meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Despite all the bad news in the quarter which might have been expected to have a detrimental effect on stock markets, that has not proved to be the case and, although markets are little changed, this must be counted an impressive performance, underlining inherent strength in markets. There is, of course, no room for complacency, but it is valid to note this point.

The tables below detail relevant movements in markets:

International Equities 31.01.11 - 29.04.11

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+2.9	+8.5	+13.0	+4.4
Finland	-2.6	+1.2	+5.4	-2.6
France	+3.4	+7.4	+11.9	+3.4
Germany	+5.9	+10.1	+14.6	+5.9
Hong Kong, China	+1.4	-2.2	+1.8	-5.9
Italy	+2.4	+6.4	+10.8	+2.4
Japan	-5.2	-8.1	-4.3	-11.6
Netherlands	+0.5	+4.5	+8.8	+0.5
Spain	+0.4	+4.3	+8.6	+0.4
Switzerland	+3.7	+7.8	+12.2	+3.7
UK	+4.6	+4.6	+8.9	+0.6
USA	+6.5	+2.3	+6.5	-1.6
Europe ex UK	+3.4	+7.4	+11.8	+3.3
Asia Pacific ex Japan	+2.5	+3.4	+7.7	-0.5
Asia Pacific	-1.0	-1.8	+2.3	-5.5
Latin America	+0.1	+1.8	+6.0	-2.0
All World All Emerging	+3.6	+3.2	+7.5	-0.7
The World	+3.9	+2.8	+7.1	-1.0

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +3.0%

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

Currency	31.01.11	29.04.11
Sterling	3.65	3.47
US Dollar	3.38	3.29
Yen	1.22	1.20
Germany (Euro)	3.17	3.24

Sterling's performance during the quarter ending 29.04.11 (%)

Currency	Quarter Ending 29.04.11
US Dollar	+4.1
Canadian Dollar	-1.5
Yen	+3.2
Euro	-3.8
Swiss Franc	-4.2
Australian dollar	-5.3

Other currency movements during the quarter ending 29.04.11 (%)

Currency	Quarter Ending 29.04.11
US Dollar/Canadian Dollar	-5.4
US Dollar/Yen	-0.9
US Dollar/Euro	-7.9
Swiss Franc/Euro	+0.4
Euro/Yen	+7.3

Significant Commodities (US dollar terms) 31.01.11 - 29.04.11 (%)

Significant Commodities	31.01.11 - 29.04.11
Oil	+24.6
Gold	+14.7

Markets

Notwithstanding the extraordinary events of the quarter, equity and high quality bond markets experienced an unremarkable quarter. In total return terms, the FTSE World Index returned +3.9% in local currency terms, +2.8% in sterling terms, +7.1% in US dollar terms and -1.0% in euro terms. Looking at local currency returns, the USA, of the major markets, stood out, with the return on the FTSE USA Index being +6.5%. The UK also performed well, with the FTSE UK Index returning +4.6%. The FTSE Europe ex UK Index returned a very satisfactory +3.4%. Previously good performing markets, like Asia ex Japan, emerging markets and Latin America, were quieter but still in positive territory as measured by their relevant FTSE indices. Understandably, in view of the catastrophic events in Japan, there was a negative performance from Japan, with the FTSE Japanese Index returning -5.2%. Elsewhere, Australia produced a satisfactory performance, with the FTSE Australia Index returning +2.9%.

Sterling had a mixed quarter, rising against the US dollar and yen but falling against the Australian dollar, Swiss Franc, euro and Canadian dollar. In sterling terms, therefore, the FTSE Australian Index returned a very strong +8.5%, whilst the FTSE Europe ex UK Index returned +7.4%. US dollar weakness reduced the FTSE USA Index's return to +2.3%. Yen weakness meant that the sterling return on the FTSE Japanese Index became more negative at -8.1%.

High quality government bond yields, as measured by ten year government bonds, tended to fall, except in the case of Germany. For ten year UK government bonds, the gross redemption yield fell by 18 basis points to 3.29%. Japanese government bond yields fell by 2 basis points to 1.2%, but, in Germany, they rose by 7 basis points to 3.24%.

As intimated above, there were some significant currency movements during the quarter, with the US dollar and yen being weak. Against the US dollar, sterling rose by 4.1% and, against the yen, by 3.2%. However, sterling fell by 5.3% against a rampant Australian dollar, by 4.2% against the Swiss Franc, by 3.8% against the euro and by 1.5% against the Canadian dollar.

