



Butterfield

Second Quarter 2010

Investment Review

Butterfield Bank (Guernsey) Limited Second Quarter 2010 Investment Review

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SUMMARY OF MARKETS AND OUTLOOK

GLOBAL EQUITIES

The second quarter of 2010 proved extremely difficult for equity markets, with the Morgan Stanley Capital International (MSCI) World Index falling by 13.26% in US Dollar terms. This more than reversed the small amount of progress made in the first three months of the year, leaving global equities lower by 10.88% during the first half of 2010 as a whole.

The recent equity market environment has been characterised by a general increase in volatility. The Chicago Board Options Exchange Volatility Index's recent peak of 45.79 does not come close to the 2008 high of 80.86. However, the average level of 26.2 during the most recent three month period is a major increase over the 20.17 during the first quarter, and reflects the significant overall increase in market uncertainty which has been evident.

There have been a number of individual events which have contributed to the recent rise in market nervousness, but the most notable has been ongoing concerns over Government financing, most notably in the periphery of Europe.

As we highlighted in our last commentary, the global economy currently finds itself finely balanced from a number of key fundamental perspectives. These include the circular dependency of emerging world growth and developed world consumption, and the near-term risks of deflation as opposed to the longer-term potential for inflationary pressures to prevail. Until recently, the fear of deflation and the need to stimulate growth in the wake of the financial crisis had paved the way for hugely supportive monetary and fiscal policy, and created an equity market environment framed by;

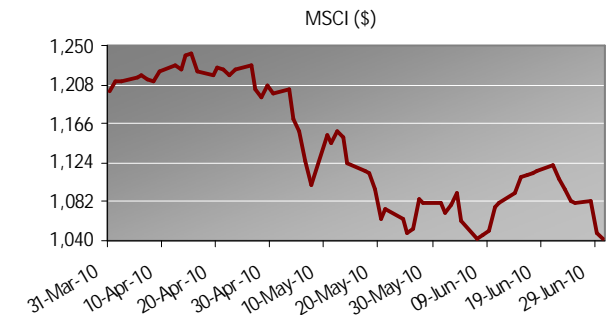
- Policymakers signalling a "growth at all costs" approach,
- Cash returns that were all but eradicated,
- Many companies that had been exceptionally swift to enact aggressive cost cutting,
- Surprisingly robust consumption (especially from the emerging world),
- GDP rebounding from previous rapid falls, on the back of inventory re-stocking,
- A supportive relative valuation picture, due to exceptionally low bond yields,
- An exceptionally low base from which to build,

As a result of this environment, many investors were encouraged to gradually climb up the risk ladder, moving from cash, through government bonds, corporate bonds of varying quality, and eventually arriving at equities. In turn, this assisted the strong rally in risk assets that dominated the last nine months of 2009.

The first three months of this year proved a little more challenging as the problems of peripheral Europe began to raise questions over the sustainability of the "growth at all costs" mentality. The second quarter has seen this debate develop, with focus falling upon the need for austerity in order to avoid the potential for a government funding crisis. This shift in emphasis underlines the environment that we have for some time considered likely, whereby the initial need to avoid a systemic financial failure is replaced by a realisation that an extended period of "belt tightening" will be needed to gradually unwind the excesses created by a long and unsustainable reliance upon credit.

To have any chance of keeping the global economy moving during a period dominated by fiscal restraint, there will be no option but to maintain historically low levels of administered interest rates. If policymakers can walk the fine line between enough austerity to avoid government funding difficulties, whilst still maintaining some level of economic growth, then the picture for equities, or at least certain areas of equity markets, will remain relatively supportive. Given this, it is worth reiterating that the equity investment cycle does not usually end whilst rates are low, or even as they began to rise. Rather, it normally takes a concerted application of the monetary brakes before equities roll over.

On balance, we still believe that the investment case for equities remains intact, but it is clear that this is a precarious position, and high levels of ongoing volatility should not come as a surprise to investors. In this environment, selective positioning is also likely to be key. A relatively low growth economic environment will make it very difficult for many companies to make, let alone grow, profits. However, some companies, or indeed broad market areas, will be better positioned to maintain progress and are likely to be



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rewarded with an increasing valuation premium. The companies that benefit within this environment are likely to be characterised by large franchises with a dominant market position, high free cash flow, high dividend cover, and attractive dividend yields. These types of companies are a natural outcome of our investment approach, and we believe that the continued rigorous application of our core long term theme based methodology will position portfolios well within the environment that equity markets are likely to face for the foreseeable future. As such, we see no reason to dramatically alter course at this stage, despite the unsettling nature of market movements.

GLOBAL FIXED INTEREST

Government bonds issued by the US, UK and the core European economies have posted strong returns during the second quarter of 2010, driven by flight to quality trades and an expectation that monetary policy in the Western world will remain exceptionally supportive for an extended period of time.

Since the collapse of Lehman's in 2008, economies have been kept on life support through easy interest rate policy as administered by Central Banks and supportive fiscal packages from national Governments. While such policies have undoubtedly eased the economic contraction and have provided the foundation for a degree of economic growth, they have not come without cost. In particular, we refer to the rapidly expanding level of Government debt that has been built up in the last eighteen months and the ability of Governments to service current debt levels and take on the additional liabilities that are likely to accrue in the upcoming years.

