meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The quarter has been dominated by the US debt standoff and the eurozone sovereign debt crisis and these concerns have left their effect on international equity markets which have experienced a poor quarter. On the other hand, benefiting from a flight to quality, highly rated government bonds have performed well. The gold price has indicated a loss of faith in paper currencies.

The tables below detail relevant movements in markets:

International Equities 31.05.11 - 31.08.11

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-7.9	-6.4	-7.4	-7.6
Finland	-18.3	-17.3	-18.2	-18.3
France	-16.5	-15.5	-16.4	-16.5
Germany	-20.5	-19.5	-20.4	-20.5
Hong Kong, China	-9.4	-8.6	-9.5	-9.7
Italy	-24.8	-23.9	-24.7	-24.8
Japan	-8.8	-2.1	-3.1	-3.3
Netherlands	-18.6	-17.6	-18.5	-18.6
Spain	-15.6	-14.5	-15.4	-15.6
Switzerland	-16.0	-10.2	-11.1	-11.3
UK	-9.0	-9.0	-10.0	-10.2
USA	-9.0	-8.0	-9.0	-9.2
Europe ex UK	-17.9	-16.3	-17.2	-17.4
Asia Pacific ex Japan	-10.3	-8.8	-9.8	-9.9
Asia Pacific	-9.7	-8.8	-7.0	-7.2
Latin America	-7.6	-7.9	-8.9	-9.0
All World All Emerging	-8.6	-8.6	-9.5	-9.7
The World	-10.7	-9.3	-10.3	-10.4

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +4.2%

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

Currency	31.05.11	31.08.11
Sterling	3.31	2.62
US Dollar	3.05	2.22
Yen	1.16	1.03
Germany (Euro)	3.03	2.25

Sterling's performance during the quarter ending 31.08.11 (%)

Currency	Quarter Ending 31.08.11
US Dollar	-1.0
Canadian Dollar	-0.1
Yen	-6.8
Euro	-1.3
Swiss Franc	-6.7
Australian dollar	-1.5

Other currency movements during the quarter ending 31.08.11 (%)

Currency	Quarter Ending 31.08.11
US Dollar/Canadian Dollar	+0.9
US Dollar/Yen	-5.9
US Dollar/Euro	-0.3
Swiss Franc/Euro	+5.8
Euro/Yen	-5.6

Significant Commodities (US dollar terms) 31.05.11 - 31.08.11 (%)

Currency	Quarter Ending 31.08.11
Oil	-1.6
Gold	+19.8

Markets

International equity markets endured a poor quarter as a result of the unsettled economic background. In local currency terms, the FTSE World Index returned -10.7%, in sterling terms -9.3%, in US dollar terms -10.3% and in euro terms -10.4%. Looking at the various markets in local currency terms, Europe ex UK experienced the greatest weakness with a return of -17.9% on the FTSE Europe ex UK Index. Within that area, Italy performed particularly badly, returning -24.8%, whilst Germany returned -20.5% as measured by their relevant FTSE index. Markets which held up better than average in local currency terms, again measured by the relevant FTSE index, were the UK and USA, both returning -9.0%, Japan -8.8%, Emerging Markets -8.6%, Australia -7.9% and Latin America -7.6%. Apart from Switzerland and Japan, currencies did not make an enormous difference this quarter. A strong currency at times adversely affected Swiss equities, but a worse than average local currency return in the FTSE Switzerland Index of -16.0% reduced to -10.2% in sterling terms. A strong yen meant that the negative return in sterling terms on the FTSE Japanese index was just -2.1%.

Concerns about sovereign debt and the banking sector caused a flight into securities which were considered ultra safe irrespective of the returns they were likely to offer. The selection of government bonds which we quote in our table are considered "safe" and, therefore, we saw yields on their ten year government benchmark issues fall sharply. In the sterling market, the gross redemption yield fell by 69 basis points to 2.62%, in the US market by 83 basis points to 2.22%, in the Japanese market by 13 basis points to 1.03% and in the German market by 78 basis points to 2.25%.

As alluded to above, the main action in the currency markets was in the yen and Swiss Franc. Against the yen, sterling fell by 6.8% and against the Swiss Franc by 6.7%.

There was little change in the oil price over the quarter as the news from Libya improved, albeit that it is likely to be a long time before output is restored to its previous level. Gold, however, reflected a lack of trust in paper currencies and it rose by 19.8% in US dollar terms.

Economics

At times like this, it is important to assess the big picture, rather than the details, in order to try to identify a sensible investment policy. That investors have no faith in most western politicians is a given. In the foreseeable future, it is more likely to be the central bankers who will prove to be of most help in stabilising the situation and perhaps pointing the way forward to a short term fix for the problems. The big issues look intractable at this time but stabilising the short term position would be a plus for investors.

