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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been another positive quarter and year for international equity investors with nearly all equity markets performing well, as our tables show. Returns from bonds have generally been positive but lower than for equities. Although currency movements were less pronounced in this latest quarter than in some previous years, movements for the year were quite significant.

The tables below detail relevant movements in markets :

International Equities 29.09.17 - 29.12.17

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+7.2	+6.0	+6.9	+5.2
Finland	-3.5	-2.8	-2.0	-3.5
France	-0.1	+0.7	+1.5	-0.1
Germany	+1.4	+2.2	+3.0	+1.4
Hong Kong, China	+7.1	+6.2	+7.0	+5.4
Italy	-3.7	-3.0	-2.2	-3.7
Japan	+8.9	+7.9	+8.8	+7.1
Netherlands	+0.1	+0.8	+1.6	+0.1
Spain	-2.9	-2.2	-1.4	-2.9
Switzerland	+2.8	+1.2	+2.1	+0.5
UK	+4.9	+4.9	+5.8	+4.1
USA	+6.6	+5.7	+6.6	+4.9
All World Europe ex UK	+0.4	+0.5	+1.3	-0.3
All World Asia Pacific ex Japan	+6.8	+7.5	+8.4	+6.7
All World Asia Pacific	+7.6	+7.7	+8.6	+6.9
All World Latin America	+1.7	-3.4	-2.6	-4.1
All World All Emerging Markets	+6.1	+6.1	+7.0	+5.3
All World	+5.6	+5.1	+6.0	+4.3

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +2.2%

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

Currency	29.09.17	29.12.17
Sterling	1.41	1.23
US Dollar	2.32	2.43
Yen	0.05	0.05
Germany (Euro)	0.47	0.43

Sterling's performance during the quarter ending 29.12.17 (%)

Currency	Quarter Ending 29.12.17
US Dollar	+1.0
Canadian Dollar	+1.3
Yen	+0.9
Euro	-0.9
Swiss Franc	+1.4
Australian Dollar	+1.3

Other currency movements during the quarter ending 29.12.17 (%)

Currency	Quarter Ending 29.12.17
US Dollar / Canadian Dollar	+0.3
US Dollar / Yen	N/C
US Dollar / Euro	-1.8
Swiss Franc / Euro	-2.3
Euro / Yen	+1.8

Significant Commodities (US dollar terms) 29.09.17 - 29.12.17 (%)

Currency	Quarter Ending 29.12.17
Oil	+16.8
Gold	+0.6

PERFORMANCE DURING 2017

International Equities 30.12.16 - 29.12.17

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+11.9	+10.4	+20.9	+6.2
Finland	+8.7	+13.0	+23.8	+8.7
France	+14.4	+19.0	+30.2	+14.4
Germany	+13.9	+18.4	+29.7	+13.9
Hong Kong, China	+37.9	+24.9	+36.7	+20.1
Italy	+15.4	+20.0	+31.3	+15.4
Japan	+21.0	+14.4	+25.3	+10.0
Netherlands	+16.2	+20.8	+32.3	+16.2
Spain	+11.5	+16.0	+27.0	+11.5
Switzerland	+19.1	+13.5	+24.2	+9.1
UK	+11.8	+11.8	+22.4	+7.5
USA	+22.1	+11.5	+22.1	+7.2
All World Europe ex UK	+14.9	+16.9	+27.9	+12.4
All World Asia Pacific ex Japan	+28.0	+23.4	+35.1	+18.6
All World Asia Pacific	+25.0	+19.6	+30.9	+15.0
All World Latin America	+21.3	+12.4	+23.0	+8.0
All World All Emerging	+27.4	+21.1	+32.5	+16.4
All World	+20.3	+13.8	+24.6	+9.5

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.8%

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

Currency	30.12.16	29.12.17
Sterling	1.24	1.23
US Dollar	2.46	2.43
Yen	0.00	0.05
Germany (Euro)	0.11	0.43

Sterling's performance during the year ending 29.12.17 (%)

Currency	Year Ending 29.12.17
US Dollar	+9.6
Canadian Dollar	+2.0
Yen	+5.7
Euro	-3.9
Swiss Franc	+4.9
Australian Dollar	+1.2

Other currency movements during the year ending 29.12.17 (%)

Currency	Year Ending 29.12.17
US Dollar / Canadian Dollar	-6.9
US Dollar / Yen	-3.5
US Dollar / Euro	-10.8
Swiss Franc / Euro	-8.3
Euro / Yen	+10.0

Significant Commodities (US dollar terms) 30.12.16 - 29.12.17 (%)