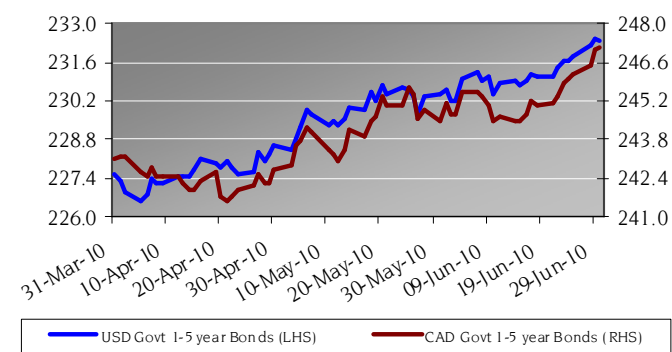
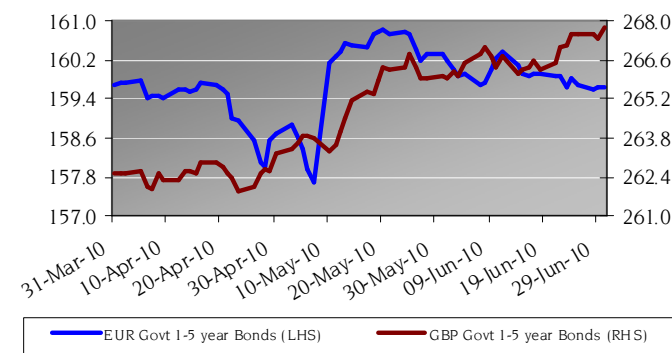
To date, it is clear that within most Western OECD countries, the economic recovery is not sufficiently strong to be self sustaining. Consumers are still only in the early stages of deleveraging and with rising unemployment levels, it appears unlikely that private consumption will be sufficient to keep economic growth on track. This has left Governments with the desire to provide additional support for domestic economies to avoid a fall back into recession, although they no longer have the fiscal firepower to support such policy measures. As has been demonstrated in Greece, bond markets are not open to endless borrowing by Governments without plausible plans to reduce deficits over a relatively short timeframe and within the current economic climate.

In our last quarterly commentary, we suggested that fiscal policy was likely to move toward centre stage with regards to bond market performance over the coming months and this has certainly been the case, especially within Europe. Yields on Greek bonds continued to widen upon fears that Greece would be unable to meet its current and future financial obligations in full. Despite various attempts by the EU to pacify markets and suppress contagion to other Mediterranean economies the situation rapidly expanded to see funding costs increase in Portugal and Spain.

The situation in Europe remains fluid, but drastic actions during the quarter have seen the European Central Bank and International Monetary Fund combine forces to offer a Eur750 billion stability package to provide support to the region's weaker sovereign bond markets. In addition, the ECB has started to purchase government bonds in an attempt to reduce the yield differential between the core and peripheral bond markets. Initial reaction has been mixed. While the package will go a long way to reduce the liquidity risk in markets, the solvency risk can only be reduced through austerity.

The stark realisation that not all European Government bonds are the same has seen a rapid deviation in bond yields between the member states, despite short term interest rates being identical. While the Mediterranean economies have suffered, 'flight to quality' trades have seen core European Government bond yields, and especially German Bunds, reach new lows.

At present, US and UK bond markets have also been beneficiaries of increased risk aversion in the World. The US naturally benefits from its status as being home to the reserve currency of the world. The UK on the other hand has seen bond yields fall due to improved market confidence that the new Conservative/Liberal coalition government has the political will to address its budget deficit in an expedient manner and maintain its AAA credit rating.



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With fiscal concerns to the fore, a wave of austerity is sweeping the globe. While it is most commendable and in fact necessary that over indebted Governments work towards balanced budgets, such action is going to weigh heavily on the Global economy over the coming quarters. As discussed above, private consumption in many OECD countries is unlikely to sustain the recent turn around in economic growth, as Governments start to withdraw stimulus and push taxes higher. There is therefore the real danger of some economies stalling and falling back into recession during 2011. In such an environment, this only leaves monetary levers on which policy makers can pull.

We therefore remain confident that monetary policy will stay exceptionally easy through the remainder of 2010 and into 2011. In particular, we anticipate that this will result in short-dated interest rates being on hold for many months to come, which in turn should support the short end of the yield curve. However, the potential for additional quantitative easing means that further out along the yield curve, the situation becomes less clear.

The preferred option of Governments appears to be based upon hoping the economy 'muddles through'. That is very much to say that the economy endures a period of anaemic growth and a relatively benign inflationary environment. This would be conducive to a low interest rate environment and suggest that longer-dated bonds remain fair value. However, we maintain that the ability for a Government to implement the number of politically and socially challenging policies required for such an outcome may be limited. As such, economic outcomes from outright deflation and potential default through to hyper-inflation can not be wholly ruled out, however remote we hope they all are. We therefore prefer to hold a relatively short duration within our bond portfolios where the interest rate environment remains more transparent.

