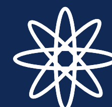

meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been a positive quarter for international equity markets with the USA being the stand out performer and, because it is the largest stock market, it has meant a strong performance from the FTSE All World Index. Equities have outperformed fixed interest securities over the quarter. In the foreign exchange market, sterling has been generally weak and, in commodities, gold continues to disappoint.

The tables below detail relevant movements in markets :

International Equities 31.05.18 - 31.08.18

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.3	+4.0	+1.6	+1.9
Finland	+2.8	+4.9	+2.5	+2.8
France	+1.3	+3.4	+1.0	+1.3
Germany	-0.9	+1.1	-1.2	-0.9
Hong Kong, China	-6.5	-4.3	-6.5	-6.2
Italy	-6.4	-4.5	-6.7	-6.4
Japan	-0.1	+0.3	-2.1	-1.8
Netherlands	+3.1	+5.2	+2.8	+3.1
Spain	+0.5	+2.6	+0.2	+0.5
Switzerland	+6.3	+10.6	+8.1	+8.4
UK	-2.1	-2.1	-4.3	-4.0
USA	+7.6	+10.2	+7.6	+8.0
All World Europe ex UK	+1.7	+3.8	+1.4	+1.7
All World Asia Pacific ex Japan	-1.3	-1.2	-3.5	-3.2
All World Asia Pacific	-0.8	-0.6	-3.0	-2.6
All World Latin America	+2.5	-0.4	-2.7	-2.4
All World All Emerging Markets	-0.6	-1.6	-3.9	-3.6
All World	+4.1	+5.7	+3.2	+3.6

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -0.8%

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

Currency	31.05.18	31.08.18
Sterling	1.28	1.31
US Dollar	2.86	2.86
Yen	0.01	0.08
Germany (Euro)	0.28	0.23

Sterling's performance during the quarter ending 31.08.18 (%)

Currency	Quarter Ending 31.08.18
US Dollar	-2.5
Canadian Dollar	-1.7
Yen	-0.4
Euro	-1.9
Swiss Franc	-3.9
Australian Dollar	+2.6

Other currency movements during the quarter ending 31.08.18 (%)

Currency	Quarter Ending 31.08.18
US Dollar / Canadian Dollar	+0.8
US Dollar / Yen	+2.2
US Dollar / Euro	+0.7
Swiss Franc / Euro	+2.2
Euro / Yen	+1.5

Significant Commodities (US dollar terms) 31.05.18 - 31.08.18 (%)

Currency	Quarter Ending 31.08.18
Oil	-0.3
Gold	-7.9

MARKETS

International equity markets have shown positive returns over the quarter. In local currency terms, the total return on the FTSE All World Index was +4.1%, in sterling terms +5.7%, in US dollar terms +3.2% and in euro terms +3.6%. Looking at local currency returns firstly, the stand out performers were the FTSE USA Index which returned +7.6% and the FTSE Australia Index which returned +6.3%. On the other hand, there were underperformances from the FTSE UK Index (-2.1%), the FTSE Japan Index (-0.1%), the FTSE All World Asia Pacific ex Japan Index (-1.3%) and the FTSE All World All Emerging Markets Index (-0.6%). Although in positive territory, the FTSE All World Europe ex UK Index (+1.7%) underperformed the FTSE All World Index. Looking at sterling adjusted returns, the stronger US dollar meant a very acceptable +10.2% return on the FTSE USA Index and it is also worth noting an excellent +10.6% sterling adjusted performance from the FTSE Switzerland Index.

International government bonds, as represented by ten year benchmark yields, changed little over the quarter. The gross redemption yield on the ten year UK government bond rose by 3 basis points to 1.31%, the US Treasury bond yield was unchanged at 2.86%, the Japanese Government Bond yield rose by 7 basis points to 0.08%, whilst the yield on the German Bund fell by 5 basis points to 0.23%.

In the foreign exchange markets, except against a weak Australian dollar, the pound fell. Against the Swiss Franc it fell by 3.9%, against the US dollar by 2.5%, against the euro by 1.9%, against the Canadian dollar by 1.7% and against the yen by 0.4%.

In the commodity markets, oil as measured by Brent crude was little changed, down just 0.3%, but gold performed poorly, falling by 7.9%.

