meridian

ASSET MANAGEMENT (C.I.) LIMITED

# INVESTMENT MEMORANDUM

The volatility in the Chinese equity market which saw the majority, but not all, of the gains from the beginning of 2014 retraced, has been reflected in a setback for international equity markets this quarter. Overall, there was little change in bond yields in the ten year government area. Commodity related currencies suffered during the quarter against the background of weakness in the sector. Oil experienced a very poor quarter and gold failed to make any headway.

The tables below detail relevant movements in markets :

## International Equities 29.05.15 - 31.08.15

| **Total Return Performances (%)** | | | | |
|---|---|---|---|---|
| **Country** | **Local Currency** | **£** | **US$** | **€** |
| Australia | -9.0 | -16.4 | -15.7 | -12.5 |
| Finland | -9.1 | -7.8 | -7.1 | -9.1 |
| France | -6.7 | -5.4 | -4.7 | -6.7 |
| Germany | -9.5 | -8.3 | -7.5 | -9.5 |
| Hong Kong, China | -18.1 | -18.7 | -18.0 | -19.8 |
| Italy | -6.0 | -4.7 | -3.9 | -6.0 |
| Japan | -8.7 | -7.2 | -6.5 | -8.5 |
| Netherlands | -8.0 | -6.7 | -5.9 | -8.0 |
| Spain | -7.9 | -6.6 | -5.9 | -7.9 |
| Switzerland | -4.2 | -7.3 | -6.5 | -8.6 |
| UK | -9.5 | -9.5 | -8.8 | -10.7 |
| USA | -6.0 | -6.7 | -6.0 | -8.0 |
| Europe ex UK | -7.1 | -7.0 | -6.3 | -8.3 |
| Asia Pacific ex Japan | -11.6 | -17.3 | -16.6 | -18.4 |
| Asia Pacific | -10.1 | -12.0 | -11.3 | -13.2 |
| Latin America | -7.4 | -18.1 | -17.4 | -19.2 |
| All World All Emerging | -13.2 | -18.1 | -17.4 | -19.2 |
| The World | -7.1 | -8.3 | -7.5 | -9.5 |

*Source* FTSE World Indices

FT Government Securities Index All Stocks (total return) : 0.1%

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

| Currency | 29.05.15 | 31.08.15 |
|---|---|---|
| Sterling | 1.92 | 1.96 |
| US Dollar | 2.11 | 2.18 |
| Yen | 0.40 | 0.38 |
| Germany (Euro) | 0.49 | 0.74 |

**Sterling's performance during the quarter ending 31.08.15 (%)**

| Currency | Quarter Ending 31.08.15 |
|---|---|
| US Dollar | +0.5 |
| Canadian Dollar | +6.5 |
| Yen | -1.8 |
| Euro | -1.6 |
| Swiss Franc | +3.1 |
| Australian dollar | +8.0 |

**Other currency movements during the quarter ending 31.08.15 (%)**

| Currency | Quarter Ending 31.08.15 |
|---|---|
| US Dollar/Canadian Dollar | +6.0 |
| US Dollar/Yen | -2.3 |
| US Dollar/Euro | -2.1 |
| Swiss Franc/Euro | -4.6 |
| Euro/Yen | -0.2 |

**Significant Commodities (US dollar terms) 29.05.15 - 31.08.15 (%)**

| Currency | Quarter Ending 31.08.15 |
|---|---|
| Oil | -19.4 |
| Gold | -4.7 |

## MARKETS

With the quarter ending on a disturbed note as a result of economic developments in China which are discussed later in this review, we have seen quite significant negative returns in international equity markets over the quarter. In local currency terms the FTSE World Index showed a total return of -7.1%, in sterling terms -8.3%, in US dollar terms -7.5% and, in euro terms, -9.5%. Looking at local currency movements first, the main areas of relative weakness were the FTSE Asia Pacific ex Japan index, -11.6%, and the FTSE All World All Emerging Markets index -13.2%. The other markets in our table showed fairly similar returns to the FTSE World Index although Switzerland held up relatively well with a total return of -4.2%. In sterling terms, the results are different in some areas in relative terms. Weakness in the Australian and Latin American currencies meant that the FTSE Australia index returned -16.4% and the FTSE Latin American index returned -18.1%, whilst the FTSE Asia Pacific ex Japan index returned -17.3%. In relative terms, the UK slightly underperformed the FTSE World index, returning -9.5%, but there was relative strength from the FTSE USA index, -6.7%, and the FTSE Europe ex UK index, -7.0%.