Currency	Year Ending 29.12.17
Oil	+18.3
Gold	+12.7

MARKETS

The final quarter of 2018 ended on a strong note for international equity investors. In local currency terms the total return on the FTSE All World Index was a very good +5.6%, in sterling terms +5.1%, in US dollar terms +6.0% and, in euro terms +4.3%. Looking at individual countries and regions, the outstanding market was Japan where the FTSE Japan Index returned +8.9%. Australia also performed well with the FTSE Australia Index returning +7.2%, whilst the FTSE All World Asia Pacific ex Japan Index returned +6.8% and the FTSE All World All Emerging Markets Index returned +6.1%. The USA was also an above average performer with the FTSE USA Index returning +6.6%. The FTSE All World Europe ex UK underperformed the FTSE All World Index returning +0.4% and, within that area, there were negative total returns from the FTSE Italy Index, -3.7%, the FTSE Spain Index, -2.9%, and the FTSE France Index, -0.1%. Switzerland outperformed with the FTSE Switzerland Index returning +2.8%. The UK was slightly below average, with the FTSE UK Index returning +4.9%, still a good performance. Currency movements were not as pronounced as in some previous quarters so sterling adjusted returns in the various indices did not differ greatly from local currency returns in most markets. One area where it did make a noticeable difference was in Latin America where the return on the FTSE All World Latin American Index moved from +1.7% in local currency terms to -3.4% in sterling terms.

In international bond markets, movements were mixed. The sterling bond market, as measured by the benchmark ten year government bond yield, performed well with the gross redemption yield falling by 18 basis points to 1.23%. There was a slight fall in the yield on the German Bund which moved down 4 basis points to 0.43%. There was no change in the yield on the Japanese Government Bond but there was a modest rise in the yield on the US Treasury bond which rose by 11 basis points to 2.43%.

As mentioned above, currency movements were less pronounced than in some previous quarters. Except against the euro, sterling was generally stronger. Against the Swiss franc it rose by 1.4%, against the Australian dollar and Canadian dollar by 1.3%, against the US dollar by 1.0% and against the yen by 0.9%. Against the euro, sterling fell by 0.9%.

In commodity markets, OPEC's efforts to increase prices by cutting back production had success and, over the quarter, oil, as measured by Brent crude, rose by 16.8%. Gold was little changed.

Turning to 2017, as a whole, it has been another positive year for international equity investors, coming on top of the very strong performance in 2016. In local currency terms, the total return on the FTSE All World Index was +20.3%, in sterling terms +13.8%, in US dollar terms +24.6% and, in euro terms, +9.5%. As is clear from these figures, currencies made a substantial difference to returns, depending upon an investor's base currency. Looking at local currency returns first, we see the outstanding performers being the FTSE All World Asia Pacific ex Japan Index, +28.0%, and the FTSE All World All Emerging Markets Index, +27.4%. There were sub par performances from the FTSE UK Index, +11.8% (but still a very good return in any circumstances), the FTSE Australia Index, +11.9%, and the FTSE All World Europe ex UK Index, +14.9%. However, if we look at the returns in sterling adjusted terms, the picture changes. There was still substantial outperformance from the FTSE All World Asia Pacific ex Japan Index (+23.4%) and the FTSE All World All Emerging Markets Index (+21.1%) but, because of the strength of the euro, the FTSE All World Europe ex UK Index (+16.9%) also became an outperformer. Conversely, because of the weakness of the US dollar, the FTSE USA Index underperformed, returning +11.5% in sterling terms, but still a good performance by any measure.

In the international bond markets, again measured by 10 year government benchmark bonds, there was little change in gross redemption yields. On the 10 year UK government bond, the yield fell by just 1 basis point to 1.23%, on the US Treasury bond by 3 basis points to 2.43%, on the Japanese government bond the yield rose by 5 basis points to 0.05%. The biggest move was in the German Bund where the yield rose by 32 basis points to 0.43%.

In the currency markets, the feature was the strength of the euro against which sterling fell by 3.9%. However, sterling was strong elsewhere, rising by 9.6% against the US dollar, by 5.7% against the yen, by 4.9% against the Swiss franc, by 2.0% against the Canadian dollar and by 1.2% against the Australian dollar.

In the commodity markets, oil, as measured by Brent crude, rose by 18.3% and gold by 12.7%. Commodities generally, enjoyed firm markets during the year.

