

Most commentaries, from tip sheets to economic academia, groan with sound and fury, meaning little. Who does not know by now about giant budget deficits in most G20 countries; that taxes must rise and so squeeze consumption? Or that despite all the weekly statistics, employment, wages and the housing markets are essentially soft? Discussing the recovery from recession is not worth much time either, since government expenditure and the restocking cycle will gradually peter out this year. Pawing over multiple macro-economic data is not a money-making exercise.

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There are only two real dynamics determining the immediate and longer term. These are seemingly opposed. The negative is the accelerating bear market in government bonds and rising interest rate pressures. The positive, that corporate takeover activity will develop to an extent never before witnessed. Such contradictory forces can uneasily coexist in equity markets for prolonged periods, just as a person can love his country but hate the government.

Proof of the great bond bear market is clear. First, is the list of the ‘ten to twelve percenters’: those many countries with annual budget deficits in that range, from the UK to Greece and America. All major industrial nations will issue bonds at an unprecedented rate in 2010 and for several years thereafter. Then, there is the growing club of ‘hundred percenters’: those countries with debt in excess of 100% of GDP and rising. In all cases, refinancing their bonds as they mature further bloats over-supply. Onto this blaze is poured the kerosene of rising sovereign defaults (‘re-negotiations’), consumer debt still at unsustainable levels, weakening tax bases and governments slowly wishing (or being forced) to reduce fiscal stimuli. Government bonds must become wealth destroying. The only surprise is how slowly this bear market is developing. The trend is not in doubt.

In contrast, company takeovers are accelerating. True, the majority have always been value destroying; Time Warner’s tie-up in the un-lamented technology boom was an outstanding example. This cycle will *not* be different, but the number of deals which are value accretive will exceed any previous peak. The reasons are simple. Whole sectors in the MSCI World or S&P 500 indices have more net cash in their balance sheets than at any time in history. Overall cash levels have reached almost 15% of market

capitalisation, with the most cash-rich sectors being industrials, pharmaceuticals and technology. In an environment of slow growth and weak pricing power earnings growth will all be about grabbing market share, not only organically but increasingly by acquisition.

Company CEOs are reluctant to hand cash back to their owners. Moreover, they are continually confirming to us in company calls that, as the inventory rebuilding cycle ends and QE recedes, growing sales will be difficult. Yet cash always burns a hole in management pockets. In many industries it is now cheaper to buy out a competitor than to build. Whole indices such as Japan are valued below book; many sectors, like railroads are trading below either replacement cost or enterprise value. Therefore growth through acquisition is not only preferable for such CEOs; unusually, it actually makes sense.

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One example is **Kansas City Southern**. Valued at \$6bn, its freight rail network runs north-south from the Great Lakes, across the Southern states and into Mexico, linking up with the fast growing ports there. Assume US economic growth is zero for the next five years - pretty bearish. Even so, a company which can move goods faster and cheaper than truckers or other railroad companies on the East or West coasts, along with a lower theft and accident rate, should enjoy 10-12% growth p.a. Additionally, its substantially larger neighbours must be greedily eyeing its assets. In nuclear power, the much expected up-cycle is no longer a chimera. Orders are picking up, ending the dearth of activity since the Three Mile Island incident in 1979. Historical low activity means there are few players left; moreover, the world is likely to settle on only two reactor designs. That being touted by the **Toshiba-Westinghouse-Shaw** tie-up, similar to Korea’s **Doosan Heavy**, is the probable winner. The other serious competitor, **Areva** of France, has too many knobs and whistles and a sky high valuation. This industry is a cartel in all but name. Cutthroat pricing is improbable, as demand will soon swamp supply. Within the sector there are even monopoly producers of key components, such as **Japan Steel**. Once again using the Armageddon background of zero growth, electricity generation in many countries faces a rising level of brown-outs if the replacement cycle does not accelerate. It is unlikely electorates - thus governments - will prefer this option.