In the international government bond market, using ten year government bonds as a benchmark, there were generally modest movements, though some major intra quarter volatility. The yield on the UK government bond rose by 4 basis points to 1.96% and on the US Treasury by 7 basis points to 2.18%. It fell on the Japanese Government Bond by 2 basis points to 0.38%, whilst on the German Bund there was a rise of 25 basis points to 0.74%.

In the currency markets, sterling rose by 8.0% against the Australian dollar, by 6.5% against the Canadian dollar, both commodity driven currencies, by 3.1% against the Swiss Franc, and by 0.5% against the US dollar. On the other hand, it fell by 1.8% against the yen and by 1.6% against the euro.

In commodity markets, oil, as measured by Brent crude fell by 19.4% and gold by 4.7%.

## ECONOMICS

The quarter has ended on a very disturbed note with significant volatility in markets as a result of the situation in China. It is always important to put matters into perspective and the magnitude of the falls which we saw, before markets staged a partial recovery, do not reflect the degree of deterioration in international prospects which, at this stage, look quite modest. Markets are driven by sentiment but also by computer trades in certain circumstances which tend to magnify the volatility. This works both ways but, when markets have a sharp fall, the media will often lead with the story of billions or trillions wiped off share prices but the reporting is not symmetrical. When markets rally, it is very rare to hear that billions or trillions have been added to share prices. This may be seen as a flippant comment but it reflects the fact that bad news travels more quickly than good news and investors can be vulnerable to these changes in sentiment as investment decisions are made to liquidate positions only for markets to recover as they usually do. Immediately after the big market fall on 24th August, there were significant withdrawals from equity mutual funds yet the international economic situation had changed very little and such decisions may prove to be very expensive when markets recover.

The proximate cause of the sharp fall in the Chinese market which spilled over into other markets was the decision by the People's Bank of China to widen the trading band around the fixing of the currency, in other words to make it a managed float. The widening of the band was quite narrow, about 2%, and the fall in the value of the renminbi against the dollar as this is written is below 3%. Those taking a negative view of China and the reasons for this action suggested that the authorities were worried about weakness in the Chinese economy and were effecting a devaluation to make the country's exports more competitive. However, a 3% devaluation in the currency is neither here nor there and would not be sufficient to change economic activity in China by a meaningful amount. The more likely reason was that China would like the renminbi to be included in the IMF's Special Drawing Rights, along with the US dollar, euro, sterling and yen, but, for this to happen, the currency has to be more market driven and this has not been the case with China. So, it seems unreasonable to assume an ulterior motive in the Chinese authorities' action as the reason for it was perfectly plausible. Furthermore, after that, substantial amounts of money were spent by the Central Bank in support of the renminbi which does not suggest that they wanted a significant devaluation.

In putting the fall in the Chinese market into perspective, we must note that since the beginning of 2014 up to its peak in June this year, the Shanghai Composite Index rose by approximately 150% and that, even after the recent significant fall, it is still approximately 50% higher in total return terms. The Chinese "A" share market is mainly open to domestic investors although, gradually, foreign investors are being allowed to buy "A" shares. It is a highly speculative market and prone to these sort of extreme movements which are not justified by economic fundamentals. Fortunately, the Chinese stock market is not large in relation to the size of the Chinese economy, about 30% of GDP, and not as important as the property market. It is estimated that only around 15% of household financial assets are invested in the stock market. However, China, although a relatively closed economy in terms of the importance of trade in relation to GDP, is the world's second largest economy accounting for approximately 16% of world GDP on a purchasing power parity basis, i.e. taking into account what volume of goods and services could be bought if currencies were aligned against each other to buy the same amount of these goods and services. The concern is that other emerging markets will be affected and a capital exodus from them occur in favour of the US dollar, in particular, and thereby make the repayment of US dollar denominated loans more expensive. The reserve position of many emerging market economies is much stronger than in earlier crises in the late 1990s, for example, but the fears still exist.