ECONOMICS

With so much background political and economic "noise", investors may well be asking themselves why stock markets in most cases have shown positive returns in the latest quarter. The much voiced saying of "sell in May and go away" would have been quite costly and it is certainly not a sensible peg upon which to hang an investment policy. So where should one start in trying to rationalise one's investment policy which, in our case, remains to be invested in equities but with strong warnings that the upward move in share prices is likely to be much more bumpy than has been experienced in recent years? Investing with a long term perspective in mind is more important than ever given the high level of returns in recent years. Whilst investors feel losses much more sharply than loss of profits occasioned by being in cash when markets are moving higher, and this is understandable, it is not rational. Investors have done best over the long term by holding on to their equity market positions and not trying to time the market. As they say "time in the market" is better than "timing the market". The point of saying this is that, in our view, there has to be a strong case for disinvesting in equities given the possible opportunity cost consequences. In times past, fixed interest securities would have been a credible alternative investment home for money taken out of equities. As our clients will know from past reviews, we regard the fixed interest market as dangerously overpriced. Whereas, with equities, if they fall back, they are likely to recover and move ahead again, in our view, with bond yields at current levels, a rise to more normal levels of interest rates will, at all but the short end of the market, result in painful price falls, only likely to be recovered as redemption dates approach, or if monetary policy becomes very loose again in the future and interest rates return to current levels. One would not expect the degree of looseness we have experienced in monetary policy in recent years to be repeated again without an enormous amount of risk being taken.

The point of reiterating our stance on our current investment policy is in the context of deciding whether current political and economic events are serious enough to suggest a reduction or, in extreme cases, an exit from our equity positions, or whether we can assume that any setback in share prices will be recovered before too long and maintain current equity exposure. We can, therefore, against the background of these two courses of action, discuss some of the issues which investors are certainly thinking about at the moment.

One of those is the threat posed by President Trump's trade policies. Most mainstream economists would not agree with the President's protectionist sentiments. Whilst some people lose as a result of free trade policies, most people have gained enormously as prices have been kept down relative to what they would be in a protectionist environment, with goods and services being produced or offered in those countries best suited for the provision of these. A free trade world stimulates economic growth and wealth. Protectionism, whilst superficially attractive to some, and President Trump certainly played this card successfully in certain US states before the Presidential election, leaves far more losers than gainers. Consider steel tariffs which the USA has introduced. They may keep some US capacity open and secure some jobs and therefore benefit some US states, but the rising cost of steel will find its way into the price of many goods, thus hitting consumers' pockets, reducing their purchasing power and cutting their living standards and cause some increase in unemployment as companies lay off employees in response to weakening demand. The theory of comparative advantage is, therefore, negated as distortions build up in markets and goods are not produced in the countries where it is most effective to do so. It is easy to be critical of President Trump for obvious reasons but investment managers do not make money for their clients by allowing prejudice to dictate investment policy. The disparity in performance so far this year between the US and other markets is substantial and there must be a reason for this. One is that the US economy is performing well in terms of growth and unemployment and this may partly be a function of tax cuts and deregulation, two moves in other parts of the world which investors would like to see but are not fashionable. We will talk about these when we come to discuss the US economy in more detail later but, when one is critical of the President's trade policies, we should keep these positive actions in mind and note the outperformance of the US stock market. It is also important to note that the USA has a case on trade. One of the President's big bugbears is the loss of intellectual property to China which can occur when China takes over a US company and another is the excess capacity of Chinese industry which has led to goods being sold on world markets at subsidised prices. For free trade to fulfil its potential, there has to be a level playing field so that goods are not dumped on world markets at below cost or are subsidised. But, notwithstanding these valid criticisms made by President Trump, his economic thinking is incorrect. It is true that the USA runs a current account deficit, but that does not have to be a bad thing if it can easily be financed. His thinking is also wrong if, as it appears, he takes umbrage at any country with which the USA runs a bilateral trade deficit. That country may produce items which the USA needs in greater quantities than the USA produces goods which that other country needs, yet against another country it may be the other way round. The President also seems to believe that, because China has an enormous trade deficit with the USA, (US$375 billion in 2017) in the tit for tat on tariffs, China can only lose because it will run out of goods imported from the USA on which to place additional tariffs. But this ignores two factors. Firstly, there is a complex supply chain throughout the world. Interfere with a small part of that and it can have unintentional consequences. The well known saying about a butterfly flapping its wings and the unforeseen consequences of that (chaos theory) comes to mind. The second point is that China can also make life very difficult for US companies operating in China. What we feel we can say at the moment is that the trade conflict is contained at tolerable levels at present, but the warning signs are there if it escalates. So far, apart from the steel and aluminum tariffs, the USA has imposed tariffs on US$50 billion of Chinese imports with China responding in kind. With important mid term elections coming up in November, it may be that the President is emphasising his "America First" approach and that he does what he says he will do despite all the warnings he is being given, including from the Republican party which has traditionally been in favour of free trade. So, the conclusion is that, at present, the trade spat is containable but, if it gets significantly worse, it would be a negative influence on economic growth and therefore the stock market.