Against the background of these market movements in 2017, it is instructive to look back twelve months to our December 2016 economic review, to see what we got right and what we got wrong in looking ahead to 2017. We were, as we have been for a long time, very negative on the bond market, believing it to be a long way from being correctly valued. In the event, this assessment was too negative. Returns were very modest, however, in the government bond markets but slightly better in the high yield bond market where yield compression was in evidence as investors chased scarce yield. Cash, we thought, was only suitable for the exceptionally risk averse investor as returns would remain very poor and that proved to be the case. In this context, we were talking about cash as a main alternative investment class to equities and bonds, not cash which was building up in a largely fully invested portfolio awaiting investment on a market setback. We ended our review by saying that our best estimate was that the highest returns would come from equities but that they would be much more modest than in 2016 and would come unevenly with some negative quarters of performance. If anything, we were too cautious in our assessment of equity returns in 2017 and any quarters of negative performance were very modest. In local currency terms, as opposed to sterling terms, the FTSE All World Index rose every month in 2017, a remarkable performance.

ECONOMICS

From an economic perspective, 2017 has ended on a positive note with a synchronised pattern of economic growth which, in the absence of any event or events which we cannot currently foresee, looks likely to continue in 2018. We have often noted in our reviews the bias in the media towards presenting negative news, but the performance of international equity markets in 2017 suggests that investors have been more balanced in their assessment of the news and have been swayed by what is actually happening rather than by what the media is reporting. More than ever in formulating an investment policy, one should put prejudices firmly in the background and assess the facts objectively.

The biggest threat to the world in 2017, and will probably continue to be in 2018, is North Korea, yet stock markets, even in Asia, have shrugged off the threat of a nuclear conflagration. This must strike some people as an extraordinarily complacent attitude to take but one must look at the reality. A nuclear war could be so devastating that it is an event that one cannot really discount in the stock market. One would not know the end result so it would be difficult to make any rational analysis. On the other hand, economic developments can be factored into investment policy making with more certainty, say, for example, taking into account the effect of a rise in interest rates. That is the paradox, explaining why the threat of an apocalyptic event like nuclear war in the Korean peninsula may have less effect on markets than economic developments. Then, from a UK point of view, there is Brexit. Whatever one’s views on Brexit are, and it remains a very divisive issue, there is no doubt that some forecasts made before and after the EU vote in the event of a Brexit vote were extraordinarily pessimistic about the UK’s economic prospects, the Treasury included. Even at the time, they appeared highly alarmist and stretching so far into the future where realistic forecasts are almost impossible that, one wonders, did bias affect these forecasts? As it has turned out so far, the UK has not done too badly economically and, whilst the UK stock market has underperformed most world stock markets in 2017, it has still shown what, in normal circumstances, would be regarded as a highly satisfactory return. As it happens, for other reasons which we will discuss later, we do regard the UK as a high risk market, but this is not related to Brexit in any major way. There were also concerns about the advance of populist political parties in the EU and the stand off in Spain between Catalonia and the government in Madrid, which remains unresolved after the separatists won a majority in the Catalan parliament in the election on the 21st December which the Spanish Prime Minister, Mr Rajoy, called. Although the separatists did not gain a majority in votes cast, it has left a messy situation. Nevertheless, apart from occasional jitters, the Spanish stock market has performed well in 2017. In the Netherlands and in France, the populists did not perform as well as expected, although they have a foothold in the government of Austria. Ironically, one of the most difficult election outcomes has been in Germany, where the two main parties shed a substantial amount of votes, leaving Angela Merkel, the most substantial and influential politician in the EU, in a much weakened position and, so far, unable to form a government. However, with the German economy performing well, the German stock market has risen significantly in 2017. Then there is the USA. It is fair to say that President Trump does not receive a good press in parts of the USA and most of the rest of the world, where one rarely hears anything positive said about him. But the US stock market has performed well in 2017, even in terms of foreign currencies where the weakness of the US dollar has pulled back returns but still to very satisfactory levels. Surely, if everything which is said about the President is true, one would be wary of investing in a country which might have some political instability. The reality is that, ignoring this extraneous "noise", the US economy has been performing well on its own. Two events have also been positive for the stock market, one high profile and the other lower profile. The high profile event occurred at the end of 2017, the passing of the most significant tax reforms since the Reagan era, which have been well received by investors, if not by many politicians and the public if the opinion polls are to be believed. The other event, is the rolling back of many regulations. The number of regulations proliferated under President Obama but President Trump has rescinded over 800 so far. Regulations carry an economic cost and can act as a dead weight on an economy, so rolling back unnecessary ones, and many of them are unnecessary, is also likely to benefit the economy and raise "animal spirits" in businesses. The performance of the US stock market in 2017 shows that investors were looking through the political and media diversions to see what was really happening. It is a question of looking at what people are doing rather than what they are saying.

Underpinning the performance of international equities in 2017 has been the maintenance of a very accommodative monetary policy which has helped to validate quite high ratings in many stock markets. Except in the USA, of the major markets, the average dividend yield on shares well exceeds that on ten year government bonds. Monetary tightening is starting to take place, albeit from a very loose level, and we will discuss this later. This background has been helpful to equities in 2017.