Connected with all of this is the fall in commodity prices and concerns that the world is entering a deflationary environment. China is an important importer of commodities, iron ore. The S & P GSCI commodity index is down about 17.6% in US dollar terms so far this year and therefore what happens in China is important. There is good deflation and bad deflation. If a fall in commodity prices is occasioned by a rise in supply, as has been the case in oil for example, then the deflation is good. Lower input costs feed through to disposable incomes and corporate profits and assist economic growth. Bad deflation occurs when the demand for commodities falls because final demand is falling in an economy so that it is demand rather than supply which is driving prices. Greece would be a good example of this where there has been a significant economic contraction and prices are falling with year on year inflation to July standing at -2.2%. This is not good deflation because it makes repayment of debt more difficult as liabilities increase in real terms given the lack of compensating growth and makes the servicing of debt more difficult. We think it likely that the deflation or disinflation which we are seeing at the moment is mostly of the good sort. The largest economy, the

USA, has just revised up its second quarter growth estimate to an annualised rate of 3.7% and the UK economy, although much smaller, is also growing quite satisfactorily (2.8% quarter on quarter annualised) and, even in the eurozone, there are signs of life although the situation is still serious.

One of the important questions for investors to consider has been the timing of the start of interest rate increases in the USA, in particular, but also the UK. In both countries, there are good reasons to start raising interest rates. The output gap, something which central bankers look at very closely, is likely to be diminishing in the USA than the UK with the OECD estimating a figure for 2015 of 0.5% in the UK and 2.4% in the USA. This measures the difference between the potential output in the economy and the actual output and, once the spare capacity is used up, inflationary pressures usually follow with upward pressure on wages and other inputs. The central bankers will be keen to be ahead of the curve in this respect but the outlook may have been complicated by the fallout from the Chinese stock market volatility and the concerns about any fall in economic activity resulting from it. Although everybody knows that interest rates in the USA and UK have to start rising and, therefore, an increase should not be unexpected, there is always the concern that there will be the equivalent of 2013's "taper tantrum" when the markets were temporarily put off their balance by the prospect of the Federal Reserve reducing the rate at which it created cash for quantitative easing in order to purchase bonds and keep down interest rates. In the event, the market got over this and the following year, 2014, was a strong year for US equities even though quantitative easing had finished. It is possible that the Chinese situation will cause the Federal Reserve and the Bank of England to stay their hands on interest rate increases temporarily but the danger of being behind the curve and not raising interest rates in good time is that it becomes more difficult to control inflation later on. Whilst it may seem strange to be concerned about inflation at the moment, when all the talk is about deflation and disinflation, all the signs are in place for a return to modest inflation, certainly in the USA and the UK.

We have often talked in these reviews about how the extreme monetary policy, which has been followed and represented by ultra low interest rates or, now, even negative interest rates and quantitative easing, has improved the attraction of equities relative to cash or fixed interest securities and the recent fall in the stock market has accentuated that relative attraction. Whilst there are arguments about whether shares are good value or expensive in terms of price/earnings ratios, whether as measured by current and prospective earnings or on a cyclically adjusted basis (the argument of those who think shares are expensive), dividend yields remain very attractive against those on high quality bonds and cash. It remains difficult to see any value in bonds unless the world goes into an extended period of deflation which we think unlikely and investment results are almost certain to be very disappointing on a medium and long term view whereas that is not the case for equities. In every significant market, equity yields are higher than those on ten year government bonds and dividends have been growing and are likely to continue to do so, albeit modestly for the time being.