Another potentially important factor for the stock market is Turkey. At this point, it is important to say that emerging markets are not a homogenous group of countries, with some of them being in a much stronger position than others. A lot of Turkey's problems are self inflicted, with economic policy becoming increasingly politicised, for example interest rates being subject to political pressure. Turkey runs a very large current account deficit, expected to be around 6% of GDP in 2018, which has to be financed and, for that to happen, there has to be confidence in the country's economic policy, which there is not at present. It is easy for contagion to spread amongst emerging markets, whether justified or not. The natural reaction is for many to flee to the US dollar in these circumstances as it is perceived as a safe haven, but the result of this is a tightening of liquidity in emerging markets and pressure on interest rates which could lead to problems in the banking sector. We have already seen pressure on the share prices of European banks exposed to Turkey. Interestingly enough, whilst the movement of funds to the US dollar is to be expected, the US stock market is scaling new highs as this is written. One might have expected US equities to pause because a stronger US dollar makes life more difficult for US exporters and has a negative translation effect when overseas profits are converted back to US dollars. However, there are positive factors benefiting US equities, as we will discuss later.

In the eurozone, Italy is a concern as investors await developments on the financial and economic front from the new coalition government which threatens to break the EU's budget deficit rules. Even before the Genoa bridge tragedy, the government planned to increase the budget deficit through its various pledges on tax cuts and universal income and now it is able to emphasise, as a result of this tragedy, the need for increased public spending on infrastructure. There is a strongly eurosceptic theme running through the new government, combining parties at each end of the Italian political spectrum. A crunch point is likely to occur fairly soon if the ECB confirms its policy of ending its bond buying programme from the end of the year. Although it cannot directly finance Italy's budget deficit, its purchases in the secondary market indirectly give support. Once the bond buying stops, Italy will have to market its bonds to potential buyers on its own virtues. That will be a challenge if it breaks the ECB's rules and we can already see how Italy's bond yields are becoming elevated. The ten year Italian government bond yield is currently 2.917% (lower than at the end of August), whilst that of the eurozone's best credit, Germany, stands at 0.355% (higher than at the end of August). With Italian public debt standing at over 130% of GDP, the warning signs are there. Whilst we have always had serious doubts about the sustainability of the eurozone given that it is not an optimal currency area, the Italian situation raises a potentially serious challenge to it. Italy is the third largest eurozone economy and any stand off between Italy and the EU would not be good news for the euro. The imbalances within the eurozone represented by what are called Target 2 balances, effectively the Bank of Italy's liabilities to other eurozone central banks, particularly Germany, would cause an immense problem if Italy left the euro. Whilst it remains part of the eurozone, the issue is academic but it would not be if Italy fell out of the euro. So political developments in Italy need watching carefully and form part of the political "noise" in the background.

China remains a concern for many investors although there is a sharp division of views. The current problems of some countries within the emerging market sector, which are highlighted by Turkey's problems, take away, to some extent, attention from other countries with major difficulties. In Latin America, Venezuela is effectively a failed state but there are continuing problems in Argentina and Brazil, whilst the South African currency has been unsettled by political developments there and has slipped into recession. With the latter having large current account and budget deficits, any change in sentiment on the negative side gets transmitted to the exchange rate. China is in a much stronger position with large foreign exchange reserves (US$3.118 trillion), which are nevertheless not as high as they were, but investors note that the currency has been weakening, probably in response to the trade spat between the USA and China. With a high level of indebtedness in the economy, the background is more uncertain than it was and this is reflected in the poor performance of the Chinese stock market so far this year. Whilst China has eased monetary policy in response to some weakness in the economy,

the authorities have been clamping down on the shadow banking sector which has grown substantially in recent years. Whilst that is a good thing from a banking point of view to try to control excesses, it acts as a brake on growth, again not necessarily a bad thing, but it can still be a negative influence on sentiment given how much store international investors place on the Chinese growth rate.

