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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

For all but euro based portfolios, it has been a satisfactory quarter for international equity investors with moderately positive returns. There has been a mixed performance from bonds as measured by 10 year government benchmark yields. In the currency markets, sterling and the US dollar have been weak, experiencing quite large falls. In the commodity markets oil and gold have strengthened.

The tables below detail relevant movements in markets :

International Equities 31.05.17 - 31.08.17

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.0	+7.8	+7.6	+1.8
Finland	-3.7	+2.0	+1.8	-3.7
France	-3.0	+2.8	+2.6	-3.0
Germany	-4.0	+1.7	+1.5	-4.0
Hong Kong, China	+7.1	+7.2	+7.0	+1.2
Italy	+5.0	+11.2	+11.0	+5.0
Japan	+2.7	+3.4	+3.2	-2.4
Netherlands	-0.7	+5.2	+5.0	-0.7
Spain	-3.9	+1.8	+1.6	-3.9
Switzerland	-0.8	+0.1	-0.1	-5.5
UK	-0.2	-0.2	-0.4	-5.8
USA	+3.1	+3.3	+3.1	-2.5
All World Europe ex UK	-1.5	+3.5	+3.3	-2.3
All World Asia Pacific ex Japan	+6.1	+7.6	+7.4	+1.5
All World Asia Pacific	+4.7	+5.8	+5.6	-0.1
All World Latin America	+9.6	+13.9	+13.7	+7.5
All World All Emerging Markets	+8.7	+9.9	+9.7	+3.7
All World	+2.4	+3.9	+3.7	-1.9

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +0.2%

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

Currency	31.05.17	31.08.17
Sterling	1.07	1.09
US Dollar	2.33	2.13
Yen	0.04	0.01
Germany (Euro)	0.29	0.36

Sterling's performance during the quarter ending 31.08.17 (%)

Currency	Quarter Ending 31.08.17
US Dollar	N/C
Canadian Dollar	-7.3
Yen	-0.4
Euro	-5.4
Swiss Franc	-0.6
Australian Dollar	-6.2

Other currency movements during the quarter ending 31.08.17 (%)

Currency	Quarter Ending 31.08.17
US Dollar / Canadian Dollar	-7.3
US Dollar / Yen	-0.5
US Dollar / Euro	-5.4
Swiss Franc / Euro	-4.8
Euro / Yen	+5.2

Significant Commodities (US dollar terms) 31.05.17 - 31.08.17 (%)

Currency	Quarter Ending 31.08.17
Oil	+3.3
Gold	+3.6

MARKETS

Except for euro based investors, it has been a moderately positive quarter for international equity investors, a satisfying result given the very strong performance in 2016 and further, more modest, progress so far this year. In total return local currency terms the FTSE All World Index has returned 2.4% this quarter, the sterling adjusted index 3.9%, the US dollar adjusted index 3.7%, whilst the euro adjusted index has been in negative territory, -1.9%. Looking, firstly, at local currency returns, the highest returns have come from Latin America, Emerging Markets and Asia Pacific ex Japan. The FTSE All World Latin America Index returned 9.6%, the FTSE All World All Emerging Markets Index returned 8.7%, and the FTSE All World Asia Pacific ex Japan Index returned 6.1%. The FTSE USA Index slightly outperformed the FTSE All World Index, returning 3.1%. Underperforming indices were the FTSE Europe ex UK Index, -1.5%, and the FTSE UK Index, -0.2%. However, the situation is quite different in sterling terms where the strength of the euro meant that the return on the FTSE Europe ex UK Index, at 3.5%, was only slightly below that of the FTSE All World Index in sterling terms. Elsewhere, a very strong Australian dollar has meant a very positive 7.8% return in sterling terms in the FTSE Australia Index, against just 1.0% in local currency terms. The effect of currency movements has been especially felt in the FTSE All World Latin American Index which returned 13.9% in sterling terms. The weakness of sterling during the quarter magnified the underperformance of the FTSE UK Index compared with the local currency indices.

In the bond markets, movements, as measured by 10 year government benchmark yields, have been more moderate than during some previous quarters. The 10 year UK government bond saw its gross redemption yield rise by just 2 basis points to 1.09%, whilst it fell by 10 basis points to 2.13% for the US Treasury bond. The yield on the Japanese Government Bond fell by 3 basis points to 0.01%, whilst it rose by 7 basis points on the German Bund to 0.36%.