But China is dominating the scene at the moment and it is worth considering what the Chinese government is trying to do in terms of its economy. Until recently, the Chinese economy was showing double digit economic growth rates and the Chinese boom was supporting other economies, for example those which are commodity based. Double digit growth was not sustainable and there was and is always a concern that inflation would move out of control thus causing social unrest given that it is necessary to create extra jobs each year to absorb people coming in from rural areas to the urban areas. So far, China has been successful in this area. Food prices were a particular concern as they could always spark off social unrest. At the moment, because inflation is so low, this is not a concern for the Chinese authorities but what has been a concern has been the profile of the Chinese economy with approximately half of GDP being accounted for by fixed asset investment and private consumption as a percentage of GDP at around 36%, a much lower level than elsewhere. Over investment in fixed assets has led to poor returns in many cases because there is too much capacity and that, in turn, has implications for the banking sector which has helped to provide loans for these investments. Therefore, the desire of the Chinese government has been to reduce the emphasis on fixed asset investments and exports, which are more dependent upon how the rest of the world is doing, and elevate the importance of private consumption which can provide more certainty of demand to the Chinese economy. This has meant a transition to single digit growth and has to be handled carefully. The target for growth is now around 7% and the latest figures for the second quarter suggest that level is being reached. However, there is a lot of uncertainty as to whether growth is running at that level with various other indicators such as electricity consumption and the purchasing managers indices suggesting that growth is not as strong as this. Unlike many other countries, China has significant economic weapons at its disposal in order to calibrate the economy. It does not mean that the central bank or government will succeed but merely that it does have options. We have often talked in recent reviews about how monetary policy has lost its power to affect economic activity in many countries. This is because interest rates have moved to around zero and therefore cuts in interest rates are not possible although there are some negative official rates in Europe and although more quantitative easing may still be possible, the power of that to affect an economy is doubtful since, if companies and individuals will not borrow at very low interest rates, throwing more money at the problem is not likely to provide the desired result. China is one economy that still has monetary fire power. One of the measures that it took at the end of August was an interest rate cut to leave the one year lending rate at 4.6% and the one year deposit rate at 1.75%. There is still some leeway on this front for further interest rate reductions which should have some effect on the economy, if used. Similarly, the bank reserve ratio requirement is very high and it has been trimmed from 18.5% to 18.0% and there is obviously a lot further to go on this, if the authorities wish, and therefore to put a lot more money back into the economy. In addition, China has massive foreign exchange reserves. Some of these has been used to support the currency but, also, it means that it can use its immense financial strength to stimulate the economy, if necessary. These points are made to show that the country is not out of financial firepower to further its economic objectives of moving to slower growing but higher quality economic growth with elevated consumption levels.

Events in China have rather moved Greece off the front page. Although progress has been made on a further third bailout (€86 billion), there is still much uncertainty about it with a further General Election to be held in Greece in September. Like most problems, if one is not prepared to face the reality, the problems become worse. In the case of Greece, there is no realistic prospect of the country paying off its debt in full yet this is too embarrassing for eurozone countries to admit and so the "extended and pretend" policy continues. Greece has lost a lot of ground since the election which brought Syriza to power and it is difficult to be optimistic about the economic prospects for the country. Greece has to satisfy the IMF that it will be able to pay back its loan since the IMF is not allowed to lend to countries where the prospects of repayment are unrealistic. Greece is not a problem which is going to go away and the fundamental flaws in the eurozone's construction mean that problems will spread to other countries in due course. The lack of will to make fundamental reforms in certain eurozone countries bodes poorly for the future since it restricts their growth prospects and, with such heavy levels of debt a feature in the eurozone, one can expect more financial crises amongst eurozone members. One country which did carry out structural reforms, including to its labour market, Spain, now sees the best growth of the large economies within the eurozone albeit with unemployment levels which are quite unacceptable for any country (22.4%). Spain and Portugal, another hard hit country, have elections coming up and these could also derail economic policies since the Portuguese opposition opposes austerity and Spanish politics have become fragmented by the rise of new parties on the left and in the centre. For the moment, though, attention seems to have moved away from Greece, in particular, and the eurozone, in general, towards China.

