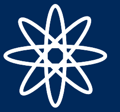
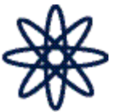


meridian

ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

It has been a pleasing quarter for international equity investors as prices have advanced on the back of satisfactory economic news, good economic forecasts, continued growth in corporate earnings and a high level of corporate activity. Bond markets have been mixed as inflation concerns have emerged in certain countries such as the UK.

The tables below detail relevant movements in markets:

International Equities 31.01.07 – 30.04.07

Total Return Performances (%)

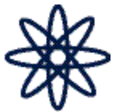
Country	Local Currency	£	US$	€
Australia	+7.9	+13.5	+15.9	+10.4
Finland	+9.0	+12.1	+14.5	+9.0
France	+6.7	+9.7	+12.1	+6.7
Germany	+9.8	+12.9	+15.3	+9.8
Hong Kong, China	+2.2	-0.2	+2.0	-2.9
Italy	+4.4	+7.3	+9.6	+4.4
Japan	-0.9	-1.8	+0.3	-4.5
Netherlands	+11.3	+14.4	+16.8	+11.3
Spain	-0.9	+1.9	+4.1	-0.9
Switzerland	+5.0	+6.3	+8.6	+3.4
UK	+5.4	+5.4	+7.7	+2.6
USA	+3.4	+1.2	+3.4	-1.5
Europe ex UK	+6.3	+9.0	+11.3	+6.0
Asia Pacific ex Japan	+6.7	+7.4	+9.8	+4.5
Asia Pacific	+2.3	+2.1	+4.4	-0.6
Latin America	+7.6	+8.6	+11.0	+5.7
All World All Emerging	+7.0	+6.9	+9.3	+4.0
The World	+4.2	+3.8	+6.1	+1.0

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +0.3%

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

Currency	31.01.07	30.04.07
Sterling	4.98	5.04
US Dollar	4.83	4.63
Yen	1.71	1.63
Germany (Euro)	4.10	4.15



Sterling's performance during the quarter ending 30.04.07 (%)

Currency	Quarter Ending 30.04.07
US Dollar	+2.1
Canadian Dollar	-4.3
Yen	+0.9
Euro	-2.7
Swiss Franc	-1.2

Other currency movements during the quarter ending 30.04.07 (%)

Other Currency	Quarter Ending 30.04.07
US Dollar/Canadian Dollar	-6.4
US Dollar/Yen	-1.2
US Dollar/Euro	-4.8
Swiss Franc/Euro	-1.5
Euro/Yen	+3.8

Significant Commodities (US dollar terms) 31.01.07 – 30.04.07 (%)

Significant Commodities	31.01.07 – 30.04.07
Oil	+18.1
Gold	+4.4

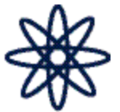
Markets

There has been an upward bias in equity markets over the last quarter with the total return on the FTSE World Index in local currency terms being 4.2%, in sterling terms 3.8%, in US dollar terms 6.1% and in euro terms 1.0%. In local currency terms, Europe ex UK has performed particularly well, returning 6.3%. The UK has returned 5.4%, the USA 3.4% whilst the FTSE Japanese index has returned -0.9%. Within Europe ex UK, Germany and Finland have performed well returning 9.8% and 9.0% respectively, whilst Spain has been weak, returning -0.9%, as worries about the over extended state of the property market surfaced at the end of April. Elsewhere, Australia continued to provide an excellent performance, returning 7.9%. Asia Pacific ex Japan, Latin America and emerging markets showed excellent performances returning 6.7%, 7.6% and 7.0% respectively. Adjusted for currency movements, the return on the FTSE Europe ex UK index rose to 9.0%, whilst that on the FTSE USA index fell to 1.2% and the FTSE Japanese index to -1.8%. The strength of the Australian dollar provided a spectacular increase in the sterling return on the FTSE Australian index to 13.5%. Returns in Asia Pacific ex Japan and Latin America regions rose to 7.4% and 8.6% respectively whilst that on emerging markets shaded slightly to 6.9%.

There was a mixed pattern in the bond markets, if we take ten year government bonds as a benchmark. Yields drifted higher with those on sterling bonds rising 6 basis points from 4.98% to 5.04% and those in euro denominated German government bonds by 5 basis points to 4.15%. On the other hand, there was quite a sharp drop in UK government bond yields, 20 basis points to 4.63%, and in Japanese government bond yields by 8 basis points to 1.63%.

There were some quite significant moves in the currency markets. Against the US dollar, sterling rose by 2.1% but against the Canadian dollar it fell by 4.3%. The US dollar fell heavily against the Canadian dollar by 6.4%. Sterling rose marginally against the yen, rising by 0.9%. Against the European currencies it was weaker, falling by 2.7% against the euro and 1.2% against the Swiss franc. The euro rose by 3.8% against the yen representing one of the "carry trade" results.