The two big problems which have been exercising markets are the USA, with its debt ceiling crisis, and the eurozone, with its sovereign debt woes. In both cases, the inadequacies of the decision making processes have made bad situations even worse. As this is written, the problems of the eurozone look far worse but, a few weeks ago, the USA was gaining even more attention, some achievement given the seriousness of the eurozone's problems. That we can say that the USA's issues are overshadowed by what is going on in the eurozone says something about the state of the eurozone but let us deal with the USA first.

The fight over the debt ceiling went to the wire and, in doing so, inflicted serious damage on the USA. The big issue in the USA is a philosophical one, between those who favour big government, manifested through higher government spending and taxes, and those who favour small government, with the opposite characteristics. It has become very personal and the bad feeling on Capitol Hill between the two Houses of Congress, each controlled by different parties, and between the Republican led House of Representatives and the President made any agreement difficult. But what was most shocking was that those involved were prepared to go to the wire on a debt default. The damage to the reputation of the USA has been very serious, but debt default would have done incalculable damage to the USA and the financial system. It beggars belief that those involved appeared, in many, but not all, cases, not to grasp the consequences of their behaviour. In many countries there is a problem with politicians having no real world experience and this has certainly been the case in the USA and also, as we shall see, in the eurozone. It is quite frightening that the personal animosities between some US politicians should bring the USA to the brink of such a dangerous precipice. The lack of goodwill is mind blowing and difficult for many people to understand, but the atmosphere in Washington is undoubtedly poisonous. In the end, a deal was done, and it has succeeded in turning investors' attention to the eurozone.

As for the deal ultimately agreed in the USA, there are no tax increases but spending cuts are locked into the agreement. US$917 billion will be cut from discretionary spending over a ten year time frame. A further US$1,500 billion of spending cuts over the next ten years is to be identified by a new Congressional committee. Should this committee fail to reach an agreement, there will be automatic spending cuts to guarantee US$1,200 billion in deficit reduction of which US$500 billion will come from defence and the rest from across the board with some exceptions. In terms of raising the debt ceiling itself, the first tranche of the authority will be passed immediately and the second tranche will be enacted once the joint Congressional Committee's recommendations are passed with a back stop procedure for raising the debt ceiling if the committee fails. Although everything about the confrontation on the debt ceiling has been unsatisfactory and a fundamental plan to deal with the USA's chronic budget deficit is still lacking, at least the short term position seems to have been fixed and investors do not have the twin concerns of the USA and the eurozone, just the latter at the moment.

But just when we thought that coming face to face with the threat of a default would bring many at the top in the USA to their senses, the decision by Standard & Poor's to relieve the USA of its AAA rating and to replace it with an AA+ rating has led to an outburst of criticism of the rating agency. Shooting the messenger, however, is misplaced. What seems to have influenced Standard & Poor's is the dysfunctional US political system and who can quarrel after what we have seen in the run up to the last minute accord? Some have criticised the agency for being influenced by this factor, but the checks and balances written into the constitution do not make for decisive policy making. In the UK, for example, if the government can hold its support amongst its MPs, it can implement its policy. When tough decisions have to be made, the UK system works much better. Investors in US government debt certainly do not want to be placed in this situation again. It would be nice to think that the downgrading of US sovereign debt would concentrate some minds in the executive and legislature but it is difficult to be optimistic.

However, where countries like the USA, Japan and UK do have a big advantage is that they control their own currencies. They can be debased by the printing of money but they can do that and their currencies can float independently. So, whilst the USA is running a budget deficit of around 10% of GDP, a horrendous level, provided it can raise its debt ceiling, it can pay its debts even though the currency may well be debased. Put crudely, it can run the printing presses.

But shocking as that prospect may seem, it seems almost a luxury against the options facing the eurozone. We would say that the decision to form a currency union in Europe without proper economic underpinnings can already be shown to have been a disastrous mistake and it cannot be said that those responsible for the creation of the euro were not warned. There seem now to be two unpalatable options and, maybe, only one. The first one, if it were politically practicable, is to go for a full fiscal union which is the underpinning the monetary union is missing. This would mean that transfers could be made around the eurozone from stronger economies to weaker ones. We see this as a non starter at present. The political opposition to the thought of such moves is growing in the northern eurozone countries and Germany is a particular obstacle with strong opposition to any such moves manifesting itself in the governing coalition. Allied to this, in the sense that it would involve the stronger eurozone members supporting the weaker ones, is the idea of a eurozone eurobond. But the principle is similar and a further objection is that, by extending the support given by the eurozone's stronger members, it would weaken these countries' own creditworthiness. It looks a non starter. The problem is that the growth prospects of the eurozone countries in trouble are not strong enough to support the level of public debt which they have outstanding, nor the level of interest rates being imposed upon them by the market. Furthermore, the internal devaluation necessary in the southern eurozone countries to compensate for the loss of competitiveness against the northern eurozone countries since the creation of the euro, would be so painful, i.e. the cutting of wages beyond anything currently contemplated, that the electorates would be very unlikely to accept the measures.