From a credit perspective, we have traditionally advocated a policy of holding bonds issued by strong, AAA rated Governments; Supranational Agencies or entities with an explicit guarantee from a strong AAA rated government. In addition, we also consider corporate bonds issued by companies that have strong balance sheets and good cashflow. In the current environment, we believe that this approach remains appropriate. Yields are exceptionally low on a nominal and real basis, however, there are sufficient risks to Governments' preferred outcomes to suggest that this is not the time to be increasing credit and duration risks within portfolios in search of higher yield.

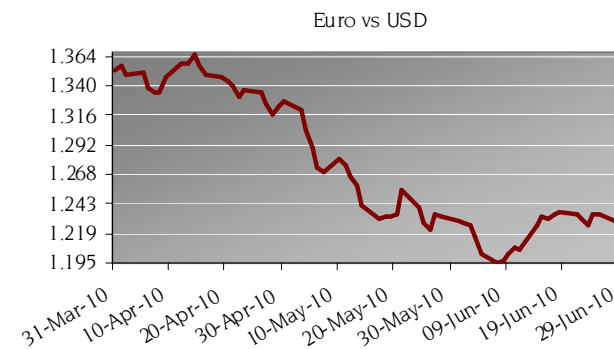
CURRENCY

Recent direction within global foreign exchange markets has been dominated by ongoing concerns about the increased risk of Sovereign debt default in the weaker economies that make up the Eurozone. Volatility looks likely to continue during coming months and this has been the key catalyst behind the Euro's weakness. Against this backdrop, the US Dollar has benefited from its status as the global reserve currency, briefly breaking below the 1.20 level against the Euro during early June.

More recently, the downward revision to Q1 GDP in the US to 2.7% from 3% has again raised questions as to the pace of economic recovery and the Dollar has drifted back through 1.23 versus the Euro. Weaker economic data in the US appears for the moment to have halted the Dollar's progress and the move back through 1.23 has likely been accelerated by traders covering short Euro positions on the back of this news.

While the US still has ongoing challenges in terms of its budget deficit and high unemployment, general market sentiment remains biased against the Euro. The Market continues to move to try and price in the increased risk of Sovereign debt default within the Eurozone, which in turn may eventually trigger some sort of break up, or re-alignment of the single currency.

During 2010 the Dollar has appreciated by over 14% versus the Euro, but this latest move should be considered in the longer term context. Since the irrevocable fixing of the exchange rates of the countries comprising the Euro at the beginning of 1999, the Euro has averaged a rate of just over 1.18 versus the Dollar. Having steadily weakened from its initial creation, the Euro began to recover in early 2002 and peaked in July 2008, just prior to the market sell off in the wake of the credit crunch and subsequent Banking crises. In the volatility and uncertainty that followed these events, the Dollar appreciated sharply, pushing through 1.25 versus the Euro, as global flows sought the safe haven of Government bonds denominated in the World's reserve currency.



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In early 2009, as stock markets recovered and risk aversion moderated, the Dollar again weakened against the Euro, falling back through 1.50 before again rallying strongly, as risk aversion and volatility returned. Renewed concerns regarding Sovereign debt and the increased risk of a default in Greece, triggering contagion into other heavily indebted countries such as Spain, Portugal and Ireland, saw the Euro sell off sharply and the Dollar again appreciate.

Against this background, the Dollar will likely remain reasonably well supported through the summer months, however, it should not be forgotten that the pace of recovery within the US economy may moderate from current levels during the second half of the year. If such a scenario develops, it is conceivable that current support for the Dollar may wane, particularly if this were to coincide with any improving newsflow out of Europe.

In the UK, the new coalition government has been quick to try and placate global capital markets by stamping their credentials as being serious in their goal of addressing the deficit and stabilising public finances. Now that the uncertainty regarding the outcome of the General Election is behind us, Sterling has benefited from the Market's current perception that some of the downside risks have been removed.

Having weakened below 1.44 versus the Dollar in the run up to the Election, Sterling has recouped some of these losses and is now back above the 1.50 level. Against the Euro, the Pound briefly fell below 1.10 in mid March, but has since risen steadily and ended the period above 1.22.

While markets have initially reacted positively to the new Government's policies on debt and the economy, the magnitude of the challenge facing them should not be underestimated. The UK has one of the highest deficits as a percentage of GDP within the EU and thus far economic recovery has been weak, suggesting ongoing GDP growth will be susceptible to the magnitude of fiscal tightening required to address the size of the deficit.

Until a clearer picture of the UK's economic fortunes emerges, we expect that Sterling will continue to trade in a 1.40 to 1.53 range versus the Dollar, but remain reasonably well supported against the Euro, which will likely remain under broader pressure.

SECTOR REVIEW

CONSUMER DISCRETIONARY

The Consumer Discretionary sub group of the MSCI World Index fell by 10.81% during the second quarter of 2010, one of the smallest declines in the ten MSCI World sectors for the three month period. Areas such as Retail Distribution, Hotels, Restaurants and Leisure, and Leisure Equipment proved particularly robust.

During the market recovery of the last three quarters of 2009, the Consumer Discretionary sector significantly and consistently outperformed the broader market, as would be anticipated in a “normal” recovery, where areas closely tied to consumer spending patterns would generally lead economic recovery.

