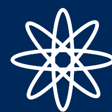

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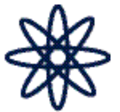
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

Investors will be pleased to see the back of 2008, a year which nobody will forget. Whilst 2009 will be very unpleasant economically, hopefully the ability to shock, a feature of 2008, will be reduced, in which case investors might reasonably expect more stability in markets which seem to be discounting much of the inevitable bad economic news which will unfold as the year progresses.

The tables below detail relevant movements in markets :

International Equities 30.09.08 - 31.12.08

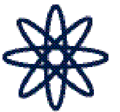
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-18.0	-10.2	-27.5	-26.8
Finland	-19.9	-1.7	-20.7	-19.9
France	-19.9	-1.8	-20.8	-19.9
Germany	-20.0	-1.9	-20.8	-20.0
Hong Kong, China	-15.4	+5.1	-15.2	-14.3
Italy	-21.2	-3.3	-22.0	-21.2
Japan	-22.3	+12.9	-9.0	-8.0
Netherlands	-24.1	-6.9	-24.9	-24.1
Spain	-15.6	+3.5	-16.5	-15.6
Switzerland	-17.7	+7.5	-13.3	-12.3
UK	-8.7	-8.7	-26.3	-8.7
USA	-22.0	-3.3	-22.0	-21.2
Europe ex UK	-20.6	-2.5	-21.3	-20.5
Asia Pacific ex Japan	-19.1	-5.3	-23.6	-22.8
Asia Pacific	-20.9	+4.4	-15.8	-14.9
Latin America	-20.0	-18.1	-33.9	-33.2
All World All Emerging	-22.6	-11.1	-28.3	-27.5
The World	-20.3	-3.2	-21.9	-21.1

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +10.2%

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

Currency	30.09.08	31.12.08
Sterling	4.46	3.02
US Dollar	3.84	2.22
Yen	1.48	1.18
Germany (Euro)	4.04	2.95



Sterling's performance during the quarter ending 31.12.08 (%)

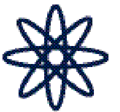
Currency	Quarter Ending 31.12.08
US Dollar	-18.2
Canadian Dollar	-6.4
Yen	-30.1
Euro	-17.7
Swiss Franc	-22.1

Other currency movements during the quarter ending 31.12.08 (%)

Other Currency	Quarter Ending 31.12.08
US Dollar/Canadian Dollar	+14.5
US Dollar/Yen	-14.5
US Dollar/Euro	+0.8
Swiss Franc/Euro	+5.6
Euro/Yen	-15.1

Significant Commodities (US dollar terms) 30.09.08 - 31.12.08 (%)

Significant Commodities	30.09.08 - 31.12.08
Oil	-53.0
Gold	-4.0



PERFORMANCE DURING 2008

International Equities 31.12.07 - 31.12.08

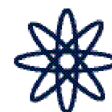
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-38.1	-31.9	-50.8	-48.3
Finland	-53.4	-38.7	-55.7	-53.4
France	-40.3	-21.4	-43.3	-40.3
Germany	-41.9	-23.5	-44.7	-41.9
Hong Kong, China	-50.1	-30.5	-49.8	-47.2
Italy	-45.5	-28.2	-48.2	-45.5
Japan	-42.0	-1.1	-28.6	-24.9
Netherlands	-48.9	-32.7	-51.4	-48.9
Spain	-36.8	-16.8	-39.9	-36.8
Switzerland	-34.0	-2.8	-29.8	-26.2
UK	-28.3	-28.3	-48.2	-45.5
USA	-36.8	-12.5	-36.8	-33.5
Europe ex UK	-42.6	-24.0	-45.1	-42.3
Asia Pacific ex Japan	-42.4	-31.0	-50.2	-47.6
Asia Pacific	-42.4	-16.5	-39.7	-36.5
Latin America	-36.9	-32.0	-50.9	-48.3
All World All Emerging	-44.7	-34.8	-52.9	-50.5
The World	-38.2	-18.2	-40.9	-37.8

