

Thesis Market Commentary

May 2011

“Whatever it may be, I fear the Greeks, even when bearing gifts” Virgil

Whilst the killing of Osama Bin Laden has dominated headlines, this has somewhat diverted attention from the rapidly escalating debt crisis in Greece and the knock on effect to the markets.

Debt crisis in Greece

Last weekend in Luxembourg an executive committee of key Euro oligarchs met to consider the fate of Greece after rumours that Athens was considering withdrawing from the Eurozone and reverting to its own currency. Despite joyous cries of auf wiedersehen and vigorous slapping of lederhosen flanked thighs, the European finance ministers are well aware that Greece's exit could cause far more problems than a further handout from the EU piggybank.

It is just one year since the €110 billion rescue plan and clearly the Greek government has shown little appetite for meeting the requirements, performing a rapid U-turn in the face of a violent civil uprising (arguably comprising a significant proportion of public employees whose jobs and pay packets have been nurtured and fattened by the governments reckless spending spree).

Notwithstanding the knock on implications for Ireland and Portugal of any further EU/IMF bailout, here are a few key figures to consider:

Government bonds

Although official sources deny any intention to default, it seems likely that any further rescue plan would involve some form of restructuring - probably exchanging short dated bonds for much longer dated alternatives. Creative financial architecture some would call it but in reality a technical default and what the ratings agencies call an SD or Selective Default. I wrote last year how this was almost inevitable at some stage in the weaker sovereign states, using the precedent of the US 'Brady bonds' which successfully bailed out certain Latin American and Asian countries in the 1980's.

However, combined with the further loans and probable extension of the repayments timetable on existing obligations, it would enable the government to spread the pain of fiscal tightening over a much longer period - if all 17 euro zone states agree! With ten

year Treasury yield at around 16% (S&P has downgraded Greek debt to a single B) and the more significant 3 year yield at nearly 25%, markets are already discounting some form of restructuring.

Currency

If Greece does pull out of the EU then, according to German Finance Ministry estimates, the new currency could lose up to 50% of its value, pushing their national deficit up to 200% of GDP and guaranteeing a drastic restructuring of all debt. The government would be forced to impose controls to stem a panic exit of capital out of the country, whilst the raising of new capital in global money markets would be virtually impossible for the first few years. Inflation (and consequently interest rates) would rise dramatically, forcing interest rates up which would stifle industrial activity and personal spending and forcing property prices down.

Banks

The change of currency would have a devastating effect on an already fragile Greek banking sector, effectively making it insolvent.

Knock on effects?

There are significant loans by other European, British and international banks which would involve massive write downs. In addition to the EU/IMF loans the European Central Bank (ECB) owns large amounts of Greek state bonds. Germany, with a 27% stake in ECB capital, would take the largest hit.

Greece, of course, isn't the only member of the walking wounded club. The potential for other distressed states to follow the same path (particularly Portugal and Ireland) would severely impact confidence by international investors.

Not all bad news, however, as safe haven seekers for bonds have been attracted to sterling, benefitting prices of gilts, which had already been recovering on the implications for interest rates following flat economic data.

Equity markets

Corporate Europe (outside of the weaker states) is in a relatively robust shape, particularly global brands. Earnings figures have been exceeding expectations, whilst heightened merger and acquisition activity has underpinned prices. We are therefore happy, for now, to maintain a modest stake in clients' portfolios, but primarily via investments where the currency risk has been hedged out.

USA

Following the surprise move by ratings agency, S&P, to place the previously bullet-proof AAA rating of US sovereign debt on 'negative watch' (not very patriotic lads!), there then followed a dramatic last minute vote to pass through President Obama's budget, without which the government would effectively have been suspended. Markets treated all this with relative indifference with both Treasuries and the dollar recovering after the briefest of minor setbacks.

The US Treasury has steered Congress to increasing the debt ceiling by a staggering \$2 trillion from now to the end of next year - although John Boehner, the Republican Speaker in the House of Representatives, has called for this to be matched by equal or greater savings. There are a lot of unhappy bunnies in Washington but this will continue to simmer until well after the next Election. In the meantime the Fed is happy for the dollar to languish and interest rates seem set to remain close to zero for some time to come.



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Market News

Banks and Financials

Uh oh, banks in trouble - again...

Rule 1 for bank analysts - never underestimate the ability of banks to lose money by taking advantage of their customers for short term gain. **Bradford & Bingley** (remember them?) lost a whole year's profits to recompensing customers over endowment mis-selling and **Norwich & Peterborough** now look like they are about to go the same way over the **Keydata** claims.

Lloyds Bank figures shocked the market with a £3.2 billion charge for mis-selling Payment Protection Insurance (PPI). Rather than going to appeal following the High Court's decision to uphold customers' rights, Lloyds' early capitulation suggests a whopping £8-10 billion penalty for the sector. For Lloyds' new CEO there is definitely an element of 'kitchen sinking' (provision making), which other banks will not be so keen to follow!

Lloyds also made further write-offs of Irish property debt, but there may yet be more to come. Margins remain under pressure as the bank reduces its dependence on emergency (and cheap) funding, and a higher number of branch disposals and job cuts are on the cards. Scottish Widows could also be up for sale with a £7 billion price tag.

Barclays posted weaker profits as the revenue at Barclays Capital, its investment bank, fell

15% from the period a year earlier, owing to a decline in the unit's fixed income, currency and commodities businesses. Overall net profit fell 5% to £1 billion. Elsewhere **HSBC** is to close down its retail operations in Russia.

The Financial Services Authority has launched an investigation into **Prudential's** failed bid for Asian life insurer **AIA**. The report by **Clifford Chance** will focus on whether Prudential's investment bank advisers **Credit Suisse**, **JPMorgan** and **HSBC** performed their duties properly.

