircuts applied during a Greece debt restructuring which could spell further woes for the banking sector. In the United States most major banks have already cleared up their uncertainties following the recent credit crisis, but in Europe authorities have only recently acknowledged that there is a problem. In order to steer these financial institutions through the current troubled waters the political will of European authorities to grow the ECBs balance sheet will be tested.

Another factor that will weigh heavily on an economic recovery in Europe (in essence lead by a strong recovery in

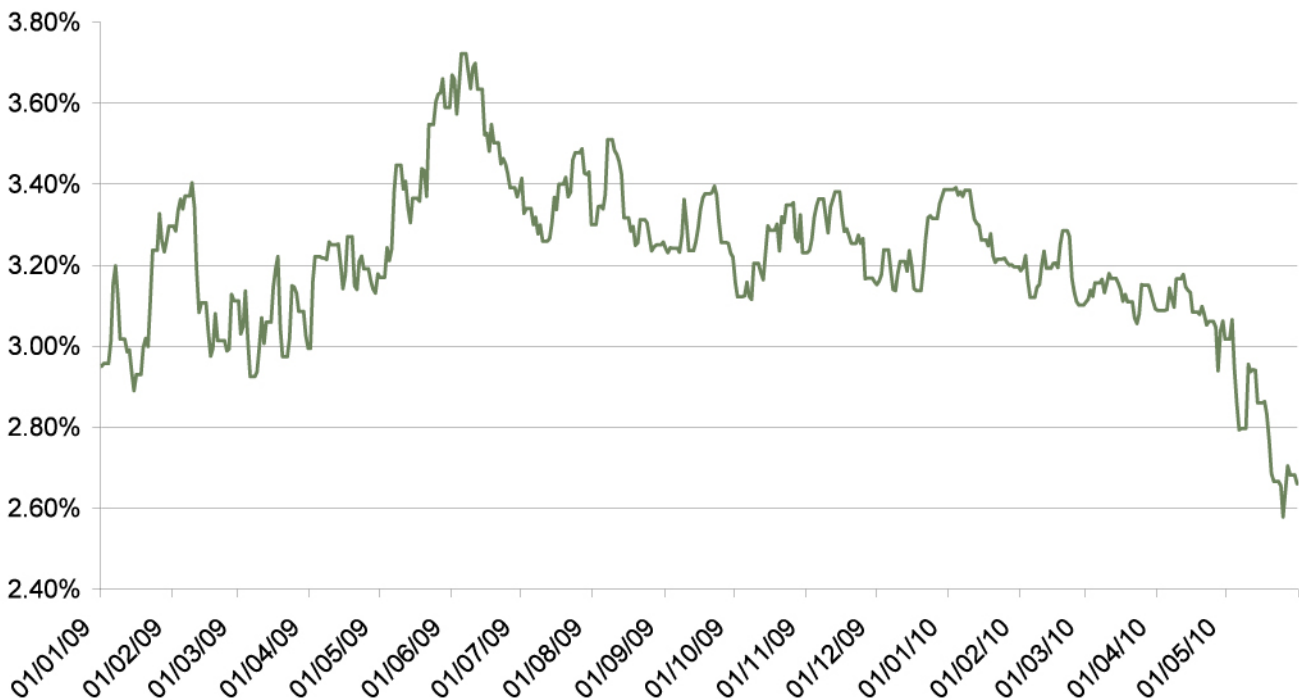
Germany) is, not surprisingly, the rate at which the Chinese economy grows. In April 2010's FOCUS we highlighted the risks associated with a slowdown in the Chinese economy, and with 5.4% of China's imports coming from Germany Chancellor Merkel and company are certainly exposed to Chinese economic policy. German exports to China have steadily increased over the last ten years, and are up 60% from a year ago. The cyclical slowdown in China may be more damaging to the performance of risk assets than the success or failure of Europe's own housekeeping. Current matters on the fiscal agenda in Europe can be addressed through political will, but issues in China may be left to the speed at which consumer confidence in China can be restored. The chart above shows how consumer confidence has recently turned, following the implementation of stricter lending conditions which negatively impacted the property market.

In summary there are three main requirements for a sustained economic recovery in Europe:

- The continued strong growth of the Chinese economy and specifically property sector
- The successful implementation of fiscal austerity packages in the peripheral eurozone members: Portugal, Ireland, Greece and Spain, and
- Not only the acknowledgement that the European banking system is in a spot of bother, but also the action that is required to restore confidence in the financial industry.

On the assumption that at least two of the three issues are under European control the danger exists that investors who are short European risk assets may be caught with their pants down on the return of any type of risk appetite to European markets. German bunds certainly seem very expensive at the moment (see chart below), and on the reversal of the current consensus risk aversion trade a short squeeze could leave investors who are too defensively positioned in the lurch. The one sector of the European equity markets that investors could however comfortably remain underweight in is the European banks.

Bundesrepublik Deutschland 10yr yield





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