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +12.8%

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

Currency	31.12.07	31.12.08
Sterling	4.57	3.02
US Dollar	4.04	2.22
Yen	1.51	1.18
Germany (Euro)	4.32	2.95



Sterling's performance during the year ending 31.12.08 (%)-

Currency	31.12.08
US Dollar	-26.8
Canadian Dollar	-9.7
Yen	-40.5
Euro	-23.3
Swiss Franc	-30.9

Other currency movements during the year ending 31.12.08 (%)

Other Currency	Quarter Ending 31.12.08
US Dollar/Canadian Dollar	+23.3
US Dollar/Yen	-18.7
US Dollar/Euro	+4.8
Swiss Franc/Euro	+11.0
Euro/Yen	-22.4

Significant Commodities (US dollar terms) 31.12.07 - 31.12.08 (%)

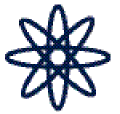
Significant Commodities	31.12.07 - 31.12.08
Oil	-51.4
Gold	+3.1

Markets

The final quarter of 2008 presents an astonishing picture. It was a dire time for international equity markets, yet the collapse of sterling meant that sterling based investors with international exposure were shielded from much of the weakness. The benefits of international diversification were never more apparent. In local currency terms, the total return on the FTSE World Index was -20.3%, in US dollar terms -21.9%, in euro terms -21.1% but in sterling terms just -3.2%. If we look at international equity markets in local currency terms over the last quarter, the UK was the best performer with a negative return of 8.7%. Movements elsewhere were remarkably similar with negative returns from the FTSE USA Index of 22.0%, Europe ex UK of 20.6% and Japan of 22.3%, whilst the figures for Asia ex Japan, Latin America and emerging markets were 19.1%, 20.0% and 22.6% respectively. However, the movement of sterling during the quarter has radically changed the sterling adjusted returns and left the UK underperforming the main markets. Compared with the negative return on the FTSE UK Index of 8.7%, the negative return on the FTSE USA Index comes in at 3.3%, on the FTSE Europe ex UK Index at 2.5%, whilst Japan returned a positive 12.9%. Indeed, there were positive sterling returns from other markets, including Spain, Switzerland and Hong Kong, China. Against the negative movement of 3.2% in the FTSE World Index, the UK underperformed.

Corporate bonds have been badly affected by the turmoil in the credit markets as even the most highly rated issues have suffered. The only place investors have been happy to invest in has been the high grade government bond market. This has been reflected in a strong performance shown by a fall in ten year government benchmark bond yields. Over the last quarter, UK government bond yields have fallen 144 basis points to 3.02%, US government bond yields by 162 basis points to 2.22%, Japanese government bond yields by 30 basis points to 1.18% and German government bond yields by 109 basis points to 2.95%. These are astonishing movements over such a short period of time.

In a quarter of shocks, one of the most significant was the magnitude of sterling's decline. For a long time, the currency was overvalued and, when sentiment changes, it can move fast. Nevertheless, the size of sterling's fall over the quarter is very serious and represents a very negative evaluation of the UK economy and its prospects by foreign investors.



Against the yen, sterling declined by 30.1%, against the Swiss franc by 22.1% and against the euro by 17.7%. Except against sterling, which fell by 6.4% against it, the Canadian dollar was itself a weak currency with the US dollar rising by 14.5% against it during the quarter.

In the commodity markets, reflating the disinflationary times in which we live, oil fell by 53.0% in US dollar terms. Gold, however, was relatively stable, falling just 4.0%, perhaps reflecting the inflationary problems which are being stored up for the future by present economic measures being taken to kick start the world economy.

