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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

This has been a particularly difficult review to write, so quickly have events moved in the eurozone sovereign debt crisis and the UK political situation as a result of the indecisive election result. Before these problems occurred, markets had turned in a good performance in the three months to the end of April. There was notable currency weakness in sterling and the euro. Post quarter end, we have seen significant volatility on fears of a eurozone sovereign debt crisis although the first signs are that the very large support package put together to shore up the eurozone's weaker economies may work with a sharp drop in the bond yields of the problem countries.

The tables below detail relevant movements in markets:

International Equities 29.01.10 - 30.04.10

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.3	+16.6	+11.3	+16.4
Finland	+5.7	+5.9	+1.1	+5.7
France	+3.2	+3.3	-1.3	+3.2
Germany	+9.7	+9.9	+5.0	+9.7
Hong Kong, China	+8.7	+13.8	+8.7	+13.6
Italy	-1.6	-1.4	-5.8	-1.6
Japan	+10.2	+11.3	+6.3	+11.1
Netherlands	+6.2	+6.4	+1.6	+6.2
Spain	-4.2	-4.1	-8.4	-4.2
Switzerland	+5.3	+7.8	+3.0	+7.6
UK	+8.2	+8.2	+3.4	+8.0
USA	+10.9	+16.1	+10.9	+16.0
Europe ex UK	+4.9	+5.9	+1.1	+5.7
Asia Pacific ex Japan	+7.1	+15.9	+10.7	+15.7
Asia Pacific	+8.5	+13.6	+8.5	+13.5
Latin America	+4.0	+16.4	+11.2	+16.3
All World All Emerging	+6.1	+14.7	+9.6	+14.5
The World	+8.7	+13.1	+8.0	+12.9

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +1.1%

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

Currency	29.01.10	30.04.10
Sterling	3.91	3.91
US Dollar	3.62	3.66
Yen	1.33	1.29
Germany (Euro)	3.18	3.02

Sterling's performance during the quarter ending 30.04.10 (%)

Currency	Quarter Ending 30.04.10
US Dollar	-4.6
Canadian Dollar	-9.0
Yen	-0.8
Euro	-0.1
Swiss Franc	-2.8
Australian dollar	-8.5

Other currency movements during the quarter ending 30.04.10 (%)

Currency	Quarter Ending 30.04.10
US Dollar/Canadian Dollar	-4.6
US Dollar/Yen	+3.9
US Dollar/Euro	+4.6
Swiss Franc/Euro	+2.8
Euro/Yen	-0.7

Significant Commodities (US dollar terms) 29.01.10 - 30.04.10 (%)

Significant Commodities	29.01.10 - 30.04.10
Oil	+22.4
Gold	+7.4

Markets

There was quite a strong advance in international equity markets this quarter after they had faltered at the beginning of the year in reaction to the Greek debt crisis, as they have also done after the April quarter end in response to wider fears about the sovereign debt issue. The FTSE World Index showed a total return of 8.7% in local currency terms, 13.1% in sterling terms, 8.0% in US dollar terms and 12.9% in euro terms. Compared with the total return in local currency terms on the FTSE World Index, the USA and Japan were relative outperformers, with local currency returns in their respective FTSE indices of 10.9% and 10.2%. The FTSE Europe ex UK Index was an underperformer although it returned a still respectable 4.9%. This was because of underperformances in the countries detailed in our table by Spain (-4.2%) and Italy (-1.6%). For sterling and euro based investors, returns in many foreign markets were enhanced by the weakness of their respective currencies. So, for sterling investors, against a return of 13.1% on the FTSE World Index in sterling adjusted terms, we saw outperformance from the FTSE Australia Index (+16.6%), the FTSE Latin American Index (+16.4%), the FTSE USA Index (+16.1%), the FTSE Asia Pacific ex Japan Index (+15.9%) and the FTSE All World All Emerging Markets Index (+14.7%).