Sterling and the US dollar suffered a weak quarter. Against the Canadian dollar, sterling fell by 7.3%, against the Australian dollar by 6.2%, against the euro by 5.4%, against the Swiss Franc by 0.6% and against the yen by 0.4%.

In the commodity markets, oil, as measured by Brent crude rose by 3.3% and gold by 3.6%.

ECONOMICS

No new economic themes of any note have developed over the last quarter, which may account for low levels of market volatility. Business might be said to have continued as usual. This is not being complacent. In a bottle half empty world, there is plenty which could unsettle investors just as, in the opposite camp, in the bottle half full world, there is quite a lot to please investors. This has been called a reluctant bull market and the tug of war between the sceptics and optimists, which the latter category has won so far, could reflect the rather grudging rise in share prices, even though in many markets they are at around record levels. Certainly, there has been no euphoria, in itself quite a bull point. At the moment, perhaps the most serious concern is the political one involving North Korea and its unpredictable regime. The launching of a ballistic missile by North Korea, which passed over Japan, and now the testing of its largest ever nuclear device, elevates the problem even further. However, it is not in any way flippant to say that economic developments will probably be more significant for the stock markets. The consequences of nuclear war are too terrible for stock markets to discount, while the more gradual effect of changing economic circumstances and outlook are likely to have a greater effect. That might sound paradoxical but no one can gauge the consequences of a nuclear war in economic terms, let alone human or any other terms, whereas they can make an educated guess about the consequences of economic developments and policies. On a day to day basis, the ebb and flow of the North Korean political crisis will affect markets but, so far, apart from those short term effects, its influence has been quite mild. For this reason, we will consider mainly economic events realising that, in a worst case scenario, a nuclear conflagration in the Korean Peninsula would dwarf any economic consequences.

As we said in the last paragraph, there have been no new economic themes in the last quarter, just a continuation of existing ones with a few new attachments. In the USA, the economy continues to grow modestly and the employment numbers have been quite strong, notwithstanding a lower than expected non farm payrolls increase in August, albeit with the qualification that the labour force participation rate remains relatively low. A recent article in the Sunday Times highlighted how this latter measure has been blighted by the opioid epidemic in the USA which has rendered so many people unable or unwilling to work.

Notwithstanding the effect which this has in limiting the size of the potential workforce, the employment market in the USA is fairly strong and the puzzle, as in the UK, is why this has not resulted in a stronger trend in individual earnings growth and inflation. Despite a lot of political noise, not much has happened on the economic policy front but, with the economy performing reasonably well, political action is not necessarily needed to improve it further. The new development is the threat of a government shutdown if no agreement is reached to raise the federal government's borrowing ceiling. This has been shunted forward to the 15th December. We will come back in more detail to the USA but, for the moment, we can note that Wall Street has performed well since last November's Presidential and Congressional elections, even though nothing much has been done on the economic front. Much more immediate attention is being paid to the course of monetary policy and by how much and when interest rates are going to be raised.

In the eurozone, not much has happened on the economic front. Growth has been better than expected and, as in the USA, most attention is focused on what the ECB will do next, whether in terms of reining back its quantitative easing programme or starting to raise interest rates. On the political front, attention is focused on France where the President, suffering a precipitous fall in popularity, is pressing on with his reforms. The first test will be how he deals with the protest against his proposed labour market reforms, a litmus test of his reformist credentials and France's willingness to change. The outcome of this challenge will be watched particularly closely in Germany. Insofar as the highly regulated French economy contributes to a low potential growth rate in the country and, by extension, the eurozone, Germany will be less willing to listen to President Macron's plans for closer integration within the eurozone. In Germany, the main interest will be who will be the CDU's partner in what is expected to be a coalition government. The markets would prefer a coalition with the market friendly FDP, which seems likely to obtain more than the 5% threshold of votes needed for representation in the Bundestag. On the other hand, a coalition including the SDP, Greens and Linke (the far left party) would be much more unpalatable to markets. As ever, the outlook for Italian politics is uncertain. Strong anti euro sentiment in Italy, although showing signs of diminishing as the economy shows a modest improvement, and the country's very high level of outstanding public debt as a percentage of GDP make Italy a potential weak link in the eurozone' structure.

