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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Investors have experienced a positive quarter as the worst of the fears apparent in the opening months of the year begin to fade. More evidence of an improvement in economic conditions, albeit from a very low base, is evident and investors have taken their cue from this. However, there is absolutely no reason to become carried away by the markets' movements because significant difficulties lie ahead. We continue to favour equities against bonds.

The tables below detail relevant movements in markets:

International Equities 29.05.09–31.08.09

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+19.4	+24.2	+25.8	+24.1
Finland	+1.7	+2.0	+3.1	+6.1
France	+13.2	+13.6	+14.8	+13.2
Germany	+11.2	+11.5	+12.7	+11.2
Hong Kong, China	+5.7	+4.6	+5.7	+4.3
Italy	+12.7	+13.0	+14.2	+12.7
Japan	+7.2	+9.2	+10.3	+8.8
Netherlands	+16.6	+17.0	+18.2	+17.0
Spain	+23.2	+23.6	+24.9	+23.2
Switzerland	+16.1	+15.9	+17.1	+15.5
UK	+12.9	+12.9	+14.1	+12.5
USA	+11.7	+10.6	+11.7	+10.2
Europe ex UK	+14.5	+15.3	+16.5	+14.9
Asia Pacific ex Japan	+11.8	+13.0	+14.2	+12.7
Asia Pacific	+9.6	+11.1	+12.3	+10.7
Latin America	+5.0	+7.5	+8.7	+7.2
All World All Emerging	+8.6	+8.4	+9.6	+8.1
The World	+11.5	+11.5	+12.7	+11.1

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +8.2%

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

Currency	29.05.09	31.08.09
Sterling	3.76	3.56
US Dollar	3.47	3.40
Yen	1.50	1.31
Germany (Euro)	3.59	3.25

Sterling's performance during the quarter ending 31.08.09 (%)

Currency	Quarter Ending 31.08.09
US Dollar	+1.1
Canadian Dollar	+1.3
Yen	-1.8
Euro	-0.3
Swiss Franc	+0.2

Other currency movements during the quarter ending 31.08.09 (%)

Other Currency	Quarter Ending 31.08.09
US Dollar/Canadian Dollar	+0.2
US Dollar/Yen	-2.8
US Dollar/Euro	-1.4
Swiss Franc/Euro	-0.5
Euro/Yen	-1.5

Significant Commodities (US dollar terms) 29.05.09–31.08.09 (%)

Significant Commodities	29.05.09–31.08.09
Oil	+6.3
Gold	-0.9

Markets

Stock markets have experienced a quarter of solid gains with currency movements, on this occasion, having little effect on returns in different currencies. The total return on the FTSE World Index in local currency terms was 11.5%, the same in sterling terms, 12.7% in US dollar terms and 11.1% in euro terms. In local currency terms the FTSE USA Index returned 11.7%, the FTSE Europe ex UK Index 14.5%, the FTSE Japanese index 7.2% and the FTSE UK Index 12.9%. Australia returned a very robust 19.4% in local currency terms. The returns from Asia Pacific ex Japan, Latin America and emerging markets were relatively less spectacular than they have been but they were still very good. In local currency terms, the FTSE Asia Pacific ex Japan returned 11.8%, Latin America 5.0% and emerging markets 8.6%. Of the major currencies, the yen was the strongest and this pushed up the sterling return of the FTSE Japanese Index to 9.2%. Currency strength also raised the return in sterling terms on the FTSE Asia ex Japan Index to 13.0% and on the FTSE Latin American Index to 7.5%. But the most spectacular absolute increase was in Australia where the strength of the Australian dollar raised the sterling return on the FTSE Australia Index to 24.4%.

Recent strength in the bond markets made for solid returns here, too. Taking ten year government bonds as a benchmark, yields on sterling bonds fell from 3.76% to 3.56%, on US dollar bonds from 3.47% to 3.40%, on yen bonds from 1.50% to 1.31% and on German government euro denominated bonds from 3.59% to 3.25%.

As implied above, the major currencies showed relatively little move over the quarter.

In the commodity markets, oil rose by 6.3% in US dollar terms whilst gold was 0.4% lower.