What has been the performance of the world economy in 2017? If we look at the OECD projections made in November, we see a satisfactory position, not rapid growth but a rate which should be supportive of a good economic background for companies to raise their profits, dividends and, hopefully, encourage an increase in corporate investments. When it made its projections in November, it saw world economic growth at 3.6% in 2017, up from 3.1%in 2016. Amongst its own members, it saw growth of 2.4% against 1.8% in 2016. Of the G7 economies, it projected the USA to grow by 2.2% (1.5% in 2016), Canada by 3.0% (1.5%), France by 1.8% (1.1%), Germany by 2.5% (1.9%), Italy by 1.6% (1.1%), Japan by 1.5% (1.0%) and the UK by 1.5% (1.8%). Amongst non OECD countries, China is projected to have grown by 6.8% in 2017 (6.7%), India by 6.7% (7.1%), Brazil by 0.7% (-3.6%) and Russia by 1.9% (-0.2%). At this stage, looking ahead to 2018, the OECD sees world growth picking up further to 3.7%, 0.1% higher than its projection for this year, although unchanged (except for a rounding difference) amongst its members. Whilst it sees US growth up a further 0.3% to 2.5%, it sees a reduction of 0.2% in eurozone growth to 2.2% and reductions also in Canada, Japan and the UK. Amongst the non OECD countries, it sees a 0.2% reduction in the rate of growth of China to 6.6%, increased growth of 0.3% in India to 7.0%, increased growth of 1.2% in Brazil to 1.9% and no change (apart from a rounding difference) in Russia, still 1.9%. Overall, if these projections are reasonably accurate, this would be a satisfactory outcome. As is logical, forecasts for corporate earnings are higher again for 2018, reflecting growth in the world economy.

What are the economic challenges for 2018? In our view, it is the progression of monetary policy where, apart from Japan, some degree of tightening is in prospect. This would be different from a definition of "tightening" in the past. This would have implied a central bank raising interest rates or perhaps increasing banks' reserve ratios. Now, with quantitative easing and the resulting ballooning of central banks' balance sheets, "tightening" may refer to a slowdown in the rate of increase of central banks' balance sheets through a reduction in quantitative easing or an actual reduction in central banks' balance sheets as a result of maturing fixed interest securities not being fully reinvested. By any standards, this is still very loose monetary policy but not quite as loose as it was. Central banks are very sensitive of the need to unwind quantitative easing at a suitable time, but they don't want to frighten the markets. Mindful of an earlier taper tantrum in the USA in 2013, the Federal Reserve is treading very carefully. There have been three interest rate increases by the Federal Reserve in 2017 from 0.5% - 0.75% at the beginning of 2017 to 0.75% - 1.0% in March, to 1.0% - 1.25% in June and from 1.25% - 1.5% in December and, in the absence of unforeseen circumstances, there will be further increases in 2018, currently projected at three. Credible advanced signalling of the Federal Reserve's interest rate intentions (and this applies to other central banks as well) is considered essential for keeping markets stable. Investors do not like unpleasant surprises. This is equally true of its intentions to shrink its balance sheet. The aggressive way is simply to sell some of its fixed interest holdings back to the private sector. One can see this action having an effect on prices because of the appearance of a big seller in the market. The more surreptitious way is to hold back from reinvesting maturing bond proceeds as they come in and this is what the Federal Reserve has chosen to do. The Federal Reserve's balance sheet has ballooned to US$4.5 trillion, the bulk comprising US$2.5 billion of US Treasury bonds and US$1.8 trillion in mortgage backed securities. The balance sheet taper starts at US$10 billion a month in the fourth quarter of 2017 and is raised by US$10 billion each quarter until it reaches US$50 billion a month. By 2020, the Federal Reserve's balance sheet would fall to below US$3 trillion. It is important that central banks' balance sheets are shrunk because, if confidence returns to the US or any other relevant economy, the money created might circulate much faster and cause inflationary pressures to build up. Whilst businesses and consumers have been cautious in the aftermath of the financial crisis, that mood could change. If monetary policy remains as loose as it is now, the inflationary pressures could build up and trying to control them might mean interest rates having to rise to levels higher than they would not otherwise have needed to reach. In the light of the tax cuts coming up in the USA, monetary policy might have to be tightened more quickly than the Federal Reserve currently anticipates.