Although the fourth quarter was particularly brutal, many of the same themes can be seen by looking at the data for the year as a whole. International equities, as measured by the total return in local currency terms on the FTSE World Index, showed a negative return of 38.2%, in US dollar terms of 40.9% and in euro terms of 37.8%. Again, sterling based investors with international portfolios were considerably sheltered from the worst effects by the severe weakness in the currency with the negative return on the FTSE World Index being 18.2%, bad enough, but 20% less bad than the local currency movement in the index. Broadly, the same pattern as in the fourth quarter applies. In local currency terms, the negative total return on the FTSE UK Index of 28.3% was less bad than on the FTSE USA Index where it was 36.8%, Europe ex UK 42.0% and Japan 42.0%. However, given the dramatic decline in sterling, these relative performances are reversed with the negative return in the USA reducing to 12.5%, in Europe ex UK to 24.0% and Japan, remarkably, to just 1.1%. Also worthy of mention, is Switzerland, where the negative total return on the local index in sterling terms was just 2.8%.

The same issues apply to top quality government bonds as applied to the final quarter of 2008. Gross redemption yields on ten year benchmark government bonds in the UK fell by 155 basis points to 3.02%, on US government bonds by 182 basis points to 2.22%, on Japanese government bonds by 33 basis points to 1.18% and by 137 basis points on German government bonds to 2.95%.

Although the decline of sterling gathered pace in the final quarter of 2008, it was evident throughout the year. Against the US dollar, it declined by 26.5%, against the Canadian dollar by 9.7%, against the yen by 40.5%, against the euro by 23.3% and by the Swiss Franc by 30.9%. For a G7 member, these are alarming declines. The stand out currencies were the yen and the Swiss Franc as the unwinding of "carry trades", to which we have often referred in past reviews, gathered pace. As we often mentioned, these were highly risky strategies.

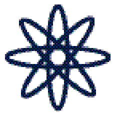
In the commodity markets, oil declined by 51.4% but not before it peaked out at around US$147 a barrel whilst gold rose just 3.1%.

Economics

Normally, we would discuss economic data from various parts of the world in some detail but this does not seem a particularly useful idea in present circumstances when events are moving so fast. Instead, we will attempt to draw some economic and stock market conclusions from what has happened and try to look forward, difficult though this is with so many extraordinary things going on.

2008 is a year that anyone connected with the financial sector will never forget, whether they be investors, investment managers, bankers, investment bankers, bank depositors, central banks, governments, regulators, businesses or individuals which rely on banks for finance. Likely scenarios for 2008 were overtaken by events which were scarcely believable, ending the year with what may be the biggest ever fraud, the scale of which is unimaginable. It is difficult to know where to begin.

The contagion in the banking sector, which had its origin in the US subprime mortgage sector, spread to banks around the world as these assets were packaged up and sold. As defaults grew, some of these assets became toxic causing a loss of confidence within the banking system and a clogging up of interbank lending as banks hoarded cash. Some of those banks which relied heavily on the wholesale market found that the funding gap placed them in great difficulties and governments and central banks intervened to provide support in different ways, including

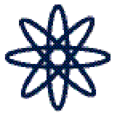


nationalisation. Whilst investors may expect securities to rise and fall in value, they do not expect their deposits to be at risk. In October, the position became exceptionally severe as some well known UK banks experienced a serious outflow of deposits. Government and central bank action was necessary to stabilise the situation and, in the UK, we have the effective nationalisation of Royal Bank of Scotland and a significant government minority holding in Lloyds TSB Group which will follow its proposed takeover of HBOS. In different ways, these types of actions were replicated throughout the world and we can feel a degree of confidence that depositors feel more secure about the safety of their money in major banks. If they do not, a run on the banks has unthinkable consequences. However, we think governments and central banks have found a way to deal with this issue.