In the UK, the issues are likely to remain the same for the foreseeable future, namely the Brexit negotiations and the uncertain domestic political situation. Whether or not Brexit turns out to have been the right decision will almost certainly not be known for a long time. What we do know is that the negotiations will be difficult and that there will be a lot of grandstanding and misinformation put out which may unsettle investors in UK markets and sterling. It is important for investors to take on board that some of the "noise" around the negotiations is propaganda and that they should not be unduly influenced by this. One of the reasons that we consider the UK stock market to be high risk is the political situation. Whilst the Conservatives have a formal agreement with the DUP, an election before the end of its five year term is possible and, with the opposition holding views which are outside the traditional spectrum of UK politics, the risk is elevated with consequences for markets and sterling. Whilst this may not seem an immediate risk, it is nevertheless a negative factor in the background. Although the UK economy has slowed down, its performance is satisfactory and the employment market strong. The forecast post Brexit economic apocalypse has not occurred, at least not yet.

In Japan, the sharp fall in the popularity of the Prime Minister, Mr Abe, due to alleged scandals, is a complicating factor at a time when the third arrow of his original programme to galvanise the Japanese economy, structural reform, is more necessary than ever to ensure that monetary and fiscal policy can work to ensure an improvement in the long term potential growth rate of the Japanese economy.

In China, the issues remain much the same as before, namely how to effect the transition to a more consumption and service orientated economy, away from fixed asset investment and exports, without reducing the growth rate to an unacceptable level. The high level of leverage in the economy remains a concern and the authorities are active in trying to contain property prices and also to intervene in a qualitative manner on overseas investment and capital outflows which had seen foreign exchange reserves at one stage to fall to around US$3 trillion although they have now recovered modestly to US$3.08 trillion.

Complementing these continuing issues is the overarching general one relating to monetary policy, which is how and when central banks will start, or continue where they have already started, to tighten, whether through reining back quantitative easing and/or increasing interest rates. The major issue for fixed interest and equity investors is how markets will react to a tightening of monetary policy and, as we discuss each area, we will refer to this issue.

Before we look at different countries and areas of the world, it will be useful to look at the most recent economic projections from the IMF in its World Economic Outlook Update of July 2017. It has not changed its overall projections from its April 2017 publication, which is for world output growth of 3.5% for 2017 and 3.6% for 2018. Its projections for Advanced Economies overall are very little changed, with no change for 2017 at 2.0% and just a 0.1% decrease for 2018 to 1.9%. Within this area, the most notable change is in the IMF's forecast for the USA where growth for this year and next is now projected to be 2.1%, reductions of 0.2% and 0.4% respectively from last April. On the other hand, there is a modest increase in the forecast for the eurozone, where growth is now projected at 1.9% for this year and 1.7% for next year, respective increases of 0.2% and 0.1%. Individually, in this area, there are some quite significant increases, most notably in Italy and Spain, the third and fourth largest eurozone economies. For this year, the projection for both countries has been revised by 0.5% to 1.3% and 3.1% respectively and, for next year, the projection for Italy has been raised by 0.2% to 0.5% and, for Spain, by 0.3% to 2.4%. Elsewhere, the forecast for Japan has hardly changed, up just 0.1% this year to 1.3%, and unchanged next year at 0.6%. Canada has seen a significant uplift of 0.6% in the IMF's projection for this year to 2.5% and a very small reduction of 0.1% next year to 1.9%. For the UK, the IMF has cut its projection by 0.3% this year to 1.7% and left next year's projection unchanged at 1.5%. Within the Emerging Market and Developing Economies area, projections are very little changed against last April, an increase of 0.1% this year to 4.6% and unchanged next year in 2018. For China, it has slightly increased its forecasts for this year and next by 0.1% and 0.2% respectively to 6.7% and 6.4%, whilst it has left its projections for India unchanged at 7.2% and 7.7% respectively. Of the other original BRIC economies, the IMF has left unchanged its forecasts for Russia at 1.4% growth for each year, whilst it has upgraded slightly its forecast for Brazil this year by 0.1% to 0.3% but downgraded it by 0.4% next year to 1.3%. Given the political situation in Brazil, projections must be particularly subject to change. So, whilst growth internationally is not strong, it can be classified as satisfactory and at a rate which provides a backdrop for markets which is unlikely to cause any nasty economic surprises. This can be one explanation of the low level of volatility in international equity markets.