Not surprisingly, in view of political and military events in North Africa and parts of the Middle East, oil rose, ending the quarter up by 24.6% whilst gold, reflecting inflationary concerns, rose by 14.7%.

Economics

Whilst international equity and high quality bond markets have experienced an unremarkable quarter, the news background has been anything but unremarkable. The movements in securities indices belie the extraordinary events of the quarter and this very modest movement in markets is testament to their underlying strength. We must say straight away that there is absolutely no room for complacency and we will review the problems as well as the opportunities which face the world economy. We are merely observing the fact that markets have weathered all the bad news involving terrible natural disasters in Japan and New Zealand, radiation worries arising from the Japanese nuclear power accident, unrest in parts of North Africa and the Middle East and military action in Libya. All the time, the sovereign debt crisis involving Greece, Ireland and Portugal has rumbled on and, of all the issues mentioned above which have occurred so far this year, the eurozone sovereign debt crisis is the one which is certain to be with us at the end of the year.

In terms of economic policy, the very poor state of public finances in the USA, Japan, UK and much of the eurozone, has meant that monetary policy has remained exceptionally loose, whilst fiscal policy, with the exception of the USA and Japan, has been very restrictive as the UK and some eurozone governments tighten fiscal policy, severely in some cases, in order to try to restore order to their public finances. However, in Asia, Brazil and some emerging markets, growth continues strongly and the problem these countries face is inflation, with food price inflation particularly problematical. The rise in oil and other commodity prices represents a transfer of purchasing power from customers to producers and acts as a brake on the growth of the world economy. So, the world economy is a curate's egg and we, in the west, where economic conditions are so difficult, tend to be influenced by events around us, rather than by the strong economic conditions in some other parts of the world.

To put matters into perspective, the IMF's latest World Economic Outlook was released in April and its overall economic projections show a world economy which is performing reasonably well and is likely to continue to do so. The key word is "overall" because its projections cover a wide range of expected performances, some of which will be well below par and others very good.

The IMF projects world economic growth for this year at 4.4% and for 2012 at 4.5% compared with 5.0% in 2010, a recovery year from recession and 2009 when growth contracted by 0.5%. The divergence of performance between advanced economies and emerging and developing economies remains very marked. The IMF projects growth for advanced economies this year of 2.4%, whilst, for emerging and developing economies, it projects 6.5% growth. It is much the same picture projected for next year. Within the advanced economies there is, of course, also a divergence of expected performance, if not so marked. The USA is forecast to grow by 2.8% this year, whilst for the eurozone the figure is 1.6% and for Japan 1.4% and the UK 1.7%. Of the major economies in the eurozone, the star is expected to continue to be Germany where growth is projected to be 2.5% for 2011 after last year's outcome of 3.5%. On the other hand, for those eurozone countries already facing a sovereign debt crisis, the projections, not surprisingly, are bad, with the Greek economy forecast to contract by 3.0% this year, Portugal by 0.5%, whilst the Irish economy is forecast to grow by just 0.5%. Spain, the next potential cause for concern, is forecast to grow by just 0.8% this year. Elsewhere, those advanced economies which emerged relatively well from the financial crisis are expected to continue their above average performance. Examples of such countries and their expected growth rates this year are Canada (2.8%), Korea (4.5%), Australia (3.0%), Taiwan (5.4%), Sweden (3.8%), Hong Kong SAR (5.4%) and Singapore (5.2%).

The real story is, of course, continuing rapid growth in Developing Asia which the IMF projects to grow by 8.4% this year, only slightly lower than last year's 9.5%. Within that area, China and India are forecast to grow by 9.6% and 8.2% respectively. Elsewhere, Brazil, after growth last year of 7.5%, is forecast to grow by 4.5% this year and Russia, the other BRIC country, is forecast to grow by 4.8% this year.

