meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

It has been another positive quarter for international equities as monetary policy has continued to benefit markets and investors chase returns, now not so easily available from bonds or cash. However, bonds, extremely expensive in our view, have had a setback and have seen some savage price falls recently highlighting the pitfalls of investing in an asset class so removed from fair value. In the currency markets, sterling has performed well, except against the Canadian dollar whilst, in the commodity markets, oil has staged a strong rebound helping to banish some of the fears about deflation.

The tables below detail relevant movements in markets :

International Equities 30.01.15 - 30.04.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.1	+4.0	+6.4	+7.2
Finland	+1.0	-2.0	+0.3	+1.0
France	+10.5	+7.2	+9.7	+10.5
Germany	+7.2	+4.0	+6.4	+7.2
Hong Kong, China	+9.2	+6.7	+9.2	+10.0
Italy	+12.0	+8.6	+11.2	+12.0
Japan	+13.8	+9.2	+11.7	+12.5
Netherlands	+9.7	+6.5	+8.9	+9.7
Spain	+10.7	+7.5	+10.0	+10.7
Switzerland	+11.0	+6.6	+9.1	+9.8
UK	+4.8	+4.8	+7.2	+8.0
USA	+5.2	+2.8	+5.2	+6.0
Europe ex UK	+9.6	+6.1	+8.6	+9.4
Asia Pacific ex Japan	+5.5	+4.8	+7.2	+7.9
Asia Pacific	+9.7	+7.0	+9.5	+10.2
Latin America	+13.4	+3.8	+6.2	+6.9
All World All Emerging	+10.7	+6.7	+9.2	+10.0
The World	+6.8	+4.4	+6.8	+7.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : -4.3%

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

Currency	30.01.15	30.04.15
Sterling	1.33	1.95
US Dollar	1.66	2.09
Yen	0.28	0.33
Germany (Euro)	0.31	0.37

Sterling's performance during the quarter ending 30.04.15 (%)

Currency	Quarter Ending 30.04.15
US Dollar	+2.1
Canadian Dollar	-3.0
Yen	+4.0
Euro	+2.8
Swiss Franc	+4.2
Australian dollar	+0.4

Other currency movements during the quarter ending 30.04.15 (%)

Currency	Quarter Ending 30.04.15
US Dollar/Canadian Dollar	-5.0
US Dollar/Yen	+1.9
US Dollar/Euro	+0.7
Swiss Franc/Euro	-1.3
Euro/Yen	+1.2

Significant Commodities (US dollar terms) 30.01.15 - 30.04.15 (%)

Currency	Quarter Ending 30.04.15
Oil	+27.1
Gold	-6.3

MARKETS

International equity markets have continued to press ahead over the last quarter. In local currency terms the FTSE World Index has returned 6.8% whilst, in sterling terms, the return was 4.4%, in US dollar terms, 6.8%, and in euro terms, 7.6%. Looking at local currency returns first, we see that Europe ex UK and Japan were the strongest performers with the relevant FTSE indices returning 9.6% and 13.8% respectively. Latin America and Emerging markets also performed well, returning 13.4% and 10.7% respectively. There were very modest underperformances from Australia, 5.1%, the UK, 4.8%, and the USA, 5.2%. There were no negative performances. Looking at sterling returns, Japan remained the best performer with the relevant FTSE index returning 9.2%. Europe ex UK remained a strong performer, returning 6.1%, but the USA slipped back to a below average but still satisfactory 2.8%. Despite currency weakness, the Latin American market still showed a positive return in sterling terms with the relevant FTSE index returning 3.8%. Emerging markets also performed well in sterling terms with the FTSE All World All Emerging markets Index returning 6.7%.

The international bond market told a different story. With yields having been pushed down to unrealistically low levels, there was always going to be a reaction. Taking ten year government bond yields, the gross redemption yield on the UK gilt rose by 62 basis points to 1.95%, for the US Treasury by 43 basis points to 2.09%, for the Japanese government bond by 5 basis points to 0.33% and for the German Bund by 6 basis points to 0.37%.

