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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The modest movements in securities' markets over the quarter belie the turmoil in the world arising from terrible natural disasters, political unrest, military intervention in Libya and radiation leaks resulting from the Japanese earthquake and resulting tsunami. After a brief setback on the awful news from Japan, markets recovered their poise. Below, we try to explain why.

The tables below detail relevant movements in markets:

International Equities 31.12.10 - 31.03.11

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+3.3	+2.0	+4.5	-1.3
Finland	-3.2	N/C	+2.4	-3.2
France	+4.6	+8.0	+10.6	+4.6
Germany	+1.8	+5.2	+7.7	+1.8
Hong Kong, China	N/C	-2.4	-0.1	-5.5
Italy	+7.6	+11.2	+13.8	+7.6
Japan	-2.6	-6.9	-4.7	-9.9
Netherlands	+3.3	+6.7	+9.2	+3.3
Spain	+8.5	+12.1	+14.7	+8.5
Switzerland	-0.1	-0.6	+1.8	-3.8
UK	+1.2	+1.2	+3.6	-2.0
USA	+5.8	+3.3	+5.8	N/C
Europe ex UK	+2.9	+5.7	+8.2	+2.3
Asia Pacific ex Japan	+1.5	+0.2	+2.5	-3.1
Asia Pacific	-0.4	-3.1	-0.8	-6.2
Latin America	-0.6	-1.0	+1.3	-4.2
All World All Emerging	+0.6	-1.2	+1.1	-4.4
The World	+3.3	+2.2	+4.6	-1.1

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -0.8%

International Bonds - Benchmark Ten Year Government Bond Yields (%)

Currency	31.12.10	31.03.11
Sterling	3.40	3.69
US Dollar	3.29	3.45
Yen	1.12	1.25
Germany (Euro)	2.96	3.37

Sterling's performance during the quarter ending 31.03.11 (%)

Currency	Quarter Ending 31.03.11
US Dollar	+3.0
Canadian Dollar	+0.5
Yen	+5.1
Euro	-2.9
Swiss Franc	+1.0
Australian dollar	+1.8

Other currency movements during the quarter ending 31.03.11 (%)

Currency	Quarter Ending 31.03.11
US Dollar/Canadian Dollar	-2.9
US Dollar/Yen	+2.0
US Dollar/Euro	-5.8
Swiss Franc/Euro	-4.0
Euro/Yen	+8.3

Significant Commodities (US dollar terms) 31.12.10 - 31.03.11 (%)

Significant Commodities	31.12.10 - 31.03.11
Oil	+23.8
Gold	+0.4

Markets

Extraordinarily, there has been little overall movement in international equity markets over the last quarter. In local currency terms, the total return on the FTSE World Index was +3.3%, in sterling terms +2.2%, in US dollar terms +4.6% and in euro terms -1.1%. Of the major markets, the USA performed best in local currency terms, returning 5.8%. Within a satisfactory 2.9% return from the FTSE Europe ex UK index in local currency terms, there were notably good performances from Spain, +8.5%, and Italy, +7.6%. There was little movement from the FTSE UK Index, up just 1.2% or from the FTSE Asia Pacific ex Japan Index (+1.5%), the FTSE Latin American Index (-0.6%) or from the FTSE All World All Emerging Markets Index (+0.6%). Australia turned in a satisfactory performance with the FTSE Australian Index returning 3.5%. Not surprisingly, in view of the terrible natural disaster and associated nuclear power worries in Japan, the FTSE Japanese Index showed a negative return of 2.6%. The weakness of the US dollar and yen over the quarter and the strength of the euro altered the balance of the sterling returns in overseas markets. The FTSE USA Index's return fell to +3.3% in sterling terms, still a very satisfactory performance, whilst the FTSE Europe ex UK Index's sterling return rose to +5.7%, a very good quarterly return. The yen's weakness magnified the negative return on the FTSE Japanese Index for investors to -6.9%.

High quality government bonds experienced a negative quarter. Taking ten year government bond yields as a benchmark, gross redemption yields on UK government bonds rose by 29 basis points to 3.69%, on US government bonds by 16 basis points to 3.45%, on Japanese government bonds by 13 basis points to 1.25% and on euro denominated German government bonds by 41 basis points to 3.37%.

In the foreign exchange markets, sterling rose by 3.0% against the US dollar, by 5.1% against the yen, by 1.0% against the Swiss Franc and by 1.8% against the Australian dollar. Against a strong euro, buoyed by the prospect of an early interest rate increase, sterling fell by 2.9%.