Whilst we all know how important China is to the world economy, it is worth emphasising that, in US dollar terms, China has replaced Japan as the world's second largest economy and, in purchasing power parity terms, it has been second for a long time. In last October's World Economic Outlook, the IMF estimated that, on a purchasing power parity basis, which is an estimate of what currencies should stand at against each other based on each currency's purchasing power, emerging and developing countries represented 46.2% of world GDP. The investment implication of this is quite simple. These faster growing areas of the world economy can keep the world economy growing at a reasonable pace and investors in those countries, which are presently experiencing very difficult economic conditions, can gain a benefit not only from investing in those countries' stock markets, but also from companies based in countries which are experiencing slow growth which have significant direct or indirect business in these areas. This is part of the explanation for the paradox of stable stock markets at a time of great economic difficulty in many countries.

Let us now go back to the major issues of the quarter, mentioned at the beginning of this review, to see if we can draw any investment conclusions from them. It seems as if a generation of " black swan" events came along in a matter of weeks. The calm reaction of the stock market suggests that investors are becoming inured to extraordinary happenings, but that does not mean that anyone should become complacent. Terrible natural catastrophes such as earthquakes and tsunamis are unfortunately a fact of life for those living in earthquake zones. The fact that Japan relies on nuclear power for part of its energy requirement and is a major manufacturer does have important implications, not only for Japan. Although the tsunami caused the damage to Japan's nuclear installations and would not, therefore, be an issue which could cause damage to many other nuclear facilities throughout the world, the danger for long term economic growth would be if countries stalled their nuclear power programmes. Although nuclear power is controversial, it is a fact that, realistically, it is needed in many countries if a power shortage is to be avoided which would, in turn, have implications for economic growth. We have already seen the German government, frightened of the political consequences, shut down seven nuclear power plants for inspection, even though the circumstances of Germany's nuclear power stations are quite different to the ones affected in Japan. With the political tide having turned against coal fired power stations, the implications for various countries' nuclear power programmes will need to be monitored because delays could have economic growth implications.

The second implication is for supply chains. With globalisation and "just in time" inventory ordering, supply chains are very interdependent and, so, interruptions to component supplies, such as those from the affected area in Japan, have had a knock on effect, not only in Japan but in the USA, UK and Europe as well as elsewhere. The affected area in Japan represents about 5% of Japanese GDP, but the effects have been significant, the car manufacturers being a case in point, and not only in Japan. In Japan's favour, for the future pattern of sourcing, is the high quality of its products but disruption to supplies from Japan could cause some diversion of manufactured parts from Japan. We will have to wait and see, but this implication, unlike that of nuclear power, would be limited to Japan. In terms of the short term economic impact, it seems almost callous, against the background of such terrible human suffering and the continuing battle to contain the nuclear radiation leaks, to mention the economic consequences but, as in the aftermath of terrible events like wars, reconstruction does provide an offsetting stimulus to the loss of GDP caused by the immediate catastrophe.

Turning to the next issue, the social unrest and political turmoil in North Africa and parts of the Middle East and the military intervention in Libya to protect the rebels, the effect on the price of oil, as shown in our table at the beginning, has been marked. Libyan oil production (its crude oil is of high quality) has been severely curtailed and, with demand expected to continue to rise for the foreseeable future, the price is responding. How this will all end, one cannot say, because one cannot foresee political developments. One tends to view all of these conflagrations as negative but it might not necessarily be the case. There may be a change of regime in Libya, order might be restored and oil production resumed. Whilst the rise in the price of oil caused by an increase in demand will curtail economic growth, a demand led price rise is far less damaging than a supply shock when a sudden reduction in supply has an immediate economic effect. The biggest concern would be if trouble spread to Saudi Arabia, owner of the world's largest oil reserves and the biggest producer. The situation in the Middle East looks a little quieter now, although still very fragile. All eyes are now on Libya.

However, one can now sense that the focus of investors' attention is moving back towards what we regard as the major economic issue, the eurozone's sovereign debt crisis. Relative to these other serious issues, it is now capturing the headlines more often, a certain sign of how important the problem is considered to be. The crisis affecting Greece, Ireland and Portugal is symptomatic of the issues facing the eurozone and part of a much wider problem, the appalling state of many countries' public finances. One can almost certainly say that the eurozone's problems will not have a happy ending.