Economics

Mood swings can be very rapid in the stock market and the change in sentiment since early March has been remarkable. To look at international equity markets now, one would think that the world economy was flourishing instead of remaining in a dangerous position. But stock markets look ahead and, at the moment, they are telling us that things will get better. It is far more complex than that and this review will try to discuss relevant aspects of the current economic situation and how these might give us a guide to the future course of the stock market.

In retrospect, it may be said that the depths plumbed in early March reflected an overreaction to events and that the sharp rebound in share prices reflected an adjustment to that. The most serious danger to the world economy was the state of the banking system following the collapse of Lehman Brothers. At times like this, it is important to step back and try to review the situation objectively and away from the emotion of the markets. To us, the possibility of a collapse of the international banking system was unthinkable. The implications for the world economy would have been frightening. For that reason, it was reasonable to conclude that various government and central bank actions would be taken to stabilise the system. That sounds very easy to say now but the nationalisation or part nationalisation of some banks, government guarantees on bank deposits, central banks' market transactions and other measures stabilised the position. We think that the point of maximum concern was when bank depositors feared for the safety of their deposits and started moving deposits from banks which were considered risky. Timely action quelled depositors' fears. This makes the stabilisation of the banking system seem very easy, quite the opposite of the reality. With the benefit of experience, customers of the banks, investors in the stock market and all the shareholders can feel as comfortable as they possibly can that the authorities, whether it be governments or central banks, now have the necessary experience to deal with any future problems with financial institutions as they arise. We think the removal of this concern is the major catalyst of the recovery in international equity markets.

We have mentioned in reviews over the previous months that an improvement in markets would reflect a change in trend in the news. It is well worth repeating that stock market cycles do not mirror economic cycles, rather, stock markets look ahead. As we mentioned before, the sequence of events would be that the economic news would move from being totally bad to slightly less than totally bad, then gradually to being stable and, next, to news being, on balance, better rather than worse and so on until the news was largely good. The expression "green shoots" was shorthand for this development. This is exactly how it has turned out. The world economy is still in a very serious condition but there are an increasing number of signs that it has passed the worst point in this cycle and that is what international equity markets are telling us.

However, this is to simplify matters. We need to examine how we have arrived at the situation where we can say that the economic position is looking a little better for this is no ordinary cycle. To arrive at this stage has involved the most extraordinary combination of monetary, fiscal and unorthodox policy measures that one could imagine and nobody should be under the misapprehension that this will be costless. The bills will be enormous and investors will need to keep this clearly in mind as they look to their future investment policy.

In terms of monetary policy, interest rates in most major centres have moved towards zero and some major central banks have engaged in quantitative easing, a modern day way of saying printing money. In fiscal policy, many countries, such as the USA and UK, are running budget deficits of unimaginable proportions whilst central banks have been buying a large range of assets from banks to provide liquidity and to try to get money markets and bank lending moving. Other policy measures have been taken.

The immediate objective of this ultra loose economic policy is to restart economic growth following the severe recession. Cheap money is aimed at encouraging borrowing (prudently, of course) and to ease financing pressures on individuals and businesses all of which directly or indirectly should stimulate economic growth. The other aspect of monetary policy, quantitative easing, has the same objective but via a different route. By buying in bonds, almost wholly gilts in the case of the UK, the objective is to lower interest rates down the yield curve thereby making it cheaper for companies to borrow. The money deposited in the bank accounts of the sellers will, it is hoped, stimulate the economy by being lent and having a money multiplier effect and being used to purchase assets and thereby raise their price. Put very simply, by attempting to raise the amount of money in the economy (this will depend upon the newly created money not being hoarded) and with a supply of assets which cannot quickly be increased substantially, prices would be raised. One might ask why one wants to increase prices given that for most of the time in the past governments have been trying to control it. The answer lies in the even worse prospect of deflation. Here, falling price levels would discourage any but essential expenditure as consumers and businesses delayed buying goods and services which they expected to be able to buy more cheaply later on. For most countries, the ideal position would be to have an inflation rate of probably around 2% which would not be too high to eat away quickly at savings remembering that, in normal circumstances, interest rates would be positive in real terms. It would be at a sufficient level not to discourage non discretionary purchases. Whilst that may be the ideal situation, in the real world, once inflation develops, it is difficult to control.