Economics

Whilst stock market performances may have been unremarkable in the first quarter, the same cannot be said for the news background, encompassing, as it did, terrible natural disasters in Japan, New Zealand and Australia, with the accompanying tragic loss of life, nuclear radiation concerns resulting from the tsunami in Japan, political unrest in North Africa and parts of the Middle East and, finally, military intervention in Libya to protect Libyan citizens being attacked by pro Gadaffi forces. Added to this, the continuing and deepening eurozone sovereign debt crisis and one might be forgiven for thinking that the stock market was not the right place in which to be invested. But that has not been the case and, in this review, we will try to show why stock markets have been stable, whilst not seeking to minimise the risks.

Before we delve into the possible consequences of the quarter's extraordinary events, we should repeat one of the main reasons why the market has recovered so sharply over the last two years, the low point from which shares started their steep ascent being early March 2009. It is the exceptionally loose monetary policy, both orthodox and unorthodox, which has been followed since the financial crisis of 2008. In the main economic areas, i.e. the USA., Japan, eurozone and UK, interest rates have stood at extraordinarily low levels and have been supplemented at various times by quantitative easing, in other words, money creation. These were monetary measures for extreme circumstances, full of potential future danger, but justified by the very serious position of parts of the financial sector, especially the banking sector where the spectre of a run on the banks was very real. The flood of new money and negligible interest rates raised the appeal of competing assets to cash such as shares and bonds. Although not stated explicitly by the authorities, rising asset prices were an important part of the objective because these give greater confidence to individuals and businesses by creating a positive wealth effect. It is still very important for policymakers that stock markets remain firm because, at a time of severe fiscal consolidation, anything which maintains confidence is valuable. We will return to this subject later but it is important to set the background to what has happened and, despite everything else which has gone on, this has remained a constant over the last two years.

Let us now look at the "black swan" events which have occurred over the last quarter before moving on to the constant which has been present over the last twelve months or so, the eurozone sovereign debt crisis.

Against the background of the tragic loss of life and suffering in Japan and New Zealand caused by the earthquakes and, in Queensland, by the floods, it seems almost callous to discuss the possible economic consequences. In Japan, although the affected area reflects only a modest part of the Japanese economy (estimated at about 5% of GDP), the supply chain is widely diversified across the economy and, with many components these days sourced on a "just in time" basis, some production has been lost elsewhere in Japan and, to a lesser extent, overseas. With globalisation, manufactured goods produced in a certain country will contain parts from all over the world. For example, the big aircraft manufacturers and engine makers have important Japanese parts in their final products. One would expect the disruption to be relatively short term, but what will be the longer term consequences? Japanese companies will certainly learn the lessons and relocate factories to safer areas, with the associated lessons taken on board for new buildings. But will foreign companies which source components and parts from Japan consider their supply strategy? Will they consider Japan too high risk? The answer is probably not because of the high quality of Japanese work and the country's resourcefulness in dealing with such issues. However, only time will tell.

In the aftermath of terrible tragedies, like war and earthquakes, rebuilding and reconstruction give an economic boost to an economy, albeit for reasons that one had wished had not happened. Investors should probably be reasonably sanguine about these issues. Several points will be knocked off GDP in Japan in the short term and some added as rebuilding and reconstruction get underway.

Perhaps the longer term issue will be the effect on various countries' nuclear power programmes. If concern about the consequences of what happened in Japan turns into policy about turns elsewhere, then long term economic growth will surely be affected. We saw an immediate knee jerk reaction in Germany, where Angela Markel, under political pressure at home, ordered the shutdown of the seven oldest nuclear reactors for inspection. The CDU's poor showing in the state election of Baden-Wurttemberg will add to nervousness already manifested in statements from business leaders. In the UK, where an energy crisis is looming if no action is taken, a setback to the nuclear power programme could cause economic problems later on because of power shortages. The future of nuclear power could be one of the major issues to arise from the Japanese disaster. At the moment, it is an issue for noting but not forgetting.

