

INTERIM REPORT - PORTFOLIO UPDATE

12th September 2011

It cannot be surprising to anyone who regularly read our Reviews, Interim Reports and Updates that Europe is tangled once again in sovereign debt and bank exposure difficulties. The only surprise is how long the Euro remained strong when the underlying fundamentals were not being addressed. In addition the "bank stress tests" were weaker in capital requirement requirements than the USA or UK and an nuclear downside risk to the quality and overall value of distressed "loans" they hold. The interbank "overnight" rates (The costs to borrow between banks) have increased considerably. In 2008/9 when this happened in the USA after Lehman Bros. failed it indicated that banks knew something that governments weren't prepared to tell.

We should consider that a similar situation is likely... or at least possible... and therefore relevant. Two major differences exist which must be considered. The first is that the difficulty is recognised; only the size of the problem is unknown. The second is that governments and the ECB have sufficient liquidity to cover the downside. Indeed if clarity can be achieved then sufficient private capital would be interested if sure of process and defined programme/s.

Last weekend G7 meeting in France issued a communiqué stating that they would work together to address the problem. However, they failed to articulate any details. European bank credit risk has surged to an all-time high, according to the "Markit iTraxx" Financial Index of credit-default swaps on 25 banks and insurers, and the euro fell last week by the most against the dollar in a year. Investors have doubts about whether Greece will implement austerity moves fast enough to get a sixth payment from last year's 110 billion-euro (\$150 billion) bailout. There is a distinct possibility that Germany will not be able to ratify their approval in/by the



29th September meeting designated to approve their payment which is part of the second "bailout" amount. The previous short term "band aid" solutions have rightly been called into question and the clamor for a cogent programme is increasing. Some evidence that Germany is subtly implementing a national programme to support their own banks, which would allow them to sustain their capital requirements should a Greek default occur; lends credence that the second Greek "bailout" is troubled. Politically it would sit much more comfortably with Germans to use money internally rather than to Greece. If this is a unilateral decision then the situation in the Eurozone will become more fragile. If however the G7, IMF and ECB were part of this agreement whereby they will act in concert with a parallel and full second "bailout" programme with Greece; then we may be facing the beginning of a series of...albeit unpopular... workable solutions to give Greece the needed backing to meet short term needs; support banks to cover "haircut" cost; buttress the ECB rescue fund with sufficient resources to battle "bond vigilantes" with a declaration that a similar format geared to each EU nations specific needs will be created and defended.

What is evident is that the political groundswell against further loans to Greece unless they meet their part of the agreement is hardening. Germany as stated, with France, Holland,

union or allow defaults. Rumours abound as to what could be done. What is certain that whichever policy is finally agreed by Eurozone countries either greater fiscal union will be required or defaults/exits must be allowed? As seventeen countries must agree to any "treaty" change no quick solution will be found there. However if Greece could be funded by some external method outwith of current processes, then the money designated (but not yet paid) by countries such as Germany could be directed at their banks and thereby cover not only a "haircut" but Basle's "tier I" capital requirements for the foreseeable future. In addition an externally controlled, defined programme with money and oversight for Greece would also allow the time...a few years... for Greece to either meet their commitments or leave the union, with less impact.

Note: It is assessed that by 2013 that the mechanism to enable a country to leave or default in a controlled manner would be incorporated. Perhaps the more disturbing aspect of these recurring European malaise is the realisation that the recent fall in the Euro's value has more to do with the ECB's decision to be less hawkish as to interest rates. The ECB is mandated toward price stability and last week's decision saw a 7% fall to date on its declaration. There is something of a disconnect, when a decision to hold rates can have such a difference in value in so short a time. Of course the very large elephant in the room has been there for some time, while the Euro has strengthened. So what can we expect going forward?

There is an old investing saying "buy on the rumour and sell on the news". We have currently rumours "a plenty". China will buy Italian Bonds. French Banks are under capitalised. Greece will sell its islands. Moody's will downgrade various European banks etc. So it goes on. What is fundamentally true is that even although the ECB kept interest rates high, many parts of the zone they serve were seriously in trouble and their common currency was the Euro. Countries, banks and citizens have all been under pressure for some time. I can provide no insight as to why the correction in value was delayed for such a period. Nor can I view the decision to hold rates would reduce exchange rates to such a level. The "can kicking" may have finally stopped. There was a time last year when a simpler solution could have been addressed. I doubt whether Europe now has the time to easily and quickly correct the problems. Indeed time is now the enemy. There was an opportunity to ring fence some of the smaller countries difficulties to stop contagion impacting the large countries. That time is past. A solution will be found but much bloodier than a year ago. Not all EU members are part of the Eurozone.