In the currency markets, sterling performed strongly. Only against the Canadian dollar did it weaken, on this occasion by 3.0%. Against the US dollar, sterling rose by 2.1%, against the yen by 4.0%, against the euro by 2.8%, against the Swiss Franc by 4.2% and against the Australian dollar by 0.4%.

In the commodity markets, oil, as measured by Brent crude, recovered by 27.1%, but gold weakened by 6.3%.

ECONOMICS

Despite the troubled political and economic background in some regions, the world economy is progressing at a modest rate and international equity markets have continued to rise. The reason, as for so long now, has been aggressive monetary policy in the form of very low or negative interest rates and electronically created money. This has raised asset prices as investors have chased returns which have not been available on cash deposits or bonds. The spillover effect has benefited equities and bonds with shares usually providing superior yields to those on bonds. Whilst it is pleasing to see portfolios providing consistently positive returns, it is important to remember that these returns have far outstripped economic growth and have been obtained seemingly oblivious of risk. It is certainly logical to be invested in shares in the type of monetary environment which exists at the moment and a case can be made for bonds, although we think the latter is wrong and the sector is very risky, but it is also important to understand the returns being made are above what it is normally reasonable to expect and that they cannot continue indefinitely at this level which is why, in our reviews, we have consistently warned that there are bound to be some negative quarterly returns. For example, in recent years, we have seen temporary setbacks due to “taper tantrums” in the USA, although the markets soon recovered from them. It is hard to believe that some of the political and economic problems, currently evident, will not affect markets from time to time.

However, what is helpful to equities, as well as quantitative easing, is that there is some economic growth which provides support for the belief that there will be further growth in profits and dividends. Of itself, that is not necessarily enough to push shares higher. They may, for example, be too highly rated although we do not generally believe that to be the case at present. Although forecasts may be wrong, it is still helpful to have, as background to one's investment judgements, the latest growth outlook from organisations like the IMF. In its April World Economic Outlook, the IMF projects world economic growth of 3.5% for this year, against 3.4% last year, and 3.8% for 2016. Within that figure, its projection for growth in advanced economies is 2.4% for this year and next and for Emerging Markets and Developing Economies, 4.3% for this year against 4.6% in 2014 and 4.7% for next year. Within the Advanced Economies group in the G7, the best performers in 2015 are expected to be the USA (3.1%) and the UK (2.7%), the best performers in 2014 as well, and that is also the case in 2016 at 3.1% and 2.3% respectively, although a lot can happen before then. The euro area's growth is expected to accelerate this year from 0.9% in 2014 to 1.5% in 2015 and to 1.6% in 2016. Of the four largest economies in the eurozone, Spain is expected to lead the way this year with growth of 2.5% against 1.4% last year and 2.0% in 2016. The biggest eurozone economy, Germany, is projected to maintain last year's growth rate of 1.6% and to increase it slightly to 1.7% in 2016. France, which experienced a disappointing growth rate of 0.4% in 2014, is expected to perform better this year with 1.2% growth projected, accelerating to 1.5% next year. Italy, the third largest economy, which suffered an economic contraction last year of 0.4%, the third successive year of recession, is projected to show very modest growth this year of 0.5%, accelerating to 1.1% next year. Japan, which experienced an economic contraction last year of 0.1% as a result of the after effects of the consumption tax increase, is projected to grow by 1.0% this year and 1.2% next year. As the difference between projected growth rates for Advanced Economies and Emerging Markets and Developing Economies shows, the latter category is still expected to show growth exceeding that of Advanced Economies at 4.3% this year, down from 4.6% in 2014, and 4.7% next year. If we look at the BRIC countries, we see two experiencing economic difficulties, Brazil and Russia, and two performing better, China and India, but with issues for both of them. Brazil has followed an inappropriate economic policy in recent years which is now having to be corrected. Last year, the economy hardly grew at all, just 0.1%, and this year it is expected to contract by 1.0% according to the IMF's projections. It sees a return to growth of 1.0% in 2016. The issues with Russia are self evident. The IMF sees last year's economic growth of 0.6% turning into contraction of 3.8% this year, followed by a further contraction of 1.1% in 2016. With political developments uncertain, the collapse in the oil price and sanctions, making economic forecasts for Russia is very difficult but it is obviously not in a good place at the moment. China, which we will discuss later, is undergoing a transition to a more consumption led economy aiming to achieve higher quality growth. The IMF projects growth of 6.8% this year against 7.4% last year and 6.3% in 2016. On the other hand, India, spurred on by economic reforms and a big beneficiary of the weaker oil price, is projected to see an acceleration of last year's economic growth rate of 7.2% to 7.5% and to maintain that rate next year. Overall, the size of these two economies, about 17.9% of world GDP, lifts the category's growth rate above that of Advanced Economies. Overall, there is nothing in the projections which suggests that the level of the international equity market is obviously wrong. There may be other issues but the growth forecasts, if they are anywhere near right, are broadly supportive.