For sterling based investors, there is the issue of Brexit and the uncertain political situation in the UK. International investors consider the UK to be one of their least favourite markets and UK based investors are increasing their overseas holdings. Of course, Brexit and the UK's political uncertainties are closely linked but, if one can separate them, we consider the latter to be a much more significant issue. Whilst both main political parties are deeply split for different reasons, there remains the possibility of a change of government by 2022, the next scheduled date for a General Election. In normal circumstances, if it is a choice between a centre right or centre left government, it may not make too much difference to the performance of the UK stock market, but this is not the case now when the main opposition party is putting forward economic policies more extreme than seen in the past. For this reason, sterling and the UK stock market are vulnerable which is why we have a significant overseas weighting in our clients' portfolios. We consider the politics a greater risk than Brexit. Although it is generating a lot of heat and bitter arguments, businesses are remarkably adaptable and, as both sides have a lot to lose (the EU quite a lot more because of its large trade surplus with the UK, £67 billion in 2017), there is likely to be more pragmatism shown when the final outcome becomes clear. That is not a given, however, as the EU's treatment of Greece makes clear with the "project" being paramount, notwithstanding collateral damage which may be caused. But whatever the outcome, sterling based investors can give themselves significant protection by holding a substantial amount of unhedged overseas assets as an insurance policy and that goes even more for the political risk outlined above. Of the risks outlined so far in this review, because investors can take some precautionary action, we rate the UK's issues less significant than the implications of an all out trade war or the fallout from Italy challenging the EU over its rules and following its own course of action which could threaten the euro.

Although we have become used to unexpected developments, so far, at least, none of these issues discussed, of themselves, seem enough to upset markets' equilibrium. That is not to say that they will not, but we have to deal with where we are today with the world economy performing quite well, led by the USA.

As we can see from the performance figures, the US market has been a significant outperformer on the back of strong economic growth, helped by tax cuts and deregulation. These have led to massive share buy backs and they have been an important support for the market. By the end of July, buy back authorisations had reached US$754 billion it is estimated. The latest quarter on quarter growth rate annualised came in at 4.2% and the year on year figure is 2.9%. The unemployment rate is 3.9% and the labor force participation rate, which has been relatively low in the USA, has crept up slightly this year and stands at 62.9, slightly below its peak rate for the year of 63.0 but above its starting level at 62.7 in January. All this could be consistent with a growth rate of about 2.8%, the Federal Reserve's latest forecast for the year, a significant increase on the 2.3% rate recorded for 2018. As might be expected, given the strength of the US economy, inflation has been creeping up, although not alarmingly. The core personal consumption expenditure index, closely watched by the Federal Reserve, stands at 1.9% year on year, near its target range, up from 1.5% in January, whilst the consumer price index stands at 2.9% year on year, compared with a 2.1% figure for January. The closely watched purchasing managers indices remain strong, although off their peak, probably affected by fears of a trade war. The latest manufacturing PMI stands at 61.3 (August) and that for non manufacturing stands at 55.7 (July), well down from its level in January when it stood at 59.9. Taken together, however, they portray an economy in reasonably good health. Retail sales have been strong with the latest figures showing year on year growth of 6.3%. Capacity utilisation has been increasingly steady with the latest reading at just over 78 against just under 77 in January. Industrial production is up 4.2% year on year and durable goods orders stand nearly 8% higher than a year earlier. Most economic indicators in the USA therefore point in a positive direction.