If we turn to look at the USA, investors have to distinguish between the politics and the economics. Whilst there is an extraordinary amount of political noise coming out of Washington, particularly from the White House, not much by way of policy has actually been enacted. There have been some executive orders and the President has made some more sympathetic appointments to various federal agencies and regulators, but legislative measures have been negligible. Obamacare was not repealed and there has been no agreement with Congress on tax packages. Legislative inactivity is not necessarily a bad thing and may even be positive if it prevents damaging legislation passing. Whilst the President may command the media's attention, the stock market is tending to ignore the outpourings from the White House. Instead, one feels that it is more interested in the course of monetary policy.

In discussing monetary policy, one of the immediate issues revolves around who is going to be chairing the Federal Reserve once Janet Yellen's term of office expires next February. The President has been critical of the Federal Reserve and many Republicans would like to see more of a rules based policy. So, we do not know at the moment if President Trump will nominate Janet Yellen or someone else to chair the Federal Reserve next February. Whoever is proposed will have to be confirmed by the Senate. Before then, the Federal Reserve will have to consider its policy on interest rates and shrinking its US$4.5 trillion balance sheet, a result of its previous quantitative easing policies which involved massive bond purchases. The Federal Reserve's balance sheet will need to be reduced at some stage, as will those of other central banks, and the question is how and when to do it. If action is delayed too long, an increase in inflation will be threatened as money starts to circulate more quickly around the economy. Different countries are at different stages of their economic cycle but there is no doubt that the USA is leading the way in starting to reverse its monetary stance. Even though the IMF has reduced its forecast for US economic growth for this year and next, as we saw earlier in this review, it still expects a moderate rather than low rate of growth, not up to previous levels but better than in 2016. We noted that the unemployment rate was low at 4.4% for August, although there is the qualification to these figures surrounding the USA's low participation rate. Nevertheless, the unemployment rate paints quite a positive figure. With the Federal Reserve targeting a 2% inflation rate, there is the puzzle, not only relevant to the USA, of why inflation has remained so low. The Federal Reserve's preferred measure is the core Personal Consumption Expenditure Index, which currently shows a year on year increase of 1.4%, well below the target rate of inflation. One of the most used economic models in the past was the Phillips Curve which reflected the trade off between unemployment and inflation. At a certain level of unemployment, inflation would begin to accelerate as spare capacity in the labour market was exhausted. At the moment, this does not seem to be happening for whatever reason. It could be technological advances which have rendered some jobs obsolete, the decline in trade union power or declining inflation expectations which have reduced the level of pay demands, not to mention disappointing productivity levels. In the USA, some states and cities have quite aggressively raised minimum wage levels, but one side effect of this is that companies will seek to offset the additional costs with increased automation, where possible, replacing labour with capital. President Trump has often railed about cheap foreign imports costing American workers their jobs. Dumping and subsidising exports does cost jobs, goes against the concept of a level playing field and represents a distortion of the market. However, in a free trade world, not distorted by export subsidies, import tariffs or other barriers, the theory of comparative advantage, whereby countries produce what they are relatively efficient at, does produce benefits to consumers, raising their relative spending power and helping growth in their home market. However, whatever is causing inflation to be lower than traditional economic models might have suggested, is giving the Federal Reserve a problem in deciding the timing of further interest rate increases and the start of the reversal of quantitative easing. Nevertheless, the current federal funds target range of 1.0% to 1.25% is negative in real terms, not so much as it was before the Federal Reserve started its series of interest rate increases last December, but still negative. If, without knowing any of the history or background or even which country was involved, one had been presented with a piece of paper containing only the central bank interest rate (in this case, the federal funds target rate), the inflation rate, the unemployment rate and the latest quarter on quarter annualised growth rate, one would conclude that interest rates were far too low and risked causing inflation and an asset bubble as borrowers took on cheap debt. The fact that inflation was not rising fast enough, in terms of meeting the central bank's target, would be very puzzling to this person as it is to the Federal Reserve. One issue of which this person would not immediately be aware, and this is the general one, is the weak productivity puzzle. Weak productivity growth is a phenomenon in the USA and elsewhere. Productivity growth is a spur to real earnings growth, for companies can afford to pay their employees more if their productivity is rising because it negates inflationary pressures. That is what politicians and economists would like to see, but it is not happening. If employers believe that labour is cheap relative to capital, they