As we have said many times before, the strength of the bond and equity markets is largely due to the monetary policy which has been followed since the financial crisis seven years ago, and this continues to be the case, with the latest catalyst being quantitative easing which was instituted in the eurozone in March. It is difficult to say anything new about this so we just need to repeat that very low or, even now, negative interest rates push money into different asset classes in search of return.

So, for equities, which have usually been bought for long term capital growth, their dividend yields suddenly became attractive relative to bonds and cash. Furthermore, given the trend of dividends to grow over time, a rising flow of income looks attractive. For bonds, those considered of high quality have seen yields in some eurozone countries and Switzerland fall to below zero. In the search for yield, lower quality issues have seen their prices elevated. Whilst there are theoretical arguments which could be used to justify negative yields, this is a highly undesirable position because risk is mispriced and there are surely going to be some large losses made in the bond market when a move towards normality in monetary policy and bond yields occurs. The situation, we think, is much better for equities. The dividend yields are not hugely distorted and equity ratings are not obviously significantly overvalued but equity prices have undoubtedly been pumped up by quantitative easing and very low interest rates.

It is worth reflecting on some of the distortions which have been created by the type of monetary policy followed over the last seven years. There is a natural tendency to think of the benefits to the borrower arising from such low levels of interest rates but, as we have hinted above, it has caused major problems for savers who are usually in the majority. For those dependent upon income from bonds or cash deposits, their standard of living will have fallen. In so far as they have attempted to replace that income by buying riskier assets such as high yielding lower grade bonds, they have exposed themselves to capital risk as well. In many cases, their consumption levels will have fallen as they have less disposable income, causing a reduction in economic activity. The counterpart of this is that those whose disposable income has been increased by lower interest payments may have been able to add to economic activity. As we said in the last paragraph, risk has become mispriced and, when that happens and defaults occur, concerns about the banking system arise. There are obviously economic consequences for those who lose money on the defaults. From an economic growth perspective, there are longer term issues. Because of the fall in financing costs, zombie companies are kept alive and this "crowds out" companies with better growth prospects which can contribute more to an economy. From a macro economic perspective, it is highly undesirable that the only way in which any economic growth can be stimulated is through rock bottom interest rates. At some stage, although, particularly in the eurozone, it does not feel like it at present, cheap money and newly created money will stimulate inflation. To say that "this time it is different" is dangerous because the chances are that it will not be. During the economic difficulties of recent years, business investment has been weak in many countries, so that when demand increases, the relevant country may have closed its output gap, i.e. it has no spare capacity. That may not be on the employment side given very high rates of unemployment prevalent in the eurozone for example but, rather, in manufacturing capacity. When that happens, inflationary pressures start to rise. So, in the USA and UK, the two best performing economies out of the G7 countries, there is speculation about the timing of the first interest rate increases of this cycle. It is important that interest rates properly reflect the normal balance between savers and borrowers and that an economy can grow around this situation. To rely on rock bottom interest rates or newly created money to stimulate any economy, and for that to be the default position, threatens long term economic damage as risk must be correctly priced and inflation not ignored. That is why, although it may affect markets in the short term, investors should welcome the start of a move towards more normal monetary policy.