Depending upon where they occur, natural disasters can have a significant effect on commodity prices and major political implications. A disaster in a major Australian agricultural state like Queensland will affect food prices. For example, one of the catalysts for the uprising in Tunisia and Egypt was rising food prices. It is an issue which worries political leaders. China is a good example. The latest Consumer Price Index in China shows a year on year increase of 4.9%, but the food component shows a rise of 11.0% and, the lower an average income is for a country, the more food expenditure represents as a percentage of income. For understandable reasons, China is very fearful of the potential for political unrest which rising food prices could cause. One of the steps the Chinese authorities have taken to deal with the situation is to raise the minimum wage sharply in certain regions. In the medium and long term, provided the market is allowed to work, rising prices encourage greater production, but this cannot be turned on overnight. The inflation problem arising from commodity price inflation and other sources is something which we will discuss later on in this review in relation to investment strategy. We have never subscribed to the view that deflation will be a bigger problem than inflation and feel that events are supporting those who have been more concerned about inflation.

One of the drivers of inflation is commodity prices and, here, one particularly thinks of oil, as, apart from food, it is the commodity price that affects people most visibly. So, the uprisings in North Africa and parts of the Middle East and, now, military intervention in Libya, are of vital importance to the direction of the oil price. Because of the unhappy series of events which has led to military action in Libya, it is natural to take a pessimistic view of the oil price based on a worst case scenario. That worst case scenario would involve Saudi Arabia, holder of the world's largest oil reserves, experiencing political unrest. Its anxiety over this possibility is likely to have been behind Saudi Arabia's prompt intervention in Bahrain, along with other Gulf Cooperation Council members. For the world economy, a supply shock causing the oil price to rise sharply rather than a more gradual rise caused by buoyant demand, is serious. A sudden reduction in the supply of oil gives economies no time to adjust. However, there could be a benign outcome, with Libya becoming a more normal country with a new set of rules and the oil flowing again. The power of communication now makes it more difficult for repressive regimes to hold on to power. If the mood of revolt gained ground, it could even affect countries like Iran one day. So, what we are saying is that, whilst it is natural to take a pessimistic view of current events in North Africa and the Middle East, they are not necessarily going to result in a bad outcome. Countries like Saudi Arabia and some UAE members are pumping more oil, albeit of a different quality to that from Libya.

Naturally, these are all issues which cause grave concern. There seems to be a number of major shocks all coming along in a short space of time, but markets, at least so far, have shown resilience.

However, one major problem which rumbles along and would, in normal circumstances, hold centre stage, is the eurozone's sovereign debt problem. It may well be the most enduring of the serious issues which the world economy currently faces, even though it may not feel this way at the moment. We have been writing about the eurozone's problems for a long time and, if we seem to repeat ourselves, it is because the fundamental problems arising from monetary union will not go away and are getting worse. This is an issue which will not have a happy ending. We all know the problem. We have made a mistake, are too proud to admit it and let it linger on until it becomes even worse and then something has to be done because the matter is taken out of one's hands.

This, then, is the problem with the euro. As established, it is difficult to understand how any objective observer could believe that it would be sustainable. Most currency unions are not. The political drive behind this project was, and still is, enormous, so a lot of pride is at stake and no one in authority has yet admitted that it was either a mistake to form the currency union or that it was constituted with a fatal flaw, this being that monetary union without fiscal union cannot work. A year or so ago, those who suggested the possibility of a eurozone break up were regarded as cranks. Now, that is not the case. Problems are coming for the eurozone's politicians from two sides. In the case of those countries which are having to take serious measures to tackle their public finances, namely Greece, Ireland, Portugal and Spain, the electorate is revolting, either at the ballot box, as in the case of Ireland and, perhaps, soon in Portugal, or on the streets in the case of Greece. There is a limit to what fiscal punishment people will take and, sooner or later in these countries, politicians are going to emerge who favour leaving the eurozone. Not having been asked whether they want to join the euro and, now, seeing harsher and harsher measures imposed upon them from outside their country, these calls to leave the eurozone will gain a resonance with voters and politicians. Of course, the problems which these particular countries face are self inflicted. They have lost competitiveness, although the case of Ireland is different, being brought to its knees by the banking crisis, itself a function of being a member of the eurozone and giving up the right to set its own monetary policy where interest rates would undoubtedly have been higher and the property boom more subdued. However, pressure is also coming from the stronger eurozone members, Germany and Finland in particular, where objections are strong to giving additional support to weaker eurozone members.

So the eurozone moves from crisis to crisis, trying to attach a sticking plaster to the problem when a fundamental solution is necessary. The yields on Greek, Irish and Portuguese bonds are such that there is no way that these economies are going to show sufficient growth to service their debts and a restructuring appears inevitable. The jury is out on Spain although it seems just about alright for the moment. However, the ECB looks as if it will start to raise interest rates shortly, perhaps at its next meeting, and this will add further pressure to those countries. So tough are the terms for those countries which receive a bailout that years of austerity are in prospect and the measures may create a vicious circle of economic decline from which they cannot recover. In the case of Ireland, for example, it is being denied a reduction in the interest rate on the EU portion of its bail out, which the new Fine Gael-Labour government has requested, unless it agrees to raise its Corporation Tax rate from 12½%, something that no Irish political party can accept. France and Germany are pressing for Ireland to raise its Corporation Tax rate.