However, as touched upon earlier, there is also good news around which it is important to assimilate in order to have a balanced view on the outlook for markets. At the end of August, the US Commerce Department announced a significant upward revision in its estimate of second quarter growth to the end of June. It now calculates that it was running at a quarter on quarter annualised rate of 3.7% compared with its previous estimate of 2.3%. This compares with a figure of 0.6% in the first three months of the year which has tended to be weak in recent years and to be weather affected, this year being no different. Reasons for the upward revision in the estimated second quarter growth rate were an increase in domestic demand and investment, higher government spending and lower imports. The one slightly negative point for the third quarter is an upward revision in inventories which means that they may be run down to meet demand in the third quarter and therefore manufacturing will be adversely affected. Higher inventories added 0.22% to GDP instead of subtracting 0.08%. The latest purchasing managers indices for the USA, closely watched data with high value for analysts, showed that the index for manufacturing fell slightly in August to 51.1 from 52.7 in July but the larger non manufacturing sector showed a very strong reading in July of 60.3 against 56.0 suggesting a moderate increase in economic activity overall which should be recognised in GDP growth. Industrial production rose by 0.56% in July compared with 0.09% the previous month and some negative figures before then. The unemployment rate has fallen to 5.1% (although the participation rate is falling gradually and now stands at 62.6%) and retail sales were stronger in July, up by 0.6% against an unchanged month on month figure in June. It has been apparent from US corporate earnings that companies with big overseas businesses have been affected by the strength of the dollar. This is affecting revenue translated back into US dollars and also foreign earnings. Investors should not necessarily be concerned about this. Currencies ebb and flow. At the moment, for example, companies based in the eurozone are seeing revenues and earnings enhanced by previous weakness in the euro. If currency trends become established, for instance say a rise in the US dollar, then it can change the level of economic activity. Companies may establish factories overseas in cheaper areas of production and domestic economic activity may be reduced as a result. At present, we would not regard this as a significant issue for the US stock market. Headline inflation remains low in the USA. In July, prices rose by 0.1% compared with June and the year on year figure showed an increase of 0.2%. There is enough strength in these figures to suggest that, in any other environment other than the one experienced in recent years, a federal funds rate of effectively zero is well out of line with what one would expect. Even if the latest GDP figures for the USA, detailed above, are not representative of the current normalised rate of growth, such a low level of federal funds rate is still highly anomalous except in the most extreme circumstances. One would hope that with a rate rise, whenever it comes, well signalled, markets will accept it as a small move towards normality and, as such, to be welcomed. Very low interest rates have benefited equities in two ways with the first obviously being the relative attractions of higher dividend yields against good quality bonds and the second because of the attraction of using cheap money for companies to repurchase shares with the resulting enhancement of earnings per share. What one would now like to see is companies using the strength of their balance sheets to step up capital expenditure in order to increase productive capacity and therefore improve the long term potential growth rate of the economy. There is some evidence from the recent US GDP figures that this is happening. For investors, the USA appears as an area of relatively low risk. The political situation is stable at present with the elections fourteen months away and the economy is moving forward well after a slow but still positive start to the year. Whilst the fall in the oil price will affect expenditure and employment in the industry, the increase in disposable income as a result of the fall in the oil price, which has hitherto been saved as evidenced by a rise in the savings ratio earlier this year, should find its way through to consumer spending and help to keep the US economy growing at a reasonable rate. The savings ratio now stands at 4.9% against a peak of 5.7% in February. The latest IMF and OECD forecasts for economic growth in the USA in 2016 are 3.0% and 2.8% respectively which, in the current environment, is satisfactory. This remains, we believe, an attractive equity market for investors although returns must be expected to be modest rather than spectacular in line with economic growth trends.

Turning now to Europe, the Greek problem has rather been pushed off the front page by China, obviously a much bigger player in the world economy. Greek elections are due this month and the result will indicate whether the Greek government's acceptance of the latest bail out package will stand. With the left having split, the chances are that it will because there may be a parliamentary majority in favour of accepting the measures, albeit that it will reflect a disparate group of politicians. Money available for Greece will be drip fed as reforms agreed by Mr Tsipras's government are implemented. Whilst the outlook for the eurozone has improved slightly in a number of ways, the chronic issues of a dysfunctional monetary union remain and its fixed currency regime for eurozone members will continue to lead to periodic crises. When these issues move up to the most important members of the eurozone, there will be major difficulties. When Mr Draghi, the President of the ECB, calls for reforms in labour and product markets his calls are falling on deaf ears. No amount of quantitative easing will work, other than in the short term, if labour and product markets are not freed up because it will limit the productive potential of an economy. One only has to look at the horror expressed by some delegates at France's ruling party meeting in recent days at the ideas espoused by the more reformist members of the French government, the Prime Minister, Mr Valls, and the Finance Minister, Mr Macron, at modest proposals or wishes expressed to move towards more flexible labour markets, to realise the magnitude of the task. Even if the reformists wanted to end the 35 hour working week which, together with the volumes of employment regulations, make life so difficult for many French businesses and contributes to the high unemployment rate in France, it would be impossible to abolish it. Possibly only a major crisis could bring about a change.