Whilst it is good that the US economy is performing well, we have to consider whether monetary policy is lagging the trajectory of the economy. It is good to see an administration cutting rather than raising taxes but that is usually best done when an economy is weak and needs stimulating. President Trump can argue that there is only a certain window of opportunity to make tax cuts of the type he wanted, given the Democrats' opposition, and that he had to do it when the Republicans held both houses of Congress. With the economy already showing decent growth and little spare capacity in the economy, significant tax cuts risk igniting inflation. Introducing pro cyclical tax cuts in an already good performing economy carries risks. These risks are twofold. The first, as we have just said, is inflation and the second is that the budget deficit will expand rapidly. The supply side argument put forward by President Trump is that the tax cuts will pay for themselves by stimulating the economy and bringing in additional tax revenues, as suggested by the economist, Arthur Laffer, who gave rise to the Laffer curve. But, if fiscal policy is stimulative given where we are with the US economy, monetary policy needs to be moving in the opposite direction, which is where the Federal Reserve is taking it, much to President Trump's annoyance. The Federal Reserve, given its independence, can take its own view, which we see articulated in the steady rise in interest rates being experienced with more to come, perhaps two this year and four next year, to get to what it believes is a neutral position, not too high to stall the economy, but not too low to stimulate inflation. It would be very risky for the US economy and, hence, investors if the Federal Reserve did not tighten monetary policy which is still loose by conventional standards with the federal funds target rate of 1.75% - 2.00% below inflation. So, investors can take comfort from the independence of the Federal Reserve. Hardly anyone thinks that ultra low interest rates and a highly stimulative fiscal policy would have a happy outcome from the US economy.

By reducing corporate taxes, it is estimated that year on year corporate earnings are benefiting by at least 7 percentage points but, even so, year on year increases of over 20% each quarter, nearly 25% in Q2, until the twelve months effect drops out of the comparison, are a pretty powerful tonic for the US stock market. With some of the tax savings being put towards increased returns to shareholders through share repurchases and higher dividends, the results are there to see in the relative outperformance of Wall Street. However, what one wants to see in addition is increased business investment to provide the capacity for future growth and part of the judgement on the success of the tax cuts will be measured by the level of business investment.

In the USA, the important mid term elections take place in November and this may put a brake on activity in the last two years of President Trump's current four year term in the White House. With the Republicans controlling the two houses of Congress and a Republican as President, it should have been a perfect combination to enact measures favoured by the Republicans, but it did not turn out that way, with losing the fight over Obamacare repeal in the first year and the hard won battle over tax cuts in the second year. There is the prospect of the Republicans losing control of at least one house in November. With all the problems dogging the President at present, there is talk of impeachment but, given that this would require two thirds of the Senate to support such action, success would seem unlikely.

The question, as elsewhere in the world where monetary tightening is occurring, is whether US equities can maintain their strength in the face of rising interest rates and a reduction in the size of the Federal Reserve's balance sheet. The USA is the country furthest advanced in reversing its earlier ultra loose monetary policy and the only one actively reducing the size of its balance sheet, currently about US$4.2 trillion, as it progressively reduces the amount of maturing asset proceeds which it reinvests. Together with a widening of the budget deficit which can be expected, at least initially, as a result of the tax cuts, the supply of bonds from the US Treasury can be expected to increase substantially. One would normally expect this to result in rising bond yields. In this context, all eyes have been on the ten year US Treasury bond to see if the gross redemption yield, which broke through the 3% barrier at one stage, would stay above that. In fact, it has fallen back quite sharply to well below 3% at the

time of writing. A flight to the US dollar from emerging market currencies as a result of the Turkish crisis could be one reason. As far as short term interest rates are concerned, it is likely that we will see five or six quarter point rises in the US federal funds rate by the end of 2019 which will take the level to around the probable inflation rate. What investors do not like is unpleasant surprises and this makes it very important that the Federal Reserve and other central banks signal their intentions very clearly. Undoubtedly, as was meant to be the case, cheap money has fuelled asset prices and it is right to reverse this position as soon as possible to restore some sense of normality to central banks' balance sheets and to leave some monetary policy ammunition for the next recession. Getting the balance right without frightening investors is the aim and it should be possible in the USA with good market signalling.

Turning to the eurozone and the EU in general, the main issue is Italy, which we have discussed in some detail earlier on. This is potentially a much more important issue than Brexit which, with a modicum of goodwill, should be capable of an amicable solution without a significant impact for either the UK or EU. At the moment, we seem a long way away from that outcome, but the point we are making is that, in an ideal world, it need not be like this. The Italian situation is of a different order because, if the populist alliance carries out its proposed economic policies on tax and public expenditure, it sets up a clash with the EU, which potentially threatens the existence of the euro, and we discussed the financial consequences of that earlier in the context of Target 2 balances. One of the major problems of the "one size fits all" characteristic of the eurozone is the loss of flexibility on the exchange rate. A flexible exchange rate is a shock absorber which helps an economy to reflect its economic fundamentals. Take that flexibility away and economic distortions build up. Germany is a prime example of the problems of the single currency. For Germany, the euro is super competitive. Were the Deutschmark still in existence, it would be experiencing a much higher exchange rate relative to most other eurozone members and its huge current account surplus at around 7.8% of GDP would most probably be nearer balance. The flipside of that is that the euro is at an uncompetitive rate for other countries, particularly in the south of the eurozone. So, Italy, which has become less competitive since the start of the eurozone has not seen the currency adjustment which would normally occur when a country loses competitiveness. Paradoxically, Italy runs quite a large current account surplus at present, around 2.6% of GDP, but this would partly be a function of low economic growth. With unemployment at 10.9%, discontent has manifested itself in the election result and the resulting threat to the EU's budget deficit rules. The idea of a parallel currency to the euro, the mini BOT, has been floated which, if put into practice, would threaten the euro. So, investors' eyes will be clearly focused on Italy.