I cannot think of any solution whereby it would be likely that all current Eurozone members will be there for much longer. Some external programme could be created to isolate Greece, with probably Portugal and even Ireland joining a "new protocol". They will phrase it as still within but at best it will be a two tiered system and some within the second level will probably have to leave, retrench and maybe sometime in the future reapply. It seems to me that European Banks are now being assailed and I believe it is likely that the Eurozone will seek to save their banks rather than wayward peripherals. From current perspectives I cannot see... within known existing options...the possibility of saving both. Certainly not in the short term. In less than sixty days the ECB head is replaced. Perhaps a new mandate will be created, however this would only work if in concert with other major policy/treaty changes and that seems unlikely.

Whichever rumour is found to be true or false if it concerns the Eurozone and is positive then markets globally will rise. Sadly and more and more frequently the news is negative out of Europe and each time the "fear factor" is darker, the impact more severe. Banks and financials still hold a major slice of each countries indices and while debt issues and bad loans/paper and pending law suits proliferate without transparency to assessed costs.

Many banks have announced that they will fight the cases, which allows them to avoid pricing them as they can state that a decision has not been made. It would be better for us if they negotiated a price which would allow us to value the rest. This would allow us to put a floor under the problem. This also is an unlikely wish to be met. Therefore as there is no consensus for much spontaneous fiscal discipline or openness in the financial systems, then something must give. Or, to be more accurate... default!

Whether it is Greece...which won't be allowed to, until and unless the haircut is covered within effected banks... or banks or indeed both eventually; banks will suffer. This will roil markets to the downside. The question is when and to what level. An external entity bailout/isolation programme won't work without a corollary to capitalise troubled banks. Even if external entities can ring-fence Greece it must come with a default. All other possibilities have already passed their sell by date. Even if by some magical "sleight of hand" process it could be presented as secured without an immediate default, before the next assessment date it would be obvious that they couldn't meet their targets. The Germans call it "the moral hazard" effect. IE. We keep chiding them. They apologies and promise to change their ways, this time. We pay the money; they do the same and we are back into a revolving, unchanging downward spiral. The perception of the likelihood of "moral hazard" event by voters in wealthier EU countries makes an internal solution less likely. The rhetoric seems to have now changed whereby the support for Greece etc., is phrased as "we can only have a stable euro if we prevent *disorderly* processes. Therefore it is our top priority to avoid an *uncontrolled* default, because it would hit not only Greece. The danger would be very high that it would hit many other countries". It seems to me that focus has moved to the form of default/process rather than the possibility of avoiding the inevitable. Subsequently, although I expect current corporate and hard data performance/results to indicate a stronger global performance than expected...which would be expected to rally markets... the clouds forming over Europe will likely overshadow overall sentiment going forward. Therefore the following suggestions are geared to that scenario.

SUMMARY.

The Eurozone has been fifty years in its construction. A considerable amount of Political and economical investment has been invested in its creation. Markets and the sophisticated elements within can act much quicker than governments. I reiterate previous statements that place me within the long term "bullish" side for the Euro. The zone's near term situation is somewhat different. Aside from "default" speculation the zone is likely to need an EU stimulation, similar to QE 2 in the USA, to help the overall general economical situation. This will weaken the Euro. Some initiative, geared to address Greek difficulties in the short term will occur. That is obvious. However whether it will be sufficient to calm "banking sector" fears is moot.

Many banks hold Greek and mortgage portfolios at par values. IE. Full value on the former and with an undefined "mark down" on the latter. In addition I view the likelihood that national governments will not wait for Eurozone solution to Greece, but unilaterally rush to support their own banks liquidity. Depending on whether one holds a "half full or half empty" philosophy these actions will effect markets.

As a general point, our current problems are no where as difficult as faced in 2008/9. Today we worry that the Eurozone's difficulties may bring us to a double dip recession. In 2009 the whole financial system was under threat. Lessons were learned as to how and what level of support is needed to support banks. Therefore our viewpoint must be addressed as to how we could and should benefit from the Current situation.

from recent highs and which I believe have good mid term upside possibilities. If markets fall then they and others will fall to even better entry level prices. A prolonged much “better” scenario is unlikely while these current difficulties remain unresolved beyond some short term fix. Banks know what assets they hold...good and bad...because of lack of transparency they don’t know what others hold. This is the reason that “interbank default rates” are so high. Therefore even if some overall package regarding Greece is implemented...which I believe is inevitable... with news that banks liquidity is protected, then markets will rally within the range I have previously outlined. This brings us back to the same. In the past any help to a beleaguered Eurozone member would support markets for six months and more. I believe we are long past a similar occurrence.

The “can” even if further down the road, will be picked up and examined and its likely future route carefully scrutinised. If these examinations occur when markets are at or near the lows of the market’s range then we may have the opportunity to buy selected investments at better discounts. News such as the BRIC countries meeting to discuss how to assist the Eurozone will add to the positive side of the equation, although without a final and overall programme to cover defaults, haircuts and realistic “tier 1” bank reserves such a move will have less impact than it deserves.