It may therefore appear somewhat counter intuitive that the sector has held up relatively well in the recent environment of falling markets and increased volatility. This reflects the envisaged trends highlighted within our equity commentary, whereby the market rewards companies that are able to maintain a stable or increasing profit profile amidst conditions that are generally difficult. Many companies within this space have positive characteristics such as strong brand recognition and high barriers to entry, which are combined with relatively high levels of emerging world exposure, the potential for consolidation amongst existing “Mega-brands”, and a demonstrable track records in terms of cost reduction. Given the characteristics of many companies within the sector, we believe that there is the potential for premium multiples to develop throughout any ongoing recovery, although a selective approach to the sector will clearly remain key.

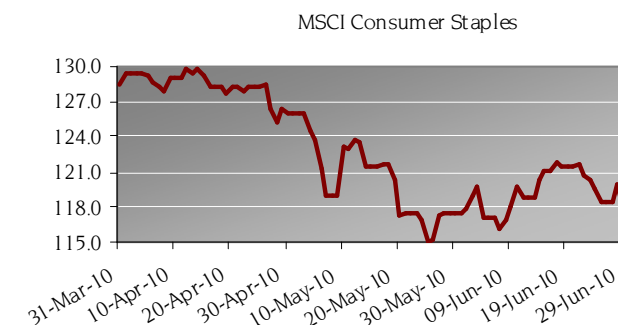
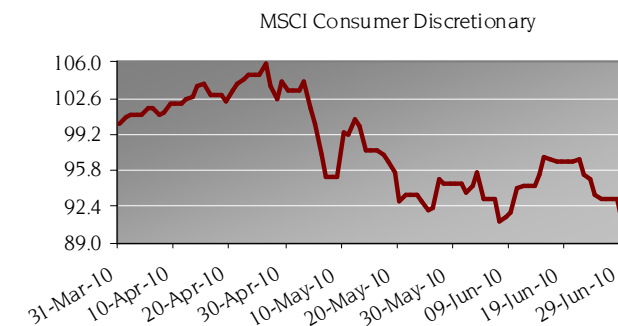
CONSUMER STAPLES

During the second quarter of 2010, the staples sub-group posted the best performance of the MSCI sectors. Although it fell by 8.81%, this represented an outperformance of the broader market's decline of 13.26%.

Aside from food and drug retailing, the sector ably demonstrated its classically defensive characteristics during the three month period as volatility increased and markets more than reversed the gains of the previous quarter.

As highlighted within our market commentary, we see an environment developing which results in a premium being afforded to companies characterised by large franchises with a dominant market position, high free cash flow, high dividend cover, and attractive dividend yields. Of all the market sectors, Consumer Staples is arguably the most dominated by such companies and, as such, is considered likely to perform relatively well. In addition, many members of the sector are relatively direct beneficiaries of growth rates in the developing world, and have implemented some of the most aggressive cost cutting measures.

There is no doubt that less buoyant consumer behaviour in developed markets would place a potential drag upon the sector, but as long as this can continue to be offset by strong execution in the emerging markets, then there is clearly a case for some areas of the consumer staples sector to remain relatively well supported during the months ahead. As highlighted previously, our focus will remain upon companies with proven domestic dominance, as well as an ability to cut costs whilst driving margins and volume growth in the emerging world.



SECTOR REVIEW

ENERGY

The Energy sector has remained under pressure during the second quarter of 2010, selling off by 16.68% versus a fall of 13.26% in the MSCI World Index. A combination of higher than average inventories in the OECD, concerns over OPEC's quota adherence and events in the Gulf of Mexico were the key factors that influenced returns.

As we have discussed in previous commentaries, we believe that we are in the middle of a longer term investment cycle within the Energy industry, driven by enduring core themes that are reshaping the make up and economic influence within the global economy. The long term story in terms of oil demand remains very positive outside the OECD, where demand is increasing at over 2.5% pa and car ownership, particularly in India and China, is rapidly expanding. The pace of economic growth within these developing economies, when set against a background of constrained and limited supply of fossil fuels, will in our view ultimately drive prices higher.

For the balance of this year and the early part of 2011, we expect that the oil price will remain in a range between USD65 & USD85, until the inventory overhang within OECD countries is gradually unwound. Oil companies' valuations continue to remain well below historic levels, with the large multinational integrated companies not reflecting the recovery we have seen in the price of Crude Oil since early 2009.

Clearly headline news within the sector has been dominated by the tragic accident in the Gulf of Mexico and the subsequent oil spill. In the wake of this disaster there will inevitably be calls for a halt in deep water oil exploration, or at the very least, a much more comprehensive plan to deal with accidents should they occur. The World, and in particular the US, ultimately needs the oil from deep water exploration, as non OPEC Oil production has been declining sharply over the last few years. While production costs in deep water fields will likely rise as a result of increased industry wide regulation, our view remains that any increase in costs will ultimately translate into higher oil prices.

As discussed earlier, the long term story in terms of global demand for oil remains very positive outside the OECD. If global demand continues to grow at current levels, it is likely that the spare production capacity within OPEC could be fully utilised by as early as 2012. Once existing spare production capacity is exhausted, the industry will have to develop more marginal fields, which will in turn support higher oil prices.