One of the problems for the eurozone since the crisis started has been that there has been no consistent voice proclaiming a clear message. The politicians, central bankers and eurocrats have been all over the place, usually pushing their own agenda. There is a glaring lack of credibility about anything anybody connected with the eurozone says and, as in many other areas, an organisation run by committee does not always work very well. There are all sorts of sub plots and cliques. As this is written, an example of the dysfunctionality of the eurozone's approval to the second Greek bail out has come into the headlines. Finland, one of the eurozone's AAA rated sovereign credits, has a strong eurosceptic element in its parliament and its price for taking part is to take cash collateral (itself borrowed) from Greece in a bilateral deal in case of a Greek default. The obvious question this raises is why should one participant in the bail out have favoured status? It is obvious that other participants are not going to like this and, furthermore, if Greece did default, the politicians in eurozone countries which did not obtain terms as favourable as those of Finland would be felt to be culpable. This issue could yet derail the bail out.

From what one can see at the moment, the option of fiscal union and, therefore, a transfer union is an unrealistic prospect. The potential transferors, the rich and more creditworthy eurozone states, would be likely to face intense opposition at home (Germany, the Netherlands, Finland and Austria would probably fall into this category) whilst the transferees would resent their loss of economic sovereignty as economic policy was dictated by their creditors. We cannot see this happening and social unrest would surely threaten the political system.

As one would expect, the one statement which mainstream eurozone politicians consistently make is that their commitment to the euro is total. They have to say this, otherwise confidence in the currency and solvency of some of the eurozone's members and banks would be shattered. But, behind the scenes, one would hope that a "Plan B" is being developed, to deal with the partial or total break up of the currency area because, if the previous possibility, as outlined in the paragraph above, is a non starter, then a break up is the only other alternative. The problems would be enormous, not least for the countries which left the currency union with liabilities in euros and their, presumably, devalued new currency in place. But, without debt write offs in the current situation, some of the eurozone's members are unlikely to be able to pay off their debts. Crucially, the effect on the banking system will be very serious. The upside is that these countries' new cheaper currencies will enable competitiveness to be restored quickly, albeit with the inflationary problems which need to be addressed as the consequences of a devaluation feeding through into the economy. As the UK, for example, has demonstrated, retaining a country's own currency has been of enormous importance. It increases the disciplines on a government to follow a prudent economic policy. If the UK government had not, for example, laid out a credible deficit elimination plan, UK government bond yields would undoubtedly have ballooned and the currency fallen. Those consequences would have led to even more severe austerity measures than have had to be imposed and what is happening in the troubled eurozone economies would have been mirrored in the UK. With a country having its own currency, the printing presses can be run and quantitative easing has been a feature, at various times, in the USA, UK and Japan. Quantitative easing is a policy with great risks but it can give some short term help, as we can see in the aftermath of the 2008/9 financial crisis. The lesson which different types of investors have learnt with the euro arises from the fact that, for much of its life, investors took little notice of the creditworthiness of the eurozone sovereign issuers of euro denominated debt. A euro was a euro, whichever country was backing the debt. Crucially, that meant that countries like Greece were able to borrow at far lower interest rates than their creditworthiness would have allowed had they maintained their own currencies. All disciplines went out of the window and these countries were able to borrow on terms nearly reflecting those of the most creditworthy eurozone borrowers like Germany.