An important side effect of the seizing up of the inter bank market was that the transmission effect of lower official interest rates announced by central banks had, at first, and continues to do in a lesser way, a very low transmission effect to borrowers as the margin between inter bank rates and official interest rates soared in the wake of banks' reluctance to lend to each other through lack of trust and their possible funding needs. The margins between the two rates have come down towards more normal levels. Governments round the world, perhaps particularly in the UK, are putting pressure on banks to pass on lower official interest rates to borrowers and to lend at least as much as before to businesses and those who might need to borrow for house purchase. There is a lot of politics in this for it is not as straightforward as some politicians like to make out. As we have just explained, wholesale interest rates have not moved in line with official interest rates and banks have to borrow, more often than not, in the wholesale market as well, so their cost of funding has not fallen proportionately. Secondly, banks have to make a commercial judgement on the interest rates to charge their customers, bearing in mind the risks involved and, thirdly, they should not be forced to lend if they do not think it the correct thing to do. It is fine to criticise the banks for what has led us to this situation but taking action to compound the problems by trying to force unwise lending will bring us back to the problems which caused the crises, albeit through a different way. One can see why some banks avoided selling shares to the government because they did not wish to be pushed into decisions which were not commercial.

An aspect of monetary policy which has not received sufficient attention is the effect on savers. Whilst politicians and central bankers have tended to concentrate on individuals and businesses who borrow money, there are more savers than borrowers and savers will be harshly affected by current minuscule interest rates earned on bank deposits. This will have a depressing economic effect because their disposable incomes will be reduced. Banks also need to retain the loyalty of their customers because retail deposits are high quality deposits and not as fickle as wholesale deposits have proved to be.

Nowhere has escaped the problems caused by the implosion in the financial sector and the effect on confidence has been drastic. We might use the example of the UK financial sector which has been so important to the UK economy and perhaps, in particular, look at the City but this situation is replicated everywhere in the world to different degrees. In the good times which have prevailed until recently, the earnings of companies and individuals were responsible for the success of, say, restaurants, retailers, estate agencies, motor car dealers and many others which benefited from the City's prosperity. The housing market in London boomed on the back of this. Now, as severe retrenchment takes place with financial businesses closing in extreme circumstances or downsizing, these multiplier benefits reverse. There will be a severe contraction in business and employment dependent upon the prosperity of the City. This is an example close to home but is and will continue to be replicated throughout the world. Businesses and individuals will try to conserve cash, putting off discretionary spending even if they are performing satisfactorily, if a business, or in employment, if an individual. The retail sector is an obvious casualty. The proliferation of sale offers is an attempt to turn stock into cash for many retailers but the quiet period after Christmas will be a test for many of them and we may expect more failures. Again, although this is an example near to home, it will be replicated throughout the world.



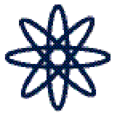
The problems of some UK retailers lie, in part, with the level of debt taken on in good times perhaps through management buyouts or private equity deals or taking on excessive debt for whatever reason. The level of leverage and build up of household, corporate and government debt are now shown to have been unwise. In the case of the housing market, in countries like the UK, USA and Spain, amongst others, it led to excessive and dangerous asset price inflation which has now burst leaving a trail of misery. Unwise lending policies were the start of the problems for the banks.

But leverage was also an important tool of the hedge fund industry which has suffered so severely from the financial implosion. In some cases, leverage was used to magnify tiny returns but, when the model came unstuck, the results were catastrophic. The more austere regime which will follow for banks and prime brokers means that the leverage option will either not be available or will be much reduced. Generous fee structures, a feature of the hedge fund industry, will come under pressure and scrutiny and a return of investors to more conventional asset classes will be a beneficial side effect of what has happened. The hedge fund industry will be much reduced in size. Meanwhile, the deleveraging which is taking place in the hedge fund industry is affecting markets and so is its need to raise cash to meet redemptions. Unfortunately, this means selling off the best and most marketable assets in many cases and this continues to affect stock markets. The indirect fallout from the Madoff scandal, which we will touch upon later, will almost certainly prolong this process.

Individual over leverage encouraged by cheap and available credit, will also cause individuals to follow a different lifestyle pattern as they deleverage themselves. This will affect aggregate demand in the economy as they spend less.

