

29 April 2010

Financial market sentiment has turned quickly with an escalation in the Greek public debt crisis. We outline our current thoughts below:

- Corporate profits are recovering strongly, but market risks remain as highlighted by the Greek crisis contagion.
- The Greek debt crisis has reached a critical point. We expect an imminent EU/IMF bail-out will bring relief to markets on a short-term basis, but suspect the challenges Greece faces will be a multi-year problem. A failure of EU authorities to provide funding within the coming few weeks would make us much more concerned, however.
- We believe our Multi Asset Funds are well diversified in accordance with market uncertainty. We scaled back equity risk in early April using put options.
- We hold no direct exposure to Greek, Portuguese or Spanish government bonds.
- With the exception of our euro-denominated funds we have reduced currency risk across the funds.
- As our perception of market risk and reward changes, we will change strategy accordingly.



## Escalation in Greece

The crisis in Greece has escalated significantly in recent days. In spite of the EU/IMF announcement of a €45bn aid package on 11 April, the yield on Greek two-year government paper has jumped from 6% to 16% at the time of writing. Confidence in the long-term solvency of the Greek government has collapsed and investors have begun to price-in a potential debt restructuring or default. Having announced a bail-out, hesitancy on the part of EU policymakers to make funds available has brought the situation to a critical juncture. The decision of Standard & Poors to downgrade Greek debt to 'junk' status (BB+), Spanish debt to AA (from AA+) and Portuguese debt to A- (from A+) was the final nail in the coffin.

As ever, from a global financial markets perspective, the big risk remains contagion. Greece is a relatively small economy, but should its government default then concerns over Portugal, Spain and potentially Italy would only intensify, not to mention the likelihood of a renewed banking crisis in Europe. Such an outcome could be a catastrophe for financial markets – the Greek government owes €273bn, Spain and Italy €560bn and €1,761bn respectively (source: EU).

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Since Greece has effectively become shut-off from capital markets, **an IMF/EU bail-out package must be made available imminently**. This, we believe, is very much the most likely outcome. At a minimum, any package must cover Greece's financing needs for the rest of 2010 and hopefully longer (perhaps up to 2012). This should then be sufficient to remove any default risk over the coming months.

**We expect a sufficiently large Greek bail-out package will calm market fears on a short-term basis.** Once the immediate refinancing risk is alleviated, attention will then turn to the ability of the Greek government to reduce the deficit. Such is the level of debt and extent of the deficit, the task facing the Greek government is immense and fraught with risk. Even with an immediate bail-out announcement, we would not be surprised if Greek solvency concerns resurface periodically over the next few years. However, with the announcement of a bail-out we believe the worst of the fears for 2010 will pass. Clearly, developments must be monitored extremely closely and should the crisis deepen further without a policy response we will of course review our investment strategy.

## **Good news**

While the situation in Europe is troubling, there has been no shortage of good news in recent weeks.

Most encouraging has been the strength of corporate profit announcements. So far, around 80% of US companies have beaten analyst expectations for the first quarter – the best performance in 17 years of data<sup>1</sup>. Strong performance is coming not just from margins (which remain robust) but also from sales growth. The trend is similar globally with strong corporate announcements coming from Japan, Asia ex-Japan and Europe also.

Economic data has also been very robust and continues to point towards a strong global recovery. Barring a serious shock, we believe the US recovery is sustainable, as we have argued for some time ([recent US hot topic](#)). Recent US data on business confidence, manufacturing production, retail sales and the housing market have been encouraging. Meanwhile Asian growth remains very strong, and even in Germany business confidence indicators have picked up materially.

## **Ashburton Investment Strategy**

The global economy is recovering far more strongly than almost anyone anticipated 12 months ago. Fundamental news flow from the corporate sector remains very supportive of equities and corporate bonds. Balance sheets are improving and profits are rebounding strongly. Given this backdrop, on our view global equity valuations are reasonably attractive.

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<sup>1</sup> Source: ISI, BBH

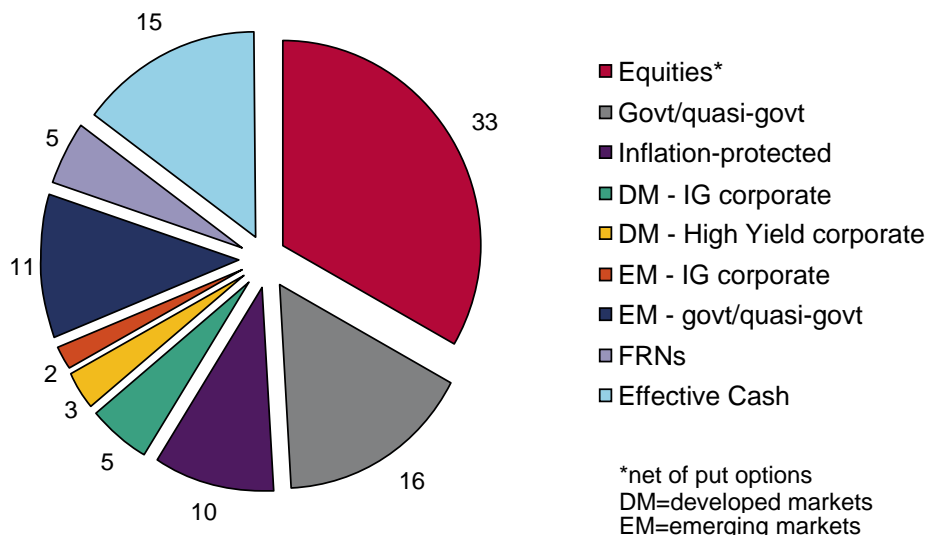
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However, as the ongoing Greek crisis highlights, there are risks to this positive view. In addition to Europe's troubles, overzealous financial regulation, Chinese policy tightening and a change in US interest rate expectations are all potential concerns. Following a strong run in equity markets from the February lows and sensing some risk of complacency in markets, we purchased put options on a variety of equity indices as protection against a possible correction. Our underlying equity exposure in the Asset Management Funds is currently 40% of NAV, although at current levels the put options reduce effective exposure to equities to 33%.

Regionally we maintain an overweight position in Japanese equities, where corporate profits are recovering rapidly, and an underweight position in Europe. The US, however, accounts for the largest share of our equity exposure (c.40% of equity exposure).

We have increased diversification within our bond holdings also. In early April we added exposure to long-dated US treasuries and TIPS (Treasury Inflation Protected Securities) on a view that the rise in real yields made these bonds attractive relative to current cash rates. We also hold exposure to a variety of corporate bonds (mainly in developed markets) and emerging market sovereign debt.

**Replica Asset Management  
Asset Allocation (28/04/10)**



Currency risk has been reduced across our sterling and dollar denominated funds, having profited from strength in Asian currencies during the first quarter (the Korean won and Indian rupee in particular). We maintain a large position outside base (c.30%) for our euro-denominated funds, spread across a variety of currencies, based on a view that the euro is likely to weaken against a basket of currencies on a structural basis.

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## **Conclusion**

As ever, our goal is to generate attractive risk-adjusted returns across our Multi Asset Funds. We believe many of the developments in the global economy are very encouraging at present, but are cognizant of some significant risks. This is reflected in our current asset allocation. A flexible approach is paramount in the current environment: to paraphrase Keynes, as the facts change we will change our mind.

**Tristan Hanson**

**Manager asset allocation and strategy**

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