In the commodity markets, oil rose by 18.1% and gold by 4.3%.



Economics

- *The IMF is optimistic about the world economy* ...... it predicts 4.9% economic growth for 2007 and 2008.
- *There is a slight concern about inflation* ...... of the G7 countries, it is a particular issue for the UK but, overall, it appears manageable.
- *Internal and external imbalances remain an issue* ...... the USA, in particular, and the UK have significant current account deficits. Internally, a number of countries have not used better economic conditions to address structural budget deficits.
- *Whilst the US economy slows down, probably temporarily, other economies will provide momentum for the world economy* ...... the eurozone, Japan and, particularly, China and India and other parts of Asia.
- *M &A activity remains a feature* ...... still relatively low interest rates, ample liquidity, a good macro economic situation and attractive share valuations provide a favourable background. This situation is likely to continue.
- *Companies still continue to take shareholder friendly actions* ...... share buy backs, special dividends, returns of capital and rising regular dividends remain a feature of equity markets.
- *Whilst we think share valuations remain sensible and sustainable, there are speculative bubbles in the world investment scene* ...... examples, we think, are "carry trades" mainly involving the yen, certain areas of the property market and the low grade bond market.

USA

- *The initial first quarter estimate of economic growth was surprisingly low* ...... it came in at 1.3%, dragged down by net exports and government spending and the housing construction market. It would be a surprise if the next two estimates did not show an upward revision.
- *The latest Beige book paints a satisfactory picture of the US economy* ...... a slightly more positive nuance on growth and the hint of slightly stronger wage pressures.
- *The latest FOMC minutes still emphasise the inflation risks to the US economy* ...... higher interest rates cannot be ruled out but most observers think this unlikely at this stage.
- *The IMF thinks this current US economic slowdown is likely to be a mid-cycle slowdown* ...... it forecasts 2.2% growth this year and 2.8% next year.
- *The weakness of the housing market is a drag on US economic growth* ...... but not all the figures are gloomy. However, the excessive inventory overhang will have to be run down before a solid recovery can occur.
- *Although above target, inflation is just about manageable* ...... the Federal Reserve's favoured measure, the core personal consumption expenditure deflator, stood at 2.2%, year on year, in the first quarter, just above the Federal Reserve's maximum 2% comfort level.

Japan

- *Standard and Poors upgrades Japan's sovereign debt* ...... it moves it from AA- to AA because of an improved fiscal position and a move towards more normal monetary policy.
- *Business confidence is holding up* ...... April's Tankan survey was generally satisfactory.
- *The yen continues to be weak because of the "carry trade"* ...... the yen is the favourite currency for "carry trade" investors to borrow to invest in higher yielding currencies. But it is a dangerous strategy.
- *Conditions are excellent for many Japanese companies* ...... no inflation and a weak currency give exporters an excellent advantage.

China

- *Growth has accelerated* ...... first quarter annualised growth was 11.1%.
- *The authorities remain concerned about excessive growth causing inflationary and bad debt problems* ...... they continue to raise banking reserve requirements.
- *Inflation is above target* ...... the March figure was 3.3% year on year.
- *Foreign exchange reserves continue to grow rapidly* ...... they stood at US$1,202 billion at the end of March.

Europe Ex UK

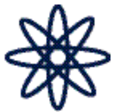
- *The eurozone continues to perform well* ...... the IMF expects growth of 2.3% in 2007 and 2008 after 2.6% last year.
- *Interest rates look likely to rise to 4% in June*...... the ECB has given a heavy hint to this effect.
- *The latest inflation figures are within the current target range* ...... April's figure was 1.8% which, after a further fall, is expected to rise again.
- *The ECB will be watching particularly carefully the progress of German wage negotiations* ...... in the engineering and metals industry, IG Metall is pressing for a 6.5% wage increase whilst the employers' organisation has offered 3%. If the ECB deems the outcome of the negotiations to be inflationary, this will influence its interest rate policy.
- *The economic news from Germany gets better* ...... the five German think tanks raise their growth forecast to 2.4% this year and the government raises its forecast from 1.7% to 2.3%.
- *The French Presidential election result could be an important stock market influence* ...... the two final round candidates have very different economic philosophies.
- *M &A activity is likely to continue at a significant rate* ...... the battle for ABN Amro may be indicative of more activity ahead particularly if the EC manages to attack successfully protectionist tendencies.