The looseness of fiscal policy is demonstrated in most countries by enormous budget deficits, in the case of the USA and UK running into double figures in percentage terms. Deficits come in two parts, structural and cyclical. Cyclical deficits reflect the state of the economy. When it is depressed, automatic stabilisers come into play to try to limit the weakness. In these circumstances, government revenues come under pressure because of the weakness of taxation receipts whilst expenditure rises on items associated with economic weakness like social security. By not attempting to address this type of budget deficit by raising taxes or cutting public expenditure, the effects of economic weakness should be mitigated. Conversely, however, in good times, the automatic stabilisers should be allowed to work to provide resources for the bad times. Thus, strong economic growth, which boosts tax revenues and limits government expenditure on social security, for example, should be used to build surpluses. Unfortunately, many governments are not keen to let the stabilisers work in good times so they are tempted to spend the surpluses leaving nothing for the bad times. So, in current circumstances, when there is a substantial economic downturn, one would expect to see countries running significant cyclical deficits.

The other type of deficit, the structural one, is the insidious one. It is that part of the deficit which is built into the system and is not a function of the economic cycle. It can best be described as a deficit arising from spending being permanently in excess of income and causes a build up of debt as a percentage of GDP and increasing debt servicing costs. To tackle a deep seated structural deficit significant changes have to be made to the profile of public spending, rather less to taxation since increases in the latter tend to be more damaging to an economy in the longer term. Those economies best placed to deal with the present economic recession are those with cyclical deficits. Those which combine the two and have a particularly large deficit have substantial long term remedial work to restore confidence in them.

These extraordinary economic measures appear to have stabilised the world economy after its plunge into recession and to have contributed to the rise in asset prices as shown by the stock market recovery. Together with the confidence restored in the banking system, to the extent that depositors are not generally concerned about the security of their deposits, these factors have had a powerful stimulus.

However, the measures taken to save the banking system and kick start the world economy have come at an enormous cost which, in the midst of current investor optimism, is in danger of being relegated to the back page. The costs will be with us for many years to come.

So what are the issues which have built up? First of all, let us discuss quantitative easing, effectively the printing of money which, given a limited supply of goods and services, will cause inflation. It does not feel like that now because quantitative easing is a very new phenomenon and the output gap, the difference between potential output and actual output, is still positive and, therefore, firms do not, at present, generally have pricing power. But, if all the additional money starts to circulate more quickly and money supply starts to increase rapidly, inflation will follow and a different set of problems will arise including a sharp increase in interest rates and all the dangers which come with them. So, at some stage, and deciding the right time will be a delicate calculation, QE has to be reversed. That will entail selling bonds back to the private sector and withdrawing the money that has been created. At a time when many governments are still likely to be borrowing heavily, the presence of a large seller in the market can be expected to raise bond yields, the exact opposite of the purpose of the present QE which is to drive down yields. The reversal of QE could be an important market factor.

In countries like the UK, QE has been an important contributor to financing the government's vast budget deficit. To put matters into perspective, the government was expected to issue £220 billion of gilts in the current financial year and the QE programme, now increased by £50 billion to £175 billion, is now covering most of that given that the level of corporate bond purchases is very small. Financing the UK's budget deficit at anything like current interest rates could become very difficult. Whilst it may seem to be doing the trick at present, it is storing up major problems for the future which is why governments in the relevant countries where QE has taken place have to take early action to address budgetary problems.

That leads on to the related issue of the size of budget deficits and how they are to be financed if relevant governments do not act. Other things being equal, if governments continue to borrow heavily the level of outstanding debt in relation to GDP will become dangerously high and the cost of servicing it will take an increasing share of government expenditure. An increasing supply of government debt could raise servicing costs in two ways, firstly through the increasing amount of government debt to service and, secondly, through a reduced credit rating which would raise relative costs and could, in extremis, compromise the ability to sell debt. A country reaching this position could have to resort to a loan from the International Monetary Fund which would then call the tune on policies to be implemented to restore finances. Some countries, Australia is a good example, came into the recession in a strong position to implement counter cyclical spending measures because of many years of prudent economic management which had eliminated domestic government debt. Others, like the USA and UK entered the recession in poor shape because the good years had not been used to build up budget surpluses. Because the US dollar is the leading reserve currency and represents the largest part of the world's foreign exchange reserves, it has an advantage over less important currencies in that a major rebalancing of reserves by the USA's creditors could prove costly if this involves, as will almost certainly be the case, a fall in the value of the US dollar. Other countries risk being unable to finance their deficits threatening a sharp rise in interest rates and a severe weakening of their currency. If debt is monetised i.e. financed by printing money, the threat to the particular currency is severe. An example, representing quite different circumstances, and extreme is Zimbabwe. Whilst QE, in current extreme circumstances, has a role in trying to kick start economies, it is potentially very dangerous if not withdrawn as soon as realistically possible. Investors need to be very wary of countries which appear to be dragging their heels on taking decisive action to restore their finances for, if they do not, markets will exact their price.