It seems that almost everyone involved with the eurozone sovereign debt crisis is in denial and a state of denial can make problems even worse. As this is written, two year Greek government bonds show a gross redemption yield of almost 25% and ten year bonds over 15%. Two year Irish government bonds are yielding around 11.6% and ten year bonds around 10.3%. Two year Portuguese government bonds yield around 7.3% and ten year bonds around 9.5%. There is no way that these countries can grow sufficiently fast to service these levels of interest rates. The projections for growth from the IMF show how difficult is the economic future for these countries. As they take measures required by the EU and IMF to address their public finances, they increase the risk of economic contraction to enter a vicious circle of decline. Apart from the embarrassment of admitting that the eurozone is not working out as they confidently forecast when it was established, which they do not want to do, the powers that be in the eurozone, whether at country or central level, are concerned to keep the sovereign debt show on the road because of the exposure of some eurozone banks to the sovereign debt of the beleaguered countries. To give an idea of the sums involved, German banks' exposure to Greece, Ireland and Portugal at the 30th September 2010, we can refer to the latest Bank for International Settlement's 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 countries are so desperate to avoid the sovereign debt problem spreading to Spain, where bond yields suggest some anxiety, but with the benefit of the doubt at present being given to it. That could, of course, change as investors' anxieties tend to spread from one country to another, as we have seen recently with Portugal. The BIS table shows France 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.

The political pressure on eurozone politicians is coming from creditor and debtor nations. The strong showing of the True Finns party in the recent Finnish general election shows the growth of eurosceptic opinion amongst the stronger members of the eurozone and this is also evident in Germany where resistance to the increasing participation in eurozone bailouts is increasing. On the other side of the fence, the Irish electors have already ejected a government they held to be culpable for the country's financial problems and the Portuguese government faces a general election after losing a no confidence vote in parliament. In Greece, there are regular protests and strikes against the government's austerity measures. With devaluation not an option within the eurozone, clawing back the competitive position against Germany involves savage deflationary measures for many years. It seems only a matter of time before one or more electorates revolts against externally ordered economic medicine leading to defaults and, perhaps, departure from the eurozone because the measures are too painful to bear. There is no mechanism for leaving the eurozone and it would be an extremely messy process but staying in looks perhaps even more uninviting. As we said, there will be no happy ending to this mess, arising as it does from a flawed concept of monetary union.

Another problem for eurozone countries is the hardening attitude of the European Central Bank towards inflation, evidenced by its recent 0.25% increase in interest rates as inflation has risen to 2.8%, up from March's figure of 2.7%. Although the repo rate, at 1.25%, remains extremely low, and far lower than would normally be appropriate for inflation of 2.8%, the problems of the eurozone mean that a sharp increase in interest rates would make a bad situation even worse. As it is, the threat of rising interest rates, even if only on a gentle gradient, is not something that the weaker eurozone members would desire. However, the ECB is the most hawkish of the central banks on inflation. At the opposite end of the spectrum, the Federal Reserve appears to be very relaxed about its extremely easy monetary policy. This has contributed to the weakness of the dollar. Its QE2 programme of quantitative easing will end in June, but repayments will be reinvested. The significant news on the USA in recent weeks has been Standard & Poor's move to put the USA on negative watch for a downgrade in view of the difficulty of obtaining agreement to reduce the budget deficit in the USA, which is forecast to be over 10% of GDP this year. The USA has been able to get away with running a deficit at around the level of the UK because the US dollar is the world's largest reserve currency and widely used for trade, so that there is always a natural desire to buy and hold dollars, but this financial time bomb, which could go at any time, does demand action and the way the US political system works, with the checks and balances between executive and legislature and now also a split Congress with real vitriol quite apparent, means that a deal is very hard to agree. However, at some stage, if a plan to reduce the deficit is not agreed, the markets will act and Standard & Poor's announcement is a warning shot across the bows of US politicians. The UK is somewhere in the middle between the ECB and the Federal Reserve. Its votes on the Monetary Policy Committee show a momentum towards raising interest rates even though six members are currently against such a move. The latest inflation figure of 4.0% was lower than expected, but still double the target rate, and a 0.5% official interest rate is very dangerous, set against such levels of inflation, because significant negative real interest rates pose a threat of even worse inflation. However, the UK has received considerable credit in the markets for its robust programme of structural deficit elimination by the end of this parliament and so, unlike the USA, the UK has not been put on negative credit watch and gilt edged securities have enjoyed significant demand. They look extremely expensive but, as we see from the troubled eurozone countries, if action is not taken early on to deal with deficits, the market will act and there is nothing that governments can do about it. The lower than expected inflation rate in the UK, while still far too high, may delay slightly the start of the programme of interest rate rises, which have to occur in the UK, but official rates will surely start to rise before very long.