All this is relevant in considering the longer term effects of the hugely stimulative monetary policy being pursued by the ECB. In reflecting that there are some early signs that the quantitative easing stimulus, begun last March, is working, although the Chinese situation is dampening expectations, the stimulus applied to the eurozone economy must not come up against the constraints to growth caused by the inflexibilities discussed in the paragraph above. If that happens, extraordinary as it may seem, inflation would threaten. This assumes more importance given the latest hints from Mr Draghi of further additions to the ECB's quantitative easing programme. The recent turbulence in international stock markets caused Mr. Draghi to give an indication that there could be still further quantitative easing in the eurozone if it was felt that the eurozone's economic recovery was threatened. At the moment, quantitative easing, mainly in the form of eurozone government bond purchases, is running at €60 billion a month and is due to continue until September 2016. This is accelerating monetary growth which can be expected to lead to increased economic activity within the eurozone. Now the question is whether events in China will affect the euro area significantly, hence Mr. Draghi's indications on future ECB policy on 3rd September. The eurozone is, of course, a long way behind the USA and UK in terms of economic recovery but the central banks in these two countries will need to reflect on the same issue, except that the question here is whether a delay in the plan to start the programme of interest rate increases is the right response to the Chinese market volatility.

The latest second quarter growth figures for the eurozone show quarter on quarter growth running at an annualised rate of 1.3%, with the year on year growth rate being 1.2%. There are some large divergences of performances. If we look at the latest quarterly figures annualised, we see the largest eurozone economy, Germany, showing growth of 1.8%, quite well above the average for the eurozone. On the other hand, the number two economy, France, registered no growth at all, heightening concerns about the French economy in the context of its inability to make any really meaningful structural reforms. If there is no significant economic growth, the debt situation will worsen adding to risks for the eurozone. The number three economy, Italy, is somewhere in the middle registering 0.7% growth. For such a heavily indebted country such as Italy, this is insufficient to stabilise the public debt position. The star performer of the larger eurozone economies is Spain where the latest quarter on quarter annualised growth rate is 4.1%. This is one eurozone country which did undertake some structural reforms in its labour market in the face of a very high unemployment rate (even now it is very high at 22.4%) and is showing some benefit but such a high unemployment rate represents a terrible waste of resources and lost growth potential.

If we look at the latest Purchasing Managers Indices from the eurozone, they are consistent with a position which is modestly better than at the beginning of the year. The latest composite index for August showed an index of 54.1, consistent with modest expansion. Within that, the manufacturing index stood at 52.4 and the services index at 54.3, the same level as the construction index reading. There were particularly good readings from Spain, consistent with the strong second quarter GDP figure with the opposite true for France which remains a concern but, again, the figure is consistent with the lack of economic growth in France, evidenced by the second quarter's GDP numbers.