will not consider it worthwhile investing in labour saving machinery. Of course, they have to believe that the business outlook is good enough to invest. It may be that interventions in the labour market by governments or states and cities in the USA to raise the cost of employing people will spur productivity growth but that may be at the expense of jobs. Two examples show how this phenomenon may play out. If one checks in at a budget hotel these days, the process is largely automated. You may not even have to interact with an individual employee of the hotel at all. The self service machine delivers the key to one's room and that is it. With customers being price sensitive and companies being cost sensitive, the squeeze is on employees. In China, at restaurants, where employees' wages are often subject to official intervention, they are experimenting with robot waiters. In China, minimum wages have risen sharply, hence the need to try to raise productivity. But productivity can rise because there are fewer people employed who produce the same or more. So productivity per person rises but job opportunities decline. This may be one reason why inflation is not rising as fast as the Phillips curve would suggest. All of this is clearly a puzzle to the Federal Reserve as it tries to calibrate its exit from quantitative easing. Apart from sub par inflation with the latest reading of its preferred inflation measure, the core Personal Consumption Expenditure Index, at 1.4%, most indicators would seem to support a further increase in interest rates before the year end. For example, the latest estimate of second quarter GDP has just been raised to 3.0%, quarter on quarter annualised, from the previous estimate of 2.6%. Although the latest non farm payroll figures of 156,000 for August were below recent levels and the previous months' figures were revised down to 210,000 (231,000) for June and to 189,000 (209,000) for July, they have still been quite strong. The unemployment rate rose from 4.3% to 4.4% but again this is quite a strong reading, notwithstanding the relatively low participation rate of 62.9%. The latest University of Michigan's Consumer Confidence Index at 97.6 was bettered only in January when it stood at 98.5. The latest Purchasing Managers Index for the manufacturing sector stands at 58.8, a very healthy figure, and that for the services sector, at 53.9, which is below June's level of 57.4. If, relative to even the current low level of inflation, interest rates, as measured by the target federal funds rate, were positive in real terms, they would not look out of line. They do now as the more hawkish members of the Federal Reserve have indicated. There are two issues for policy members to consider, interest rates and the rollback of quantitative easing. There are differing views on the sequencing of these events but they can be done together, with the latter method of monetary tightening also likely to put upward pressure on interest rates. Raising the target federal funds rate is more eye catching and its consequences can easily be understood by borrowers and savers. Reversing quantitative easing is more subtle but, in one form, could also seem quite dramatic. The more eye catching way to reversing quantitative easing is for the central bank to sell back to the private sector some of the assets which it has bought. The presence of a big seller in the market would be likely to raise bond yields. The more subtle way, and one which the Federal Reserve has talked about, is to reinvest only part of the maturing bond proceeds and coupons which it receives, thus, creating a funding gap which has to be met by the market. This is a much less obvious way of doing the same thing. It might seem like splitting hairs to try to distinguish between these two methods of reversing quantitative easing but the psychology of the situation is important. We recall the taper tantrum of 2013 when Ben Bernanke began musing about tapering quantitative easing before stopping it completely. The market became very jittery for a while. At that time, quantitative easing was still occurring, but now it is in a neutral position with maturity proceeds and coupons being reinvested but no new net central bank buying actually occurring. The more subtle method has attractions but, whichever method is chosen, and this applies to interest rate increases as well, the signalling must be very clear. The market does not like shocks.

With Wall Street at around its all time high and plenty of sceptics still around, it is, as we have said in past reviews, very important that US corporate earnings rise to validate the increase in share prices which we have seen and, on this, the news has been encouraging. First and second quarter corporate earnings showed annual increases of over 10%, with energy, information technology and financials leading the way in the second quarter, with the only negative sector being consumer discretionary. Many US companies have experienced a favourable tailwind from the weaker US dollar. With the US economy performing satisfactorily, as shown by the adjustment to second quarter GDP figures, the US corporate earnings outlook is set fair. Whereas, post Donald Trump's election last November, the market was buoyed by hopes of significant corporate and personal tax cuts as well as for a favourable tax regime for the repatriation of overseas cash held by US companies, more emphasis is being placed on the earnings performance of US companies, which, at present, are showing positive signals. Whilst Washington may appear totally dysfunctional, if one avoids all the "noise" emanating from there, matters seem to be progressing quite well on the economic front. The big challenge for equity and bond markets in the USA is how they will react to further interest rate increases and the start of the reversal of quantitative easing.