There has been some evidence of a slowing down in the pace of economic growth in the eurozone. The annualised rate of economic growth in the second quarter for the eurozone was 1.5%. Within that, Germany's growth rate, on the same basis, was 1.8%, that of France was 0.6%, for Italy the figure was 0.7% and, for Spain, the fourth largest eurozone economy, it was 2.8%. The closely watched purchasing managers' indices, although significantly lower than at the beginning of 2018, have remained quite stable in recent months. The latest eurozone composite PMI stands at 54.4 whereas, in January, it was 58.8. The current reading signifies moderate growth for the eurozone. Within that overall reading, there was little difference in the services index reading which was 54.4 and the manufacturing index which was 54.6. The laggard was the construction sector, where the latest reading was 50.3. The German composite index stood at 55.7, that for France at 55.1, that for Italy at 51.7 and the one for Spain at 53.0. There has been a weakening of consumer confidence, however, which has been noticeable for the last three months with the August reading starting at -1.9. The eurozone's unemployment rate, although it has been coming down over the year, remains much higher than in the USA, UK and Japan, with the rate currently standing at 8.3%. Retail sales have been showing only modest growth with the latest figures showing just a 1.2% increase, year on year. Besides Italy, the development of trade discussions between the USA and EU will be important. Parts of the EU have a lot to lose if an outright trade war develops and investors will be watching developments closely.

For the eurozone stock markets, the development of the ECB's monetary policy will be an important influence. The ECB is well behind the USA and UK in reversing its monetary policy stance with no movement on interest rates with the official interest rate standing at zero. Where there has been some movement has been in tapering its bond purchasing programme from €60 billion a month to €30 billion a month and now to €15 billion from the beginning of October, on present plans, stopping them altogether at the end of the year but, so far, with no plans to shrink its balance sheet after that as the Federal Reserve is doing in the USA. The size of the ECB's monetary stimulus and the fact that it is still felt necessary ten years after the financial crisis to have such loose policy has to be a concern. Whilst the eurozone is likely to show growth of around 2.0% this year, that is not a huge figure when set against the size of the stimulus applied and the concern is that there will be no monetary ammunition left when the next recession comes along. It is very unlikely that Germany would go along with another large bond buying programme and, assuming that official ECB interest rates have not moved significantly above the current level, cutting interest rates significantly into negative territory would be dangerous, not least for eurozone banks. The "one size fits all" interest rate policy is an unsatisfactory feature of the single currency. The ECB has to try to set a rate which is the best compromise for the whole area, but current rates are not appropriate for a number of the countries, with Germany being a particular example. As mentioned earlier, all eyes focus on Italy. If anything goes wrong there, it will be very serious for the eurozone. Keen attention should be paid to Italian government bond yields. As the potential threat from the Italian political situation grows, so the yield on, say, the ten year Italian government bond has risen and the gap against the equivalent German government bond widened. It could be the canary in the mine. As always, one should distinguish between the problems in the eurozone and the companies in which one can invest and, although the European markets have been relatively out of favour, it does not appear an expensive area. It is interesting to note that Switzerland, an important investment area for us, has reversed underperformance, with Switzerland perhaps being seen as a safe haven outside the eurozone in these uncertain times.