The European Financial Stability Facility is in place now and the European Stability Mechanism is to come into place in 2013, but these mechanisms cannot isolate the problem and, if eurozone countries get into trouble, they threaten other countries in the eurozone because the problem cannot be isolated. Electorates in the relatively strong countries will wake up to this, especially if they themselves are subject to austerity measures.

What the eurozone is really scared about are problems in the banking system caused by sovereign debt defaults. Because of the inter relationship between the European banking system and its holdings of sovereign debt, the solvency of eurozone members is of crucial importance since it is impossible to isolate trouble spots. To give an idea of the sums involved, German banks' exposure to Greece, Ireland and Portugal (on the assumption that the latter needs a bail out, now confirmed) at 30 September 2010, we can refer to the latest Bank for International

Settlements review of March 2011, which has a table devoted to foreign exposures of banks to Greece, Ireland, Portugal and Spain. Exposure to the first three countries is US$326.2 billion, with a further US$242.4 billion to Spain. The size of the Spanish economy, the fourth largest in the eurozone, shows why eurozone members are so desperate to avoid the sovereign debt problem spreading to Spain. Whilst Spain is having to pay much more for its money than the best credit, Germany, the pricing of Spanish debt suggests that investors believe that Spain has a sporting chance of getting by without a bail out. France is shown as having exposure of US$215.7 billion to Greece, Ireland and Portugal and a further US$224.7 billion to Spain. Spain has low exposure to Greece and Ireland, but exposure to Portugal of US$108.6 billion. In total, the BIS table shows exposure to Greece, Ireland and Portugal of US$1,413.4 billion and a further US$1,098.8 billion to Spain.

Dramatic and shocking as recent natural disasters, political unrest and military action have been, it is reasonable to suppose that the issue which will still be with us at the end of the year is the eurozone's sovereign debt problem. With almost total certainty we can say that it will not go away.

So, how will policy makers react to what is going on and what does it mean for investors? At a time of severe fiscal stringency in the UK and eurozone, in particular, and heightened anxieties internationally arising from the issues we have discussed, the pressure on those controlling monetary policy is to keep it very loose for fear of derailing a recovery. This does not apply to those relatively successful economies like Australia, Canada, China and other parts of Asia which have started to raise interest rates, as they have done it from a position of strength and are following orthodox policy in tightening monetary policy against the background of relatively strong, or improving, economies to try to avoid inflationary pressures building up. That inflationary risks are being run with monetary policy in the UK, USA and eurozone, there is little doubt (Japan is rather more difficult to call). It is a question of balancing these risks against a tightening of monetary policy which would choke off economic growth. Central banks have different mandates and that of the USA is broader and more flexible than those of the UK and the eurozone. At the moment, inflation is not such a concern for the USA as it is for the UK and eurozone, and the continued weakness in the housing market and high level of unemployment will inform the decisions of the FOMC's members. However, in any circumstances, a target Federal Funds rate of 0.00% - 0.25% is exceptional and will leave many economists instinctively uneasy. In the UK, the policy dilemma is acute. Not only is there a substantial negative real rate of interest, as measured by official rates, but people's inflation expectations are rising and this informs wage negotiators' demands (the outcome of these might be quite different in this environment). With three members of the Monetary Policy Committee in favour of raising interest rates, the balance of the argument appears to be shifting and an interest rate rise, or series of them, can be expected soon. The question is whether this upward movement in interest rates will make the economic recovery more difficult? We will discuss this further when looking at the UK. UK inflation is substantially over the target level of 2% but, in the eurozone, it has only recently breached its target of close to, but just below, 2%. The ECB is more hawkish on inflation and, having given a strong hint of a forthcoming interest rate rise, it is unlikely that the recent series of extraordinary economic events will long delay its expected increase in the official rate, currently 1% (it has just been raised to 1.25% as this review is finalised). An upward movement of interest rates along the curve (if that happens) is the last thing that the struggling eurozone members need, but the ECB may be more concerned about the upward pressure on inflation.