In the eurozone, monetary policy is not at the stage it has reached in the USA in that the ECB is starting to reduce the rate of increase in its balance sheet as opposed to starting to shrink it. Its balance sheet stands at approximately US$5.2 trillion and it plans to reduce the rate of asset purchases from January 2018 to €30 billion a month from €60 billion. This is "tightening" by a gentler method than even the USA's very cautious method but it points in the direction of a move in monetary policy. However, the ECB has not yet moved its interest rates. In the UK, monetary tightening is evidenced by the recent decision of the Bank of England's Monetary Policy Committee to raise interest rates by 0.25% to 0.50%, thus restoring last year's post Brexit reduction which most commentators now see as having been unnecessary. Only the Bank of Japan, with a balance sheet of about US$4.6 trillion is not moving. A move towards normality in monetary policy is to be welcomed as a sign that the economic recovery is becoming more established. However, the emphasis must be on "towards". Monetary policy is light years away from being normal in the understood sense of the word. It is still supportive to asset prices. Apart from the need to reduce central banks' balance sheets for the reasons mentioned above, monetary policy is going to be needed as a weapon when the next downturn in the economic cycle occurs. This would normally occur when central banks reduce interest rates to try to stimulate economic activity. At the moment, with interest rates where they are, they hardly have any ammunition.

From where we sit, at the turn of the year, the world economy looks set fair and the main issue for investors to consider is whether stock markets can take a monetary policy tightening in their stride. With higher interest rates, shares will have more competition for money available for investment.

The best scenario is for economic growth and, hence, corporate profits growth to support the stock market against the adverse consequences of monetary tightening. If that tightening is occurring because economic growth is improving then, at least in the early stages, that should be supportive to equities. How monetary policy develops in 2018 could determine the course of the stock market.

From the general we now move to the particular and review the major markets and economies of the world, starting with the USA where the Federal Reserve, in announcing the latest interest rate increase, raised its economic growth forecast for 2017 slightly to 2.5% but raised it sharply for 2018 to 2.5% from 2.1%, the same level as the OECD's forecast. The latest quarter on quarter annualised growth rate of 3.3% shows an acceleration in economic growth, whilst the third quarter year on year rate was 2.3%. The closely watched purchasing managers indices also show a buoyant reading with the index for manufacturing at 59.7 and that for non manufacturing at 55.9. In October, the latter figure had exceeded 60, a very buoyant level, and, in September, the manufacturing index had exceeded 60. Unemployment, notwithstanding the usual caveat about the low labour force participation rate, stands at 4.1% against 4.8% at the beginning of the year and the non farm payroll figures, allowing for the distortion caused by the hurricanes last autumn, have been quite strong nearly all year. Capacity utilisation figures have been creeping up all year and other measures like durable goods orders have shown a strong year on year trend, up 7.1% on the last reading. All this has happened when little occurred on the economic front in terms of policy making which suggested that the economy had its own momentum. Now, of course, there has been big economic news with the President managing to achieve a major tax package, something which had appeared to elude him earlier. This is a very significant economic event. In terms of business taxes, the most eye catching feature is a reduction in the headline rate of corporate tax from 35% to 21%. The headline rate was seen as becoming increasingly out of line with that of other countries. Companies with large overseas businesses kept large cash sums out of the USA to avoid the penal tax rate if they repatriated and there was also a regular flow of tax inversions as US companies moved their domicile although that was recently made more difficult. An important qualification was that, for many US companies, the headline rate was not the actual rate because of tax deductions. In order to encourage investment, businesses will now be able to deduct the cost of assets which they can depreciate straight away instead of having to amortise them over several years. There is a move from a worldwide tax system for US companies to a territorial system so that they are taxed in the countries where they operate and the US does not tax them on those profits. This is an incentive to bring back money to the USA. The foreign cash balances of US companies are estimated at US$2.6 trillion and they will be able to repatriate this cash at a 15.5% tax rate. There will be an additional cost to businesses with high levels of interest payments in relation to EBITDA (Earnings before Interest, Taxation, Depreciation and Amortisation). Corporations will only be able to deduct interest expense with a ceiling of 30% of EBITDA for the first four years and of EBIT (Earnings before Interest and Taxation) thereafter. As well as for companies, there are tax cuts for individuals. The Tax Policy Centre estimated that those in the lowest earning 20% of the population would see their income increase by 0.4%, for those in the next 20% above the figure, the increase would be 1.2%. For the next two groups of 20% above this, the figures would be 1.6% and 1.9% respectively and, for the top 20%, 2.9%. Except for the highest 20%, the marginal propensity to consume is high, so there should be a spending boost to the economy. As well as cuts to taxation for individuals, there are some higher costs for others, so the above is a net estimate and different organisations have different views. The theory behind taxation is hotly debated by economists and politicians. The most painless way to improve government finances, reduce unemployment and increase wealth is higher economic growth. One unwelcome by-product of the financial crisis was that government debt rose in most countries and rising debt tends to bear down on economic growth as increased servicing costs of the debt weaken government finances leading to tax rises which dampen disposable income, and/or public spending restraint, both of which weaken economic activity. Some economists favour tax rises, for a variety of reasons, some political and some economic, but such moves are unlikely to be helpful to economic growth. For example, France suffered badly when President Hollande introduced significant tax increases in the early part of his term of office. These are now being reversed more aggressively by President Macron to increase the business appeal of France and there is a reasonable expectation that this will increase the long term potential growth rate of France. However, the country is highly indebted, so the need for President Macron's supply side reforms, which include employment law reforms to boost growth as a way of dealing with the public debt problem, is obvious.