Moving on to Japan, there is obviously a concern about the effect on the country of a full scale trade war but, apart from that, the main interest has been around the Bank of Japan's monetary policy and whether there was some subtle change taking place around the target of keeping ten year Japanese Government Bond yields at around zero (the current yield is 0.1%). At the end of July, the Bank of Japan announced a slight change to its monetary policy. In the short term, the negative interest rate of -0.1% will be maintained. For the long term interest rate, the Bank of Japan will purchase Japanese government bonds so that ten year JGB yields will remain at around zero per cent. The tweak is that the Bank of Japan says that, whilst buying these bonds, yields may move upwards and downwards to some extent depending upon developments in economic activity and prices. The Bank of Japan said that it will conduct purchases in a flexible manner so that their amount outstanding will increase at an annual pace of about JPY80 trillion (US$718 billion). In other guidelines, the Bank of Japan said that it will purchase exchange traded funds and Japan real estate investment trusts so that their amounts outstanding will increase at annual paces of about JPY6 trillion (US$54 billion) and JPY90 billion (US$808 million) respectively. The Bank of Japan may increase or decrease the amount of purchases depending on market conditions. The Bank of Japan said that the Japanese economy was expanding moderately and that labor market conditions continued to tighten steadily. The unemployment rate is standing at 2.4%. Despite this quite optimistic economic projection, there is one disappointment for the central bank in that inflation has not responded as expected to these generally better economic conditions. Whilst many economists in the past would have welcomed current benign inflation conditions, in Japan they act as a discouragement to consumer expenditure. If consumers are expecting prices to rise, they are likely to spend more and stimulate economic growth. Although it is the world's third largest economy, Japan does not usually attract the headlines. The stock market in relative terms has been one of the better performers so far this year but only in relative terms and this perhaps sums up its economic position well, not one of the best performing economies but not having the problems and risks of some others.

We have discussed two of the issues surrounding China earlier and they are clearly potentially big ones. Second quarter growth was strong with the annualised quarter on quarter rate of 7.4% and year on year growth at 6.7%. One must expect this rate to slow down because of the uncertainty about tariffs and the clamp down on the shadow banking sector. The latest purchasing managers indices show very little change this year, implying some modest growth by Chinese standards (much higher, obviously, than in developed countries). The latest manufacturing PMI stands at 51.2 and that for non manufacturing at 54.0. As we noted earlier, China has had a poor performance this year relative to many stock markets and the pressures are increasing on it. A full scale trade war with the USA would provide China with a major challenge. One of the warning signs is a weakening currency which may antagonise President Trump even more. The potential for China remains huge but investors need to be mindful of the short term issues which face China.

We have discussed the issues facing investors in the UK and by far the greatest, in our opinion, is the political risk. It may be unusual for political considerations to be more important than economic considerations but we believe this to be the case here. Like a number of other European stock markets, the UK has underperformed this year and is a long way behind the USA. This is unfortunate in a number of ways because the UK is showing some strength in various areas. The employment record is enviable. Its unemployment rate at 4.0% is approximately the same as that of the USA but with a higher labor participation rate level. It is less than half the rate of the eurozone. Encouragingly, and not receiving very many headlines in these Brexit dominated times, public finances have been improving rapidly so that, in the first four months of the current financial year, government borrowing is 40% less than in the same period last year. Whilst the policies needed to achieve this position have not been popular, they have been necessary. If a temporary stimulus is needed for the economy post Brexit, it may now be possible. The overall level of outstanding public debt to GDP is still too high, but it is manageable providing prudent policies are followed. Consumer prices have fallen back from their peak and now stand at 2.5% year on year against a figure of 3.0% in January, whilst the core rate is 1.9%. However, as elsewhere, official interest rates are well below inflation and the Bank of England is proving to be very cautious in raising them against an uncertain background. It raised interest rates in August by 0.25% to 0.75%, although no more rises are expected until next year. As far as our exposure to the UK equity market is concerned, we favour mostly those companies with significant overseas earnings, the rationale being that, in the event of the political risks in the UK materialising, sterling is likely to weaken and, as well as the direct exposure in our portfolios to overseas securities, these UK overseas earners should provide some limited protection. It may be a long time before the political and, to a lesser extent, Brexit position becomes clear so we are likely to take a cautious view of the UK stock market for some time.

Although it has been a positive quarter for international equity markets, there remains no room for complacency in view of the background political and economic "noise" which we have discussed in this review. There has been a largely unbroken record of quarterly growth in portfolio asset values and it would be unrealistic to expect this to continue. We still regard fixed interest securities as very expensive and, with economic growth likely to be satisfactory in the absence of any of these negative risks, which we have discussed, materialising, our best estimate is for continued positive performances from equities, but with some negative quarters. Investors do, however, need to monitor the risks which we have discussed.

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