So, one would expect that we are approaching the end game as far as the eurozone's sovereign debt crisis is concerned. But is there a third way? Since the crisis started, eurozone policymakers have been consistently behind the pace of events, applying sticking plaster to problems as and when they arose. By muddling through, they have hoped to stay on top of the problem but, as we have tried to show, that will not do as the project will collapse under its own contradictions. As we see it, the likely short term policy will be to monetise the debt of troubled sovereign eurozone members. The ECB, in some ways the most orthodox of the central banks as shown by its decision to raise interest rates twice in recent months in the face of above target inflation, has had to do many things which are an anathema to it, such as buying in troubled eurozone members' sovereign bonds and providing liquidity for troubled banks against collateral of a quality which it would not normally take. It was opposed to private sector involvement in the second Greek bail out, a stance it backed down on at the last moment on the promise that this involvement would relate to Greek debt only. That guarantee seems to be an example of hope triumphing over experience as Greece is not the only eurozone member which is unlikely to be able to pay off its debts in full. But the elephant in the room is the eurozone's banking system where vast quantities of eurozone sovereign debt reside and that is what will be exercising the ECB most of all. What we think the ECB will do is to monetise some of these countries' debt by buying even more of their bonds. If it is not able to sterilise these purchases by issuing securities to soak up the money used to buy these bonds, it will indulge in its own form of quantitative easing. The ECB's already swollen balance sheet will balloon further but, by maintaining this policy, it may be able to prevent banks, as some have had to do in the case of Greece, from having to make further write offs. In its preliminary statistics for 31 March 2011, the Bank for International Settlements estimates that European banks' exposure on an ultimate risk basis was, Italy US$1,044 billion, Spain US$789 billion, Ireland US$520 billion, Portugal US$255 billion and Greece US$153 billion. At 26 August, the ECB had □115.595 billion of eurozone government bonds on its books bought under the Securities Market Programme, bolstered by the purchases of Italian and Spanish government bonds to drive down yields which, on ten year bonds, had risen above 6%. Providing the pretence can be maintained that none of the eurozone countries apart from Greece have defaulted, the eurozone's banks (and non eurozone banks) will not have to make provisions. The ECB's ultimate nightmare would be the collapse of the eurozone's banking system, so all stops are going to be pulled out to prevent this from happening. We suspect that the ECB will keep buying the troubled eurozone countries' bonds, as and when they deem it necessary to maintain confidence, for example by keeping Italian and Spanish government bond yields below 6%, which they have succeeded in doing so far. At the same time, by various means, the banks will be encouraged to raise their capital cushion to enable them to absorb more losses. Of course, if any of the countries whose bonds the ECB holds defaults, it will raise the prospect of the ECB's recapitalisation, meaning that eurozone governments will have to provide more money. This is the "try to muddle through approach", which is what the eurozone's political leaders instinctively prefer, but it only puts off the day of reckoning when one of the two paths outlined above will have to be followed. We suspect that it is the second one, the fragmentation or complete break up of the euro.

As we can see from the sharp volatility of stock market movements, none of this has been good for investors' nerves in the short term. Whilst neither of the two major issues, the US debt ceiling stand off and the continuing eurozone sovereign debt crisis, came as any surprise to investors and therefore might have been expected to have been discounted by markets, the troubling way in which both crises were handled showed they had the ability to shock. The volatility of the markets can be partly explained by the profile of some of the participants, such as high volume short term traders, hedge funds with the ability to go short and computer driven programme trades. Then there are forced sellers, perhaps those facing margin calls or where collateral has proved insufficient. All these, and other factors, cause a lot of "noise" in the market and, even for hardened professionals, the volatility has been unnerving. However, as always, it is important to stand back, not do anything hasty and assess the position. Short term traders can get on the wrong side of issues but that is the risk which they take. Long term investors can comfort themselves with the fact that dividends still get paid and that a valuation reflects a point in time. The danger of being intimidated by the markets and selling shares because the market has fallen sharply is that, if prices recover, as they usually do, the shares are likely to be repurchased at much higher prices when confidence has returned. The loss of profit may never be recovered and the performance will suffer permanent damage.

It goes without saying that the recent market volatility will have dented confidence amongst businesses and individuals and, although the market has not had a major fall, it will, nevertheless, have created a negative wealth effect and made businesses and individuals more cautious about spending. So economic growth rate forecasts will be trimmed and the question is whether this will tip the world economy into a double dip recession. It is obvious that the chances have increased for the reasons just described but these events do not make it a probability. Whilst we are all very aware of events happening on our own doorstep in the UK and eurozone and also in the USA, we need to remember that on a purchasing power parity basis (i.e. the exchange rates that would be realistic) developing and emerging markets would account for almost half of world GDP. These areas continue to grow strongly and the impetus they give to the world economy is likely to mean that it avoids a recession. There are other things which could help. If events in Libya unfold favourably and there is the prospect of an increase in supplies of its high quality oil, the oil price could ease back leading to more spending power for individuals and businesses. We are conditioned to looking at events in a pessimistic way. Sometimes things go the right way and a transfer of spending power from oil producers to consumers could help the world economy in the short term, if it happens. However experienced investment managers and investors are, it is difficult to avoid being caught up in the emotions of the market, so that when everything looks bad, as it has done recently, little consideration is given to what could go right and, of course, vice versa.