This is where we believe bond investors need to be very careful. Negative or very low inflation can lull investors into a sense of false security as they see what would normally be considered low bond yields (please see those for ten year government bonds in the table at the beginning of this review) looking less anomalous at current inflation levels. However, the enormous size of most governments' budget deficits and the effective printing of money through various forms of quantitative easing in some countries should give investors pause for thought and that, far from being worried about deflation possibilities at present, they should be more worried about inflation in the future. Many government bond prices do not discount the possibility of a buyers' strike in some countries if they keep getting offered more and more debt to buy at interest rates they consider inadequate for the risk. Currency collapses in those countries with large current government budget deficits and/or high overall levels of public debt which refuse to take remedial action should also be a cause of concern for bond investors. The short term palliative of central banks creating money to buy bonds, thereby temporarily depressing yields, should not lull bond investors into a false sense of security. We regard bonds as dangerous territory.

As far ahead as one can see, politicians are going to have to make very difficult decisions necessary to stabilise public finances in the countries worst affected. Generally speaking, politicians find it hard to make difficult decisions especially if elections are looming. In some countries, difficult decisions will only be forced on them by the markets or the need to call for IMF help and then there is no choice. Whilst an economic recovery will help those with structural deficits will have to take dramatic action in the form of public spending cuts and/or tax increases. The effect, inevitably, will be to dampen growth prospects and, selectively, this will affect the growth of corporate earnings. Investors in equities will have to be aware of this and watch for markets getting ahead of themselves.

In past reviews, we have indicated our concern about the growth of protectionist sentiment. When times are difficult, countries tend to look inwards. If protectionism does take hold, it will be bad for economic growth and, by extension, to the stock market. Careful note needs to be taken.

If we move back to the present, and look at some of the causes for optimism or, at least, less pessimism which have so excited equity markets, we can look in general terms at the recent news release from the OECD giving details of the performance of OECD economies in the second quarter compared with the first quarter. The following excerpt from its quarter on quarter growth data for the first two quarters of 2009 shows the world economy stabilising at its lower level of activity.

Quarterly GDP Volume Growth (% change on previous quarter)

	2009 Q1 %	2009 Q2
OECD – Total	-2.1	0.0
EU	-2.4	-0.3
Euro area	-2.5	-0.1
G7	-2.1	-0.1
Canada	-1.6*	-0.9*
France	-1.3	0.3
Germany	-3.5	0.3
Italy	-2.7	-0.5
Japan	-3.1	0.9
UK	-2.4	-0.8
USA	-1.6	-0.3

Source: OECD - * Canadian statistics from Statistics Canada report – 31/08/09.

The OECD comparison of Q2 2009 with Q2 2008 shows how deep the recession has become.

Quarterly GDP Volume Growth (% change Q2 2009/Q2 2008)

OECD – Total	-4.6
EU	-4.8
Euro area	-4.7
G7	-4.6
Canada	-3.2 *
France	-2.6
Germany	-5.9
Italy	-6.0
Japan	-6.5
UK	-5.6
USA	-3.9

Source: OECD – *Canadian statistics taken from Statistics Canada report 31/08/09.

If we now move on to next year, the IMF's World Economic Outlook update, published in July, painted a more optimistic assessment for 2010 than it did in its previous assessment in April. This is how it sees the growth projections in 2009 and 2010 in excerpts from its forecasts.