The strategy for our Portfolio clients to buy in at lower values still exists. However I do believe that markets will test lower values... probably 5-6% but possibly 10%. I would like your longer position to benefit from those entry values if possible. Bonds although generally thought to be less volatile still have exposure to current circumstances. We are still heavily weighted to cash in portfolios. The situation today is driven by some outstanding fundamentals but generally emotions and lack of good governance. This will change but while we are experiencing the various... as yet unresolved... issues, then the next weeks/month then certain of the companies/value investments I selected and sent a few weeks ago to you will probably reach lower entry points. Recent purchases mostly are paying dividends which will buffer any further fall, although I am very confident that the absolute low...if reached... is around 10% from here. The challenge in these times is to select those investments with sufficient downside cover while ensuring that their current values are more a factor of overall market malaise rather than a specific sector’s future economical performance possibilities.

IE.Those investments able to accelerate faster than a recovering general market with better opportunities to sustain demographic growth over the long term. The news that China...specifically with Italy... and the BRIC countries in general are looking at ways of assisting the Eurozone have helped markets tentatively rally the past few days. However, although any help will be welcomed, the scale of the difficulties will not be solved by some token assistance in buying bonds. They could buy positions in state owned companies, but any benefit would be quickly negated by the political reaction.

French Banks have been down graded by Moody’s and they are expected to be reviewing other European Banks with a critical eye. Subsequently money is mainly chasing US Treasuries and Gold with some Forex placements for the slightly braver. Overall the professional investor/trader has decided that markets will fall and have placed “shorts” to benefit. These “shorts” are time sensitive and as such if markets rise or remain flat, they are required to cover their “short position/s” and need to buy at market prices. This is often the reason one sees markets rise without apparent reasons. This of course adds to volatility and “fear” factors. As news is presented markets react then reverse once logic is applied. In effect markets are way a head of policy makers and it makes it very difficult to judge/time whether a market is moving because of “short” covering or whether a mainline trend has just begun.

Last year we offered our Capital accumulation clients (IE Vision, Viva, Pension Plus etc) a reallocation/diversification programme which moved accrued capital within a more hedged format and new contributions allocation into Euro, financial and other areas we thought would be negatively affected. This allows clients to buy long term growth at short term distressed prices. This has meant that overall investment values have performed better than markets. Portfolio's have different challenges as we have discussed in previous reports and reviews. I take the view that while there are considerable short term volatility worries that within a relatively short period IE. One year; overall sentiment will have changed considerably as current problems are either partially resolved and/or viable programmes have been presented, while transparency regarding debt mainly identified and priced. Within fifteen months governments will have changed and the new incumbents charged to deal with issues. These inevitable scenarios...even without resolution... will have the markets back at least to June 2011 highs; IE the S&P 500 at 1300, a circa 11+% increase.

As previously mentioned within and in earlier reviews/reports the difficulties are well known and have been for many years. Our situation although volatile is at least partially if not completely priced in and funds are available to meet reasonable and more importantly, coherent political decisions from developed countries. Emerging markets have experienced a "collateral hit" in their market values. However generally they hold surpluses, have booming internal growth geared to demographical pressures and not exceptionally exposed to global difficulties. Major international companies have already found new markets and where necessary will buy new growth opportunities. Therefore notwithstanding short term difficulties medium to long term investors logically must be in a "half full" state of mind. With this "half full" philosophy conditioned by some short term induced pragmatism the following reasoned suggestions seem appropriate.

STRATEGY.

The following assumes a number of positive and negative scenarios occurring. A definitive plan regarding Greece is eventually agreed. Whether a "kick down the road" for at least two years or an orderly default. Either will require an assessment of Bank's exposures to risk. NOTE: At the present moment the ECB is actually guaranteeing these bonds. However after 2012/13 these guarantees are withdrawn. Once we arrive there any failure to the loan/debt will be the full and sole responsibility of the bondholder. Any agreement on Greece must have a strategy whereby either a haircut or deferred but stronger bond replaces existing troubled paper. Either way transparency will be achieved.

"Arab Spring" countries will stabilise into more democratic or dictatorial entities. Either way a positive result will add to growing confidence levels; the negative will push up oil prices and adding to each buying and selling countries GDP. (Although it will be a negative for spending overall it does add to underlining ratios). USA and EU with other European countries find the necessary fortitude to address difficult governance issue. If markets are convinced they will rise if not they will fall; offering a lower entry buying level. However, if they don't then next year election primaries will require candidates and parties to articulate policy ideas to address outstanding issues; thereby finding more consensual policies. This means they must promise to act on tax and entitlement reforms. At least initially this will rally markets and sustain for a few years.

