



REZCO MANAGERS REPORT

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Icebergs and Sub-prime countries

Until recently it would have seemed that the investment climate had become more conducive to holding equities, however some of the potential icebergs or risks, which we have mentioned before have come to the surface.

One of the more significant Icebergs at the moment is the whole issue of sovereign debt. The short term solution to the financial crash of 2008 was for governments to step into the gap and supply the liquidity and demand that had evaporated in the private sector. This was done by vastly increased budget deficits, low interest rates and in the case of the USA, UK and more recently within the Eurozone by flooding the system with money printed out of thin air.

None of these measures are sustainable, nor are they intended to be. They are intended to buy time until the underlying economies recover to replace the lost liquidity and demand. Sometimes, as in the case of Greece, time and confidence run out before a solution can be found. The IMF and EU are going to have to put up north of \$100bn to stop Greece defaulting on its' debt. Greece was and is small enough to contain but with ratings agencies downgrading Spain and Portugal, the rot may start to spread. There is a very real risk that this could set off a whole new round of bank losses.

The USA, the world's biggest economy, has a Sovereign debt level and budget deficit, that when measured as a percentage of GDP, are very similar to Portugal. The UK's debt level is similar but its' budget deficit is in fact a couple of percentage points worse than Portugal. The USA and UK avoided major problems last year by resorting to the simple mechanism of printing money out of thin air. The aforementioned is also politely referred to, in the USA's case, as Quantative easing or expanding the Federal Reserve's Balance Sheet. This was done to the tune of \$ 1.5 trillion.



The countries within the Euro cannot individually do this and need to pay their debts with real money, hence the pressure on Greece, Portugal and Spain. However the resolution to the Greek crisis was the European Central Bank buying the debt that had to be repaid. It is highly unlikely that the market will allow the UK and USA the largesse to print money again this year. Expect the UK to be the next to be lined up for some speculative concern.

Austerity is in for some deficits are out

The economies of Europe are leading a newfound zeal for fiscal responsibility. Other countries such as the UK are starting to follow suit. This is a trend which the stock market greatly fears as it will certainly severely crimp economic growth.

In the short term countries trying hard to get their budget deficits down will face large impediments to growth. The countries such as the USA who are madly spending their way out of trouble face long term pain as the markets are eventually going to object violently.

Companies superior Government Debt?

One concern to all investors is that Central Banks may decide that printing money is the great solution to having more. Strangely enough this may be a big positive for equity markets. Intelligent investors including Sovereign Wealth funds and nations with trade surpluses such as the Chinese can certainly see the long term attraction of holding shares in quality companies when compared with holding foreign government's debt. There are already cases abounding where large company debt is trading at lower yields than the countries they represent. A reversal thought impossible a year or two ago.

Investment Stance

What we know is that keeping all your money under the mattress is not going to help the investor sleep well as inflation will erode its' value. Equities should do better than cash over the long term but the risks at the moment tend to be of the iceberg type - large, mostly out of site but devastating if you hit them. Full steam ahead is not the prudent strategy in these waters rather something closer to 50% throttle. Choosing the right equities is therefore as important as ever.

For a fund with a strong capital preservation tradition, we are cautious and will restructure the portfolio when and where necessary to provide the correct balance between risk and reward thereby continuing to produce the best risk-adjusted returns possible.