Aviva has raised £381 million through the disposal of 15% of its stake in Dutch provider **Delta Lloyd**, reducing its shareholding from 58% to 43%, citing better use of these monies.

Media

Vivendi, the French media conglomerate, has taken full control of **SFR**, a large mobile phone operator, buying **Vodafone's** 44% stake in the company for \$11.3 billion in cash. The deal gives Vivendi full control of SFR - one of the biggest cellphone carriers in France.

News that Bart Becht, chief executive of **Reckitt Benckiser**, is to step down from the Anglo-Dutch consumer products group wiped almost £2 billion from the value of the group's shares on the day of the announcement.

The media sector saw a couple of takeovers with **Pearson** paying \$230 million for **Schoolnet**, a digital education business based in New York

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Comparative Index performance ▼

Indices	Value as at 30/04/11	% Change on Month	% Change 2011 year to date	% Change on 12 Months
FTSE 100 Share	6069.90	2.73%	2.88%	9.30%
FTSE All Share	3155.03	2.85%	3.01%	10.19%
Dow Jones	12810.50	3.98%	10.65%	16.37%
Euro Stoxx 50 EUR	3011.25	3.45%	7.82%	6.90%
Nikkei 225	9849.74	0.97%	-3.71%	-10.92%
FTSE A British Government All Stocks	156.00	1.87%	-0.24%	1.95%
Sterling/US\$	1.6707	4.24%	7.01%	9.38%
Sterling/Euro	1.1284	-0.33%	-3.26%	-1.77%

→ Economic news drives markets...

Primarily 93% of the 28 corrections (ie. bear markets) in the S&P 500 in the last 77 years were caused by some combination of the following three factors:

Economic recession: 50% of the corrections were triggered by an economic recession. There has only been one recession in the last 77 years which has not caused a correction in the equity market (ie. in 1945).

Shocks: a further 25% are primarily due to shocks (eg. onset of WWII, Korean War and removal of price controls in 1946).

Rising cost of capital: a rising cost of capital has been a key contributory factor to almost two thirds of the 28 corrections since 1928.

A significant rise in the cost of capital has a 93% chance of triggering a correction.

Persisting uncertainties about the pace and durability of the recovery in global economic activity have exerted downward pressure on a number of cyclical sectors in recent weeks. Reflecting the impact of a broadly based softening in commodity prices, with the copper price falling by around 10% from its recent highs, the mining sector has lost momentum and is currently trading around 10% below its 12-month high. The general retail sector, in contrast, has rallied strongly in recent weeks and is currently trading 15-20% above its recent lows.

Having grown by an average of 0.75% a quarter in 2010, US real GDP grew by around 0.5% in the first quarter of 2011. This lowered

the annual growth rate to 2.25%, down from an average of close to 3% in 2010, and has contributed to a downward revision to 2011 full-year growth forecasts.

In the UK, latest survey data points to a moderation in the pace of recovery in the manufacturing sector in the current quarter. The underlying picture, however, remains one of expansion and we should expect growth to be maintained in the coming quarters.



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Market News

and **WPP** making a significant investment in a German advertising agency business. **Reed Elsevier** also issued a statement for its first quarter and has seen good underlying revenue growth in most of its businesses.

Resources

Oligarch, Alexander Mamut, a friend of Roman Abramovich with close links to the Kremlin, is closing in on a cut-price deal to buy **Waterstone's** from the troubled retailer **HMV**.

Turning to resources, **Vedanta** has paid **Petronas** \$1.5 billion for a 10% stake in **Cairn India** as it seeks to step up the pressure on New Delhi to permit it to take over the oil company. **Tullow Oil** is suing its ex-partner **Heritage Oil** for \$313m and at long last **Rio Tinto** has secured control of **Riversdale Mining**.

BP's first quarter figures were not too bad, although they were below analysts' expectations and the share price has underperformed both the market and peers over the last three months. The 'undershoot' is due to poor exploration and production performance and the North Sea tax hit.

Retail

Next has raised its profit forecast for the year after the recent warm weather boosted sales of summer outfits. For the 13 weeks to the end of April, sales were up 5.2% on a year ago. Next added that much of the rise was due to increased spending ahead of the Royal Wedding weekend.

However, **Thorntons** issued a profit warning after the hot weather over Easter led to a sharp drop in its chocolate sales. The retailer said the hot weather in the Easter week contributed to a 22.8% drop in like-for-like sales compared with the same week last year. The critical Easter trading period accounts for about a third of all store sales in the first four months of the year.

Other

Whitbread's competitive position saw it deliver 11.5% growth in sales and a 20.1% increase in underlying profits - thanks to Premier Inns and Costa Coffee. Its emphasis is on giving customers value for money, winning market share and keeping a tight control of costs.

Rexam has reported that trading so far this year has been encouraging, and overall performance is comfortably in line with its plans. However, it is still early in the year and the traditionally busy summer season will influence the full year results of the beverage can maker.

3i Infrastructure delivered strong results, with the NAV coming out some 2.5% better than estimates, primarily reflecting an encouraging performance from a recent new investment and improved income returns from its portfolio of infrastructure assets



After revolution cometh devolution?

Finally I hadn't appreciated that Chichester harboured a hotbed of Scottish nationalism, hence my surprise last Friday when - presumably celebrating the success of the SNP in the local elections - we found ourselves being 'serenaded' outside our office by a mysterious (and unfortunately not entirely proficient) lone piper. After revolution cometh devolution - what price Scottish gilts I wonder?

Sources: Longview Economics, Oriel Securities, Citywire, BBC News & Dealbook.com

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