Against this extraordinary background, what should investors and investment managers make of all this and how should they position themselves? One thing we feel we can continue to say with confidence is that sterling fixed interest securities offer very poor value. The relationship between yields and inflation on UK gilts is very unfavourable for sterling investors. Foreign investors, an important source of recent demand, may not be so bothered if they take a positive view on sterling and are concerned by the eurozone's debt woes. But this does not alter the fact that obtaining a negative real yield at purchase cost is superficially a very unattractive proposition. Fundamental justifications could include a view that inflation is experiencing a temporary spike and will fall sharply, so that the current gross redemption yield on a ten year gilt of 3.69% may not appear bad value. At present, that view appears optimistic. A second justification could be that every other asset class looks so unappealing that the relative return on a gilt is enticing in the circumstances. For this latter justification to hold, one would have to make a string of pretty pessimistic assumptions although that would not be to say that they were wrong. However, if we look at the UK market and the FTSE 100 index (admittedly with a majority of overseas earnings in it), we see a current dividend yield of 3.05% perhaps rising to about 3.5% this year and a p/e ratio falling perhaps to below 11 this year. Prima facie, equities would seem to be more appealing. What do they have going for them? With strong growth expected in emerging and developing economies this year, as well as the Newly Industrialised Asian Economies, companies based in those areas and in the major industrialised countries which have exposure to them, will benefit. In its World Economic Outlook Update in January, the IMF forecast economic growth to be 4.4% overall in 2011 but, in the Newly Industrialised Asian economies, to be 4.7% and, in emerging and developing economies, 6.5%. This was before the Japanese earthquake, which will lower overall growth slightly, one would think. Notwithstanding cost pressures, one would expect corporate profits to continue to recover and rise against such a backdrop of economic growth. If that happens, we would expect the improving trend of dividends to continue, an important fundamental for shareholders when comparing the attractions of other assets. Companies with a significant spread of international operations are used to dealing with currency fluctuations, an issue which has been highlighted in recent times, when we have often seen quite marked movements in currencies in a short period of time. A more general point is that holders of shares have a call on real assets. That is an important concept at a time when money is in danger of being debased by quantitative easing, where applied, and negative real interest rates. Many businesses, though obviously not all, have the pricing power to protect themselves from inflation and, by extension, to their shareholders through increasing dividends which will help to offset inflation. Some companies will, therefore, represent an inflation hedge. Commodities can also fall into this category and can be accessed by the same route.

What about cash? Holding cash, ready to invest on a setback in equity markets, makes sense because, with all the bad news and potentially bad news around, there is a chance of finessing entry at a more favourable point. Markets cannot rise in a straight line. But they are beginning to show resilience, as shown by the steady performance in March, against the background of a whole host of events which could have been expected to upset confidence badly. It is almost as if investors are inured to these "black swan" events. To hold cash as the main investment at current short term interest rates, as opposed to keeping it as an opportunity to invest at a lower level, would only be appropriate for those who are so risk averse that they would be more comfortable with losing money in real terms.

We turn now to look at individual countries and areas of the world, starting with the USA. In terms of issues which are important to the US economy, the state of public finances looks far larger than anything else. It is like a slow motion train crash. Everyone knows the problem but politicians seem incapable of stopping it and, eventually, if nothing is done the accident will take place. US public finances, including those of many states, are out of control. Yet nothing is being done about it at the executive level and attempts within the legislature to come to a bipartisan agreement on deficit reduction do not seem likely to progress. At the state level, more progress is being made. A requirement to balance the budget in operating terms means that action is being taken with some high profile activity in states like Wisconsin which have attracted headlines. At the federal level, there is no such urgency. As issuer of the world's largest reserve currency, the USA has benefits that, say, the UK does not. Both countries have horrendous budget deficits. The UK has taken decisive steps to eliminate the structural deficit over the lifetime of the current parliament and has been rewarded in the bond market for so doing. Whilst we are sure that this is the right thing to do, in truth the UK had little choice. The UK's creditors would have taken fright, bond yields would have risen and sterling would have fallen. Because the US dollar is the world's largest reserve currency, the USA has more latitude. Foreign governments have to hold US dollars in their reserves, whereas they generally do not have to hold sterling. If they dump US dollars, they are putting at risk the value of their remaining reserves. The US dollar is needed as the currency of transaction for many commodity trades and normal international business transactions. At some stage, though, those who lend to the USA are going to have had enough of its financial profligacy. The US dollar will weaken and interest rates rise. A budget deficit forecast at around 10% of GDP this year takes a lot of turning round and, in the USA, the political system does not make decisive action easy. This, then, is a problem for the future and one which is certain to occur. The question is when?