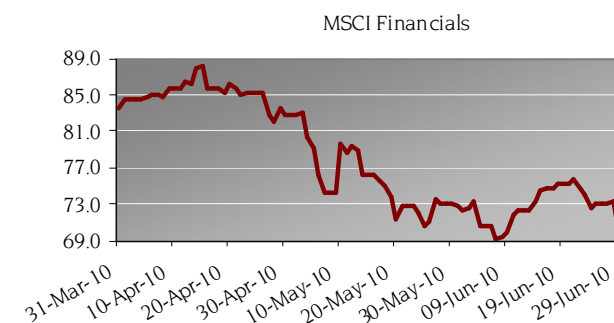
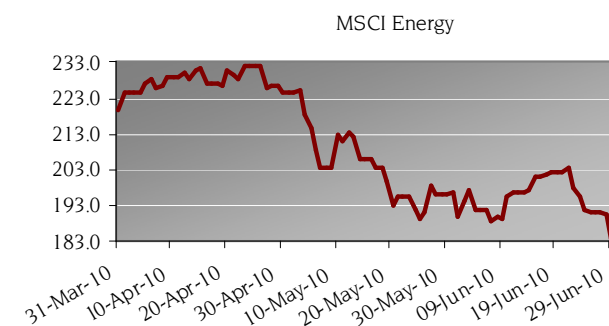
FINANCIALS

The Financials Sector has had an exceptionally difficult quarter. In all, the sector has posted a decline of 16.26% since the end of March. This compares to the loss of 13.26% that the MSCI World Index posted over the same timeframe, making the Financials sector rank ninth out of the ten sectors that comprise the MSCI.

Over recent quarters we have remarked upon the difficulty in analysing financial companies. Comment during this time has been focused upon changes to accounting practices, the extrapolation forward of what we saw as unsustainable trading profits, and concerns about how new financial regulation may limit future profitability. More recently however, a new variable has taken centre stage, namely the credit crisis emerging in a number of sovereign bond markets.

Up until recently, the credit status of major Governments appeared beyond question. However, as fiscal balances have deteriorated through the recession and been compounded with the cost of 'bailout' packages, the unthinkable is becoming a possibility. To date, the real pain is only being seen in Greece, although a level of contagion is starting to be seen through Portugal and Spain's bond markets. Given the level of holdings of such bonds across many of Europe's largest financial institutions, rising concerns of sovereign debt default or restructuring are naturally being reflected in the in book values and future earnings profiles.

Over recent years our strategy has been to hold an underweight position within the financials sector. Given the latest developments and general market sentiment, we maintain our diversified and under weight stance to the sector.



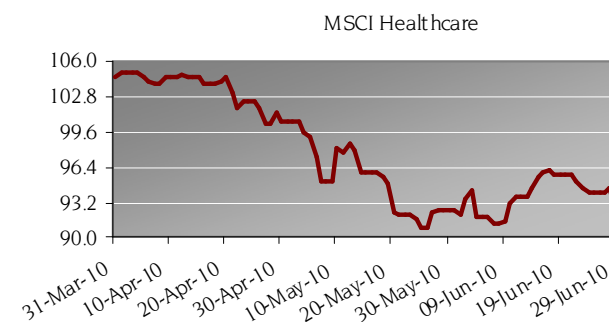
SECTOR REVIEW

HEALTHCARE

The MSCI World Healthcare Index posted a decline of 11.41% during the second quarter of 2010, which was a slight outperformance of the 13.26% fall in the broader MSCI World Index. Within the Healthcare group, stocks within the medical equipment industry posted the largest declines, as companies within the sub sector announced earnings that were negatively impacted by the US Healthcare reforms.

As we move through the remainder of the year, the earnings reports from companies within the sector will show whether the new US Healthcare legislation has had a positive or negative impact on the various sub sectors within the industry. Thus far, the companies that have been most negatively impacted are pharmaceutical companies that have a high proportion of sales to customers who fall within the Medicaid program. The reforms have increased the discounts that companies have to offer to qualifying patients for branded drugs, to 23.1% from 15.1%. This has reduced margins for pharmaceutical sales in the US, at a time when many companies face the challenge of patent expiries on highly valued treatments. Whilst the short term effect has been negative, in the longer term volumes should benefit as more Americans utilise the benefits of their health insurance, this increase in volumes should go some way to offsetting the decline in margins.

Despite the short term challenges for the sector, the medium to long term fundamentals are attractive. Companies within the sector are undoubtedly going to benefit from the significant shift in demographics in Europe, the US and Japan, as older people tend to require greater levels of healthcare. The wider reach of the US Health insurance should also see volumes gradually pick up, as patients become more aware of the range of healthcare treatments available to them. The sector also has some level of valuation support, with low P/E multiples compared to the 5 year average, consistent dividend growth and manageable levels of gearing.

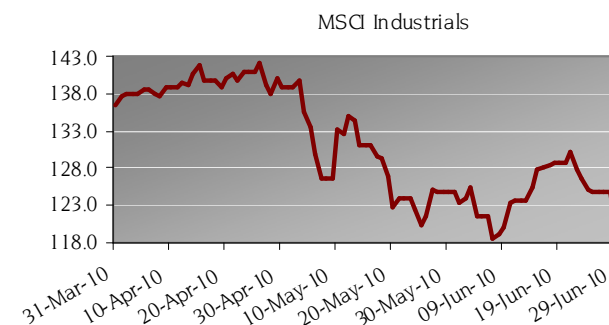


INDUSTRIALS

As with the rest of the equity market, the Industrials sector has performed poorly over recent months. During the latest quarter, the sector has fallen by 12.13%, marginally better than the MSCI World Index which fell by 13.26% over the same period.