UK

- *First quarter GDP growth is slightly lower than expected* ...... it comes in at 0.7% with an annual rate of 2.8%.
- *Relative to the experience elsewhere, inflation is a problem* ...... the latest CPI at 3.1% is 1.1% above target whilst the old measure and the more representative one for most people, the Retail Price Index, stands at 4.8%, its largest rise since 1991.
- *Because of the trends in inflation, the Bank of England is likely to raise interest rates further* ...... there may be more than one rise.
- *The housing market will be a key indicator for interest rate policy* ...... London is effectively an economy of its own because of the strength of the financial services industry but, nevertheless, rapid house price increases may call for further interest rate action.

Summary

- *The positive international economic outlook should provide support for equities* ...... corporate earnings should continue to advance, albeit at a more modest rate.
- *With shares on reasonable multiples, earnings growth should support moderately higher share prices this year* ...... additional support comes from a range of shareholder friendly measures.

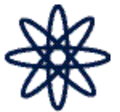


- *There is excessive risk taking in some areas of the financial markets* ...... this could led to difficulties but we do not count equities in this category.
- *The yields on bonds continue to look too low* ...... although inflation is not a major problem, it is not dead and real yields, particularly in the UK, look too low.
- *In absolute and relative terms, shares, to us, look more attractive than bonds or cash* ...... we would continue to expect outperformance from them, albeit with periods of volatility such as seen last May and June and, to a lesser extent, at the end of February.

Abridged Summary of Projections from the IMF's World Economic Outlook April 2007

Real GDP Growth (%)			
	2006 (actual)	**2007 (estimate)**	**2008 (estimate)**
World	5.4	4.9	4.9
USA	3.3	2.2	2.8
Eurozone	2.6	2.3	2.3
Japan	2.2	2.3	1.9
UK	2.7	2.9	2.7
Other emerging markets & developing countries	7.9	7.5	7.1
China	10.7	10.0	9.5
India	9.2	8.4	7.8

Inflation (consumer prices)			
	2006 (actual)	**2007 (estimate)**	**2008 (estimate)**
USA	3.2	1.9	2.5
Eurozone	2.2	2.0	2.0
Japan	0.2	0.3	0.8
UK	2.3	2.3	2.0
Other emerging markets & developing countries	5.3	5.4	4.9
China	1.5	2.2	2.3
India	6.1	6.2	4.3



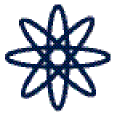
General Government Structural Balances			
	2006 (actual)	**2007 (estimate)**	**2008 (estimate)**
USA	(2.7)	(2.4)	(2.4)
Eurozone	(1.3)	(1.0)	(1.0)
Japan	(4.3)	(3.9)	(3.7)
UK	(2.7)	(2.2)	(2.0)

Current Account Surpluses / Deficits as a % of GDP			
	2006 (actual)	**2007 (estimate)**	**2008 (estimate)**
Advanced economies	(1.6)	(1.6)	(1.6)
USA	(6.5)	(6.1)	(6.0)
Eurozone	(0.3)	(0.3)	(0.4)
Japan	3.9	3.9	3.6
UK	(2.9)	(3.1)	(3.1)
Newly industrialised Asian economies	5.6	5.3	5.1
China	22.6	23.6	23.4
India	(9.8)	(10.1)	(9.2)

As we can see from the table of economic growth projections, the IMF is expecting 2007 to be another good year for the world economy, with growth only slightly lower (4.9%) than in 2006 (5.4%). At this stage, it sees the same rate of growth in 2008. Both these projections are unchanged on its September 2006 World Economic Outlook forecasts.

Within the overall unchanged forecast, there have been detailed changes. Notably, the IMF has marked down this year's and next year's growth forecasts for the USA by 0.7% and 0.4% respectively. It now sees growth this year of 2.2% and 2.8% for next year. On the other hand, it has raised its forecasts for the eurozone for 2007 and 2008 to 2.3% for both years. Whilst it has slightly reduced its forecast for France this year to 2.0%, it is markedly more optimistic about Germany (+0.6% to 1.8% this year), Italy (+0.5% to 1.8% this year) and Spain (+0.6% to 3.6% this year). It has also raised its forecasts for those three countries next year whilst keeping France's forecast unchanged. The IMF has marginally upgraded its forecast for the UK this year to 2.9% (2.8% was its previous forecast) and 2.7% for next year (2.5%). It has slightly adjusted its forecast for Japan this year, raising the figure to 2.3% (2.1%) but has marginally reduced its forecast for next year to 1.9% (2.0%). Elsewhere, the major change is to the forecast for India where growth this year is now seen at 8.4% (7.3%) and for 2008 at 7.8% (7.1%). The figures in the table confirm that China and India, in particular, continue to provide an important driver for world economic growth. Given the latest Chinese economic growth figures, the forecasts may even be on the conservative side.