As for the current state of the US economy, it seems to be progressing reasonably well. The last estimate of fourth quarter US GDP growth showed an increase from an annualised rate of 2.8% to 3.1%. The Federal Reserve, too, seems to have moved to a more optimistic assessment of the outlook. The FOMC described the US economic recovery as on a "firmer footing". There was a slightly more optimistic tone on the labour market. It said that it "appears to be improving gradually". In comments on consumer spending and business investment, it mentioned that they "continued to expand". The FOMC was quite sanguine about inflation, despite higher commodity prices. It expected upward inflationary pressure arising from higher commodity prices to be "transitory". These comments are important because they do not suggest that the FOMC is in a hurry to raise interest rates. It indicated that it would publicly continue the QE2 programme of bond purchases in place to the end of June. Ideally, the second bout of quantitative easing, QE2, will be the last. It is very dangerous for the US economy to be addicted to it. It risks debasing the currency and setting off serious inflation. The difficulty of exiting it is that, prima facie, it could cause bond yields to rise as a big buyer of government and other bonds exits the market. The first part of reversing QE is to stop the Federal Reserve's buying programme, using newly created money, and the second part is to sell back the securities purchased by the central banks to the private sector to suck out the cash created. This is an issue which investors in the USA and elsewhere will have to face.

The real drag on the US economy continues to be the housing market, where depressed prices and activity continue to impose a negative wealth effect on many households and represent a drag on bank profitability in the form of bad loans. Not all of the news is negative but there is currently no sign of a decisive turnround. Two indicators from the housing and construction sector were mildly positive, the rest were negative. The National Association of Home Builders reported a marginal increase in its builder sentiment index, from 16 to 17 out of a scale of 100. There was also an increase in the number of Americans signing contracts to buy homes in February, but it was not evenly enough distributed to give major cause for hope. On the negative side, sales of previously owned homes fell by 9.6% in February. This was the first decline in three months. The Commerce Department reported that new home sales fell by 16.9% in February and prices were at their lowest since December 2003. The S&P/Case Shiller index of house prices in twenty metropolitan areas fell by 0.2% in January which was the seventh consecutive monthly decline. The construction of new houses fell by 22.5% in February compared with January and building permits fell to a record low, down 8.2% from January. So, there is not a lot of joy in this area of the economy.

The balance of the US economic statistics released over the past month veers slightly towards the favourable. The ISM indices for manufacturing and services in March still record quite high figures even though lower than in February, 57.3 in the case of the services index and 61.2 in the case of manufacturing. The jobs market looks to be improving modestly. Non farm payrolls rose by 216,000 in March, with the jobless rate declining by 0.1% to 8.8%. The unemployment rate has fallen 1% over the last four months. The New York Federal Reserve reported that its Empire State general business conditions index rose to its highest level since last June. Factory output rose 0.4% in February. Consumer spending rose by 0.7% in February following a 0.3% increase in January. The Business Round Table's economic index shows that optimism amongst the chief executives of US companies has risen to the highest level since records began in 2002.

But the news was not all one way. There was a sharp fall in the IBD/TIPP economic optimism index, which fell from 50.9 in February to 43.0 in March. Durable goods orders fell by 0.9% in February, the fourth decline in the past five months. The Thomson/Reuters University of Michigan consumer sentiment index fell in March to its lowest reading since November 2009. This is not surprising given all the bad news in March. Likewise, the Conference Board's US consumer confidence index fell from 72 in February to 63.4 in March. Orders for manufactured goods fell by 0,1% in March.

As we can see from the table at the front of this review, the US equity market had an above average performance in the first quarter of 2011. The background for corporate profits and dividends has been good on the basis of the recovery in economic activity in 2010 after the recession of 2009. Firm action at an early stage to rein in costs is bearing fruit and now companies need top line revenue growth, which some are seeing. The weakness of the US dollar helps those companies which have exports or significant overseas businesses. Although more highly rated than European markets, equities are not excessively rated in the USA and, as elsewhere, the lack of attractive alternative investment options favours equities. All the time, however, investors have to consider how the USA is going to confront its enormous debt problem.