Excessive borrowing is and was not confined to individuals, companies and hedge funds. Some governments were guilty of borrowing too much, none more so than the UK. Hindsight has been much in evidence in 2008 but one thing which has been obvious for a long time and to which we have made regular reference was that the UK's public finances were in a poor state given the level of economic growth which was being shown. We made the point that when an economic slowdown came there would be a problem. We did not envisage an international financial crisis such as we have seen so the problem for UK government finances is far worse than we could have imagined. Whilst the government will say that the overall level of public debt in relation to GDP is modest compared with that of some other countries, that is not the point. The level of current and projected borrowing in relation to GDP is extremely serious. In the pre Budget Report, the Chancellor said that borrowing would increase to £78 billion this year and to £118 billion in 2009/10, 8% of GDP, before starting to fall. Already these figures look optimistic given the economic growth forecasts upon which they are predicated which was 0.75% for this year, -0.75% to -1.25% next year with growth of 1.5% to 2.0% in 2010. These forecasts look too optimistic and, consequently, so do the forecasts for government borrowing.

One of the features of the year has been the collapse of sterling. Had there not been so much else going on, it would surely have been headline news. The precipitous decline of the currency reflects the loss of confidence in the UK economy. Public finances look to be very seriously compromised and the external deficit is also too large. The UK economy is seriously unbalanced and perhaps the only surprise is that sterling held up for so long when it was clearly overvalued. Whilst the UK does not have to defend a fixed exchange rate and therefore not have to use up foreign exchange reserves to support it, the fall in the pound could get out of control. The momentum is certainly against sterling at the moment and currencies often overshoot or undershoot realistic parities on a purchasing power parity basis. There is a distinct possibility that sterling could go into this position since there is not a lot to support it. Overseas takeovers for cash of UK companies have dried up and foreign investors, already badly burned on the currency, might decline to buy UK government securities to finance the large government deficit. Given that UK government bond yields are so low and government bonds look so expensive, they may decide to sell UK government bonds. If the Bank of England resorts to what might be termed the "printing press" route, there could be serious concerns about future inflation, also a concern for the currency. At present, the world is in a disinflationary environment but, once that situation ends, the sharp decline in sterling, unless it is



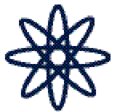
reversed, which seems unlikely, will lead to rising inflation and current bond yield levels on other than short dated issues will look totally inadequate for the risks involved.

The UK government has said little, if anything, about the appalling performance of sterling. Given the gravity of the UK's economic situation, one of the worst of the major economies, it is possible that the foreign exchange market will take the matter out of the government's and Bank of England's hands and force a change of policy to address the unacceptably large fiscal gap. We will discuss the investment implications of this later.

Although most other countries' fiscal positions may not be as bad as that of the UK, nearly all countries have used every orthodox and unorthodox method to try to prevent or limit the recession. Orthodox monetary policy has nearly exhausted its potential because there is little room for interest rates to be cut much further. Were the world to enter a deflationary period then even nil official interest rates (what we effectively have in the USA and Japan) would represent a real interest rate. Unorthodox measures, such as quantitative easing, may follow which, in shorthand, can refer to printing money. Some call it, in reference to Ben Bernanke's earlier work, a helicopter drop of money on an economy. One can see why central banks would be so anxious to prevent deflation. We have all been brought up to fear inflation and economic policy has often had to revolve round trying to tame it. However, deflation, really only experienced recently by Japan, has equally unpleasant effects. The prospect of falling prices can deter consumers and businesses from buying goods and services which they do not need immediately because they believe that they may be able to purchase them more cheaply later. Such actions have an immediate contractionary effect on the economy. For businesses which have costs which they may not be able to reduce immediately, the incidence of lower revenue caused by lower prices can spell financial trouble. For individuals and companies which have borrowings, the real value of liabilities increases during a deflationary period, again a cause of potential financial trouble. So anything other than a short period of falling prices spells trouble, particularly if it is a universal phenomenon. Where it happens to be a country in isolation, it is possible that external trade will help to offset the downside of deflation. The concern at present is that it will be a worldwide phenomenon. From what we can see at present, that is unlikely although we may see individual quarters of falling prices.