In our previous commentary, we noted that the Industrials sector had been through a painful period of adjustment following the recession, but had come out stronger from a cost/revenue perspective. While this is naturally good for the sector, the market had also re-rated the sector such that additional upside in share prices would be predominantly driven by revenue growth rather than additional cost cutting measures. To this extent, the fortunes of the sector would be closely aligned with those of the economy as a whole. Therefore, while recent returns within the sector have been disappointing, they are understandable within the context of equity markets in general and in particular, the deterioration of leading economic indicators.

From a strategy perspective, we remain marginally underweight to the sector based upon our view of a slowing economy. As detailed earlier in the report, the wave of austerity measures that have been announced over recent weeks are likely to be a headwind to economic growth as we move into 2011. With regard to individual stocks, positions have been skewed towards those areas that will continue to benefit from government sponsored programs and large infrastructure projects, particularly in emerging economies.



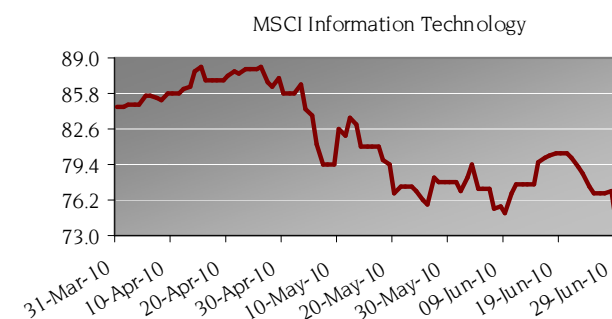
SECTOR REVIEW

INFORMATION TECHNOLOGY

The MSCI Information Technology sector performed largely in line with the broader MSCI World Index during the second quarter of 2010, posting a decline of 13.37%. Stocks within the software and communication equipment sub sectors led declines, as some of the larger components within those groups announced worse than expected earnings results.

Having begun the period positively, stocks within the Information Technology sector were dragged lower by worse than expected first quarter earnings reports. In addition, rather more sanguine outlooks from a number of the large bell weather companies in the sector led investor sentiment to turn negative. As the global economy recovered from the financial crisis, expectations for earnings growth accelerated sharply. It is therefore understandable that as the economic growth outlook becomes somewhat more finely balanced, companies adjust their outlooks to reflect slower growth. In the coming months, movements within cyclically sensitive sectors, such as information technology, will likely be determined by the extent to which company earnings either beat, or miss, consensus expectations.

As long as economic growth remains positive, even at the relatively slow pace we expect, demand for information technology to enhance efficiency should remain robust. There are also a number of areas of technology that are seeing positive demand trends due to shifts in consumer habits, these include sectors such as storage, security and networking. These groups are seeing strong demand growth, largely due to the increase in the delivery of media over the internet, as consumers move towards downloading content via the web, rather than through more traditional mediums. We remain overweight the sector, favouring companies with good cash flow generation, niche positions in their market and strong balance sheets.

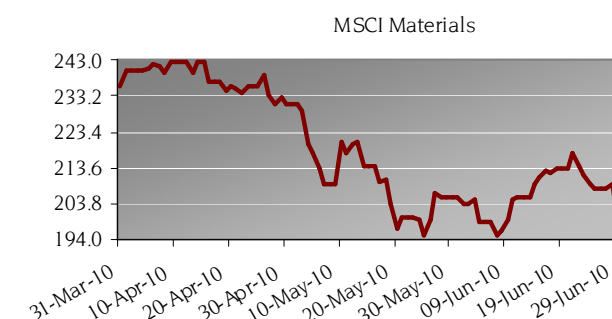


MATERIALS

The Materials sector again marginally underperformed the broader market during the second quarter, falling by 16.13% versus a drop of 13.26% in the MSCI World Index.

Since our last quarterly review, commodity markets have corrected on concerns about the increased risk of Sovereign debt default in Europe, combined with ongoing worries over a bubble developing in Chinese residential property. In respect of China, the market has become increasingly focused upon the risk of policy makers implementing various monetary tightening measures aimed at deflating the housing bubble, but in turn also triggering a wider slow down in the economy.

The other issue which has negatively impacted the sector relates to the proposed controversial resources profits tax in Australia. Initial proposals by the Australian Government for a 40% levy, retrospectively applied, were met with stiff resistance from the large multinational mining companies with significant Australian activities. Negotiations between the companies and the Government are ongoing, with the promise of a speedy outcome. However companies are keen to ensure that any deal that is put together with new Prime Minister Julia Gillard will carry through post the election, assuming the Government is re-elected. The removal of this uncertainty and a workable compromise would be positive for the mining sub group.



Overall, we believe that a growing demand for commodities and resources, driven by the urbanisation and infrastructure build out in developing countries such as China and India, will continue to provide attractive medium term investment opportunities. We therefore maintain our overweight bias within client portfolios

SECTOR REVIEW

TELECOMMUNICATION SERVICES

Although the MSCI World Telecommunication Services sector posted a decline of 9.89% during the second quarter of 2010, it was the second best performance of the 10 sectors within the MSCI World Index. The sector also outperformed the broader market decline of 13.26%, largely thanks to the relative performance of the wireless telecoms sub sector.