We can also see from the table at the beginning of this review that European equities, helped by the rather improbable strength of the euro, have enjoyed a strong quarter when currency considerations are taken into account for non euro investors. Why might this be? One general point which we have made before is that companies can be in quite a different position from the countries in which they are headquartered. It does not follow that a country in financial trouble should automatically taint the performances of its own companies. It might do, as it did last year for the weaker eurozone members, but, as we can see from the table, Spanish shares, after significantly under performing in 2010, enjoyed a strong partial recovery in the first quarter of this year. The weakness of eurozone bonds could have its counterpart in the strength of its equities. We have discussed how strong credits like Germany can be drawn into the problems of others by participation in the bailout. Investors have a very good reason for thinking that they may be better off in shares. After all, there are many world class companies based in Europe with extensive international interests which are benefiting from the emerging trends in the world economy.

Amidst all the bad news from the eurozone, there has been some good news, which it is worth recording, if only to give balance and also to indicate why the European stock markets have risen during the quarter. Both purchasing managers indices for eurozone manufacturing and services are at reasonably high levels. The services index rose from 56.8 in February to 56.0 in March. This is the highest reading since August 2007. The manufacturing services fell from 59.0 in February to 57.7 in March, still a satisfactory reading. In Germany, obviously an important influence on eurozone data as the area's largest economy, factory output recovered by 1.8% in January after falling 0.6% in December. German exports, much in demand in the current environment, rose by 24.2% in January. Eurozone production rose 0.3% in January after a revised figure of a 0.2% increase in December.

In Japan, economic data is almost academic at present in the light of the devastating earthquake and tsunami. In the immediate aftermath of the tragedy, the Bank of Japan acted to stabilise markets and the monetary system. On the Monday after the disaster, the Bank of Japan made Y21,800 billion available to institutions and carried out its own quantitative easing by doubling its asset buying programme to Y10,000 billion. A few days later, it announced further action to stabilise the markets with two more cash injections and an expanded asset purchase scheme. As we said earlier on, the economic effect will be to dent modestly immediate economic activity but to stimulate it later this year and beyond as the rebuilding and reconstruction programme gets under way. Many investors have shunned the Japanese market because of previous bad experiences but ratings and dividend yields are both attractive. For example, the dividend yield on Japanese equities is well above that on ten year Japanese government bonds. The estimated dividend yield on the Nikkei 225 index for this year is about 1.9%. The reasons for being invested in Japan are what they always were. Japan is home to many leading world class companies and, notwithstanding all its problems, this fact is worth bearing in mind. As with the USA, however, Japan is going to have to address its serious public debt problem, with a gross outstanding public debt of over 200% of GDP.

We have touched upon the prime concerns of the Chinese leadership, inflation and, particularly, food price inflation, because of the potential for political unrest. We may expect to see more measures to try to reduce the risk of inflation, currently 4.9%, rising further away from its desired level. The property market is a target because of the knock on effects for inflation of a booming property market. There have been instances where the authorities have tried to tame food price inflation by leaning on companies to defer food price rises. Meanwhile, the Chinese economy continues to grow strongly, with industrial output in the first two months of 2011 rising by 14.1% year on year compared with 13.5% in December.

Finally, we turn to the UK, where the main event in March has been the Budget. The Coalition is now beginning to face its sternest tests as interest groups start lobbying and agitating against the "cuts". It is important to be accurate. Public expenditure is not being cut. The rate of increase in public expenditure is being reduced. For many, it is a distinction without a difference and, naturally, every interest group is fighting their corner. Some may face real cuts, but that is not the overall position. Those advocating the Coalition's policy of eliminating the structural deficit over the life of the current parliament do not have their voice heard as loudly as those who complain. In the former camp, besides the government, one might find international organisations like the IMF and OECD, the employers' organisations and various economists and think tanks. Politically, the Coalition is likely to become increasingly unpopular as tax increases bite, disposable incomes fall and so does public sector employment. It will require a very strong will to see these measures through to the end of this parliament and strains within the Coalition are bound to increase. Whilst the economic case for restoring public finances to some semblance of order is overwhelming, it is a difficult case to make out when voters are facing very difficult times themselves in many cases. But, as we have said before, a more gradual approach to reducing the deficit, as some advocate, is a high risk approach which could result in an early financial and economic crisis. As we have seen in the eurozone, the rating agencies are not backward in cutting sovereign debt ratings and it is almost inconceivable that the UK would retain its AAA rating in such circumstances. If the UK's rating were downgraded, relative borrowing costs would rise and, almost certainly, absolute borrowing costs, as we expect interest rates to rise in any case. The UK's level of outstanding debt is going to grow anyway. If the debt reduction target were to be approached more gently, debt would rise even faster, for there would be no guarantee of faster economic growth to boost public finances.