Year on Year % change

	2009	2010
World output	-1.4	2.5
USA	-2.5	0.8
Euro area	-4.8	-0.3
Japan	-6.0	1.7
UK	-4.2	0.2
Canada	-2.3	1.6
Newly industrialised Asian economies	-5.2	1.4
China	7.5	8.5
India	5.4	6.5
Brazil	-1.3	2.5

Source: IMF World Economic Outlook Update – July 2009

If the IMF's economic forecasts for next year are anywhere correct, then a very significant turnaround from this year is in prospect. We must be very clear as to what we mean by this. It is not a move towards more normal growth levels but a sharp turnaround from a very deep recession. In normal circumstances, the growth rates forecast by the IMF for next year would be considered anaemic but they represent riches compared with this year and evidence of an improvement in conditions which validates next year's growth forecast. Increasing evidence of an improvement in conditions has caught investors' attention. This will be helpful in reducing the damage caused to governments' finances by the recession but the automatic stabilisers will still be in action as social security costs continue to rise, unemployment being a lagging indicator. Whilst companies have been cutting costs, which has helped some companies to produce better than forecast earnings, a better quality of earnings growth would be that caused by top line revenue growth which is more easily able to be actioned if the economy is growing.

More specifically, the IMF's forecasts show that, even in the depths of recession, countries like China and India have been displaying growth rates which are the envy of the major developed economies and, next year, growth is expected to accelerate again. One of the features of the world economy is that power is visibly moving east, whether to the Middle East (in certain countries) or the Far East. Very often, turning points in history are only recognised after the event when one can use the benefit of hindsight. But this is not the case with this phenomenon. Day by day, one can see the economic power of the east increasing whilst that of the main developed countries recedes. The disastrous state of public finances in a number of the major developed economies bears witness to this. In its simplest manifestation this shift of power argues for meaningful exposure to faster growing areas of the world economy not only in the east but in emerging markets generally.

Not only are many of the economies in these areas growing more rapidly than those of developed economies but they represent pools of enormous wealth through their sovereign wealth funds. Countries such as Abu Dhabi, Saudi Arabia, Hong Kong, Kuwait, China, Singapore and Algeria have huge pools of wealth. In the west only Norway, because of its energy wealth, comes near. High profile activity during the past year has centred around investment in the financial sector which has not always been well timed and their activities have met with hostility is some quarters but many western countries are not in a position to complain too loudly given their precarious budgetary positions and the need to finance their deficits. We expect sovereign wealth funds to become even more important players in international financial markets and, given that they will want long term growth, after a very difficult 2008, equity and property markets should benefit from their presence as western deficits are recycled.

The UK, as a relatively open economy, is well placed to benefit from this investment and it will be helpful if it makes some contribution to offset the enormous problems facing the UK as a result of its dire public debt position. In these reviews, since the onset of the financial crisis last year, we have generally avoided making comments on individual countries because of the general situation in favour of attempting to look at the big picture and how it may play out for investors. But, as we move away from the eye of the storm, it seems appropriate to become rather more specific, particularly about the UK as most of our clients are sterling based and in view of the problems which it faces.

We are all guilty from time to time of using hindsight but no hindsight was needed to realise that, as a result of the lack of control of public spending in recent years, the UK would end up with serious problems. We have often written about this. If the growth of public expenditure regularly exceeds the growth rate of the economy there will be problems with public finances and, perhaps, inflation. Even when the goal posts were moved on the then Chancellor of the Exchequer's golden rule, the criticism was not as severe as it should have been. What we did not know was that an international financial crisis would develop which made a bad situation worse to the extent that the problems facing the UK are amongst the most severe of those of the developed economies. The situation is compounded by the imminence of the General Election which is likely to be held next May and cannot be held later than early June. If a government is in denial about a problem then action to deal with it cannot be taken. In terms of the economy, eight months is a long time and one fears if things are allowed to drift.

The problem surrounds the precarious state of public finances and the resulting threat to the UK's credit worthiness. It is instructive to lay out the figures to show how shocking they are. These are the monthly deficits so far this financial year with comparable monthly figures in brackets.

£ billion

April	9.169	(1.745)
May	19.163	(12.028)
June	13.415	(7.324)
July	8.016	(surplus 5.224)
Year to date	49.763	15.873

Compared with July 2008 when outstanding public debt was £627.20 billion, the level for July 2009 was £800.80 billion representing 56.8% of GDP compared with 43.5% in July 2008. These levels of monthly borrowing are unsustainable. The huge QE programme, which has now been extended to £175 billion, coincidentally the Treasury's forecast for this financial year's budget deficit, has largely been used to buy gilts but it will fool no one to see the central bank creating money effectively to finance part of the government's deficit. If debt is monetised, confidence in the value of a country's currency can easily be eroded.