UK

Plenty of 2009 full-year results from the portfolio, almost all in line or ahead of forecasts. Price action has been particularly strong for **Petrofac**, which announced the demerger of its North Sea oil and gas assets, along with massive growth in its Middle East order books. **Meggitt** ran up as well, as cost-cutting initiatives have been realised ahead of schedule. **Cobham's** outlook was a little weaker than expected, so the weighting was reduced. Others cut as they approached target prices or the weighting became excessive: **Imperial Tobacco**, **Britvic** and **G4S** for the former reason, **Invensys**, **Sainsbury** and **Rank Group** for the latter. Recent speculation about **Vodafone's** stake in **Verizon Wireless** starting to pay dividends, both literal and metaphorical, was rightly taken positively by the market.

Global

Several new holdings have been added since the beginning of the month. **Kansas City Southern** (US rail freight), **Doosan Heavy** (Korean nuclear player) and **Varian** (radiotherapy equipment) all have structural growth drivers, with strong market positions. **Sony** and **Nokia** have well-known products underpinned by rebounding brand value. **Monsanto** has never been as cheap as it looks today, after hitting the low point in its earnings cycle at the end of 2009. **France Tel**, **KPN** and **Swisscom** were cut back to avoid excessive weightings. Beneficiaries of global infrastructure spending, such as **Japan Steel Works**, **Shaw Group** and **Ansaldo** now account for over 10% of the fund, confirming our positive view on specific areas of tight supply and monopolistic pricing power, such as nuclear and rail. Notable performance contribution is starting to come from **Thai Beverage**, as news seeps out of its market share recovery in beer. An underappreciated consumer staple stock, it should re-rate as awareness grows.

Emerging Markets

As for Global above, **Doosan Heavy** and **Nokia** (c. 60% of sales from emerging markets) were bought. **Profarma**, a Brazilian pharmaceutical distributor also joined the fund – it should be a consolidator of a fragmented industry, bolstered by expansion of private sector consumption and increased public access to healthcare in Brazil. Strong monthly gains in Chinese equities have failed to offset sharp falls since the beginning of the year, driven by state-imposed caps on bank lending. Meanwhile, emerging market sovereign bond spreads are plumbing two-year lows, indicating optimism about the strength of the global recovery. The fund remains more defensively positioned than the consensus.

Japan

Various portfolio movements, including some interesting new stocks: **Yaskawa Electric** makes motion control and robotic equipment for major equipment manufacturers, with market leading technology. **Kureha** (specialty chemicals) and **Hitachi Metals** both play into niche markets which have their own demand drivers. **Yahoo! Japan** rejoins the fund after an absence of almost two years – top line growth should return and the effect on earnings per share will be magnified after some chunky share buybacks. Pharmaceuticals weightings have been cut as stocks ran up – **Takeda** was sold completely at target price, and **Eisai** and **Daiichi Sankyo** cut as they got close. Token gestures by **Lawson's** management in the aftermath of an employee's fraud were less than satisfactory, and the stock was sold. Japan's economic recovery seems on track and the outlook for the market as a whole is attractive.

Europe

Results have been buoyant almost across the board, with **Ansaldo** and **Ahold** standing out; dividend hikes of 15% and 28% respectively confirm the sustainability of rising earnings. **Indra Sistemas** hit the target price and was sold, as there was no reason to revise up forecasts. **K+S** saw seasonal road salt revenues spike after poor weather across the end of 2009, but this effect was offset by depressed nitrogen fertiliser markets; the stock has trodden water since, but should see some uplift when the first quarter results feed through. Broad equity indices have rallied in relief at some progress on the Greek situation; possibly a better indicator of trouble ahead is the fact that Greece had to offer more than 3% above German bund yields to get their latest €5bn of bonds into the market; expect another €17bn or so to hit the market before year end. Germany, by contrast, saw a surprising uplift in monthly employment levels and rosier business surveys. **GEA Group**, which has some gearing to this factor, has spiked up 25%, bolstered by an improvement in order trends reported alongside its 2009 results.

Global Income Fund (previously 200 fund)

The fund is being re-launched under the new name "Bedlam Global Income Fund", with no changes to the process or the target dividend pay-out (4.5%). If you have not received details of the re-launch, please visit the website at www.bedlamplc.com, or email a request for information on info@bedlamplc.com.

Bedlam Asset Management plc is authorised and regulated by the Financial Services Authority (212757).

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Past performance is not a reliable indicator of future results.