In the international bond markets, whilst weaker eurozone credits, of which Greece is the most notable example, have been under pressure, perceived high or higher quality bond markets have benefited. Taking ten year government bonds as a benchmark, there has been no change in the quarter on the gross redemption yield on sterling government bonds at 3.91%. The yield on US government bonds has crept up slightly by 4 basis points to 3.66%. German government bonds have benefited from the flight to quality in the eurozone with the yield falling by 16 basis points to 3.02%. Japanese government bond yields fell by 4 basis points to 1.29%.

In the foreign exchange markets, sterling and the euro experienced a torrid quarter. Against the US dollar, sterling fell by 4.6%, against the Canadian dollar by 9.0%, against the Australian dollar by 8.5% and against the Swiss Franc by 2.8%. There were minor falls against the yen and euro of 0.8% and 0.1% respectively.

In commodity markets, oil rose by 22.4% and gold by 7.4%.

Economics

The story remains the same, as it has for many months now, with a rising stock market and a troubled world economy. The explanation for the paradox remains the same. The stock market cycle does not have to move in tandem with the economic cycle. Markets are looking ahead to better times which appear to have arrived but, before we go any further, we must heavily qualify this statement. After a dire 2009, economic growth will start to recover from a low base. This is the international picture but it's a curate's egg. The good part is Asia, some Middle Eastern economies, some emerging markets, not covered by these two areas, and Brazil. The bad part or less good part is the West and Japan. Within Europe, there are some very serious cases, most noticeably Greece, but there are also valid concerns about Portugal, Spain, Ireland, Italy (perhaps) and the UK. One advantage of being able to invest internationally without penalty is that one can attempt to escape localised problems.

The Greek problem has been building up for several months now, but has now reached a head and is, in our view, symptomatic of the biggest economic problem facing the world economy, the danger of one or more sovereign debt defaults. It is not only the defaulting country which loses but its creditors, such as banks, and, with some banks still in a weak position, the knock on effect of a default would be serious and could have a domino effect.

The Greek debt position is a complex one because of the political drama being played out on the sidelines. In our view, the euro has always been a flawed project which would end in tears at some time or other, although how this might come about could only be conjecture. The Greek problem is very unlikely to result in the demise of the euro but it could well be the first step on the path to the single currency area dissolving, or at least fragmenting at the edges, with one or more countries leaving as they find the costs of staying in unacceptable. The data Greece presented to gain admission to the euro was not in accordance with the facts. As a result of consistently overborrowing, the country has run out of credit with its current trends of annual borrowing and overall level of debt unsustainable. The interest rates which the market is now demanding cannot be paid by Greece. Furthermore, although the eurozone countries and IMF have promised support, firm details are lacking and it is dependent upon policies which the Greek government may not be prepared to implement or deliver given the evidence of the social unrest already seen. What is happening in Greece is only a more blatant flouting of the Stability and Growth Pact than has been obvious for a number of years in many eurozone countries and, now, the disciplines supposedly imposed by the agreement are meaningless and totally disregarded. The culture of the countries comprising the eurozone varies enormously, with Germany and Greece perhaps representing the opposite extremes. Economically, Germany is very disciplined with a fear of inflation and large deficits. The Greek economy is very informal with relatively little economic discipline, a large and cosseted public sector of a size far in excess of what is needed, and poor tax collection outcomes. That anyone should believe that the Greek economy could converge with Germany is extraordinary. The political dynamic of the euro overwhelmed economic arguments against forming a single currency union with the results which we now see.

The eurozone as a whole faces a major problem, although it has different facets. In Greece, it is obviously financial, with the prospect of default and all that entails facing it. In Germany, it is political. Because the voters were never asked if they wanted to give up the Deutschmark, and there is evidence that there is a lingering attachment to it, the German government is in a very difficult position if it appears to be willing to help to bail out a profligate member of the eurozone which has got to its present state through its own fault. Within the ruling coalition, there is opposition to such a move and the constitutional court, which is very strict in ensuring that the constitution is not violated, may well be called into action by German economic professors who have been prepared to test the legality of anything which affects German sovereignty, including bailing out other members of the eurozone. We now know that the professors have been denied an injunction stopping a loan to Greece but the Court could decide later on that the German government's action is unconstitutional. The German government would be likely to be flying in the face of public opinion if it was being seen to go against the no bailout policy.