In discussing the IMF's World Economic Outlook forecasts earlier in this review, we noted the continued spectacular growth expected from China. However, China's problem is inflation, particularly food price inflation. The latest consumer price index to the end of March shows year on year inflation at 5.4% in China, but the food element of that is 11.7%, whilst the non food element is 2.7%. In countries where many people spend a significant proportion of their income on food, the danger of sharply rising food prices is not only an economic one for those concerned but also a political one for the government because, as we have seen in the recent troubles in North Africa and the Middle East, rising food prices can stir up political unrest. The Chinese authorities are very concerned about this which is why they have taken certain administrative action to keep down food prices although, of course, that merely suppresses the problem. China has actively been trying to keep control of inflation by raising bank reserve requirements and interest rates and more may be expected if the situation does not improve.

However, as the indices show, stock markets have been remarkably benign against such an extraordinary background. We mentioned earlier that investors seem to have become inured to unexpected bad news but, on the positive side, markets have been buoyed by good growth in corporate earnings in many countries and dividends as well. The current US reporting season is better than expected and, although rising input prices are bound to have an effect on profitability, for many companies they are not at a level which threatens to pare back earnings growth significantly. With price/earnings ratios still looking good value and dividend yields also, especially when measured against bonds, equities have had support. With very low short term interest rates, investors continue to search for income and they have found this in the equity market and also the bond market, although we continue to regard bonds as very expensive. A yield of around 3.5% on a ten year UK gilt, with inflation at 4.0%, looks to be extremely poor value and this situation is replicated in most markets. At some stage, quantitative easing, where practised, is going to have to be reversed, otherwise inflation risks rise. Central banks cannot print money without an inflationary risk and, therefore, the bonds which have been bought by the private sector with newly created money will need to be sold back at some stage to take the money out of the system. At that time, bonds may find headwinds much stronger and one would have to look at the implications for equities also. In the meantime, the end of QE2 in the USA, whilst not reversing QE, does remove a major buyer of Treasury bonds from the market and we wait to see what effect this will have.

Against the background of the projections made by the IMF for the world economy, we now turn to look at individual areas of the world economy starting with the USA.

The move by Standard & Poor's to move the USA's credit rating outlook from "stable" to "negative" has more symbolic than practical importance at this stage because it implies what everyone knows, namely that the USA's debt position will become unsustainable if no action is taken to address the very serious state of public finances. Whilst the UK, with a broadly similar level of budget deficit, had no option but to address the issue quickly, the USA has been able to put off the day of reckoning by virtue of its position of having the US dollar as the world's largest reserve currency. The US dollar has to be held in other countries' foreign exchange reserves and is the currency most widely used in trade. But these "advantages" do not give the USA carte blanche to follow reckless borrowing policies which one day will catch up with the USA if robust action is not taken to address the deficit. Unfortunately, the political system in the USA militates against the type of robust action which is being implemented in the UK. The checks and balances between the executive and legislature mean that, even if the President was minded to propose remedial action, Congress might not agree. The situation is made worse by Congress being split, with the Democrats being in control of the Senate and the Republicans of the House of Representatives. Add in a poisonous atmosphere between the two parties, with different solutions to the debt problem being favoured, and there is every prospect of stalemate on this crucial issue. Whilst investors' attention is focused on the eurozone's sovereign debt woes, the USA has avoided attention, as we can see from the table at the beginning of this review showing the performance of ten year government bond yields. However, Standard & Poor's timely warning shows that the clock is ticking for the USA's debt problem.

That the USA has been able to finance these huge deficits seemingly easily is partly due to the two rounds of quantitative easing. The second US$600 billion round is due to come to an end in June and, according to the FOMC minutes issued in April, almost all members saw no need for a taper, as in earlier rounds of asset purchases in 2009 and 2010. Printing money may have been the way to avoid a meltdown in the financial crises but it is an extreme measure with consequences which need to be controlled, the main one being inflation. Although the forecasts for the world economy are quite good for this year, part of the impetus for growth comes from the extremely loose monetary policy being followed in many parts of the world. This manifests itself in extraordinarily low interest rates, the extreme end of orthodox monetary policy, and quantitative easing, the unorthodox aspect of monetary policy involving the printing of money. Both the orthodox and the unorthodox aspects of monetary policy must be reversed, otherwise there will be severe consequences for the currency and for inflation. Our table of currency movements at the beginning of this review shows that the US dollar has been the weakest of the major currencies this quarter. In one way, this may be surprising, given the problems in the eurozone but, in the latter, the first move has been made towards a more conventional monetary policy with the 0.25% increase in interest rates recently announced by the ECB. There is nothing to suggest that short term US interest rates are likely to rise in the near future. Because the USA is a relatively closed economy, a depreciating currency is not going to have as severe an impact on inflation as, say, in the UK.