Against a generally benign economic background, one of the slight worries is inflation which is above target in the USA and, particularly, the UK. The IMF's forecasts are not alarming but success in containing inflation will depend upon appropriate monetary policy being in place and commodity prices, particularly oil, not getting out of control. We will be discussing interest rates later on in this review.



Whilst the international economic outlook is generally benign, there are issues which need to be monitored and which could have an effect on the economic situation and, hence, stock markets. These relate to external and internal imbalances. We show from the IMF's forecasts those for central government structural balances - i.e. deficits (but they could be surpluses) which are adjusted for the cyclical economic position. Generally, they do not make for good reading. Strong economic growth should mean that governments use this benefit to run surpluses and improve their financial position ready to deal with more difficult economic times. That has generally not happened and, as the table shows, there are significant structural deficits. The result could be difficulty in addressing the next economic downturn. The other deficit, the external one, is the one which attracts more attention with that of the USA standing at around 6.0% of GDP. Current account deficits are not necessarily good predictors of currency movements because of the size of capital flows. For example, although the US dollar has been weak so has the yen and Japan has a very large current account surplus as the table shows. At the moment, on the other side of the equation, the UK is running a large current account deficit but the pound is quite stable.

The forecasts suggest that the world economy can withstand what is probably a mid cycle pause in the US economy before it starts to accelerate again next year. Quite strong growth in the eurozone, Japan and the UK will help but the impetus given to international economic growth for China, India, other parts of Asia and the emerging markets and developing countries remains very significant.

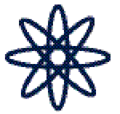
Overall, the IMF suggests a positive outlook for the world economy over the next two years and it rates the downside risks to the world economy less than it did in its previous report last September. It now puts the chance of world economic growth falling below 4% in 2008 at 20%.

The economic outlook is clearly important to investors as they assess the outlook for the stock market. What this outlook from the IMF suggests is that the environment is right for further corporate earnings and dividend growth, a background that might be expected to be good for equities.

What have been the main features of the last quarter? At a stock market level, the continuation of extensive M & A activity stands out. It has reached very high levels in the USA, UK and Europe. What are the reasons? Firstly, the long period of economic growth, which has led to a substantial increase in corporate earnings, has given companies the confidence to contemplate corporate deals and, the more confident they are, the larger the deals they consider. So, a good macro economic background is conducive to a high level of corporate deals.

Secondly, equity ratings are quite modest in most countries and short term interest rates and bond yields are still relatively low. The relation between earnings yields, the reciprocal of the P/E ratio, and ten year government bond yields, for example, is favourable for financing takeovers with earnings yields quite well in excess of bond yields. Ample liquidity provides the fire power for large deals. Private equity is much in the news. In the USA, private equity is bidding US$44.5 billion for the utility, TXU, whilst, in the UK, there has been a bidding frenzy for Alliance Boots with the final private equity bid having been worth £11.1 billion. Private equity has substantial sums available and Alliance Boots may not be the last FTSE 100 company to be taken over. Private equity has certain advantages over public companies in making takeover bids. Although the backers want a good return on their investment, companies taken over can conduct themselves out of the public eye and without the onerous disclosure rules placed on public companies. Whilst investors in public companies closely scrutinise every quarterly or half yearly result, private equity owned companies can take a longer term view. Arguably, they can, therefore, afford to pay more for companies which they are buying.

Linked to this, but perhaps a reason more specific to the UK, is that regulatory pressure in the UK, which forced some institutions to sell equities and buy longer dated bonds, left shares looking oversold. One only has to look at the string of medium to large UK companies which have been bought by overseas investors to realise that they have seen value in these companies which has not been seen by domestic investors.

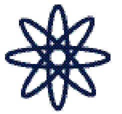


This level of takeover activity can only flourish in an environment where takeovers from domestic and foreign companies are not blocked or hindered by regulatory or government interference. In this respect, the UK has one of the most liberal regimes which is to its credit. Europe has considerable protectionist tendencies, most notably in France but also elsewhere. These barriers are supposed to be coming down with the single market and in so far as the European Commission is successful in eliminating protectionist measures, it should open the way for a lot more corporate activity in Europe. A case in point has been the takeover bids for the Spanish utility, Endesa. The Spanish authorities initially wanted a Spanish solution and then placed significant barriers in the way of the German utility, E.ON, which made a superior bid. Eventually, the EC broke down the restrictions placed on E.ON, only for E.ON eventually to be thwarted by a Spanish-Italian bid, although E.ON will acquire some of the assets it wants.

Economic power is visibly shifting to the Middle East and Far East. With substantial sums available for investment, Middle East investors have been active in western stock markets, either acquiring companies or building up stakes in large companies. We may expect this trend to continue.