The move towards normality in monetary policy, even if very tentative, as it is bound to be, has implications for equities and bonds, particularly the latter. A wide range of bonds is selling at negative gross redemption yields in Europe. At the time of writing, if we look at 5 year government bond yields, we see negative yields from government bonds issued by Switzerland, Denmark, Germany, Slovakia, the Netherlands and Sweden. Out at ten years' maturity, Switzerland's government bond was standing on a negative gross redemption yield although now it is slightly in positive territory. So, investors holding these bonds are paying to be able to invest in them. Are there any circumstances under which this can be a sensible investment? If you are a foreign investor in these countries and believe that your domestic currency will weaken against the Swiss Franc, euro or Danish Kroner and you are right, then, of course, you can make money in your domestic currency but, with negative yields, you might find it safer to place the funds on deposit since, although you would receive a negative interest rate, you would avoid further capital loss if the bond you had bought fell. One of the concerns around the eurozone at present is deflation. The year on year headline inflation figure, having been negative, is now zero although the core rate, which excludes volatile food and energy prices, is positive. If, and we do not believe that this is likely, persistent deflation becomes the norm then one can theoretically make a positive return if the deflation rate is greater than the negative yield upon which the bond was bought. Whilst theoretically sound, we doubt if many investors are buying bonds on negative gross redemption yields for these reasons. Quantitative easing has created a high demand for good quality eurozone bonds. By September 2016, the ECB will buy more than €1 trillion in assets (government and private sector bonds) with 80% of the risk being taken by member countries' central banks. The biggest purchaser will be Germany but with its budgetary position strong and the country not, therefore, a big issuer of bonds, there is a scarcity value driving down yields. But other than in a period of prolonged inflation, which we do not see, it is difficult to see how these bonds can be anything other than very bad investments on any investment term. If, for any reason, there was to be an extended period of deflation, credit risks would arise as the real value of liabilities rose. Whilst government bonds might seem sounder than corporate bonds in such circumstances, the negative economic effect of corporate defaults on an economy could weaken the sovereign with consequences for its debt rating. At the moment, even very highly indebted eurozone countries like Italy are able to borrow at extraordinarily low yield levels, 0.577% for five years and 1.412% for ten years, but weak economic performance raises debt levels and, at some stage, credit risk will be properly priced. None of this convinces us that holding bonds at sub zero or very low yields is likely to be a good investment. A return to more normal yield levels will involve a significant fall in prices as one moves further along the yield curve.

What are the implications for equities arising from this position in the bond markets? So far, this situation has clearly been helpful for equities as money has flowed into them seeking returns which are not available elsewhere. Some investors may not be natural holders of equities but the lack of yield on bonds and cash has driven them in that direction. One of the significant supports for equity markets, arising from the fall in interest rates, has been the attraction to companies of using cheap money to fund share buy backs. Investors have benefited from companies' reluctance to invest and, as cash has built up, they have repurchased shares and raised their dividends. They have also borrowed money at very low interest rates (Apple is a good example) to repurchase shares and the maths of the operation are compelling. So, with money cheap, share repurchases, under the right circumstances, can be a good use of the money. According to Factset, S&P 500 companies spent US$125.8 billion on share repurchases during the fourth quarter of 2014 and, on a trailing 12 month basis, US$564.7 billion. 72% of the Index participated in share buybacks during the fourth quarter of 2014. This activity can have positive short term effects as, in the right circumstances, it can raise earnings per share but even the most ardent enthusiasts would like to see companies now increasing capital investment as that will provide the opportunity for the company to grow. One of the original aims of the very loose monetary policy instigated in the aftermath of the financial crisis was to raise asset prices and instil a positive "wealth effect" both for individuals and for companies. For individuals, a rising share portfolio might encourage spending and help kick start the economy and, for companies, also to start spending. The most obvious side effect, which is what we are seeing now, is a spurt in Merger and Acquisition activity as company directors feel more confident about prospects. Of itself, M & A activity may not have much of a direct effect on an economy but it can have indirect effects in spreading confidence.