Whilst Greece is the worst offender on financial discipline, others like Spain, Portugal, Ireland and, perhaps, Italy are at varying distances behind Greece. Therein lies the problem for, if a precedent is set with Greece, what is to stop other countries seeking bailouts because their debts have spiralled out of control? Although Italy is not perhaps such a problem at the moment because its current budget deficit is not at the alarming level of the others mentioned above, even though its overall level of public debt is very high, a country like Spain, which is much larger than Greece, would be a very serious problem if it got into trouble. The seeds of another major banking crisis would be sown.

For a currency union to work, there has to be convergence around inflation and public finances, the latter being the rationale for the Stability and Growth Pact. That clearly has not happened. In countries like Greece, but also a number of others including, importantly, Italy, a G7 country, costs have risen far more quickly than in Germany since the euro came into existence, so competitiveness has been lost. Although it is no long term panacea, devaluation would normally be one of the policy tools available to governments to provide short term relief to the problem. Countries like Greece gave up that option when it opted to join the euro. The alternative way to restore competitiveness is to institute severe deflationary measures and that is the path which Greece is taking as it struggles to bring its budget deficit under control. The danger for Greece is that the vicious circle of deflation will reduce economic activity even further, thus damaging the tax base. It is a Catch 22 situation. Whilst IMF and other eurozone countries' financial support may stave off a short term liquidity crisis, it does not attack the solvency issue. Although the UK has a very serious budgetary problem, at least it was not in a currency straitjacket and the weakness of sterling has provided some relief and help to businesses involved in exporting. Other eurozone countries in a very serious but less desperate position, at the moment, also face weak domestic demand and the result is that, as we shall see from the latest economic forecasts, growth in the eurozone is expected to be relatively weak this year and next. In so far as Greek contagion drives up yields on the bonds of weaker eurozone countries, the negative effect on demand will be accentuated indirectly.

It is difficult to see where this eurozone crisis will end. Were not so much political capital invested in the project, exit from the eurozone would be easier for the countries which have lost competitiveness. The governments of the countries in the worst trouble are fighting the problem with one hand tied behind their back, since they are not able to devalue their currency. However, the unmentionable subject of a possible Greek exit from the euro is increasingly being mentioned in political circles, notably Germany, where sympathy for Greece is in very short supply. There is also another dimension. What will the populations of these countries, Greece at the moment, but perhaps others later, think? Evidence of social unrest in Greece is apparent with regular, mainly public sector, strikes and street clashes with police. There must be serious doubt as to whether the Greek government, especially a left wing one with strong connections to public sector trade unions, will have the stomach to implement even larger public spending cuts than the eurozone countries and IMF might demand. This could equally well apply to some of the other southern European countries which may get into difficulty with their debt.

What does the present situation in these countries imply for investors, and what effect will any extension of the problem have? We are already seeing renewed stress in the eurozone bond market. This is most obviously the case in Greece where the yields on the ten year government bond, at the time of writing, rose even further over the equivalent German government bond. The investment concern is for European banks which hold debt issued by some of these weaker eurozone countries. The implication for the bond markets of the eurozone are fairly clear. Whereas, before the financial crisis blew up, investors did not distinguish greatly between various eurozone government bond issues (very simplistically a euro was a euro wherever it came from), that sense of complacency has well and truly disappeared now. We might, therefore, in the bond market see a flight to quality to the best eurozone credits, particularly Germany, and increased premiums on the more lowly rated eurozone credits reflecting the risks which the Greek situation has highlighted.