The threats to the UK economy are very real and investors should not allow themselves to be lulled into a sense of false security because the stock market has shown a significant recovery. It is worth listing the obvious risks. Firstly, the government may have difficulty in financing its deficit. It may have to pay significantly more to borrow in absolute and relative terms. Doubts about the creditworthiness of the country could result in a credit downgrade which would raise the relative cost of borrowing. Before the recent buying of gilts by the Bank of England under the QE programme, it was estimated that foreign investors owned about one third of the gilt edged market. Should they take fright and reduce their holdings, the fall out would be very unpleasant both for sterling and for gilt yields. If the debt were monetised by the Bank of England, using QE to purchase gilts on a regular basis, it is likely that the currency would weaken significantly. If the situation became so bad that the country had to seek a loan then policy would be dictated by the lenders as it was when the IMF came in during the late 1970s. None of this argues for currency strength and, although the pound fell a long way last year, and it is very difficult to forecast short term currency movements, we have been surprised at its recovery this year. The dangerous state of government finances plus the inflationary dangers down the line make us very nervous for the prospects for UK bonds.

At present, cash yields next to nothing and the justification for holding it, apart from waiting for a market setback to commit further funds to the market would be that one was so pessimistic about the equity market that it was better to earn almost nothing rather than risk the potential loss of capital through commitment to the equity market. Notwithstanding the very difficult position in which the UK economy finds itself, the share market has relative attractions. First of all, compared with ten year government bond yields and especially against cash, dividend yields are attractive despite reductions by some companies. At 3.7% the yield is better than on ten year gilts and far better than on cash. At some stage, notwithstanding the present economic position, dividends will start to grow. If QE starts to cause inflation later on then many companies will be well placed to deal with it by raising their prices. Moreover, UK plc has substantial overseas interests. It is estimated that about 40% of the business of the FTSE 100 companies derives from overseas. There are two possible benefits from this. Firstly, exposure to faster growing economies than that of the UK will help to support earnings and, secondly, if we are correct about the risks to the currency, many UK companies will provide a hedge against a falling pound.

Looking further ahead, overseas exposure should remain of benefit to UK investors whether it be directly through owning shares in overseas markets or, indirectly, through owning shares in UK companies with substantial overseas interests. This is because the measures to correct the UK's public finances will have to be so severe that they are likely to limit growth for years to come and, probably, to result in sub-average growth against most other industrialised countries. Direct or indirect overseas exposure remains very important in these circumstances as some sort of insurance policy against risks perceived in the UK economy. It will also be important to see how whichever government wins the next election addresses the problem of restoring public finances. The choice is public expenditure cuts, tax rises or, most likely, a combination of the two. All will have a depressing effect on the economy but a bias towards public expenditure cuts will have more beneficial long term effects since tax rises will probably have malign short term effects which will not easily be able to be reversed. These are the loss of incentives which will reduce private sector wealth creation and the danger of the tax base being eroded by emigration of individuals or companies. The effects of the financial crisis on the UK's public finances have been and will remain severe and falling tax receipts are one reason for the severe level of the budget deficit. The financial sector is likely to prove particularly volatile. So, the type of measures which will have to be introduced to restore the UK's public finances will also inform investors' decisions. There are good and bad ways to do it but action will have to be taken after the election even though the outline of the plans should be announced as soon as possible in an attempt to forestall markets closing in on the UK.

The world economy, thanks to dramatic action by governments and central banks, has proved resilient in the face of a financial storm of unimaginable proportions. All the stops have been pulled out whether monetary, fiscal or simply unorthodox. The reward for this has been a stabilisation of the world economy at much lower levels of activity. But it is important that investors do not get carried away by this. The world economy remains in a very serious situation. Unemployment will go on rising for a long time. This will happen in the public sector, as companies continue to trim costs. Many more companies will go out of business and one of the most dangerous times for companies is when business starts to increase and working capital needs increase but the finance is not available. So, even after economies start to resume economic growth, individual indicators such as unemployment and the number of company failures will continue to rise. Furthermore, some of the euphoria will wear off as the inevitable cuts in public spending and tax increases take effect. There is going to be a big economic hangover. In the UK, substantial tax increases have been announced both indirect (the restoration of VAT to 17 1/2% for example on 1 January) and direct coming into effect next April. Many people will feel much poorer and this situation will be replicated in many countries although not to the extent that will be evident in the UK by virtue of its particularly dire finances. The east is likely to perform relatively much better with growth rates in countries like China that the industrialised countries can only envy.