If we look at certain market signals, we can see that they are pricing in a very bleak future. In particular, interest rates are in the spotlight. At the very short end, they are largely administered by central banks but, as was the case recently, rates can spike if banks are not confident enough to lend to each other and park funds at the central bank. This lack of confidence can be a short term factor and more relevant, we would argue, are longer term interest rates as evidenced in government bond markets. The Japanese government bond market is a special case because yields are historically very low and do not correlate well with other markets but, if we look at ten year government bond yields in the UK, USA and Germany, we currently see (31 August) gross redemption yields of 2.63%, 2.22% and 2.25% respectively. If we, simplistically, compare these gross redemption yields with the latest consumer price inflation figures in the respective countries, we see that the starkest anomaly is in the UK where the latest CPI year on year increase is 4.4%. In the eurozone, the latest figure is 2.6% and in the USA, 3.6%. So, all real returns at current inflation levels are negative, very significantly, in the UK. What could this mean? One interpretation could be that investors think that current inflation levels are an aberration and will fall back sharply so that these current very low gross redemption yields could actually be positive in real terms if one believes that the normal expected level of inflation will be very low. That interpretation might be consistent with the depression/ severe recession outlook which some bearish commentators have. The second reason might be that investors are so concerned about the solvency of some countries that they have sold bonds of such issuers and bought those of the strongest credits, irrespective of their yields. The eurozone would be the best example of this with investors fleeing the bonds of Greece, Ireland, Portugal, Spain and Italy to go into German government bonds. A third reason could be that, with negligible interest rates available on short term deposits in many cases, investors are travelling up the yield curve in search of higher yields, albeit that they are negative in real terms. A fourth reason could be that investors believe that the economic outlook is so awful that they are prepared to lose money in real terms to avoid losing even more in other asset classes. Of course, there is a common thread running through these different arguments, which is that we are in very unusual economic times. How valid do we think these various reasons for such low normal and negative real yields are? As for the first possibility, we do not buy the inflation argument. We think there is likely to be significant inflation built into the system. Whilst commodity prices will always fluctuate, we believe the long term trend remains upward. Demand for commodities from Asia and China, in particular, is likely to remain strong. In the case of oil, OPEC has been quite successful in maintaining high price levels and it would be unwise to count on weak economic conditions causing a sharp fall in the oil price again as it did after the 2008 financial crisis. Rising environmental taxes will also be drivers of inflation. Periods of economic weakness do lead to more competition in the retail sector, for example, but we cannot expect this phenomenon to have more than a moderating influence on inflation and certainly not to such an extent that it turns the current negative real yields on bonds positive. Notwithstanding all the current problems, we think politicians and central bankers have enough tools at their disposal to avoid a depression which could be expected to affect price levels. A recession, perhaps one year of negative growth, would not have a significant effect on inflation in our view. The second possibility mentioned above certainly rings true. There has been a flight to perceived quality and these countries' bonds have benefited. Even though Standard & Poor's has downgraded the USA, this has not been reflected in the yields at which the US Treasuries sell. The third reason also looks plausible. Investors are creeping up the yield curve to obtain extra yield even if that is a riskier policy. The fourth reason does not seem so plausible to us, although some extreme pessimists may be following this course of action. If one looks at the relationship between bond yields and equities, which we think is valid although others do not, equities look far more attractive. If we take the UK, for example, Bloomberg estimates for the current year dividend yield on the FTSE 100 index is 4.08%, which compares with a gross redemption yield of 2.62% on a ten year UK government bond. If we look at Germany, the relative yields are 4.47% and 2.25%. In the USA, there is little difference, 2.33% on the S & P 500 Index against 2.22% on the ten year US Treasury bond. If we look at Japan, rather a special case, the yields on equities look unusually attractive against bonds, with Bloomberg estimates for the current year dividend yield on the Nikkei 225 at 2.16% against the gross redemption yield on the Japanese ten year government bond of 1.03%. Index linked issues also look expensive with investors on some inflation assumptions prepared to invest for negative real returns. Price/earnings ratios also look appealing. In most of the main European markets, including the UK, p/e ratios on current year forecasts are mostly in the 8 to 9 region, whilst for the S & P 500 it is estimated to be just under 12. Of course, if the world economy were on the verge of a depression and the outlook for company profits was correspondingly poor, then these figures would not be realistic and shares may not be good value, but we do not think that the world economy is on the verge of anything so bad. We take the view that, whilst the austerity measures in the eurozone will certainly dampen demand and growth in the USA will be fairly modest, developing and emerging markets will provide sufficient impetus for modest growth in the world economy overall. We mentioned earlier how important these economies are in relation to world GDP. This is a judgement call but, on fundamentals, it is difficult to see any value in these bonds and plenty of value in the equity markets.