Stocks within the wireless group outperformed their fixed line competitors during the period, as acquisition news suggested that valuations within the group were attractive on a long term basis. The main deal that was announced during the period was Telefonica's bid for a controlling stake in Brazilian wireless operator Vivo. The move also suggests that diversified operators might seek to increase exposure to wireless, particularly in emerging markets, as competition for fixed line customers remains tough. Emerging markets are attractive as they have lower penetration rates than developed markets, and therefore subscriber growth has the potential to add significant value for the companies that operate in those regions. Having a presence in emerging markets does not guarantee success, as competition for subscribers is as difficult in these regions as it is in the developed markets. In addition, average revenue per user tends to be lower as demand for value added services, such as data, is lower than in developed markets.

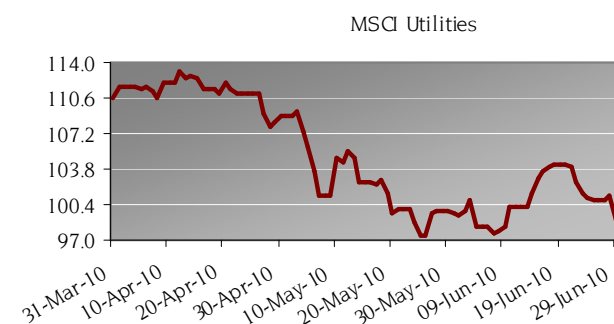
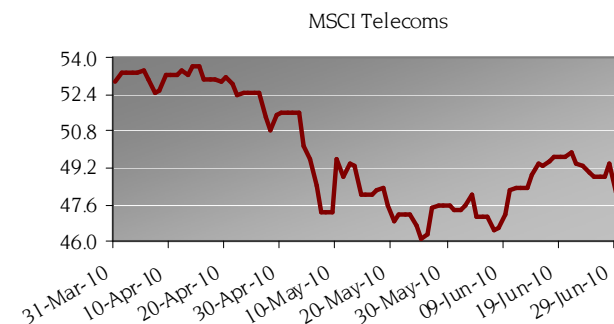
While certain companies within the sector are well positioned to take advantage of both emerging market growth, and increased demand for data in developed markets, overall, excessive competition and regulatory challenges lead us to remain selective in our positioning as well as being underweight from an overall perspective.

UTILITIES

Returns for the Utilities sector during the latest quarter have been disappointing, falling by 10.94% over the three month period. Despite a poor nominal performance, the sector proved to be the fourth best performing of the ten MSCI sectors which, on average, fell by 13.26%.

While the sector performed marginally better than the broad market, it is disappointing that the overall risk averse tone of the equity market was reflected so prominently within the Utilities sector. As with the previous quarter, a degree of the poor performance can be attributed to the geographically diverse nature of the Utilities sector and the weakness of the Euro versus the US Dollar. However, weakness within the sector was driven to a large extent by electric utilities, which have seen margins on power generation decrease in line with lower commodity prices.

Fundamentally, we would expect the low beta sector to continue to outperform the broad market in difficult market conditions. Low interest rates, stable cashflows and relatively inelastic demand make utilities' defensive business models and good dividend flow appealing to investors. However, we maintain that the current political and economic environment will see pressure placed upon the current regulatory regimes to limit price pressures on consumers such that it that may unduly affect future profitability. To this extent, we choose to remain underweight this sector at the present time.

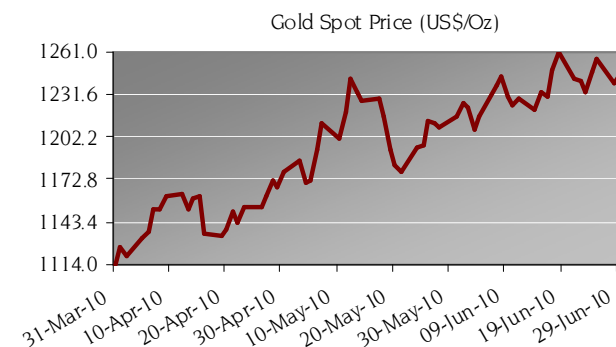


GOLD

The price of gold continued to trend higher during the second quarter of 2010, as strong investment demand pushed the metal to a record close of US\$1,260.27 on 18 June, before it settled at US\$1,241.65 by the end of June. The 11.41% gain in the second quarter came despite continued strength in the US Dollar, which has historically been a negative factor for gold, as concerns over the high levels of sovereign debt led investors to seek exposure to real assets.

Investment demand has been the key driver for the price of gold during the second quarter, with the largest source of new demand coming from exchange traded products that are designed to track the price of the metal by holding physical bars. Exchange traded products have seen an increase in physical gold holdings of over 380 tonnes in the second quarter, taking their combined holdings to over 1,780 tonnes. To put the importance of the holdings into context, according to official reserve statistics, France is the 5th largest Government holder of gold, owning 2,435 tonnes, whilst the 6th largest holder is China, with 1,054 tonnes. Whilst the increase in holdings through exchange traded products has provided a boost to the price gold, there is a potential for the sheer size of the holdings to cause a higher level of volatility in pricing. Unlike many of the largest Government holders, who have signed an agreement to limit their gold sales, it is possible that a shift in investor sentiment could see a significant unwinding of positions in exchange traded products. This would naturally have a negative impact on pricing in the shorter term.