Eurozone equity markets are likely to ride the bond crisis better. Any company, more likely to be a financial one, directly affected by any eurozone government bond defaults or customer defaults caused by the economic crisis in the particular country, will be vulnerable. So, too, in a less obvious way, will be companies relying heavily on the eurozone for their business because the impact of restrictive economic policies in the region aimed at reducing budget deficits will mean slow growth in the region. This is much the same argument as we have used for the UK before and which we will discuss later. Moreover, the exposure of many high class eurozone based companies to faster growing areas of the world will help to limit the effect and the weakness of the euro, occasioned by the Greek debt problem, should also help profitability for some companies. In this respect, every cloud has a silver lining because the previously strong euro had been unhelpful for eurozone based exporting companies and those deriving profits from overseas. So, we would be much less concerned about shares than bonds in the eurozone.

There is no easy solution to the eurozone's debt problems, currently manifested in the Greek problem. If the eurozone countries with debt problems try to rectify their position within the eurozone, it will involve a long period of painful deflation which the population may not be prepared to wear, leading to social unrest, probably on a bigger scale than we have seen. If they leave the eurozone and return to their legacy currency, the value of euro incurred debts will rise and default would almost certainly follow with the consequent exclusion from international debt markets. This is a dilemma which has arisen because political objectives have transcended economic considerations with the predictable consequences which we are now witnessing.

As the preparation of this review is almost complete, news has come in of a substantial loan package agreed by European policymakers to stave off a sovereign debt crisis caused by Greece's problems but which, as we have said, threatens to spread to other eurozone countries like Portugal and Spain. The EU has announced a package of up to €750 billion in conjunction with the IMF to countries in the eurozone facing problems in financial markets. The ECB has also said that it will buy government and private debt to counter "severe tensions in certain markets". Under the terms of the package, eurozone governments have pledged €440 billion in loans or guarantees, with €60 billion more from the EU's budget and up to €250 billion from the IMF. The ECB also announced that it would restart its unlimited fixed rate offering of three month loans.

Whereas previous reaction to the much smaller package proposed had been unfavourable, showing that, if there is a problem, it is better to go for overkill, this present very large package has, on the first day that markets are open after its announcement, been greeted very favourably. We would draw the analogy with the fears about runs on the banks in late 2008 which so spooked markets. Once a way had been found of reassuring depositors about the safety of their deposits, it removed a major concern from the markets. Although investors expect stocks and shares to go up and down, they do not expect to fear for the safety of their deposits. Once this fear was removed, although the economic position of the world economy remained bad, at least a major negative factor had been removed and this marked the start of a return to confidence for markets. The package just announced by the EU may reflect a similar situation. Everyone knows that a number of eurozone economies are in serious trouble with their deficits but a way may have been found of restoring confidence to markets.

But, of course, there is a price to pay for this support package. Besides Greece's well documented problems, Portugal, with a budget deficit expected to reach 8.5% of GDP this year, and Spain, with one of 9.8%, have both promised to announce further "significant" additional budget cuts in 2010 and 2011. Whether the population of both countries will wear this is another matter. The ugly demonstrations in Greece are not a good precedent.

Germany or, at least, the German government, has also paid a high price. Giving money for bailouts is vigorously opposed by the majority of the population who do not see why they should pay for a lack of discipline elsewhere in the eurozone. This has posed a very difficult problem for Mrs Merkel. The euro could be said to be a Franco-German project so there is some moral obligation to try to sustain monetary union and German banks are exposed to eurozone debt. But the population is resolutely opposed to lending money and the loss of the important state election in North Rhine Westphalia is a bitter blow reflecting hostility to Germany's participation. Had the founders of monetary union paid more attention to the economic pitfalls rather than the political attractions, they would not have found themselves in this very difficult predicament.

For the markets, important time may have been bought within the eurozone, but the issue of how economies are going to converge whilst remaining in the eurozone still remain. We can be sure that this issue is going to be with us until the monetary union partly fragments, which we think is likely because of the hostility of the population of southern European eurozone members to the unpleasant economic medicine which is going to have to be administered.

The explosion in public and private debt will put a dampener on international economic growth as measures to reduce it take place. But, fortunately for investors, there are areas of the world which are performing much better than the West and Japan, as excerpts from the latest projections in the IMF's April 2010 World Economic Outlook show.

