# CLOUGH GLOBAL

**Allocation Fund - GLV**
**Equity Fund - GLQ**
**Opportunities Fund - GLO**

# Letter from Chuck Clough

June 2010

Financial market volatility returned in recent weeks and many stocks have declined 20-30% from their mid-winter highs. The Funds' net asset values have declined as well, but in our view not only are many of our equity holdings priced particularly inexpensively but there are reasons to believe this decline will soon burn itself out.

In coming months we think the combination of a shortage of yield in the bond markets and strong corporate cash flows should provide ongoing support for equities. We believe our strategy of identifying global profit cycles and having the patience to allow the financial markets time to recognize them should be quite effective in a low interest rate world over the longer term.

We see three reasons why it will be difficult to have high interest bearing securities for the next several years. First, household debt declined 1.7% in 2009. It was the first decline since 1945 according to a report in Barron's. Residential mortgages make up 75% of consumer credit and represent a major source of interest bearing securities. However, new mortgage supply is dependent upon the combination of new housing investment and inflation of the housing stock. Housing is still depreciating and loan to value ratios are declining so neither new construction nor inflation is likely to reemerge anytime soon. This suggests new interest rates will be very low for quite some time on the mortgage front.

Secondly, the contraction of the banking system is visibly underway. Bank loans fell 18% year on year in April 2010 according to the Federal Reserve, and such declines are rare in the postwar period. According to the Wall Street Journal, the total number of retail bank branches will actually decline this year. Banks are "aggressively pruning their sprawling operations to get rid of locations deemed unattractive." Deposit rates are likely to remain at liquidation levels until the process is complete, a multi-year undertaking in our judgment.

Third, US business cash flow is strong. Again, according to the Wall Street Journal, non-financial businesses alone in the US have $932 billion in cash. With so much of the corporate capital stock overbuilt, investment is likely to remain weak, businesses are likely to be managed for cash and debt is likely to be liquidated. In a nutshell so long as private debt is declining, we think the shortage of yield will only worsen and the forced migration of investment capital into equities both here and abroad will likely reemerge.

Moreover, the deleveraging going on in the economy should eventually translate to the financial markets. In particular, the decline in financial market leverage and the lessening of speculative capital should eventually bring about a decline in market volatility going forward. That seems equity bullish to us. People own a lot less stock than they used to and that alone reduces selling pressure. [1]

That leaves the economy with two pillars of stranded capital: (1) the large stock of household savings trapped at the money rate; and (2) the pile of excess reserves at the Fed. The common fear is that private lending will revive and bring about the inflation event the world believes is coming. We don't think that is likely for a simple reason. The base effect of today's huge private debt structure limits additional borrowing because the cost of servicing already existing debt restricts its further expansion. We think the real macro risk is the US recovery decelerates and deflationary pressures reignite. As we opined in earlier letters this is not necessarily bearish for equities, particularly where investment and capacity is reduced and productivity is upgraded, nor should it short circuit the emergence of new profit cycles in which we are investing. [1]

It also suggests to us that capital will flow to investment opportunities that offer good returns at very low cost. What is so encouraging in the face of this is the number of emerging profit opportunities we see in the world.

We still believe the major investment story is emerging world consumption. Asian assets, in particular will be the key beneficiary of low money rates in the developed economies. The Shanghai Composite (market index composed of A and B shares traded on the Shanghai Stock Exchange) is down 19% this year and the Heng Seng (market weighted index of 33 stocks making up approximately 70% of the market value of all stocks traded on the Stock Exchange of Hong Kong) is down 11%, and we think the negatives are known and reflected in current prices. Discounts to book (amount security is trading below its book value) for many Chinese real estate developers are steep, as deep as 45% in some instances. Predictions of a China credit bubble and a coming investment collapse remain a constant staple in the popular media and we still think these analyses are too simplistic. In China for example, the bank credit to GDP ratio is the lowest of all the major economies. Office building is 3% of GDP (gross domestic product) and urbanization still creates a continuing housing shortage and the need to invest.