So far, we have concentrated on the results of the financial crisis, i.e. the economic crisis, but we should not forget the causes. One can argue that macro economic policy, particularly on the monetary side, was too loose and regulation not strong enough but the damage to the financial sector was so great that these extraordinary measures, referred to earlier, had to be taken. Survivors in any economic crisis or downturn tend to emerge stronger as weaker competitors fall by the wayside and it will be the same here. There are a lot of bad assets to be worked through and, inevitably, those with the worst problems are the most constrained either by the government, the central bank or commercial necessity. Their problems are those also of individuals and businesses who find themselves unable to obtain finance or, if they can, possibly at a much higher relative price than previously. Such a state of affairs has macro economic consequences in terms of reduced economic growth. This provides increased business and profit opportunities for the stronger financial institutions. This will be an important theme for investors in the financial sector in future.

The anger directed at financial institutions by the public and the politicians will result in much more control over their activities and intrusion into areas not previously entered by governments and regulators, bonuses being a topical example. This is why many banks seek to stay outside the arms of their respective governments by not being beholden to them in terms of shareholding and other forms of support. In the UK, for example, Barclays and HSBC avoided the UK government taking a shareholding in order not to be subjected to restraints under which Lloyds Banking Group and RBS operate. Investors should remember this in the euphoria which has seen dramatic rises from very low levels in more speculative financial stocks. We will see a much more sober and regulated financial sector in future and, if extra regulation succeeds in avoiding the level of risks which led to the present situation, it will be worth it. Investors will want to stay with the quality financial businesses in this environment because their stronger financial position will provide what opportunities there are for sustainable growth. There is still an immense amount of clearing up to do in the financial sector which will continue to weigh on the world economy.

After a quarter of abnormally high returns as markets continued to recover from the depths of last March, it is right to keep one's feet on the ground by emphasising the seriousness of the current problems which remain and the unpleasantness of the medicine which governments will have to disperse in the future if credibility in their countries' financial position is to be retained. It is going to be a long haul.

But there will be a recovery and it is right to end with some of what might loosely be called "green shoots" which have been apparent in the past month. These "green shoots" might represent less bad news, stability or even better news. Markets look ahead and this is what they have latched onto during the last quarter.

So we end this review with a random selection of the type of news that has helped to lift stock markets over the last quarter. In normal times, these indicators may even seem to be disappointing but, in the context of what the world economy has been through this year, they represent "green shoots".

We start with the USA where the ISM survey of American manufacturers showed the headline index rising to 48.9 in July from 44.8 in June, the best levels since August 2008. The US Commerce Department reported that factory orders rose by 0.4% in June following a 1.1% rise in May. Excluding transport, orders rose by 2.3% following a 0.9% increase in May. Production at US factories, mines and utilities rose by 0.5% in July, the first increase since last December. The figures were boosted by increased production from US carmakers. New orders for US durable goods rose by 4.9% in July following a fall of 1.3% in June. In the housing sector, the National Association Realtors reported that its index of house sales for completion was up by 3.6% in July. The S&P/Case Shiller Index of US house prices in 20 metropolitan areas showed an annual decline of 15.4% in June compared with a year earlier, down from an annual decrease of 17.1% in May. Sales of new homes in the USA rose by 9.6% in July following an upward revision for June and reflected the strongest pace of sales since September 2008. Sales of existing homes rose for the fourth consecutive month in July. They rose by 7.2%. There was a fall in unemployment in June for the first time for over a year with the rate falling from 9.5% to 9.4% with employers cutting a less than expected 247,000 jobs. Inventories declined by 1.7% in June. Declining inventories suggest that manufacturing will pick up over the coming months. The IBD/TIPB Economic Optimism Index rose from

46.3 in July to 50.3 in August. These figures indicate mild optimism. The Conference Board said that its consumer confidence index rose from 47.4 in July to 54.1 in August. The Federal Reserve Bank of Philadelphia said that its manufacturing activity index rose in August to 4.2 from -7.5 in July, the highest rating since November 2007.