However, the USA's creditors will not be happy to see the value of their US dollar holdings of Treasury bills and bonds declining in international purchasing power terms each year. Whilst a wholesale move from US dollars to other currencies is not practical because even relatively small sales would involve cutting off their nose to spite their face, a change in emphasis is quite likely. The problem will grow when the Federal Reserve halts its quantitative easing programme, thus taking out of the market a major purchaser of US debt other than the reinvestment of debt repayments it receives. It will be interesting to see how the US Treasury markets react to the end of quantitative easing's latest round in the USA and at what stage investors begin to react to the lack of any serious action to address the USA's budgetary problem. With 2012 being election year, politicians, with a few exceptions, are afraid to be candid with voters about the USA's deficit problems.

In terms of macro economic news, the first estimate of the USA's first quarter GDP growth is 1.8% annualised, compared with 3.1% annualised in the fourth quarter of 2010. Consumption was held back by the rise in petrol prices and by a fall in government spending. Federal Reserve officials have reduced their forecast for economic growth this year. They now expect GDP to grow by 3.1% to 3.3%, against their earlier forecast of 3.4% to 3.9%. Headline inflation is expected to be 2.1% to 2.8%, quite sharply up from their earlier estimate of 1.3% to 1.7%. The core rate is now forecast at 1.3% to 1.6% compared to the earlier forecast of 1.0% to 1.3%. They are, however, a little more optimistic on unemployment, now expecting the rate to be 8.4% to 8.7% this year compared to 8.8% to 9.0%, which was their previous forecast. Underlining the point made above about very loose monetary policy, the FOMC says that interest rates were likely to remain "exceptionally low" for an "extended period".

Although the first quarter growth rate, as first estimated, is disappointing, there are individual indicators which are quite encouraging. The ISM's purchasing managers' index for manufacturing, whilst falling marginally from 61.4 in February to 61.2 in March, was still at a high level. Similarly, the same index for the services sector fell to 57.3 in March from 59.7 in February but was still at a satisfactory level. There was some moderately good news on the employment front. Non farm payrolls rose by 216,000 in March and the jobless rate fell from 8.9%, a two year low. Retail sales continued to improve, rising 0.4% in March after a 1.0% rise in February. Industrial output rose by 0.8% in March following a 0.1% increase in February. The Conference Board's indicator of consumer attitudes rose from 63.8 in March to 65.4 in April. Durable goods orders rose by 2.5% in March, with February's figure revised to a 0.7% gain from an original 0.9% fall. However, the Achilles heel for the US economy remains the housing market, where continued overall weakness has a malign influence on the economy. The news is not overwhelmingly bad, but positive indicators are not sufficient to turn round the problem at this stage. On the positive side, the number of housing starts and permits for future home construction rose by 7.2% in March. Sales of previously owned homes rose by 3.7% in the month to March. On the negative side, the National Association of Homebuilders/ Wells Fargo Market Index fell to 16 in April from 17 in March. According to S & P/ Case Shiller, the average price of a single family home fell 0.3% in the month to February following a 0.2% fall the previous month.

So, it is a mixed picture from the USA but one important bull point for the US equity market has been a better than expected first quarter as far as corporate earnings are concerned. Despite economic headwinds from rising import costs, corporate America has fared well. The low value of the US dollar is helpful to many US companies, with export business and overseas subsidiaries. As elsewhere, very low interest rates have encouraged investors to look for better returns from other assets, and US equities and bonds have benefited from this trend.