First of all, China's huge domestic savings rate, its foreign reserve holdings and the high down payments required to purchase real estate all argue against widespread credit defaults. Household debt is 17% of GDP, according to BCA research. compared to almost 100% in the US. And our belief is that its high investment rate is still adding to the economy's productivity. A recent Morgan Stanley research report notes how low China's capital to labor ratio is when compared to other economies. For example fixed capital formation per capita (measures value of acquisitions of new or existing fixed assets by the business sector, governments, and "pure" households less disposal of fixed assets) in

China is only 14%, 11%, 6% and 4% respectively of that in Taiwan, Korea, the US and Japan. Of those four economies, only in the US and Japan are capital stock additions largely offsetting depreciation of the current capital stock. To us that suggests that return on investment is still strong in China, and as its capital to labor (percentage of capital to labor in an economy) ratio rises, so will productivity. Since there is so much stranded capital in the world's financial markets, the needed capital will likely be available to China at low cost. To look at China's capital formation or debt growth in the eyes of western standards is not a valid approach. For one, as China moves from an importer to an exporter of higher value capital goods there is even more need for domestic capital investment. And as China's consumers gradually adopt more of a credit culture, personal income growth of 10-12% should easily turn into consumption growth in the mid teens. To us the popular negativism about China simply increases the potential upside for stocks. Fortunately we are able to invest substantial research resources into trying to find the best investment opportunities not only in China but across the Asian consumer economies.

Bank credit has also grown rapidly in Brazil. In 2009 it grew 15%. Since credit and profit growth are highly correlated we think a strong profit uptrend is likely. Real interest rates are still high (almost 4%) and mortgage activity is beginning to emerge. If real interest rates decline, domestic demand can potentially benefit. Mortgage debt is 3% of GDP and has a long way to rise.

Finally, we believe; we have also maintained many of our energy investments. There is an enduring value to long lived oil reserves at a time most are in unstable political hands. Restrictions on deep water production in US waters in response to the Gulf of Mexico disaster will only result in less supplies going forward. We believe oil production from current fields will soon peak and global oil supplies will gradually tighten. These barrels can be replaced but only at much higher costs and we have positioned the portfolio to reflect the growing value of easily accessible reserves. Moreover, consolidation is beginning in both the oil and oil service industries. Exxon Mobil's* acquisition of XTO Resources** and Schlumberger's** recent bid for Smith International** put all of this in the spotlight.

Other themes of note reflected in the Funds are focused on industries where restructuring has reduced capacity and enhanced productivity to the point we think even a modest increase in demand substantially increases profits. For example, if automobile demand simply recovers to the level of scrappage, profitability among the original equipment auto parts companies will rise sharply. In fact it already has even at lower production rates. It is one of the few industries where pricing power (the effect that a change in a firm's product price has on the quantity demanded of that product) is emerging. Pricing power is even beginning to emerge among the tire manufacturers, whose profitability has been held back by raw materials cost increase. We see these cost increases reversing as replacement demand for tires and pricing recover in the months ahead. The same dynamics are present in the aerospace industry where a recovery in travel demand after a long period of equipment parts underproduction is bringing on profit recovery.

The Funds also own hotel operators and selectively hotel REITs (Real Estate Investment Trust) which have little to no leverage and which can benefit from pricing gains as occupancy recovers.

Finally, we believe our case for a longer period of lower money market rates should support profit recovery across the insurance sector and the funds are well represented there. The market's perception of what many of these companies are worth is often distorted by recent experiences. Many cyclical and financial companies were insolvent not that long ago and we think many analysts view this as if the same risks are prevalent. Several mortgage insurers were recently able to raise amounts which rivaled their market capitalization. Many life insurers still sell below book value (the value at which an asset is carried on the balance sheet) because of lingering balance sheet issues, but the boom in corporate cash flows continues to allow quality spreads to collapse and we suspect many of those stocks will price closer to stated book in the months ahead.

We sincerely appreciate your interest in our funds. If you have any questions about your investment, please call 1-877-256-8445.

Sincerely,

Charles I. Clough, Jr.

* Exxon holding is 0.21% of Total Net Assets in each fund: Clough Global Allocation Fund, Clough Global Equity Fund, and Clough Global Opportunities Fund as of 4/30/10 .

** No current Fund holdings

[1] *Federal Reserve Flow of Funds*

*Past performance is not a guarantee of future results.*

*Foreign investing involves special risks such as currency fluctuations and political uncertainty.*

Clough Capital Partners, L.P. is a Boston–based investment management firm that has approximately $3.0 billion under management. For equities, the firm uses a global and theme–based investment approach based on identifying chronic shortages and growth opportunities. For fixed–income, Clough believes changing economic fundamentals help reveal potential global credit market opportunities based primarily on flow of capital into or out of a country. Clough was founded in 2000 by Chuck Clough and partners James Canty and Eric Brock. These three are the portfolio managers for the Clough Global Equity Fund, Clough Global Allocation Fund, and Clough Global Opportunities Fund.

*Forward-looking statements are based on information that is available on the date hereof, and neither the fund manager nor any other person affiliated with the fund manager has any duty to update any forward-looking statements. Important factors that could affect actual results to differ from these statements include, among other factors, material, negative changes to the asset class and the actual composition of the portfolio.*