From a macroeconomic viewpoint, we can be fairly sure that interest rates will remain very low in all the main economic areas. If they do rise in the USA and UK, it will still be to a level which is historically very low. This is likely to be quite a supportive background to equities although the speed at which they have risen and the troubled political and economic background make periodic setbacks in the equity markets very likely. Dividend yield comparisons remain favourable for equities compared with bonds and, furthermore, dividends are growing. The estimated dividend yield on the S&P 500 Index this year is around 2% whereas the 10 year US Treasury bond yields are only a fraction over that. Given that US dividends are growing, nearly 12% last year and further rises expected this year, this relationship is relatively favourable for US equities. It does not take into account the cash returned to shareholders. If we look at Europe, the expected dividend yield on the Euro Stoxx 50 is, according to Bloomberg, 3.38%. If we compare that with the yield on the most highly rated eurozone government ten year bond, that of Germany, which is currently 0.587%, the relative attraction of equities in the eurozone can be seen. In the UK, the estimated dividend yield this year for the FTSE 100 index is about 3.8% and the yield on the ten year gilt is 1.856%. Outside the eurozone, but still in Europe, the estimated dividend on the Swiss market index is 3.18%, whilst the Swiss ten year government bond yields -0.069%. In Japan, the forecast dividend yield on the Nikkei 225 is 1.5% whilst the ten year Japanese government bond currently yields 0.3%. In a yield starved investment world, the relative attraction of equities is clear. With this magnitude of absolute or relative (in the case of the USA) yield advantage it is possible to look at prospective earnings multiples a little more liberally. According to Bloomberg, the US market, as measured by the S & P 500, stands on a twelve months forward price/earnings ratio of just under 18 whilst, for Europe, the equivalent figure is just over 16 and for the UK just under 17. For 2016, the ratings are expected to fall further as profits increase on the back of further economic growth. Combined with the dividend yield advantages of equities, either in absolute or relative terms, the ratings do not seem excessive but shares do depend for their current levels on profits continuing to rise.

As we look at the world economy, we see some, probably temporary, slowing down of the US economy. The first quarter's GDP figures, just released, showed quarter on quarter GDP growth of just 0.2% annualised, lower than expected as bad weather (as in the first quarter of 20145) adversely affected the economy, together with the effect on exports of the west coast port strike. The strengthening US dollar was also a headwind, as noted by a number of US companies in their first quarter earnings report. A pick up in the rate of growth would certainly be expected in the second quarter as the effects of the bad weather wear off. Assuming that this quarterly setback is nothing more than a temporary phenomenon, we would expect the Federal Reserve to continue to debate the timing of the first interest rate increase. We have outlined the dangers of inflation arising from not acting to raise interest rates in time. The output gap is subjective but the US cannot be far away from using up its slack after which inflationary pressures can be expected to become an issue. So, a move towards normalising interest rates before this becomes a problem will be necessary. Although the first quarter growth rate was disappointing (future revisions may change the picture), there are positive signs for the economy which suggest that the output gap is closing fast. A good indicator may be evidence that pay is picking up. High profile wage increases from Wal-Mart and McDonalds point to a tightening employment market and the knock on effect could be higher consumer spending once consumers feel more confident about their financial position. Although recent employment numbers were disappointing, these were for one month only and there is not enough evidence to suggest that this is the start of a deteriorating trend following a succession of very good numbers. The latest unemployment level remains at 5.5% although a low participation rate, now at a low point of 62.7%, is always a qualification for this figure in that a low participation rate can make the unemployment figures look better than they really are. Although the latest purchasing managers indices were a little lower than the previous month's figures, overall they were still comfortably within positive territory. The manufacturing index stood at 51.5 against 52.9 the previous month whilst that for non-manufacturing, a much larger section of the US economy, stood at 57.8 against 56.5 the previous month. Whilst year on year consumer price inflation was in negative territory at -0.1%, the core rate was positive, suggesting that deflation is very unlikely to affect the USA. Given how out of line with the norm interest rates in the USA stand and that the country is in a relatively good economic state, there needs to be a series of significant negative economic events to occur to make the Federal Reserve hold back from its planned interest rate increases, otherwise it will be behind the curve. Although markets will have to face up to the reality that interest rates have to rise at some time, it is far better that the Federal Reserve raises them in its own time and at its own pace rather than to be forced by inflationary pressures to raise them more sharply and more quickly. That would disturb the stock markets. At this stage, we know that interest rates will start to rise but we do not know when. For a firmer underpinning to the US equity market, investors need to see revenue growth (at present hampered in economic terms by the strength of the US dollar) with less emphasis on earnings per share growth being generated by share buy backs. US businesses need to reverse a disappointing trend in business investment, admittedly exacerbated by the fall in oil prices which has affected capital expenditure in the energy industry, otherwise the potential growth in the US economy will be adversely affected. For that to happen, confidence must recover. Share buy backs from US companies with very strong balance sheets have helped to keep US shares performing well and are likely to continue to do so in the near term but this phenomenon cannot go on indefinitely without some negative growth implications which is why some institutional investors are now pressing companies to invest more to secure their future position. But, as we look around the world at investment prospects, the USA remains one of the lower risk ones and an area we feel should be well represented in an international equity portfolio.