So, corporate activity has certainly helped to support equity markets for a while in two ways. Firstly, it has acted as a spur to sentiment and, secondly, it has taken equity out of the market. This latter trend has also been accentuated by share buybacks which are being conducted on a large scale as companies use their large cash flows or seek to make their balance sheets more efficient. Companies have acted in a very shareholder friendly manner which has also been a support to equities. In February, the Financial Times quoted research by Citigroup which showed that, since 2003, £118 billion had been returned to shareholders through buybacks and special dividends in the UK. Citigroup said that this represented 63% of total dividends paid during the period. In Europe, the return represented 56% of total dividends paid and the amount returned was 292 billion. Interestingly, payout ratios have fallen. Whilst it is estimated that there has been a doubling of corporate earnings in Europe since 2003, dividends have only risen by 45%. The respective figures for the UK are given as 55% for earnings growth and 30% for dividend growth. It is said that payout ratios are at a fifteen year low in Europe and an all time low in the UK. This provides some support should the corporate earnings environment deteriorate in the future.

One of the features of securities' markets since the end of last May's and June's volatility has been the very low levels of volatility seen in markets. There was a wobble at the end of February when China's stock market temporarily fell back after a big rise but conditions are returning to the level seen before then and investors appetite for risk has been increasing. We see dangers of bubbles developing in certain financial and related markets, indeed we may already be there. We would emphasise that this does not relate to equity markets where we consider valuations to be reasonable. What we are thinking of is the "carry trade" mainly affecting the yen whereby borrowers of yen at minimal interest rates convert into higher yielding currencies to obtain the benefit of higher return. With very little volatility in markets, it has seemed a low risk strategy given the large interest rate differentials between, say, the yen and New Zealand dollar or Australian dollar. But both New Zealand and Australia have very large current account deficits whilst Japan runs a large current account surplus. Investors cannot indefinitely count on profit from the interest rate differentials being a given and feel complacent ignoring the danger of the yen recovering sharply. Another bubble is, we feel, in the low grade bond market where yield compression over top rated bonds is far too narrow. In February, the Financial Times reported that Moody's Investors Services said that only 1.57% of all junk rated debt defaulted in 2006 compared with 1.8% in 2005. However, it warned that default rates would almost double to 3.07% by the end of this year. It also warned that the historical average of 4.9% could be breached over the next two years as the quality of the junk issues in the sector declines. We also think that certain areas of the property market are in a bubble. Interestingly, just before this was written, there was a scare in the Spanish stock market about its real estate sector. Prices have risen very rapidly and, with Spain in the euro, it does not have the power to set its interest rates at the appropriate level. If property prices in Spain should fall sharply, the rising trend of euro interest rates could exacerbate the trend. This would be a highly paradoxical situation but underlines a critical fault line in the euro.



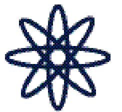
Although stock markets have been steady over the quarter, events in Iran have caused the oil price to rise over the quarter. It appears not to have been an issue with investors but OPEC supply constraints have tightened conditions in markets.

Although Wall Street has advanced over the quarter, worries about the housing market have exercised the minds of the bears. During the course of the quarter, problems with sub-prime lending have come to the fore, a factor, for example, in the results for HSBC. The housing market weakness is one of the reasons for the downgrading of this year's economic growth forecasts for the USA by the IMF. At this stage, it does not appear to have spilled over to the rest of the US economy.

Finally, currency movements have commanded attention during the quarter with US dollar weakness, yen weakness and euro strength. We have talked about the effects of the "carry trade" on the yen. The dollar's weakness, apart from concerns about the size of the current account deficit, is due to expectations that lower economic growth will cause the Federal Reserve to reduce interest rates later this year at the same time as euro and sterling interest rates will have gone in the other direction.

We turn now to look at individual countries and regions, starting with the USA, where the first estimate of first quarter GDP growth was lower than expected at an annualised rate of 1.3%. It is, of course, quite possible that the next two estimates will be revised upwards. Recent figures (we think here of fourth quarter 2006 GDP estimates) have been subject to significant revision and one's instincts are that there will be an upward revision in this case. Drags on growth were net exports and government spending besides, of course, housing construction where residential investment fell by 17%. On the other hand, the important element of personal expenditure rose by 3.8%. So, it is very much a curate's egg of a picture but the figures suggest that consumers remain optimistic and their expenditure represents a very important part of the economy. The latest Beige Book has recently been published covering economic conditions in March and early April. From it, one detects a slightly increased emphasis on growth prospects compared with March. Growth was described as "modest or moderate" in most districts and it did not indicate, as it had in March, that there was some slowing in several districts. Tight labour market conditions were noted, as we would expect from the USA's low unemployment figures, with the hint of tightened wage pressures for skilled workers. The last FOMC minutes, published towards the middle of April, emphasised that it regarded inflation as the biggest risk to the US economy and it did not rule out higher interest rates, although it emphasised its flexible approach, and many commentators still expect the Federal Reserve to start lowering interest rates later this year. As we noted earlier, when discussing the IMF's latest World Economic Outlook, it has reduced its forecast for US economic growth this year from its September projection of 2.9% to 2.2% whilst next year's forecast of 2.8% growth is 0.4% less than its earlier forecast. Although accepting the possibility that the weakness of the housing market could trigger a more prolonged slowdown or even a recession in the USA, it believes a growth pause seems more likely than a recession and that is what the forecasts above indicate. If the bottom of the mid cycle slowdown is growth of 2.2%, that is not a bad outcome. One improving trend it foresaw in relation to the USA is a lowering of its forecast for the USA's current account deficit this year to 6% against its September forecast of 7%.