Clearly, the sovereign debt issue is the problem most exercising investors' minds, but the sub-plot, connected with this, is the diverging performance of the eurozone economies. This, of course, was not meant to happen because monetary union was supposed to bring economic convergence rather than the divergence, which is what has actually happened. If we use the IMF's latest economic projections, we see that Germany is forecast to grow by 2.5% this year. Whilst Greece and Portugal are forecast to contract by 3.0% and 1.5% respectively, Germany is in a sweet spot. The competitive level of the euro, increasing competitiveness within the eurozone as a result of stringent cost controls, including wage costs, and products which the world currently desires, i.e. high value added manufactured goods, have all come together to propel the German economy forward. The German economy has been pulling ahead of that of its main rival, France, for a number of years now.

Apart from the ongoing sovereign debt problems, the most significant item of news in April emanating from the eurozone was the decision by the ECB to raise interest rates by 0.25% to 1.25%. We have discussed this earlier and, suffice it to say that, as the central bank most hawkish on inflation, inflation at 2.7%, at over 70 basis points above its target, is too high to risk. Of itself, 25 basis points will not make much practical difference but the symbolism is important. The interest rate is well below what one would normally expect at the current inflation level but raising it to a level of, say, 2% over inflation would be the straw which broke the camel's back for a number of the weaker eurozone members. During April, Eurostat published figures showing that the overall budget deficit of the eurozone in 2010 was 6% of GDP, down from 6.3% in 2009, with the level of public debt, as a percentage of GDP, rising to 85.1% in 2010 compared with 79.3% in 2009. That there has not been a worse crisis has been because interest rates have been so low but a return to more normal levels of interest rates would spark off further trouble. If we take a country like Italy, which has a structural imbalance less serious than those of other economies, and look at its overall level of public debt as a percentage of GDP, the IMF estimates that its gross debt this year will be just over 120% of GDP which is an exceptionally high figure and leaves the economy very vulnerable to interest rate rises, especially as the Italian economy is not expected to show fast growth.

The curate's egg nature of the eurozone economy is shown by the breakdown of Markit's purchasing managers' index for April, which rose from 57.6 in March to 57.8 in April. The index level for France was high at 62.4 and, for Germany, very satisfactory at 59.9. With the average for the eurozone below both of these levels, it can be seen how weak the figures were elsewhere. Other general indicators from the eurozone as a whole show weak retail sales in February when they fell by 0.1%. Eurozone industrial production rose by 0.4% in February to be up 7.3% over the year. New industrial orders have been strong over the year, being 21.3% up in February compared with a year previously. In February, they rose by 0.9% over the month. In Germany, the strongest of the major eurozone economies, new industrial orders rose by 2.4% in March. Showing the economy's relative strength, Germany's exports rose by 2.7% in February, whilst imports rose by 3.7%. The trend in German unemployment is improving, with the number of people being out of work at its lowest since June 1992. The good economic performance has meant that progress towards stabilising public finances has been good. The German government has forecast that the public deficit will fall to about 2.5% of GDP this year and an almost balanced budget by 2015. The worry for many, in Germany, is that they are helping to support profligate members of the eurozone, which is why there is opposition to the level of German involvement in bailouts of eurozone countries in trouble.

But the eurozone's financial woes do not mean that eurozone shares are unattractive. As with US companies, many eurozone based companies are able to benefit from exposure to faster growing areas of the world economy. The German example we quoted is just one, but the same is true elsewhere, although the profile of some economies is such that they are left out of the benefit which some other eurozone members are deriving from, say, China's fast growth.

This provides the lead in for China, where, as we have said earlier, the authorities' main worry is inflation. Growth continues strongly at 9.7% in the first quarter of 2011, only fractionally lower than the 9.8% recorded in the fourth quarter of 2010. But in the year to March, inflation rose by 5.4%, a thirty two month high. The Chinese authorities are trying different ways of curtailing inflation. As well as raising interest rates (the latest one to 3.25%) and bank reserve requirements partly to dampen down significant property price inflation, strict price controls are being imposed on some basic consumer items. This merely suppresses the problem. The exchange rate is creeping up and is likely to be a weapon in the attempts to curb inflation. Keeping the renminbi close to a weak currency like the US dollar worsens the reported inflation damage. Food price inflation, running at roughly twice the general inflation level, is a worrying problem for the Chinese authorities because of the potential for social unrest. The sheer momentum of the Chinese economy and its effect on the rest of the world economy is shown by the fact that, in the year to March, Chinese exports rose in value by 35.8% whilst imports rose in value by 32.6%. The shift in economic power from west to east is perceptible by the day and it is important that this is recognised in a portfolio's investment policy. It may even be an indirect recognition through investment in business or countries (Australia comes to mind) which benefit from China's rapid growth. China certainly has problems of which inflation is the most important in the short term. A combination of interest rate rises, increased bank reserve requirements and a rising currency is likely to be used, as well as price controls on basic items. So far this year, the renminbi has only been allowed a slight rise against a weak US dollar, but this is likely to change with a more aggressive rise being targeted because of the inflation problem.