On the basis that lower taxes, such as those announced in the USA (whatever the quarrels about the details), are more welcome than higher taxes, the macro economic issue in the USA is that, with the USA in an economic upswing, tax cuts are piling on pro cyclical forces. The USA has a budget deficit of approximately 3.5% of GDP and clients will have heard the saying about fixing the roof when the sun is shining, which means using the good times to reduce deficits in readiness for the bad times. One of the reasons why the UK has, and still has, big problems in bringing down its budget deficit is that public spending in the UK rose sharply before the financial crisis in 2008, at a time when the economy was performing well so that the roof was not fixed. This meant that, when the recession came and the UK economy contracted sharply (-4.1% in 2009), public finances deteriorated sharply and are still not in a good state although they are improving. This could be the issue in the USA. Defenders of the tax cutting measures say that supply side reforms (not only tax reductions but also the rolling back of some regulations) will stimulate the US economy and pay for themselves. The Tax Foundation, a US think tank, says that its model shows that the tax cut plan would lead to significantly lower marginal tax rates and the cost of capital which would lead to a 1.7% increase in GDP over the long term, 1.5% higher wages and an additional 339,000 full time equivalent jobs. It suggests that the cuts would spur an additional US$1 trillion in federal revenues from economic growth. Over the next decade, GDP would be increased by an average of 0.29% per annum, and GDP growth would, on average, be 2.13% compared with 1.84%. In 2018, GDP growth would be 0.44% over the baseline forecast. Its forecast for benefits for taxpayers depends upon economic growth. In its static model, the plan would lead to 0.3% lower after-tax income on average for all taxpayers and 0.6% lower after-tax income on average for the top 1% in 2027 due to the expiration of the majority of the individual income tax cuts but retention of chained CPI. When accounting for the increased GDP, after-tax incomes of all taxpayers would increase by 1.1% in the long run. It says that, over the next ten years, the Tax Cuts and Jobs Act will add almost US$448 billion to the deficit. The US Treasury said that the bill would bring in US$1.8 trillion in new revenue. It projected 2.9% economic growth per annum on average. These forecasts assume that the rest of President Trump's programme will be implemented in relation to infrastructure spending, deregulation and welfare reform. Of course, there are many other forecasts and the plans are politically very divisive with no Democrat Congressional members supporting the tax cuts. Probably, the key to the success, or otherwise, of the Act will depend upon whether the supply side theorists are correct and that the cuts will stimulate growth and help to be self funding, or whether those who think that they will not achieve their objective and that the level of federal debt will balloon and impact upon economic growth as debt servicing costs rise are correct. Also, whilst most individuals will spend the extra disposable income, what will companies do? This is an important question. The hope is that they will be sufficiently attracted by the outlook for the US economy to invest, with the added attraction of the depreciation benefit. Companies may pay higher wages, raise dividends or increase share buybacks which may help the stock market in the short term. Economists and the government would prefer that they raise capital investment. Whatever one thinks of the Act, it represents a major supply side reform which should be attractive to stock market investors. The bill for the Act or, for the optimists, the benefits, may not be apparent until later. As a result of the Act, some analysts estimate that it might increase earnings per share by 6% (with others saying more) above what they would otherwise have been. Given the current performance of the stock market investors, at least investors are warming to the tax proposals.

As we look back on our review of twelve months ago, one of our main concerns about President Trump's policies, if enacted, was their protectionist tone. His protectionist pronouncements undoubtedly helped him to win the election, as is seen in his performances in states like Michigan, Ohio and Wisconsin, but, as an economic policy, protectionism has little to commend it and a lot about which to be critical. Trade wars damage economic growth and risk recession or even depression. So far, his bark has been worse than his bite. The USA has pulled out of the Trans Pacific Partnership and is trying to renegotiate NAFTA. Tensions with China are rising but have not led to any material increase in protectionism. There have been high profile interventions like the 300% tax on imports of Bombardier "C" Series planes into the USA but this has been an exception. There is no reason to be complacent because protectionism is a threat to the world economy and stock markets. So, the concern we noted twelve months ago remains. With mid term elections due in November, there is the possibility that the Republicans could lose control of Congress (they suffered on major reversal in Alabama recently when they lost a Senate seat to the Democrats), in which case there may be legislative deadlock. That might not be bad for the stock market as the economy is performing quite well on its own and does not need further government intervention to help it to continue to grow. Janet Yellen steps down as Chairman of the Federal Reserve in February but, at this stage, given the performance of the US economy, three more interest rate increases might occur and, if anything, the tax cuts might encourage the Federal Reserve to adopt a more hawkish policy on interest rates given that the economy's automatic stabilisers are being dismantled by the tax cuts which could threaten overheating and inflation as we described above. In these circumstances, monetary policy might have to adopt a more prominent role. Despite these caveats, the US equity market still features heavily in our asset allocation. Its extraordinary run of almost uninterrupted growth with very low volatility must be broken at some stage but we are long term investors and, as of now, we see no need to take the risk of encashing gains in this market with the resulting opportunity cost should Wall Street continue to move ahead.