However, whilst we may clearly see and feel the disinflationary environment at present and worry about the possibility of deflation, we must be very alert to the possibility that the orthodox and unorthodox monetary and fiscal measures being taken by central governments and banks throughout the world are sowing the seeds of future inflation. In anticipation of that time, as soon as there is sufficient evidence that economic recovery is underway, central banks will have to reverse some of the extreme measures which they have taken, interest rate reductions being one, and fiscal policy, which is very loose, will have to be tightened. Whilst independent central banks might be able to do the former, governments will find it politically harder to do the latter especially as incumbent governments are likely to receive some of the blame for what has happened, fairly or unfairly. The probable size of some governments' budget deficit in relation to GDP, the USA and UK for example, is eye watering.

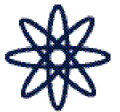
Looking to the future, there are a few certainties, one of which is much tighter financial regulation. Before we discuss the banks in this context, we should discuss the implications of the Madoff scandal. In a year when one thought one had ceased to be surprised by anything in the financial world, one was proved wrong at the end of the year when Madoff's alleged Ponzi scheme was revealed. That anything on such an astronomical scale could remain undetected for so long seems astonishing and one feels that there is a lot more to come out. For now, two consequences seem certain. Although Madoff was not strictly a hedge fund, feeder funds into accounts with his business were and, as a result, have incurred various degrees of loss, some of them severe both in relative and absolute terms. There is no doubt that regulation will become a good deal stricter. The second consequence is that the hedge fund industry will contract further. It was already reeling from substantial redemption requests and having to suspend redemptions in some funds or park illiquid assets in different vehicles for later redemption. The leverage available to the industry is declining and forced sales by hedge funds to reduce their borrowings and/or meet redemption requests have been affecting the stock market. The industry has always relied on a certain



mystique justified by the perceived need of hedge funds to stop competitors knowing what they were doing within the portfolios. With hindsight, the vagueness of Madoff's purported strategies can now be understood. However, investors will not be prepared to take so much on trust in the future and many will withdraw from the industry. This may spark a further large round of redemptions which, until it has worked itself out, may continue to affect markets. The number of funds will reduce considerably, fees will be under pressure (the 2% + 20% formula always seemed extraordinarily high compared with conventional investments) and the fund of funds industry, where a further layer of fees applies, will be under particular pressure. One of the reasons, it seems, why Madoff was able to perpetrate his scheme was that his firm acted as custodian and broker whilst the auditor comprised a three person firm. Third party custody and administrative arrangements seem certain to be the norm. The world of hedge funds is likely to be diminished, less costly and more regulated. Conventional investments should benefit.

Financial institutions and banks in particular will be regulated much more closely. Governments, central banks and regulators have had a serious shock. The result is that banking will become more like it used to be and there is a strong case for arguing that this is a good thing for the long term economic wellbeing and, whilst growth might be slower in the future, should be more sustainable if fewer risks are taken. Capitalism has taken a major hit and what has happened has given governments with interventionist tendencies the opportunities to intervene in the economy and the financial system in a way which may have been more difficult prior to the financial crisis. Because of the poor economic outlook for 2009, it is possible that business failures, personal bankruptcies and a further fall in house prices may require some banks to strengthen their balance sheets again. This could mean further investments by governments.