It is the housing market that is of interest to most economies at present as they try to assess the outlook for the US economy. Although the figures point to weakness, it is not all gloom. The National Association of Realtors reported that pending house sales rose by 0.7% in March although expressing caution because of defaults by homeowners with high risk mortgages. In March, there was a slight increase in housing starts which rose to an annual pace of 1.518 million units and applications for building permits rose to a rate of 1.544 million homes a year. New home sales rose by 2.6% in March. Existing single family home sales rose by an annualised 9% in the first quarter. On the other hand, sales of existing homes were weak in March. They fell by 8.4% to 6.12 million and the inventory of unsold homes rose to 7.3 months worth compared with 6.8 months in February although cold weather could be an explanation. Clearly, the inventory overhang will take some months but its reduction is a prerequisite for a recovery in the market.



Although inflation is higher than the Federal Reserve would like to see and its minutes reflect that, it is of greater concern than the possibility of a slowdown; at the moment it seems manageable. March's producer price index was unchanged. Core consumer inflation was just 0.1% in March after 0.2% in February and the year on year rate was 2.5%. There has been an improvement in the Federal Reserve's favoured measure of inflation, the core personal consumption expenditure deflator, which, in the first quarter, was up 2.2% year on year. The Federal Reserve does not like to see it running above 2.0%, so there is work to do but it is not a major issue at this level.

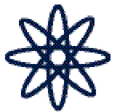
Although recent economic news from the USA has been mixed, it certainly has not felt like a 1.3% quarter as the first estimate of first quarter GDP numbers suggests. The ISM's index of manufacturing activity in March stood just in positive territory at 50.9. Its index of service sector activity, although it slowed down, was still in positive territory at 52.4 (54.3 the previous month). The employment numbers have been positive with 180,000 jobs added to the March payrolls with the unemployment rate falling to 4.4%. Retail sales have been quite buoyant. They rose by 0.7% in March. Durable goods orders, ex aircraft, rose by 1.5% in March. Core capital goods orders rose by 4.7%.

The weakness of the US dollar has a benefit for US companies in that it makes their exports more competitive and increases the dollar value of their overseas earnings. Although the rate of growth of corporate earnings has slowed down, the situation is buoyant enough for companies still to feel confident about embarking on further corporate activity and this is likely to remain a positive support for the US equity market.

The improvement in the Japanese economy is reflected by Standard & Poors' upgrading of Japan's sovereign debt to AA from AA-. Factors influencing the upgrade were an improvement in the fiscal position and a move towards more normal monetary policy. The primary budget deficit was described as "very close to balance" whilst the general budget deficit is expected to fall to slightly below 5% of GDP compared with 8.2% in 2002.

In early April, the Tankan survey was published. There was a very slight deterioration in business confidence related to the outlook for the global economy. But the deterioration was only slight with the diffusion index for large manufacturers falling to 23 from 25 in October. Sentiment was rather weaker for small and mid sized manufacturers with the diffusion index falling from 12 to 8. Labour shortages are expected to worsen. There was a mixed view of future conditions but larger manufacturers were more positive. For the moment, interest rates remain on hold at 0.5%. The Bank of Japan said that it considered that the Japanese economy was continuing to expand moderately. However, the Bank of Japan continues to want monetary conditions to move further towards normality. The Governor of the Bank of Japan told parliament that monetary conditions remained "very accommodating". Of course, these conditions are excellent for many Japanese companies, including exporters where a combination of ultra low interest rates, a weak currency and no inflation give them a significant competitive advantage. The "carry trade" is a highly risky strategy and a move towards a more normal level of interest rates, provided differentials with other "carry trade" currencies narrowed, would be likely to start an unwinding of these risky deals. The Japanese stock market has underperformed this quarter, but economic fundamentals look quite good and it remains an area in which to be represented. The Chinese benefit is attractive.