As we saw from the OECD forecasts, it is expecting the eurozone to perform well in 2018, albeit at a slightly lower rate than in 2017, although intuitively one feels that the forecast might have to be raised from 2.2% given its current momentum. Given how poorly the eurozone economy has performed in recent years, the recovery is welcome. But it is also important to analyse the problems of the euro area which could come back to haunt it when the next recession comes along, which it will do even though it may seem far away today. The eurozone since its inception and enlargement has never been an optimal currency area. Using one currency for countries with quite different economic profiles is a recipe for trouble. A flexible exchange rate is an important shock absorber but Greece, Spain, Portugal and Ireland could not use this when trouble hit their economies after the financial crisis. Instead, they were forced into internal devaluations with devastating effects on their economies, even though there is in these countries a considerable improvement at present. One of the next problems can be clearly foreseen. The German economy is firing on all cylinders at present. The economy is growing rapidly by eurozone standards, 2.5% for 2017, according to the OECD, and unemployment is very low at 3.6%. The economy is in danger of overheating. For Germany, the euro is considerably undervalued, hence a 7.9% current account surplus, an extraordinarily high figure. This should be the canary in the mine for the eurozone. The exchange rate and interest rates are too low for a country growing so strongly but, in the absence of a central bank which can control interest rates and perhaps indirectly affect the exchange rate, it is tied by the ECB. For some other eurozone countries, the problems are the opposite. The danger is that inflation could take off in Germany. If the normal monetary tools cannot be used because it is a currency zone, then the only domestic lever available is fiscal policy, i.e. tax rises or public spending cuts to take the strength out of the economy and, in this way, to subdue inflation. In political terms, this is a non starter at present given that a new government has not been formed and that the federal government is running a surplus of around 0.6% of GDP. Eventually, one imagines the ECB will be under pressure to speed up the process of monetary tightening as inflationary problems become apparent. It seems that the ECB will stop quantitative easing altogether before starting to raise interest rates. When it does start to raise interest rates, those countries with high levels of debts, such as Italy, will see servicing costs rise, making a difficult situation worse. The banks hold large amounts of government bonds, not to mention, of course, the ECB, and the old debt uncertainties could return. The eurozone is performing well at the moment, helped by the extraordinary monetary action of the ECB. The latter has to be reined in if inflation is not to become a problem down the line and one of the economic consequences is likely to be lower economic growth given how structurally weak some of the eurozone economies are. The President of the ECB, Mr Draghi, has been urging eurozone countries to do more in the way of structural reforms but progress has been limited and the current economic upturn will reduce the incentive to reform. When the next recession comes, the eurozone will have very little firepower left to deal with it. In the short term, the main focus of investor attention will be on the Italian elections in March. Because of the size of its economy, Italy is the Achilles' heel of the eurozone. Its banks hold a large amount of non performing loans which act as a drag on the economy. At over 130% of GDP outstanding public debt as a percentage of GDP is very high and, if servicing costs returned to anywhere near normal levels, the budget deficit would become problematical. With the eurozone economy performing relatively well, it may seem strange to introduce a discordant note but a very obvious problem is looming on the horizon. For the present, we are happy to hold a significant interest in Europe, quite a lot of which is Switzerland and therefore not directly affected by this issue although, as we have seen in the not too distant past, it affected the value of the Swiss Franc given its status as a safe haven, causing the Swiss Central Bank to take drastic action to prevent an uncontrolled rise in the Swiss Franc. There are many world class companies in Europe and, for the moment, we are concentrating on them rather than the political problems for the eurozone occasioned by the inability of individual members to follow an interest rate policy which is appropriate for them. The fundamental problems of the eurozone are likely to be highlighted when the next recession occurs.