In the eurozone, there was better news, too. The Markit Purchasing Managers' Index for manufacturing rose from 42.6 in June to 46.3 in July, the second biggest monthly increase for 12 years. The equivalent figures for the services sector rose from 44.6 in June to 47.0 in August. There was a significant fall in the rate of decline of GDP in the second quarter in the eurozone with GDP falling by just 0.1% from the first quarter compared with 2.5% the previous quarter. The Purchasing Managers' Index in the eurozone rose to 50.0 in August from 47.0 in July. Very much helping the eurozone's performance has been Germany where, after a significant decline in economic activity, the news has become better. Second quarter GDP rose by a seasonally adjusted 0.3% following the first quarter's fall of 3.5%. Factory orders for June rose by 4.5% following a 4.4% increase in May. Export orders provided a catalyst for this rise. Investor confidence as measured by the ZEW Centre for European Economic Research rose to 56.1 in June from 39.5 in July, the best level for over three years. The PMI Index for the service and manufacturing sectors rose from 49.0 in July to 54.2 in August. Business is also more confident, the Ifo Business Climate Index rose to 90.5 in August from 87.4 in July. The GfK sentiment index amongst consumers rose to 3.7 for September compared with 3.4 in August. In France, the second quarter GDP figure showed an increase of 0.3% following a 1.3% decline in the first quarter.

In Japan, there was a turnaround in GDP which grew at an annualised rate of 3.7% in the three months to the end of June.

In China, the star performer in terms of economic performance, retail sales rose by 15.2% in July over the previous year compared with 15.0% in June. Industrial output rose by 10.8% compared with a year previously and this represents the third consecutive monthly increase in the growth rate. The manufacturing sector expanded for the fourth successive month in July. The CLSA/Markit survey showed its main index rising from 51.8 in June to 52.8 in July.

In the UK, and looking at the housing market first, there are a number of more encouraging indicators suggesting that the worst has passed in this sector. Halifax reported that house prices rose by 1.1% in July, following a 0.4% fall in June reducing the annual decline in house prices to 9.9%, the smallest annual drop since June 2008. Official figures showed that house prices rose by 2.6% in the quarter ending June 2009 compared with a fall of 3.8% in the first quarter. This reduced the annual decline in house prices to 10.7% from 12.7% in May. Nationwide's index of house prices in August showed that they rose by 1.6%, the fourth month in a row and are showing the fastest rate of increase for two and a half years. The annual decline slowed to 2.7% in August from 6.2% in July. The RICS reported much better sentiment amongst its members as 8% more estate agents said they expected prices to rise rather than fall over the next three months. The Council of Mortgage Lenders reported that lending had risen by 23% during June and gross mortgage lending rose by 26%. The number of approvals by banks for mortgages rose in July compared with June and 76.7% higher than a year previously. In the construction sector, the CIPS/Markit Construction Purchasing Mangers' Index rose from 44.5 in June to 47.0 in July. While still negative, it is less so than previously. The CIPS/Markit Index for the manufacturing sector rose from 47.4 in June to 50.8 in July. A strong inflow of new orders boosted the figure. Construction orders rose by 18% in the second quarter compared with the first quarter but still 21% below the figure a year previously. The CBI reported a slight improvement, still from a bad position, in the manufacturing order book balance amongst its members. It was -54 in August compared with -59 in July. In the high street, official statistics showed that sales rose by 0.4% in July compared with June to make the annual rate of gains 3.3%. According to the CBI's distributive trade survey, 34% of retailers said sales rose during August compared with a year ago whilst 51% reported a fall.

These items of relatively good news are still outnumbered by poor data but they do represent a shift in activity since the very worst days of the recession and it is indicators like these that have increased investor confidence.

With stock markets ahead for the year, many investors will consider this a good result particularly as the year started off so unpromisingly with heavy falls in the first two months of the year. Whilst the world economy remains in a bad way, hopefully there will be no more of the nasty shocks which so unsettle markets. If investors have visibility, even if not for very encouraging economic and financial news, that should help to put some fears to rest and support equity prices. There is a lot of cash on the sidelines and some of this is likely to be committed should markets experience a setback.

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