The eurozone continues to be dominated by the Greek situation although, as our tables at the beginning of this review show, this has not stopped eurozone equity markets from performing well. It is difficult to say anything new about the long running drama. Positions are becoming so entrenched that a climbdown by either side looks very difficult and areas of compromise difficult to find. Whatever the eurozone's leaders may say, a Greek exit from the euro would be difficult for the euro project since it was supposed to be irreversible. If one country exits, the suggestion that this was a "one off" becomes more difficult to sustain. Greece cannot pay off all its debts and everyone knows that. It has lost valuable time since the election and tax revenues have suffered. The government would experience an enormous loss of face if it were to bow to the previously named troika's demands, yet, even if it defaults on the regular series of debts to be repaid, it is difficult to know how it would meet its internal obligations. Given the collapse in taxation receipts, Greece's primary budget surplus which excludes interest payments is expected to be lower than planned. In that situation, if the country defaulted on its debts, a primary surplus would enable it to meet domestic obligations but the margin has almost disappeared. Trying to scrape together cash from municipalities shows the magnitude of the crisis and even that will only pay short term obligations to state employees and pensioners. It appears that the Greek crisis is about to reach its denouement only for another twist and turn to appear. However, if the country has insufficient funds to meet its domestic obligations, one feels it has come to the end of the road. There is certainly no room for complacency. Even though the IMF has raised its growth forecasts for the eurozone, it is still a fundamentally flawed project which will give rise to periodic crises. The inability of countries to adjust their exchange rate is central to eurozone countries' problems. Meanwhile, as outlined earlier, the quantitative easing policy of the ECB is causing money to flood into the securities markets and raising equity prices as investors search for yield. However, although obviously well behind the USA in its development of monetary policy, as it has only just started quantitative easing, the same issue will arise later on when it has to, firstly, stop quantitative easing and then raise interest rates to stop inflation becoming a problem. That this action is a long way off does not mean that threats to inflation will not arise and demand that the ECB does not fall behind the curve in raising interest rates. Eurozone shares do not look overvalued but an ugly end to the Greek crisis could certainly affect the eurozone equity and bond markets in the short term.