What may all this mean for stock markets in 2009 and can we find any causes for optimism? Dealing with the latter point first, although everything feels very bleak at present and the news will be unremittingly grim, at least for the first part of 2009, green shoots will appear. Equities are likely to anticipate economic recovery, however shallow, before it occurs. What might these green shoots be? A recovery in merger and acquisition activity is likely to be one event. Although there is a severe lack of confidence at present, almost certainly there are bargains around. Lord Keynes has been enjoying a huge revival as governments have tried to spend their way out of trouble but he also referred to "animal spirits". These are likely to encourage purchasers with money, and there are plenty, notwithstanding what has happened, to dip their toe in the water by making opportunistic bids for companies or assets which are up for sale. Once this happens, other purchasers are likely to follow suit. In the UK, the sharp fall in sterling may encourage foreign investors to step up their purchases of UK assets but, as stated earlier, these are not likely to be government bonds. A second cause of recovery might be the improvement in disposable incomes of those in work or businesses caused by disinflationary influences currently present. This will obviously not apply to everyone but lower interest costs or, say, falling petrol prices, to give an example, could leave more money to spend which could be a catalyst for economic recovery. An improving equity market would also engender more confidence. Why might equities recover when the economic news is unremittingly gloomy? Overall, shares look cheap even though the corporate earnings outlook for 2009 is poor. Many companies will maintain and even increase their dividends, although the attention will focus on those which cut or omit them. The minuscule rates of interest available on bank deposits will focus attention on yield and many shares offer attractive yields. Even 3% or 4% yields, if there is a reasonable chance that they can be sustained, look attractive compared with deposit interest rates or top quality bond yields. They should provide better returns than most maturities of bonds. For UK investors, such investments would also seem to be a good way of benefiting from the weakness of sterling as many large UK companies have substantial overseas earnings and offer yields within this bracket. Other than in short dated issues, bond yields look to be in bubble territory. We are talking here about AAA rated government bonds. Corporate bonds experienced a torrid time in 2008 as the credit markets seized up. Whilst the very low yields on AAA rated government bonds reflect the cut in official short term interest rates, which have forced some investors to look for any yield, the flight to perceived quality and the possibility of deflation, we believe the yield levels seen in the table at the beginning of this review are unrealistically low in some cases, with the UK and



USA particularly coming to mind. The dangers arise from the vast amount of government debt which is going to be issued to fund large budget deficits which could cause serious indigestion in the market and the inflationary potential of the measures being taken at present to kick start the world economy including quantitative easing. Medium and long dated bonds look dangerously exposed. With many good quality equities yielding more than government bonds and with the potential for dividend growth in equities, any reduction in risk aversion is likely to see a sharp swing in sentiment between the two asset classes.

Within the international bond market, the situation regarding eurozone bonds is particularly interesting and dangerous for the eurozone. Whilst those involved with the euro project are congratulating themselves on its tenth birthday, various signs abound that this is far from an optimal currency area. In the same way as UK policy makers cannot deny the verdict of the foreign exchange markets on the UK, so eurozone policy makers cannot deny the strains which exist within the eurozone's economy. One look, at the time of writing, at the ten year government bond yields of Germany, the eurozone's best credit with a yield of 2.95% and those of Austria (3.85%), Belgium (3.79%), Greece (5.23%), Ireland (4.44%), Italy (4.38%), Portugal (3.97%) and Spain (3.85%) shows that all is not well. In the past, countries, like Italy which lost competitiveness were able to devalue. Now they cannot and a loss of competitiveness is bound to lead to internal strains, likely to reflect themselves in rising unemployment and then perhaps social unrest. The different attitude of Germany with a solid domestic budgetary position and others towards the stimulus package shows the strains within the currency area. This could be one of the issues of 2009.

The news for at least the first part of 2009 and probably right through it and into 2010 will be grim. Unemployment will rise sharply and many businesses will fail. We must hope that protectionist tendencies which come to the fore in times of economic difficulty do not gain great traction for this could compound the present difficulties. Absent that, we would expect the equity market to start to anticipate better times even though economic recovery is likely to be slow. Although top quality as opposed to corporate bonds have performed well in the totally unexpected situation which occurred in 2008, medium and long dated issues everywhere look very exposed.

It is inevitable that 2009 will continue to provide unpleasant surprises. Our best estimate is that much of the bad news is already in share prices although individual companies are likely to continue to provide unpleasant surprises. As the year progresses, more attention is likely to be given to the inflationary problems which are likely to arise later on as the result of the abandonment of fiscal and monetary discipline in the face of the unprecedented problems which faced the world economy in 2008.

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