As for the UK, the government has set is course for the current parliament in terms of the structural deficit which is to eliminate it. It will be a very tough journey and, although the Conservative part of the coalition performed well in the recent local elections, it can expect to become very unpopular as the measures to stabilise public finances are increasingly felt by the electorate. It is going to be a long haul to restore order to the UK's public finances, but it has to be done. So serious is the level of the budget deficit, that any backsliding is likely to be punished by the markets in terms of pushing up government (and, therefore, other) bond yields and pushing sterling down, accompanied most likely by a ratings downgrade for the UK.

The first estimate of the UK's first quarter growth has come in at 0.5%, more or less reversing the 0.5% weather related contraction of the fourth quarter of 2010. The figure is quite likely to be revised as more information comes in, but it was roughly what was expected. One of the dampeners on growth was the construction sector but the business leaders in the construction sector believe that there is something wrong with the numbers used with business, they think, being stronger than indicated. Most evidence from the economy suggests that it continues to grow but perhaps at a slowing rate if indicators like the purchasing managers indices are correct. The idea is that, as the public sector contracts, the private sector will take over and take up the slack. That is quite possible. When the public sector is expanding quickly it "crowds out" the private sector. Usually, this is thought of in terms of interest rates as increased government spending not financed by tax increases forces up interest rates. Because of the extremely loose monetary policy currently being followed in the UK that is not yet happening, but it might in due course. But "crowding in" will be what the government hopes happens. As the public sector is cut back, there will be less competition from the government for resources helping the private sector to acquire factors of production more cheaply. Furthermore, there should be opportunities from the private sector to pick up work currently performed by the private sector. With real incomes falling, as inflation (currently 4% on the CPI measure) runs at a higher level than pay increases and taxes rise, some help from exports is necessary. Unfortunately, manufacturing as a percentage of GDP has fallen from about 22.5% of GDP in 1990 to about 13% now, so there is a limit to how far faster growth in many other economies will help the UK. But it should be of some help. In the April Quarterly Industrial Trends survey, of the 451 manufacturers which responded, 36% said that they had seen an increase in output in the past three months whilst 15% said that output had fallen and anecdotal evidence suggests that the manufacturing sector is doing quite well. However, the UK is not alone in experiencing a declining share of manufacturing as a percentage of GDP although it has been more precipitous. At the current level, it is on a par with the USA and ahead of France, although well behind Germany and Japan, and all of these are a long way behind China where the figure is around 42.5%. With the decline in sterling in recent years, the UK should be well positioned to benefit from the competitive level of its currency but it does not appear to be gaining relative advantage at present.

The uncomfortable position of having the Bank of England interest rate at 0.5% and inflation much higher was very slightly relieved by the CPI coming in at 4% in March, lower than expected. This is twice the target level and potentially highly inflationary to have such a large negative interest rate. But whilst fiscal policy has to remain so restrictive because of the state of public finances, natural economic anxieties are somewhat relieved. However, as elsewhere in countries where interest rates are at very low levels, there will, in due course, have to be the start of a move towards normality. This need not be bad for equities or longer term bonds, were it not that the latter were seriously overvalued. Dividend yields and ratings remain supportive for equities.

Whilst the overall outlook for the world economy appears satisfactory, it must be emphasised that, with much bad news around, as well as some good, investors are likely to experience volatility in the market values of their portfolios. For example, in 2010 there were three good quarters, taking the calendar year as the measure, and one bad quarter, and such a pattern may be repeated this year. However, we are long term investors and are encouraged by reasonable equity valuations to believe that they remain the asset class of choice. We see no value in bonds whilst substantial cash holdings relative to portfolio size, unless waiting to make opportunistic purchases, are only for the exceptionally risk averse, in our view.