Since the financial crisis of 2008 and the recession in 2009, companies have strengthened their balance sheets and many are in a strong cash position. We are seeing dividends rise and company earnings in most countries have been growing satisfactorily. Common sense tells one that recent events will have an effect on many companies' earnings in the second half of this year, but the state of companies' finances suggests that they will be able to withstand the slowdown without having to cut their dividends overall. One manifestation of strong balance sheets is a pick up in corporate activity as companies with cash take advantage of acquisition opportunities. We have seen this recently in the technology sector with Google bidding for Motorola Mobility and Hewlett Packard for Autonomy plc. It would not be surprising if cash rich companies used the opportunity of a fragile equity market to make opportunistic acquisitions.

If we look at various countries and areas of the world, starting with the USA, we have already noted that Standard & Poor's has downgraded its credit rating from AAA to AA+ although neither Moody's nor Fitch has followed. One would hope that this would be a wake up call to those on Capitol Hill. As we have noted already, the checks and balances built into the constitution do not make for quick decision making and, in the context of the personal and ideological animosities which exist, recent events connected with the debt ceiling have been a major "own goal" for the USA. So, whilst Standard & Poor's has been criticised for downgrading the USA in some quarters, one cannot fault its analysis of the decision making process. However, for reasons which we have mentioned, the USA can get away with this dangerous lack of action for a time, but not indefinitely, whereas other countries or currency zones cannot.

As with some other economies, the USA has entered a period of economic slowdown. The second estimate of second quarter GDP, just published, shows an annual rate of growth of just 1% compared with the first estimate of 1.3%. So, the growth in the quarter was just 0.2% to 0.3% over the previous quarter. The size of the budget deficit in the USA, at around 10% of GDP, precludes a fiscal boost even though some commentators would like to see this, so much of the burden could remain with the Federal Reserve and monetary policy. However, after two bouts of quantitative easing and zero interest rates, the scope for further monetary policy initiatives must be limited. In early August, the FOMC announced a freezing of short term interest rates for two years. To quote "the Committee currently anticipates that economic conditions, including low rates of resource utilisation and a subdued outlook for inflation over the medium run, are likely to warrant exceptionally low levels for the federal funds rate at least through mid 2013. .... It would continue to assess the economic outlook and was prepared to employ its policy tools as appropriate". However, an obstacle to further monetary loosening by whatever method, is inflation, notwithstanding the comments above. It is not a serious problem but a core rate of 1.8% in the year to July and 3.6% at the consumer price index level in tandem with a targeted federal funds rate of effectively zero is not a combination which would normally call out for further monetary loosening. At the end of August, Ben Bernanke made his much anticipated speech to central bankers at Jackson Hole, Wyoming. There was probably not a lot he could say in front of September's FOMC meeting but, such was the expectancy, that markets were bound to hang on his every word. We know that the meeting is being extended to a second day "to allow a fuller discussion". Mr Bernanke said that the Fed "is prepared to employ its tools as appropriate to promote a stronger recovery … the Federal Reserve has a range of tools that could be used to promote additional monetary stimulus". So, we will have to wait and see but the stimulus which can come from a big fall in interest rates cannot happen given where US interest rates are standing and repeated bouts of money printing become less effective if borrowers, both corporate and personal, are wary. One feels that, for this to happen, confidence has to return. Corporate balance sheets are healthy but companies are not minded to spend, whereas many individuals, as we can see from the state of the housing market, are overborrowed. The Thomson/Reuters University of Michigan index fell from 63.7 in July to 54.9 in August. Its consumer expectations index fell to a very low level, 45.7, compared to 56.0 in July. The money created by quantitative easing has to find its way into the system so a lack of confidence amongst borrowers blunts the effectiveness of such unorthodox monetary policy.

To put the agreement on the debt ceiling into context, the non partisan Congressional Budget Office has, on the basis of the agreement reached between Congress and the Administration, reduced its forecast of the federal deficits over the next ten years from US$6.737 billion, estimated earlier this year, to US$3,487 billion. This is predicated on the agreement to generate at least US$2,100 billion in government savings by 2021. Lower interest rates are also expected to help. But the estimates are based on there being no extension of the Bush era tax cuts. Were they not to come to an end, the US$3,487 billion figure mentioned above could reach US$8,500 billion. This would raise the level of public debt, as a percentage of GDP, to 82% by 2021 compared with 61% if the CBO's baseline projections come true. Beyond that, the demographics make the budget mathematics very unpleasant. The danger, as nearly everywhere, is that the politicians' time horizon rarely stretches beyond the next election, whereas long term planning is needed and measures taken early to prevent a crisis later on. Whatever one may think of recent behaviour of US politicians, one good result, however well hidden it might be, is that at least there is a discussion about the size of government. As an example of how detached from reality politicians can become, the opposition party in France is putting forward, as policy, a reversal of the present government's move to raise the minimum pension age to 62 and proposes to put it back to 60. That 62 is a very low age, given increased longevity, is beside the point. To reduce the retirement age to 60 defies all logic and prudent planning for the future. That this should happen, when the eurozone is in crisis, is even more extraordinary.