Before we consider the outlook for investment in the UK markets, we should list the main points of the Budget statement. Short term economic growth forecasts have been reduced. The Office for Budget Responsibility (OBR) now forecasts that economic growth in 2011 will be 1.7% (previous forecast 2.1%) and for 2012 that it will be 2.5% (previous forecast 2.6%). 2013 and 2014 are predicted to show growth of 2.9% and 2015 2.8%. For the current year 2010-11, public sector borrowing is forecast to be £146 billion, slightly below the target of £149 billion. However, mainly because of inflation, it is forecast to be £47 billion higher over the next five years, the forecast figures (previous estimate in brackets) being £122 billon (£117 billion) for 2011-12, £101 billion (£91 billion) for 2012-13, £70 billion (£60 billion) for 2013-14, £46 billion (£35 billion) for 2014-15 and £29 billion (£18 billion) for 2015-16. Not unexpectedly, inflation forecasts have been increased. The expectation for this year is that inflation will be between 4% and 5% compared with the OBR's earlier forecast of 3.0%. For next year it has raised its forecast to 2.5% from 1.9%.

For markets, the key issue is maintaining the confidence of the UK's creditors. So far it has, but any significant slippage in the programme of deficit reduction is likely to be badly received. Politically, it is going to be a very difficult for the coalition because of the range of interest groups ranged against it. These groups will gain a much greater hearing than those who explain why the current level of borrowing, if not properly addressed, threatens something far, far worse than the very unpleasant five years which the UK will have to endure. Whilst it is tempting to theorise on why it might be better to reduce the deficit more slowly than currently planned, the practicality is that the bond and foreign exchange markets could turn on the UK at any time, such is the fragility of the UK's public finances. For investors, this means that holders of gilts and, by extension, other sterling bonds, must monitor these political developments closely. Even on the best outcome, the one where the path of deficit reduction is successfully followed, we believe that sterling bonds are expensive. On the worst assumption, which might mean that the Coalition lost its nerve or collapses, the outlook would be very serious, with significant losses likely to be incurred by holders of sterling bonds. What would these two scenarios at the opposite end of the spectrum imply for holders of UK equities? A positive outcome to the deficit reduction programme should be beneficial for UK equities. Whilst we expect sterling bond yields to rise and therefore provide more competition for equities, we think equities could absorb this on the basis that a continued recovery in the world economy (if it occurs) should provide the background to rising company dividends. The general point which applies to UK companies (particularly the larger ones) is that they derive a considerable amount of their earnings from overseas (the majority) and therefore, in many cases, have significant insulation from any problems which the UK may face. If the UK's creditors lost confidence, say because of a credit downgrade, and interest rates rose sharply, that would provide a much greater challenge to UK equities, although one which would be likely to be mitigated by a fall in sterling, which would boost many companies' earnings, and these companies, with significant overseas exposure, could be regarded as a devaluation hedge.

As indicated above, in discussing the OBR's revisions to its previous borrowing forecasts, the main reason was a deterioration in the inflation outlook. It has, for some time, been a mystery to many why the Bank of England was so sanguine about the inflation outlook. Intuitively, it was difficult to understand. Whereas in many countries, not so much the UK, people were worried about deflation, in the UK if it ever was a concern, is certainly not now. The split in the Monetary Policy Committee, with three members now favouring an increase in interest rates, indicates a shift in opinion which is soon likely to manifest itself in a rise in interest rates but, from such a low level, it is unlikely to pose a threat to UK equities. As in the USA, quantitative easing is going to have to be reversed at some stage and that will pose a different set of questions for the market, but the UK economy is too fragile at the moment for this reversal to be considered.

The remarkable thing about the quarter just ended was that it was not remarkable. With a number of extraordinary and unpleasant events occurring within a short space of time, one would not expect the type of outcome which we have seen in international equity markets. A sharp fall might have been expected. But it did not happen. After what investors have been through in the past two and a half years, they may be becoming more inured to such events and looking through them to more fundamental issues. Because the news is still so bad, we must expect setbacks from time to time which will provide opportunities to commit more cash to the equity markets. For the foreseeable future, monetary policy is likely to remain supportive to markets but, further down the line, there will be challenges as monetary policy tightens and quantitative easing is reversed. We are not there yet, however. Equity ratings and dividend yields remain supportive as corporate earnings and dividends continue to grow. Bonds, as we have made clear, remain unattractive investments for the reasons given. There is no room for complacency but we continue to regard high quality equities as the asset of choice.