We look now at Europe where stock markets, with the exception of Spain, have performed well during the last quarter. The economy continues to be quite robust but has yet to feel the effect of the series of interest rate increases which the ECB has instituted. A further quarter point interest rate increase in June to 4% is almost certain. The ECB President gave a broad hint to this effect after the April meeting. Mr Trichet said that he would not say anything that would aim at changing financial markets' expectations of another quarter percentage point rise to 4% in June. In terms of inflation in the eurozone, 1.8% on Eurostat's latest figures for April compared with 1.9% in March, the ECB is expecting the figure to fall in coming months because of statistical effects before rising again. One of the factors it will take into account will be the level of wage settlements, particularly in Germany. In recent years, pay increases have been held down to reflect the difficult business background but Germany has made a remarkable recovery and this has encouraged the trade unions to seek much larger pay increases.



The ECB will be watching negotiations in the engineering and metals industries. At the time of writing, IG Metall is seeking a wage increase of 6.5% whilst the employers have offered a rise of 3% including bonus payments. Money supply growth, which the ECB watches more than many central banks, continues to grow strongly at an annual rate of 10.9% in March compared with 10.0% in February.

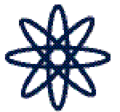
In other items of economic news, the purchasing managers' index for the eurozone remained strongly in positive territory in March even though it was slightly down in February's reading at 55.4 compared with 55.6. The EC's eurozone sentiment index remains at a high level, 111.0 in April compared with 111.1 in March. Capacity utilisation in industry also rose. We mentioned earlier the weakness in the Spanish property market and, above, we mentioned that the cumulative effect of the ECB's interest rate rises are yet to be felt. In the housing markets, statistics show that house purchase lending slowed down slightly in March to a rate of growth of 8.9% in February. The ECB will not be unhappy with this.

The news from Germany remains positive. The five German think tanks' latest forecasts suggest growth of 2.4% this year. The budget deficit is forecast to fall to 0.6% of GDP and they predict that, in 2008, the country is likely to produce a balanced budget, taking into account federal, regional and social security finances. Unemployment, 5 million in 2005, is expected to fall to 3.5 million in 2008. In another upbeat report, the Ifo business climate index for April rose to 108.6 from 107.7 in March as companies expressed growing confidence. At the same time, the German government has raised its outlook for economic growth this year from 1.7% to 2.3%, very close to the forecast in the previous paragraph. The VDMA engineering association reported that orders in March were 47% higher than a year earlier which, according to the association's chief economist, reflected the highest growth rate since the mid 1970's in mechanical engineering.

France is obviously dominated by the Presidential election. The two candidates who went through to the second round represent quite different visions of the future. Most observers agree that France needs to change its attitude towards regulation, taxation and the size of the state if it is to improve its long term growth prospects. It has lost significant ground to Germany, for example. Realistically, whilst there is some internal recognition of the need for change in France, life is not uncomfortable enough for the majority to accept radical change, for example to the 35 hour working week. So, if Mr Sarkozy should win, he is likely to face significant domestic opposition to moves which would liberalise the French economy. The French stock market, should Mr Sarkozy win, may be encouraged to make further progress in anticipation of measures which, in the long term, might be expected to improve prospects for the French economy. Should Segolene Royal win, companies might find life more difficult although the strong overseas business of many top French companies will be helpful.

Overall, economic prospects for Europe look good, at least in the short term. Although European shares have performed well, ratings look moderate and further corporate earnings growth, such as we are presently witnessing, is likely to sustain a further advance. M & A activity is likely to be a further catalyst. We are already witnessing a major battle for control of ABN Amro. Depending upon the extent to which the EC can enforce liberalisation of markets and attack protectionism, will be the pace of activity in the M & A market. With ample liquidity and still relatively low interest rates, we expect corporate activity to be supportive to markets.

In the UK, the latest GDP data showed the economy growing by 0.7% in the first quarter with the annual rate at 2.8%. The main concern is inflation where the news has not been good. At the producer price level, there was an increase of 0.6% between February and March. The year on year increase was 2.7%. The respective core figures, which exclude volatile items, were 0.4% and 2.9%. Input prices rose by 1.2% in March, largely because of the rise in the oil price, and, for the year, the increase was 0.7%. At the retail level, inflation is becoming disturbing. The consumer price index rose by 3.1% in March, year on year, 1.1% over the target whilst the more meaningful Retail Price Index was up 4.8%, its largest rise since 1991. Wage negotiators will look at the latter figure, which, to many people, because it includes housing costs, is more meaningful. Almost certainly, the Bank of England will raise interest rates at least once more and possibly several times because inflation does



seem to be in the system even though the Bank of England expects the rate to fall back in the coming months. At present, earnings, including bonuses, are running at an annual rate of growth of 4.6% whilst, excluding bonuses, they are running at a rate of 3.6%. There is some evidence that companies are putting more emphasis in their remuneration policies on rewarding performance rather than at the level of basic pay. That is some protection against the onset of bad times.