Whilst the weakness of the US dollar should help many US companies' earnings, the strength of the euro can be expected to play the other way with many eurozone exporters whose overseas business lies outside the eurozone. This is likely to be one reason why eurozone equities underperformed other major markets in local currency terms in the latest quarter although when calculated in US dollar or sterling terms, the underperformance against world markets is very small and satisfactorily positive in absolute terms. As we saw in our comments on the IMF's latest economic growth projections, the IMF has raised modestly its projections for eurozone growth this year pointing to positive surprises in activity in late 2016 and early 2017. The latest eurozone GDP figures for the second quarter show year on year growth at 2.2% and annualised quarter on quarter growth of 2.5%. Looking at the four largest eurozone economies for the second quarter, Germany showed year on year GDP growth of 2.1% and quarter on quarter annualised growth of 2.5%, for France the respective figures were 1.8% and 2.2%, for Italy 1.5% and 1.6% and for Spain 3.1% and 3.6%. The latest Purchasing Managers Indices point to a solid performance for the eurozone. The composite index stands at 55.8 and, within that figure, the manufacturing index stands at a healthy 57.4, the services index at 54.9 and the construction index at 53.1. Within the individual country figures, a striking number is the latest manufacturing PMI for Germany which stands at 59.4. Unemployment remains a serious problem within the eurozone, particularly for Spain, Italy and France, of the four largest economies, and elsewhere like Greece, for example, where it stands at 21.7%. However, the overall eurozone unemployment level has been drifting down this year, now standing at 9.1% compared with 9.5% in January. However, the slightly improving unemployment situation has meant, as one would expect, better index readings for consumer and business confidence and also retail sales. But there is certainly no cause for euphoria. This modest level of growth has been achieved on the back of an extraordinarily large monetary stimulus, both in terms of the level of interest rates, negative in many maturities, and quantitative easing, such that the size of the ECB's balance sheet has ballooned to €4.256 trillion (the total balance sheet size of the Federal Reserve, ECB, Bank of Japan, Bank of England and Swiss National Bank is around US$15 trillion). If it takes that amount of stimulus to bring about a modest level of growth, it shows how deep the underlying problems of the eurozone are. However, just as in the USA, the ECB faces a dilemma. Inflation is well below its target level. The latest level of consumer prices in the eurozone is 1.3% year on year and the core consumer price level is 1.3%, below the ECB's 2% target level. The strength of the euro is not helping. The dilemma is more difficult for the ECB than it is for the Federal Reserve, Bank of Japan, Bank of England and Swiss National Bank because it is a monetary union rather than a single country and economic conditions vary considerably, say, between Germany on the one hand and Greece on the other. The dangers of a bloated central bank balance sheet are common but, for the ECB, there are some particularly difficult issues. It is supposed to apportion its bond purchases in accordance with each country's capital key, basically a country's relative size in relation to the eurozone, but the matter is additionally complicated by the limits to the amount of bonds that the ECB can buy in relation to a country's outstanding debt in circulation, 33%. The eurozone's best credit, Germany, is expected to run a budget surplus this year, which means that its reliance on the financial markets is limited, whereas countries like France, Italy and Spain, with quite large budget deficits, need to keep issuing government bonds. If the ECB keeps buying bonds, which it will do at least until the end of the year at €60 billion a month and almost certainly afterwards, albeit at a reduced rate, it could reach its limits with Germany as well as some other eurozone countries. If it tries to raise the allowable limits, it will almost certainly encounter legal problems within Germany, yet, if it waters down the capital key rules, it could be buying a disproportionately large amount of other countries' bonds where it is not up against the limits, say, of those of France and Italy. That raises the risk level to the ECB since quite often countries have to issue bonds regularly and on a significant scale because their budgetary balance is weak. That is a generalisation, of course, but Italy is a highly indebted country with a credit rating lower than that of Germany. Its outstanding level of public debt in relation to GDP is around 133%. These bond availability issues may determine how the ECB proceeds after December. Currently, it is buying €60 billion of assets a month and it has already relaxed its buying parameters. Continually adding to the ECB's balance sheet is a high risk policy, so the practical limitations it is going to come up against may inform what we presume will be a tapering policy after next December. As with the USA, the way in which it is signalled to the market will be very important.