Today's conference call between the presidents of Germany, France and Greece will add little new

However no positive solution comes without uncomfortable repercussions. I view that EU Banks will need between 200-300 Billion Euros to prop up their balance sheets. If China or other countries or indeed the IMF and or World Bank etc., buy Greek debt held by banks then...especially the former... will buy at a discount. We will have the "haircut" value, which all other banks must then price. Markets will rise. If the latter buy at full value, then banks that sell, will have cash to improve their tier I capital bases. Their shares will rise.

I should state that although there is a genuine positive moment of the conference call as they positively speak in unison as there will be little new to say, combined to actual policies, that markets will react much quicker than they possibly can. As such I believe markets will quickly disregard this event unless back by significant policy changes. If they don't, markets will initially fall; however greater pressure will be applied to fix the problem and once seemed to be addressed, markets will rally. Finally as to Greece. It probably won't be called a default but something that walks and quacks very much like that will occur sooner or later; they just can't meet their austerity programme requirement.

The final outstanding issue is the USA housing markets. They will either have to accelerate the foreclosure process or find a way to wipe out part of the outstanding mortgage values. Otherwise the backlog, circa 11 million distressed mortgages will further erode overall values. They have a number of initiatives to assist homeowners to remortgage their loan at lower rates. The programmes are targeted to the associated costs of the process. Again whether they do succeed is moot. Never the less the presently stalled process will be restarted and no matter how slowly, prospects for the sector will improve. If they fail then this too will become part of the political process and front and centre of a new government mandate.

While all the above are processed through the system, certain demographic influenced areas are also playing their natural role. Water and natural resources futures are assured. Developing countries internal discretionary spending are increasing as their citizen's purchasing power has been aided by their currency strength and salary-living Standard improvements. Food and basic commodities are influenced by these improvements but further droughts and floods difficulties will hold prices high. Uranium and alternative energy sources no matter how contentious must be part of the solution or demand will surpass supply. Maybe a new breakthrough will occur in the next decade or so, but growing demand will require existing technologies to be applied. The next USA government will be forced to open national resources to exploration. It will have a dual aim; to create needed higher paid jobs and reduce dependency on foreign supplies while lowering trade gaps.

Precious metals rally especially gold, have I believe a time date. I do see them reaching higher levels but not before a further fall; probably around \$1650 USD. Depending on whether we see some early signs of fiscal and governance intelligence, will determine its future. Certainly if an upswing of positive sentiment can be sustained for a reasonable time then a moment will arrive when the risk ratio in equities will overtake any rational upside to gold. Silver however could fare a little better. Whether it then rises again will depend on what policies or future programmes are either implemented or suggested. If poor then it will pop and may even rise to \$2000 USD. However I reiterate my view that governments will be forced to act and sooner than later consensus and risk appetite will begin to change. This will be the moment when future gold rises will reach a ceiling.

Some inevitable secondary events will further tweak positive and downward trends. Notwithstanding the EU's sovereign debt problems, most economical observers believe that a stimulus package of 1 trillion USD equivalent is required to "kick start" the zone. This will further depress the Euro, but help exporting

would be a better place for investing; to the benefit of their markets. When forced to explain markets I always state the viewpoint that it's all about perception and psychology. Societies are hardening to the view that solutions must be found. As they are implemented their psychological attitude will improve. Tax changes and a more conciliatory political environment will help. Companies will see demand possibilities and begin to crank up production. This is the way that cyclical economies function. The question for our Portfolio clients is whether we position for the future now as there are many investments caught by collateral damage or wait a little longer until the current scenarios play out a little, as there could be even more unfair collateral damage to come.

SEPTEMBER 15TH 2011

While in the process of creating some "Model" portfolio suggestions, yesterday's conference call was followed by the joint announcement from the ECB and the FED today that a joint move to support European banks. Markets in Europe rallied. Gold dropped and Treasury yields rose as traders moved out of the safest investments. The European Central Bank, the U.S. Federal Reserve and three other central banks said Thursday they would provide European banks with dollars in three loan instalments. This initiative will help allay worries that European banks would struggle to raise dollars in short-term credit markets which have hung over banks in recent weeks.

Beyond the initial positive reaction it must be understood that...although the main players are finally beginning to speak together... the only real change is that the existing term of seven day loans to banks have been moved to ninety days. Very useful to allay short term concerns but does little to address the underlying difficulties. Never the less as has been discussed above anything which adds to confidence is a plus. How this will affect markets beyond a few days is difficult to immediately assess. Indeed I shall need a few days just to assess its impact. An initial look at the change in cost for banks to insure risk only fell 0.4% after the news. This means that although markets have rallied over the past few days... although on very low ratio... the experts who assess risk still hold the rates at near record highs. Unless this changes we are likely to see very moot sentiment. Therefore I shall review our "Model" portfolio suggestions in light of today's news and send a revised list when completed.

Regards

Alan Lamb