Although much of the economic news from the USA has been bad, and the housing market, in particular, shows little sign of recovery, there have been some more positive indicators. For example, US industrial output in July rose by 0.9%, up from 0.4% in June. Orders for US durable goods rose by 4% in July, the biggest rise for four months. June's fall was less than expected, at 1.3%, against the originally reported 2.1% fall. US consumer spending recovered in July. It rose by 0.8% over the month, this being the biggest rise for five months. As consumer spending accounts for about 70% of US GDP, this could be an encouraging sign.

However, whilst we believe that the economic situation in the USA is manageable now that the debt ceiling stand off has been ended, although with major problems facing the USA in the future, the position in the eurozone is the most serious, as we have indicated in our earlier discussions of the eurozone's sovereign debt crisis. The ECB has received criticism in some quarters for its decision to raise interest rates by 50 basis points, in two stages, recently. Admittedly, at 1.5%, they cannot be considered high but, at a time of ultra low interest rates in most other troubled countries, it seems to be perverse to raise them when the pressing need is to achieve some economic growth which, together with low interest rates for those countries in financial trouble, will make some positive contribution to their making some headway with their debt problems. Raising interest rates makes the job more difficult. Whilst one has sympathy with the ECB, in the sense that even the 1.5% level to which its raised interest rates would normally be considered to be far too low a level with inflation well above its 2% target at 2.5%, it has had to undertake policies, such as buying in troubled eurozone members' bonds, that it would never of dreamed of having to pursue. In the current circumstances, it might be the pragmatic solution to rescind the interest rate rises to take a little pressure off weaker eurozone members.

As with most other major industrialised countries and, in this case, monetary union areas, growth has slowed down. Eurostat estimates that second quarter growth was just 0.2% compared with 0.8% in the previous quarter. The previous powerhouse, Germany, showed growth of just 0.1% in the second quarter compared with 1.3% during the first quarter. Growth was flat in the second largest eurozone country, France, whilst growth in the third and fourth largest eurozone economies, Italy and Spain, was 0.3% and 0.2% respectively. The Greek economy shrank at an annualised pace of 6.9% in the second quarter and revised forecasts indicate negative growth of nearly 5% this year. Ironically, one of the best performing eurozone economies in the second quarter was Belgium, which showed quarterly growth of 0.7% and this in a country which had been without a government for fifteen months.

In order to try to improve their public debt profile in the face of the eurozone sovereign debt crisis, a number of countries have been forced to take extra austerity measures. Besides Greece, Ireland and Portugal, the subject of the bailouts, Spain and Italy, in response to the sharp rise in their sovereign bonds' yields, have been forced to take additional austerity measures to back up their countries' credibility and so, too, has France, where a slowdown in growth, referred to above, has upset borrowing forecasts and forced more austerity measures upon the country. Critics of these countries' further austerity measures say that, by reducing the countries' level of economic activity, they will worsen the state of public finances. However, it is a circular argument because if no action is taken, the bond markets will take fright and push up yields to levels which will shut out these countries from the international bond markets and make defaults more likely. Then measures imposed from outside, such as we have seen in Greece, Ireland and Portugal, will be even more severe. The truth is that markets will expect governments to be taking action to improve their borrowing and public debt profiles. The optimists will hope that these countries can be helped by growth elsewhere in the world economy. Because all of these countries are trapped in a monetary union, the problems seem intractable but, as we have said before, this should not affect investors' views about high quality eurozone companies. Their fortunes do not have to mirror those of the country in which they are based or the eurozone in general. They can do well by having business in faster growing areas of the world.