On the practical front, probably the two issues most of interest are the progress that President Macron will make on his labour market reforms and the forthcoming German elections. The former will be a litmus test of France's willingness to reform and with it Germany's acceptance, or otherwise, of President Macron's plan for a closer union. If, as with previous attempts to liberalise France's rigid and heavily regulated labour market, the government backs down, Germany is unlikely to be impressed but, if he succeeds, as he well might on this occasion, Germany is likely to look more favourably on his plans for a closer union. Added to this is the forthcoming German election and the make up of any coalition which we discussed earlier.

The strength of the euro, against which the US dollar fell by 5.4% over the last quarter, does not have an easy explanation. It is always possible to rationalise a movement after the event. In this case, one could say that an improving economic outlook is the harbinger of tighter monetary policy which could be expected to boost the euro, that the eurozone's large current account surplus at around 3% of GDP also boosts the demand for the euro, and that a dysfunctional scene in Washington adds to the euro's attractions. All this is speculation, though, but it adds to Mr. Draghi's difficulties, since tightening monetary policy would be likely to increase the attractions of the euro and add to the eurozone based companies' difficulties.

Although it is the third largest economy, Japan tends to receive fewer headlines and less attention than the other major areas. In normal circumstances its very high level of public debt and poor demographics would attract a lot of attention but most of its large stock of debt is held internally. Recent economic news from Japan has been good. For the quarter ending in June, the Japanese economy recorded its sixth consecutive quarter of growth which represents the largest unbroken run for a decade. Year on year growth was 2%, up from 1.3% the previous quarter, and the second quarter's annualised quarter on quarter growth rate reached 4.0%, compared with a revised 1.5% figure for the March quarter. Encouragingly, the growth was stimulated by domestic demand and, particularly, consumption. As with the USA and eurozone, Japan is struggling with a lower than desired level of inflation. The Bank of Japan, too, is targeting 2% inflation and having trouble reaching that level. In July, the Bank of Japan reduced its inflation forecast for the year to March 2018 from 1.4% to 1.1% and for the following year from 1.7% to 1.5%. Whilst the Federal Reserve and the ECB appear to be in tightening monetary mode, if ever so carefully, the Bank of Japan shows no sign of following that path. It has kept overnight interest rates at -0.1% and continued to say that it would cap ten year JGB yields at around zero and will continue with asset purchases at the level of around ¥80 trillion a year. The popularity of the Prime Minister, Mr Abe, has dropped sharply as a result of a corruption scandal which may make it more difficult for him to proceed with supply side reforms to free up the economy and increase its long term potential growth rate. Japanese corporate profits are rising as well as dividends and, for the moment, absent the North Korea situation getting even worse, it appears a relatively stable market for international investors.

As far as China is concerned, economic growth seems well anchored. We noted at the beginning of this review that the IMF has raised modestly its growth forecasts for this year and next to 6.7% and 6.4% respectively. The latest GDP figures for the second quarter show year on year growth of 6.9% and second quarter on quarter annualised growth of 7.0%. The latest purchasing managers indices are modestly in positive territory at 51.7 for manufacturing and 53.4 for non manufacturing. The spotlight on China is likely to increase next year as certain "A" shares enter the MSCI Emerging Markets Index. The issue most concerning economists and investors at present is the very high level of public and private debt in the Chinese economy. In its annual review of the Chinese economy, as opposed to the World Economic Outlook data which we quoted above and at the beginning of this review, the IMF raised its forecast for annual growth between 2018 and 2020 to 6.4% against its previous estimate of 6.0%. One reason that the IMF raised its forecast was because the authorities have allowed the build up of debt which may help growth in the short term but can store up trouble for later on. The IMF now forecasts that the country's non financial debt as a percentage of GDP will exceed 290% of GDP by 2022 against 235% last year. Nevertheless, the Chinese authorities are making attempts to limit credit growth. For overseas investments, China is now taking a more qualitative approach, only allowing those investments of which it approves. Four high profile companies were targeted. These have all expanded aggressively overseas. Local government has been trying to cool an overheated property market and has had some success, as the rate of housing sales has slowed dramatically in July compared with earlier in the year. In July, they grew by 2% annually, whereas in the first six months of the year the rate had been 21%. For those seeking reform to open up the economy, the increasing party control of state owned enterprises has been a disappointment. Control instincts remain very strong but, notwithstanding the IMF's comments, the Chinese authorities appear well aware of a lending based bubble with its effects on the banks and the economy. For the moment, though, China is not a major concern for investors who are probably more interested in seeing if it can exert more control on the North Korea regime.