IMF Projections (world output year over year % change)

	2009 (actual) %	2010 (estimate) %	2011 (estimate) %
World output	(0.6)	4.2	3.3
USA	(2.4)	3.1	2.6
Euro Area	(4.1)	1.0	1.5
Germany	(5.0)	1.2	1.7
France	(2.2)	1.5	1.8
Italy	(5.0)	0.8	1.2
Spain	(3.6)	(0.4)	0.9
Japan	(5.2)	1.9	2.0
United Kingdom	(4.9)	1.3	2.5
Canada	(2.6)	3.1	3.2
Newly Industrialised Asian Economies	(0.9)	5.2	4.9
Russia	(7.9)	4.0	3.3
China	8.7	10.0	9.9
India	5.7	8.8	8.4
Middle East & North Africa	2.4	4.5	4.8
Brazil	(0.2)	5.5	4.1

Source: IMF World Economic Outlook Update - April 2010 (excerpts)

From these projections, the broad thrust of which represents mainstream thinking about the trajectory and profile of economic growth at present, it can be seen that the eurozone is expected to be a laggard this year and next as far as economic growth is concerned, with projected year on year growth at just 1.0% this year and 1.5% next year. Also lagging this year is the UK at 1.3% projected growth which is forecast to pick up to 2.5% next year. Japan is somewhere in the middle this year with growth at 1.9%, better than the eurozone and UK but behind the USA, whilst next year it is projected to grow faster than the eurozone but behind the USA and UK. Canada, one of the countries which has emerged best from the economic and financial crisis, is expected to have two good years, growing by 3.1% this year and 3.2% next year. However, heavily indebted USA is expected to grow at a similar rate to Canada this year but behind it next year.

But the real story, and the one which gives hope to investors, is what is happening outside Europe, Japan and, to some extent, the USA. If we look at the projections for Asia, particularly China and India, the Middle East and Brazil, we see what is behind the forecasts of a strong recovery in world output this year.

Turning to the UK, we are writing this in the aftermath of a hung Parliament which emerged from the General Election. This is a very unsatisfactory result, given the scale of the challenges facing the UK, because of its horrendous budget deficit problem. We have noted in previous reviews that the politicians appeared to be in denial about the UK's deficit for fear of frightening the voters. If there was ever any doubt that this was an issue, the tackling of which could be put off until a more convenient moment, then that belief, misplaced though it certainly was, should have quickly been dispelled by the potential and actual (in the case of Greece) sovereign debt crisis. If the UK delays credible action on deficit reduction it could suffer retribution in markets in the form of a much higher cost of borrowing or a collapse in the currency. This is being written as news of a Conservative/ Liberal Democrat coalition has emerged. At the moment, there is no issue which approaches the budget deficit reduction in economic importance for, if the deficit is not tackled, then all other aspirations of the political parties fall by the wayside. It is difficult to overstate the seriousness of the UK's fiscal position and a strong government is necessary to push through unpopular policies to reduce public debt.

As with all countries with severe budget deficit problems, unpalatable measures will be necessary in order to rectify the position. Realistically, these are going to be a combination of public expenditure cuts and tax increases which are going to weigh down on economic growth in the countries concerned. Whilst both ways of attacking the deficit will subdue demand in the economy, the preference should be for spending cuts in order to reduce the "crowding out" effect of the public sector on the private sector. For, if such economies are to have a good chance of resuming a respectable long term growth rate, they will have to be driven by the private sector. Tax increases stifle entrepreneurial talent and act as a disincentive for businesses either to start up, expand or remain in the country in question.

What does this scenario mean for investors? If we are talking about sterling based investors, but it could also to a lesser extent, be about euro based investors, an area which experiences many of the same deficit problems and also currency weakness, then the profile of many UK and eurozone based international based companies is positive for equities since, by virtue of their history, many of them are significantly exposed to faster growing economies of the world. It remains possible to be based in a low growth problematical economy like that of the UK and some eurozone countries and still have the opportunity to see capital growth in equities, perhaps also helped by the weakness of the domestic currency. The majority of business of the FTSE 100 companies is derived from overseas directly or indirectly. Furthermore, if deficit reduction measures are concentrated on the reduction of public spending, thus reducing the "crowding out" effect on the private sector, it should allow room for more domestically orientated companies to prosper in time.