The Japanese stock market performed well in 2017. Here, monetary policy is not starting to be reversed as the Bank of Japan continues to buy assets in an enormous size to try to keep ten year government bond yields down to zero in an attempt to stimulate the economy and push inflation to 2%. Because the majority of public debt is held internally, the spectre of an exchange rate crisis is not present and the Bank of Japan and the government can be more aggressive with their tactics. The equity market has also been supported by public bodies investing in equities through exchange traded funds. This introduces interesting corporate governance issues. With Mr Abe's convincing election victory in 2017, he has a free run to achieve his objectives of modest inflation to encourage consumer spending and investment and also the "one arrow" of the three, structural reform, which rather lagged in his first period of office (the other two "arrows", fiscal and monetary, were fired). Japan has long term problems, particularly bad demographic trends and a very high level of public debt as a percentage of GDP, ameliorated to some extent by the fact mentioned above that most of its debt is held internally but this does not take away the problem. In the short term, economic growth has recovered, the OECD expects growth of 1.5% in 2017 but this is giving rise to pressures in the labour market where unemployment stands at 2.8%. Mr Abe is making attempts to encourage more women into the labour force. But Japan has very low immigration and this is a problem for the economy as it could reduce the country's long term potential growth rate. Its proximity to North Korea is obviously an issue but one, we think correctly, that the stock market is not taking into account for the moment for reasons which we mentioned earlier in this review. With the political situation apparently settled in Japan, growth established and the economic objectives clear, modest exposure to Japan is desirable.

In China, political developments have taken centre stage with President Xi tightening his grip on power and his thoughts established in the constitution. In the economic sphere, the party's grip on state owned enterprises is strengthening and the emphasis on the market is not what many investors understood it as being. Growth, at least in the published figures, is steady, and international investors, notwithstanding political developments, are likely to increase their weightings in Chinese A Shares as they become, in a modest way initially, part of the MSCI Emerging Markets Index this year. Indirect exposure to China through companies in Asia has been our preferred way of being involved in this economic powerhouse. Worries earlier in 2017 about capital flight as the country's foreign exchange reserves shrank to around US$3 trillion have receded as the authorities made it more difficult to move money abroad and, for most of last year, the country's foreign exchange reserves have been rising. Qualitative control of overseas purchases has become apparent and certain types of acquisitions and by certain companies have been stopped. This remains an important market in which to be indirectly involved. As our table shows, Asia has been an excellent performer in 2017.

As the table also shows, emerging markets outperformed developed markets in 2017. The growth rate in emerging markets is usually higher than in developed markets. With strengthening economies in many countries, in some cases helped by higher commodity prices, investors moved further into these countries. We remain of the view that portfolios should have exposure to these countries which are likely to continue to exhibit better growth rates than developed countries. A year ago, there was the expectation that the US dollar would strengthen as interest rates rose and that this would attract money away from emerging markets, perhaps causing liquidity problems. In the event, this did not happen but investors should beware of the effect which a much stronger US dollar may have on emerging markets. For the moment, however, that does not look to be the case.

Politics as much as economics can be an influence on markets and this is why we regard the UK stock market as one with elevated risk. We have never been of the view that, if a portfolio has a sterling valuation base because a client is based in the sterling area, it should predominantly hold UK or sterling assets. With the UK at just over 6% of the world market capitalisation, to have a multiple of that weighting in the UK implies a particularly rosy view of the UK. Unless there is a good reason, and there may be in some cases, we believe that the UK should be regarded with the same degree of objectivity as any other market. History shows that an unhedged diversified portfolio of international equities has far outperformed a solely UK one. If one looks at the total return on the FTSE All World Index for the ten years ending December 2017, one sees that the total return was double that on the FTSE 100 Index, at 146.86% against 72.17%. But, now the UK carries a significant political risk. There is a possibility of a change of government before the next scheduled General Election in 2022 which would bring in one with policies, as currently articulated, more extreme than anything seen before in the UK. If these policies are enacted, it is highly likely that sterling and the stock market would be severely affected. Apart from the wisdom of diversifying a portfolio geographically at any time to spread the risk, we think it very important for sterling based investors to factor in the possibility of a change of government. The obvious insurance policy is to have significant exposure to international equities. Whilst the UK stock market may look relatively good value, it is sometimes important to follow an investment policy which aims to hold on to what you have. After such a long period of positive international equity performances, emphasising non UK exposure meets this requirement and this will continue to inform our investment policy in 2018. Like last year, we continue to believe that bonds offer very poor value and any reversion towards mean in yields will involve significant price falls as one moves along the maturity spectrum. Although, as this is written, markets continue to move ahead and equities remain our preferred asset class, we must expect some setbacks from time to time in 2018. This is not a reason for disinvesting given the opportunity costs risks described earlier. If there is a reasonable setback, and where we hold cash which has built up, we will commit this to the market if the circumstances look right.