As we said at the beginning of this review, we regard the UK as a high risk market because of the uncertain course of the Brexit negotiations and the government's weak political position, post the June election, which leaves it vulnerable to all sorts of unexpected events. With a huge gap between the government's and opposition's policies in many areas, this matters. Brexit is a hugely divisive issue and we must expect a lot of propaganda and grandstanding from politicians and negotiators. So far, UK markets have adopted a more mature approach, tending not to become sidetracked by all the noise. So economic data will be spun to suit one side's particular case and, at some stage, the aggressive posturing could unsettle markets. The media does not help here. Most of the items of news accentuate the negative rather than giving a proper balance. The UK economy has slowed down but not dramatically. The latest year on year GDP figures show growth of 1.7% and the second quarter's year on year annualised growth rate is 1.2%. The latest purchasing managers indices support a picture of an economy demonstrating moderate growth. The positive reading for the manufacturing PMI at 56.9 (55.3) chimes in with reports of increasing levels of activity in the manufacturing sector helped by the lower value of the pound. The EEF, for example, the sector's representative body, reported a string of encouraging data. The balance of companies planning to increase investment was positive across all UK regions. The number of groups hiring new employees was at a three year high. 33% more companies reported increased sales abroad than a decline or stagnant orders. However, the manufacturing sector represents about 10% of the UK economy so, however well it is doing, it will always be in the shadow of the services sector which accounts for about three quarters of the economy. The latest reading for the services PMI at 53.2 was slightly lower than the previous month's level of 53.2. The construction sector PMI, the smallest of the three came in at 51.1 reflecting a very modest level of growth. The government's weak parliamentary position means that it will find it hard to move as quickly as it would like to move to a balanced budget. Opposition to any measures to try to improve the country's financial position will find a receptive ear in the current climate. Because of the Brexit negotiations and the difficult political position of the government, we continue to believe that UK exposure should be modest compared with overseas exposure and that an important part of UK exposure should be in companies with substantial overseas business which would benefit if sterling were to fall further.

We have touched above in the discussion about the UK's prospects about how the media tends to emphasise what it perceives to be negative news but rarely gives coverage to the same extent of positive news. Heavy emphasis is given to budget cuts (often reduction in the rate of increase in expenditure) but very rarely to the reasons why spending has to be limited in the interests of stabilising public finances or the consequences for a country in terms of income and employment, to name but two areas, if a country's public finances get out of control. It was therefore very refreshing to see recently an excellent article by a contributor to The Times financial section under the heading "What's with the gloom? Why cheeriness might be the order of the day". In this article, the writer points to a number of positive facts which get lost behind the air of despondency which prevails, even though we are nine years into rising equities. Some of the positive facts he mentions are that economies have been growing, corporate financiers are increasingly busy, the US economy soldiers on with growth of over 2% and takes rising interest rates and an unconventional President in its stride. Technology giants are prospering. Europe has begun to develop a head of economic steam and the euro is strong. The new French President is not deemed bad for business and European corporations are more active generally. He refers to the strong performances of the UK equity indices since Brexit and healthy UK company balance sheet and dividends. It is good that someone has written an article like this and, although it is not fashionable to emphasise the positive aspects of the world economic scene, it is what investors have been quietly doing and this is reflected in the progress of share prices. Successful investment demands a dispassionate view of data rather than partisanship to support a particular viewpoint.

It remains our judgement that shares are the most appropriate asset class in which to be invested notwithstanding their strong performance over a long period. We continue to emphasise that some negative quarters must be expected simply because there have been so many positive quarters but we consider there to be a greater danger of being out of the market. Bonds remain significantly overpriced in our view. In the current environment, we believe that sterling based investors should hold a widely geographically diversified portfolio.