Moving on now to Japan, the economy is striving to recover from the aftermath of the earthquake, tsunamis and nuclear reactor disaster last March. Anecdotal evidence from companies suggests that recovery is proceeding more quickly than might have been expected and, for industry, supply chains are being quickly restored. Although the economy contracted by 0.3% in the second quarter, if this figure is eventually confirmed, it is a better outcome than forecasters had predicted. Japan has had to contend with another problem, a strong currency. Concerns about the euro and the US dollar manifested themselves, amongst other ways, in demand for the yen, causing the Bank of Japan to intervene in the currency markets again to try to suppress the value of the yen. As Japan gets through yet another Prime Minister, Moody's has downgraded the country's credit rating to Aa3, citing the build up of debts. Political weakness makes the task of attacking the debt problem very difficult. Its very high level of outstanding public debt in relation to GDP, over 200% at the gross level, means that, some day, it, too, will be vulnerable to a loss of confidence in the credit markets. For the moment, because nearly all of the debt is held domestically, it is not as vulnerable as eurozone countries are. But, as with the USA, the day is approaching when serious attempts to get on top of the borrowing position have to be made. As with eurozone countries, Japan has many world class companies which are in a good position to benefit from the high Asian growth rates and Japanese shares look good value on a yield basis against bonds.

China's relative position is, of course, good. It is the world's largest holder of foreign exchange reserves and it is continuing to grow at rates the west can only dream of, except that the west does not have the productive potential to match China's growth rate so, if it did get anywhere near, inflationary pressures would soon show. In fact, inflation is China's biggest problem at the moment. In July, Chinese consumer price inflation stood at 6.5%, slightly higher than June's 6.4% levels, with the biggest worry for the Chinese authorities being food prices, which were 14.8% higher than a year earlier, with the price of pork having risen almost 60%. There are now signs of some easing of food prices. Elsewhere, various indicators for fixed asset investment, industrial production and retail sales show signs of a slight slowdown. However, the rest of the world has a vested interest in China continuing to grow strongly. The latest trade data shows that, whilst exports were 20.4% higher in July than a year earlier, imports were up 22.9%. So, it is a delicate balancing act for the Chinese authorities. They want to keep down inflation because, as we have seen elsewhere, it has the power to cause social unrest, the last thing the Chinese authorities want, yet the economy must still continue to grow rapidly to provide job opportunities for those coming in from rural areas. Right at the end of August, the authorities tightened monetary policy further, so they obviously still have some concerns about the economic indicators. The persistence of high inflation might persuade the authorities, providing they are not leant on from outside, to allow the renminbi to appreciate faster in order to put downward pressure on the rise in inflation.

As in the USA, eurozone and Japan, the economic news from the UK has been consistent with an economic slowdown, leading to pressure on the Chancellor to relax his policy on tackling the deficit. Second quarter growth was estimated at 0.2% to take year on year growth to 0.7%. As we have said earlier, we regard this suggestion of slowing down the deficit reduction programme as totally unrealistic, given the market's reaction to the sovereign debt issues of eurozone countries in trouble. It is much better for a country to be in charge of its own economic policy, however austere the measures have to be, than to be dictated to from outside, as in the cases of Greece, Ireland and Portugal. So, as was always going to be the case, political pressures on the Chancellor will be strong. He can point to the very low interest rates at which the UK can borrow as vindication of his stance and it is important to note how beneficial this situation is. The UK also has a much longer average debt maturity compared with most so, from an investment perspective, this raises the importance of sticking to the plan over the life of this parliament. The market would not be likely to react well to any backsliding on deficit elimination.

The worsening international economic background has led to forecasts for the UK economy to become less optimistic. The Chairman of the Office for Budget Responsibility has acknowledged that the target of 1.7% growth for the UK economy this year is optimistic. For that target to be met there would need to be growth of 1% in each of the two remaining quarters this year. The Bank of England has downgraded its growth forecast for this year to 1.4% compared with its previous forecast of 1.8% and has a concern about inflation because of doubts about the amount of spare capacity in the economy. If there was a lot of spare capacity, the economy would be able to grow without concerns about inflationary pressures arising. The Bank of England has doubts. In its report on the UK, the IMF casts doubt on the capacity of the UK to grow as quickly as the government hopes. The IMF reckons that structural unemployment is higher than the OBR believes. The IMF estimated long term unemployment at 6.8%, nearly 300,000 more than the official estimate of 1.9 million, 5.25% of the labour force. For this reason, although the IMF does not advocate any change in plan and does not endorse any immediate tax cuts, it thinks that it is going to be a close call as to whether the Chancellor meets his target. The IMF estimates that the structural budget will only just fall into surplus in 2015/16 by 0.1% of national income.

With markets fluctuating significantly from day to day, investors understandably are nervous because the economic problems are severe and nobody appears to be on top of the eurozone's sovereign debt problem. However, the problem is largely a regional or country one because elsewhere in the world economic growth is satisfactory to good and, as we said earlier, these countries constitute a very important part of world GDP. In these circumstances many companies, particularly those with an international bias, should hold their own and, in our view, equity valuations are reasonable whereas bond yields look unattractive for the reasons outlined in our review. Dividend yields are often appealing. It is bound to be an uneven ride in the equity markets but, for long term investors, equities remain attractive.