In the longer term, supply and demand fundamentals should provide support to the gold price, with the most important change in the supply/demand balance coming from a shift in stance by Central Banks. Central Bank sales have been a feature of the gold market for a number of years. Such had been the extent of selling pressure that in 1999 14 countries, and the European Central Bank, agreed to restrict the amount of metal they would collectively sell each year. Although the Central Bank Gold Sales Agreement remains in place, allowing a total of 400 tonnes of gold to be sold per year, Central Banks were in fact net buyers of metal in the final three quarters of 2009, and only 15 tonnes were sold in the first quarter of 2010. This change in stance is particularly important for the Central Banks of Emerging market countries, such as China and Russia, as they hold a relatively small percentage of reserves in gold. China's appetite for gold has seen their reserves build from 600 tonnes in 2003, to the current holding of 1,054 tonnes, fed by internal supply. The Chinese Government has recently signed an agreement with a US gold miner to import unprocessed gold for the first time. This will allow China to build its holding without having to make purchases in the relatively small open market. This agreement is likely to be the first of many such arrangements, as the country seeks to diversify reserves away from US Treasury holdings. Therefore, despite the potential for periods of heightened volatility in the short term, the longer term fundamentals still seem supportive for the metal.



QUARTERLY STATISTICS

EQUITY INDICES

	31 March 2010	30 June 2010	Percentage Change
Global			
MSCI World Index	1,200.53	1,041.32	-13.26
MSCI World Index (Sterling)	790.29	695.93	-11.94
MSCI World Index (Euro)	887.11	849.57	-4.23
United States			
Dow Jones Industrial Average	10,856.63	9,774.02	-9.97
S & P 500 Index	1,169.43	1,030.71	-11.86
NASDAQ Composite Index	2,397.96	2,109.24	-12.04
Europe			
DAX Index	6,153.55	5,965.52	-3.06
FTSE 100 Index	5,679.64	4,916.87	-13.43
Dow Jones Euro Stoxx 50	2,931.16	2,573.32	-12.21
Far East			
Nikkei 225 Index	11,089.94	9,382.64	-15.40
TOPIX Index	978.81	841.42	-14.04
FT World Actuaries Pacific Rim X Japan (US Dollars)	410.68	362.00	-11.85
FT World Actuaries Pacific Rim X Japan (Sterling)	401.39	358.73	-10.63
Hang Seng Index	21,239.35	20,128.99	-5.23

MSCI WORLD SECTORS

Consumer Discretionary	100.19	89.36	-10.81
Consumer Staples	128.43	117.12	-8.81
Energy	219.99	183.01	-16.81
Financials	83.57	69.98	-16.26
Healthcare	104.53	92.60	-11.41
Industrials	136.35	119.81	-12.13
Information Technology	84.61	73.30	-13.37
Materials	235.82	197.79	-16.13
Telecommunications Services	53.00	47.76	-9.89
Utilities	110.73	98.62	-10.94

QUARTERLY STATISTICS

BOND INDICES

	31 March 2010	30 June 2010	Percentage Change
Bloomberg Bond Indices - Global Bond Index (US Dollars)	245.96	249.75	+1.54
Bloomberg Bond Indices - Global Bond Index (Sterling)	272.28	280.49	+3.02
Bloomberg Bond Indices - Global Bond Index (Euro)	231.81	257.69	+11.17
Bloomberg Bond Indices - US Govt 1-5 Year	227.56	232.40	+2.13
Bloomberg Bond Indices - UK Govt 1-5 Year	262.56	267.76	+1.98
Bloomberg Bond Indices - Canada Govt 1-5 Year	243.12	247.13	+1.65
Bloomberg Bond Indices - Euro Govt 1-5 Year	159.71	159.66	-0.03

FOREIGN EXCHANGE RATES

Sterling versus US Dollar	1.5191	1.4963	-1.50
Sterling versus Euro	1.1228	1.2206	+8.71
Sterling versus Swiss Franc	1.5970	1.6128	+0.99
Sterling versus Canadian Dollar	1.5427	1.5892	+3.01
Sterling versus Japanese Yen	141.94	132.55	-6.62
US Dollar versus Euro	1.3533	1.2257	+9.43
US Dollar versus Swiss Franc	1.0512	1.0777	+2.52
US Dollar versus Canadian Dollar	1.0155	1.0620	+4.58
US Dollar versus Japanese Yen	93.44	88.58	-5.20

LIBOR 3 MONTH RATE

Sterling	0.65	0.73	+12.84
US Dollar	0.29	0.53	+83.17
Canadian Dollar	0.41	0.84	+103.66
Euro	0.58	0.71	+22.29
Swiss Franc	0.25	0.11	-54.73

COMMODITIES

Reuters/Jefferies CRB Commodity Price Index	273.34	258.52	-5.42
Gold Spot \$/Oz	1,114.50	1,241.65	+11.41
Brent Crude Index (London)	81.26	75.70	-6.84
Crude Oil Futures (New York)	83.76	75.63	-9.71

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