The economic numbers for Japan have been disappointing. The second quarter's annualised growth rate was a negative 1.6% and year on year growth was 0.7%. The latest Purchasing Managers Indices are consistent with only very modest growth. The composite level for August stood at 52.9 and, within that, the index for manufacturing stood at 51.7 and for services at 53.7. The latest industrial production figures for July were disappointing showing a fall of 0.6% following a much stronger June reading of 1.1% growth. The year on year increase is just 0.2% down from 2.3% in June. Combined with disappointing GDP numbers which showed second quarter annualised quarter on quarter growth at -1.6%, the outlook for "Abenomics" is much more cloudy. The attempt by the Bank of Japan to target 2% inflation has been stymied by the fall in the oil price. The latest year on year consumer price index for July showed a rise of 0.2% with the month on month figure at -0.1%. The aim of the first arrow of Mr Abe's economic policy, the monetary one, was to loosen monetary policy to such an extent that inflation would rise to 2% and thereby stimulate consumption and investment to raise economic growth. With the years of deflation, the problem was one of a delay in expenditure in the expectation of purchasing the goods or services more cheaply, thus exacerbating a downward spiral in the economy. A major problem for Japan relates to its enormous level of public debt in relation to GDP and very poor demographics which provides a long term economic challenge. Whilst the uncertainties over the outcome of "Abenomics" continue, equity investors can take some confidence from one of the supply side reforms introduced which was to mandate a much larger position taken by public funds in equities as opposed to bonds. During the last two years the Bank of Japan has purchased JPY28 trillion (US$23 billion of exchange traded funds trading 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 JPY 30 trillion (US$240 billion) would follow suit. This is different from the recent Chinese action to support the stock market with public funds. Japan is trying to change the culture of investment. So it remains a high risk/high reward market but the optimists need to see signs of "Abenomics" working and, in that respect, the third string of the bow, structural reform, is important for, as with the eurozone, very loose monetary policy must not come up against supply side constraints. With Japan being so heavily indebted, the economy needs all the growth it can get.

As with the USA, the UK looks an oasis of calm compared with many other countries. There are significant problems, notably the size of the public debt, but a path has been plotted to eliminate the budget deficit, albeit that, in the July budget, this date was put back one year to 2019/20. This is, of course, well past the time planned in the Chancellor's first budget in 2010 but external economic events have caused the timescale to be pushed back. The big plus for the UK stock market has been the resolution of the political concerns prior to 7th May when it looked as if there would be an indeterminate result which would have caused concerns about the course of economic policy in the light of the debt issues and the need o address them. That concern has, at least, been allayed. But there is absolutely no room for complacency. The UK is still running large budget and current account deficits. The prospective budget deficit forecast for 2015/16 of 3.7% of GDP is still large and the current account deficit running at around 6% of GDP is at a serious level. At the moment, confidence in the UK remains relatively high so the deficit can be comfortably financed but the UK is vulnerable to a weakening of confidence and this could seriously impact the exchange rate. At the moment, this is not considered an immediate threat, but it is right to keep it in mind as an investor. Companies with significant overseas business, which have been suffering currency headwinds, would gain some relief. Sterling is, in fact, weakening against the euro and the US dollar at the moment although whether this is significant or not only time will tell. UK economic data has generally been satisfactory. Second quarter GDP annualised growth came in at 2.8% with the year on year growth rate being 2.6%. Unemployment, although the fall appears to be flattening out, is at 5.6%. There are also some signs that productivity is improving, important as wage growth increases and helpful in reducing the pressure for interest rate increases. The latest purchasing managers indices were a little weaker than the previous month's but still satisfactory. The composite index stood at 55.1 (56.6) and, within that, the manufacturing reading stood at 51.5 (51.9), services 55.6 (57.4) and construction 57.3 (57.1). As in recent years, the weakness of the eurozone's economy is a threat to economic growth forecasts currently put by the OBR in July's budget at 2.4% for this year and 2.3% for next year. The fact that potential political instability, the biggest concern to the UK market in our view at the beginning of the year, now appears to have been removed, puts economic concerns into perspective, and we rate the UK equity market as relatively attractive.

Stock market volatility is always unsettling. However, for investors it is important not to be intimidated by large and sudden moves in the market which may be out of all proportion to the significance of the news which precipitated the fall. One has to ask whether things have really changed so much as to justify such a movement. We have attempted to show in this review that against the well known problems in China and the eurozone, there are also positive developments in the world economy, notably in the USA's economic performance and the benefits which should arise from lower commodity prices. It may take some time for the volatility to work its way out of the equity market, but the relative attractions remain. Our judgement at the beginning of the year was that markets would be likely to grind higher this year but that there would be periods of weakness, leading to the odd negative quarter, and that the increased volatility seen in 2014 would be a feature of 2015. This is broadly what seems to be happening although, given that the international equity market is modestly lower on a year to date basis at the end of August, it will need a positive final quarter to validate the prediction for a modest rise. So, we remain in favour of shares and continue to see a lack of value in bonds which we think remain dangerously exposed to a change in sentiment, given their minuscule yields.