In such difficult economic circumstances, the case for equities arises from large companies' exposure to faster growing overseas markets and such companies' experience in operating in countries with different levels of growth and fluctuating exchange rates. If the home country's currency is under pressure than this may also benefit the relevant companies' profitability. Notwithstanding the recovery in international equity prices from March 2009's low point and factoring in the expected increase in corporate earnings in most areas, dividend yields and price/earnings ratios still look reasonable. What we are saying is that, even in countries with serious economic problems, equity markets can still be the most attractive repository for money. Yields on government bonds do not to us generally reflect the risks involved, whilst a large cash weighting, suitable for the most nervous of investors, provides only a very low return. It is likely that, in the major currencies, interest rates will remain very low given the fragile nature of the world economy at present.

Whilst the two big stories at the moment relate to the problems in the eurozone and the indecisive result in the UK General Election, there has been some good news outside these two areas (and some from within) and it is necessary to reflect on data which gives some support to the more optimistic IMF World Economic Outlook forecasts referred to earlier. In some areas, like the USA and Asia ex Japan, the balance of positive news is becoming stronger and we detail below some of the positive data from the USA in April. The ISM index for the manufacturing sector rose in March to 59.6 compared with 56.5 in February, whilst that for the services sector rose to 55.4 in March from 53.0 in February. A survey by Business Round Table, which is the association of chiefs of large US companies, reported that 29% expected to increase corporate payrolls over the next six months compared with 21% who predicted a fall. The Commerce Department reported that inventories at the wholesale level rose 0.6% in February, a higher figure than expected as businesses became more confident about the future. One of the reasons for the economic turnround has been the inventory cycle. During the worst of the crisis, inventories were drawn down as companies felt uncertain about the future and did not want to produce more than necessary. The IBD/TIPP US economic optimism index for April rose to 48.4 compared with 45.4 in March. US high street sales rose by 1.6% in March which was the largest increase since last November. The New York Federal Reserve's "Empire State" business conditions index for manufacturing activity in New York State rose to 31.86 in April compared with 22.86 in March. Although new orders for large manufactured goods fell by 1.3% in March, this was due to the cyclical commercial aircraft sector. Excluding the transportation sector, new orders rose by 2.8%, a better than expected figure. The US Conference Board's index of US consumer confidence rose to 57.9 in April compared with 52.3 in March. The Chicago Purchasing Managers Index rose to 63.8 in April from 58.8 in March. In the housing market, the National Association of Realtors reported that contracts for pending sales of previously owned US homes rose by 8.2% in February to 97.6 from a downwardly revised 90.2 in January. Sales of new homes rose by 27% in March. The Commerce Department reported that new home sales rose at an annual pace of 411,000 which was the strongest month since July 2009. Overriding this data, was the first estimate of GDP growth in the first quarter which, whilst slower than the 5.6% annual rate in the fourth quarter of 2009, was still a reasonable 3.2%. This figure may, of course, be changed at later data comes in.

Elsewhere, in China, the economy grew at an annual rate of 11.9% in the first quarter of 2010 which is the fastest rate of expansion since 2007. The Chinese authorities are worried about excessive growth because of the potential for inflation and have taken various measures to try to cool down the economy which, from time to time, has had an effect on international stock markets.

In Europe and the UK, there have been individual items of good news but the wider issues of the eurozone sovereign debt crisis and the UK hung election and debt problem completely overshadow items of individual news although, hopefully, in the UK the emergence of a coalition government will make the difficult economic decisions easier to take as the danger of another election soon is more or less eliminated.

Nevertheless, compared with this time last year when the economic news was nearly all bad, the position has improved markedly. It is still a very dangerous economic world but policy initiatives to deal with problems like those some banks faced in 2008 and 2009 and the sovereign debt crisis which has blown up this year, seem to show some success, vital to restoring market confidence and validating the recovery in share prices over the past fourteen months.