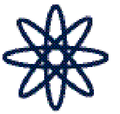
The housing market will be watched closely by the Bank of England as it assesses the need for further interest rate increases. Boom followed by bust in the housing market has the potential to cause major problems for the UK economy so the Bank of England will not want to see acceleration in the pace of house price increases. The position is complicated by the fact that London is effectively an economy of its own. The strength of the financial services industry with the attendant wealth that it has brought, together with the inability to increase the supply of property materially, means that prices can go to seemingly exorbitant levels which interest rate rises cannot easily contain. Elsewhere, though, the position is different and interest rate increases can be expected to have more effect. Mortgage equity withdrawal is running at very high levels. In the fourth quarter of 2006, the Bank of England put the figure at £14.6 billion, 6.7% of post tax incomes against 5.5% in the first quarter. If house prices were to fall at any stage, demand stimulated by mortgage equity withdrawal would dry up with serious contractionary effects on the economy. So, house prices are crucial to an analysis of the UK economy.

So, what is the latest evidence on house prices? Halifax reported a 1% increase in house price increases in March. Its index reflected the smallest monthly increase since last summer. The RICS survey said that an increased percentage of its members saw an increase in house prices in March as against a fall. The Department for Communities and Local Government reported a fall of 0.1% in the price of an average house in February compared with January to give a year on year increase of 12.1%. Its estimate of house price inflation in London over the same period was 16.7%. The latest index from Nationwide suggested a 0.9% increase in April compared with a 0.5% increase in March. The annual growth rate rose to 10.2% compared with 9.3% in March. However, on a quarterly trend, it detected a slowdown in the rate of increase, 2.1% in the three months to April compared with 3.3% to January. One element of concern, in addition to the rate of house price increases, is that lending criteria appear to have been relaxed. According to the Council of Mortgage Lenders, the figures for February show that 24.5% of borrowers took out interest only mortgages. In February, the median loan was 3.13 times the income of the median borrower compared with 2.99 times a year earlier. One indicator does, however, suggest that the series of interest rate increases may be starting to have an effect. The British Bankers Association reported that mortgage approvals in March were 12% down in the same month last year. Underlying net mortgage lending rose at a slower pace than the recent average. These may be straws in the wind but the evidence on house prices is not conclusive. The housing market is a key driver of the domestic UK economy and further evidence of any acceleration of house prices or a weakening of the market will be eagerly waited.

British companies are generally in a robust financial state. Official statistics show that corporate profitability rose to its historically highest level at the end of 2006. The net rate of return on capital for non-oil companies was 14.7% and, including oil companies, it was 15.1%. The Treasury believes that this strong profitability position will lead to strong growth in investment this year - it forecasts growth of 6.5% to 7.0%. This component of growth is a high quality one for an economy.

Interest rate increases take some time to make their effects felt on an economy and this is the case in the UK. Consumer confidence seems to be holding up as do retail sales. Unemployment is ticking up. Nevertheless, 2007 should be a reasonably good year for the UK economy, as suggested by the IMF's forecast of 2.9% growth this year. The greatest uncertainty would appear to be inflation and the response of the Bank of England to bad figures. If interest rates have to be raised significantly, the outlook for the UK economy could be quite different.

China continues to be anxious to restrain excessive economic growth in order to ward off inflationary problems and bad debt problems in the banking sector. Banking reserve requirements have been raised regularly.



The background to these frequent increases is 11.1% annualised growth in the first quarter of 2007 as announced by the National Bureau of Statistics. The latest inflation figure for March is 3.3% year on year, higher than the central bank would like to see. Chinese growth continues to be a catalyst for international economic growth and its foreign exchange reserves have now reached a staggering US$1,202 billion at the end of March, by far the largest in the world and now well ahead of Japan's foreign exchange reserves.

The promising economic outlook described in the IMF's latest World Economic Outlook seems the most realistic prospect at present. There are always negative issues but, to us, they seem outweighed by the positives as we know them at present. Shares do not seem expensively rated at present whilst bonds still seem to us to be overvalued. Any realistic adjustment in bond yields in the foreseeable future is not likely to detract significantly from the attraction of equities. We do have to say, however, that the risk appetite for some classes of investment (not equities) is excessive and, if in some related way, it spread to shares, for example, a sudden very sharp speculative rise in share prices, we would not be happy about it. We would hope that shares ended 2007 with a modest, but satisfactory, return in the high single digits reflecting little change in ratings but higher corporate earnings. That would be a good base upon which to build further growth, assuming economic prospects for 2008 turn out to be somewhere in line with the IMF's forecasts.

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