As our table shows, the Japanese equity market has been the star performer during the last quarter. Whilst the economy, post the 1st April 2014 consumption tax rise from 5% to 8%, has been a disappointing performer, the Bank of Japan has undertaken an aggressive quantitative easing policy aimed at raising inflation to 2% and ridding Japan of the deflationary mindset which has held back economic growth for many years. The fall in the oil price has hampered the achievement of this target. We have often said that this is a high risk/high reward market. It is high risk because Japan is hugely indebted domestically with public sector debt at around 220% of GDP. Very low interest rates made it possible to service this debt easily enough at present and most of the debt is held domestically. Having its own currency is also helpful but this does not alter the fact that should the yen suffer from serious weakness at any time because of its very high level of internal debt and interest rates have to be raised to protect the currency, its debt servicing costs could cause the budgetary position to become even worse. The country does have very substantial foreign exchange reserves, US$1.24 trillion, to add to its strength but Japan's debt burden is not something which can be ignored. Helping the equity market is the Japanese authorities' instructions to public sector funds to switch allocations from bond to equities. During the last two years, the Bank of Japan has purchased JPY2.8 trillion (US$23 billion) of exchange traded funds tracking the Japanese equity market. Last year, it was announced that the Japanese Government Pension Investment Fund would set a 25% target each for the allocation to Japanese and overseas equities, up from 12% in both cases. At the end of March, it was announced that three Japanese public pension funds controlling JPY30 trillion (US$249 billion) would follow suit. This is bound to be supportive to the Japanese equity market but does not alter the fact that Japan has a serious fiscal problem. The third arrow of "Abenomics", the one of structural reform cannot be implemented soon enough as increasing Japan's long term potential growth rate is vital especially as the country's demographics are so poor.

For China, the balance remains very delicate. The sharp increase in Chinese share prices, particularly the domestically traded "A" shares, is not due to the reflection of better economic news but to a periodic bout of speculation. As the IMF forecasts suggest, a slowdown in the growth rate is in prospect as the country transitions away from fixed asset investment towards consumption. The closely watched purchasing managers indices are both slightly in positive territory. For manufacturing, it is only just, though, with a reading of 50.1, whilst the reading for non manufacturing is more comfortably in positive territory at 53.7. The rate of increase of industrial production is in decline with the latest figure being a year on year increase of 5.6% compared with 7.9% the previous month. The month on month increase was 0.25% against 0.40% the previous month. Because of the vast internal indebtedness in China, a move into deflation would be serious as it would raise the value of public and private liabilities and the bad debts of the banking system. The latest year on year inflation rate in China is 1.4% and the month on month rate -0.5%. The authorities will try whatever is necessary to stop the economy moving into deflation. With its very strong external finances, China continues to develop its overseas investments quite substantially, helping to provide a better balance to the economy both through additional trading opportunities arising from those investments and the income which they will produce. Given that the Chinese authorities can act more quickly than most to influence the economy, there must be a reasonable chance that it will be able to achieve the outcome it deserves. International investors continue to watch closely economic developments in China and analyse the influence which they will have on international stock markets and the world economy.

Finally, we come to the UK where we saw the stock market as being high risk in front of the General Election with the opinion polls indicating a messy result, something that would not be helpful given the UK's two large deficits in the budget and the current account. As this is written, the General Election has turned up a surprise, at least in relation to the opinion polls, with the Conservatives gaining an absolute majority. Uncertainty is something which unsettles stock markets and this surprising result will help to reduce that. It is very early days and it will be necessary to see how things develop on the political front but with the economy performing quite well, notwithstanding disappointing first quarter GDP figures at 0.3%, quarter on quarter, early thoughts are that the election result will be helpful in retaining confidence in the UK.

As the recent sharp fall in bond prices shows, investors must be very cautious about the type of assets in which they invest. Bonds offer a salutary lesson in buying assets which are clearly overvalued with recent price falls in some markets showing equity type movements and showing that, in some cases, bonds are not the low risk assets they are sometimes made out to be. Notwithstanding the recent rise in bond yields, we still consider them to be seriously overvalued. For equities, our favoured asset class, we continue to believe that their movement upwards will be uneven as they respond to difficult political and economic news but we believe that the dangers of being out of the market in terms of opportunity cost for long term investors outweigh the risks of short term setbacks.