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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equity markets showed a generally positive performance in the final quarter of 2013 although there remained areas of relative weakness in some areas, notably emerging markets. Bonds were weak and, temporarily at least, ten year government bond yields in the U.S.A. and U.K. broke through 3%. The feature of currency markets was the strength of sterling and, to a lesser extent, the euro and Swiss Franc, with the Yen, Australian and Canadian dollars being very weak. Gold continued to display significant weakness for 2013. The feature was the strong relative performance of equities against bonds and, within developed international equity markets, a strong relative performance from developed equity markets compared with emerging markets. In currency markets, the weakness of the yen and currencies related to commodities, like the Australian and Canadian dollars, was very notable. In the commodity markets, gold endured a torrid year.

The tables below detail relevant movements in markets :

International Equities 30.09.13 - 31.12.13

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+3.8	-2.9	-0.7	-2.5
Finland	+9.6	+9.1	+11.6	+9.6
France	+4.3	+3.8	+6.2	+4.3
Germany	+11.1	+10.6	+13.1	+11.1
Hong Kong, China	+2.9	+0.6	+2.9	+1.1
Italy	+9.0	+8.5	+11.0	+9.0
Japan	+9.7	+0.1	+2.4	+0.6
Netherlands	+7.0	+6.5	+8.9	+7.0
Spain	+9.1	+8.6	+11.0	+9.1
Switzerland	+2.6	+2.0	+4.3	+2.5
UK	+5.0	+5.0	+7.4	+5.5
USA	+10.4	+7.9	+10.4	+8.4
Europe ex UK	+6.3	+5.5	+7.9	+6.0
Asia Pacific ex Japan	+2.9	-0.9	+1.4	-0.4
Asia Pacific	+6.2	-0.4	+1.9	+0.1
Latin America	+0.7	-5.3	-3.1	-4.8
All World All Emerging	+3.2	-0.7	+1.6	-0.2
The World	+8.1	+5.2	+7.6	+5.7

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : -1.4%

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

Currency	30.09.13	31.12.13
Sterling	2.73	3.04
US Dollar	2.63	3.03
Yen	0.69	0.74
Germany (Euro)	1.80	1.94

Sterling's performance during the quarter ending 31.12.13 (%)

Currency	Quarter Ending 31.12.13
US Dollar	+2.4
Canadian Dollar	+5.7
Yen	+9.7
Euro	+0.5
Swiss Franc	+0.6
Australian dollar	+7.1

Other currency movements during the quarter ending 31.12.13 (%)

Currency	Quarter Ending 31.12.13
US Dollar/Canadian Dollar	+3.2
US Dollar/Yen	+7.2
US Dollar/Euro	-1.9
Swiss Franc/Euro	-0.1
Euro/Yen	+9.2

Significant Commodities (US dollar terms) 30.09.13 - 31.12.13 (%)

Currency	Quarter Ending 31.12.13
Oil	+2.3
Gold	-9.3

PERFORMANCE DURING 2013

International Equities 30.12.12 - 31.12.12

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+21.3	+2.6	+4.5	N/C
Finland	+43.5	+47.2	+50.0	+43.5
France	+23.8	+26.9	+29.3	+23.8
Germany	+26.2	+29.4	+31.9	+26.2
Hong Kong, China	+9.5	+7.4	+9.4	+4.7
Italy	+17.6	+20.6	+22.9	+17.6
Japan	+54.8	+25.0	+27.3	+21.8
Netherlands	+22.9	+26.0	+28.4	+22.9
Spain	+26.5	+29.7	+32.2	+26.5
Switzerland	+24.0	+25.2	+27.6	+22.1
UK	+18.9	+18.9	+21.1	+15.9
USA	+32.8	+30.4	+32.8	+22.1
Europe ex UK	+23.4	+25.2	+27.6	+22.0
Asia Pacific ex Japan	+11.4	+2.7	+4.7	+0.1
Asia Pacific	+29.0	+12.3	+14.4	+9.5
Latin America	-4.9	-15.7	-14.1	-17.8
All World All Emerging	+3.9	-5.3	-3.5	-7.7
The World	+27.4	+22.4	+24.7	+19.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : -3.9%

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

Currency	30.12.12	31.12.13
Sterling	1.85	3.04
US Dollar	1.76	3.03
Yen	0.79	0.74
Germany (Euro)	1.32	1.94

Sterling's performance during the year ending 31.12.13 (%)

Currency	Year Ending 31.12.13
US Dollar	+2.0
Canadian Dollar	+9.0
Yen	+23.9
Euro	-2.4
Swiss Franc	-0.9
Australian dollar	+18.6

Other currency movements during the year ending 31.12.13 (%)

Currency	Year Ending 31.12.13
US Dollar/Canadian Dollar	+6.8
US Dollar/Yen	+21.5
US Dollar/Euro	-4.3
Swiss Franc/Euro	-1.5
Euro/Yen	+27.0

Significant Commodities (US dollar terms) 30.12.12 - 31.12.13 (%)

Currency	Year Ending 31.12.13
Oil	-0.2
Gold	-27.6

MARKETS

The final quarter of 2014 has seen further progress registered in most international equity markets. In local currency total return terms, the FTSE World Index has returned 8.1%, in sterling terms 5.2%, in US dollar terms 7.6% and in euro terms 5.7%. Looking at local currency returns first, the USA led the way with a return of 10.4% on the FTSE USA Index. Japan also performed very strongly with a return on the FTSE Japanese Index of 9.7%. The FTSE UK Index and FTSE Europe ex UK Index lagged with local currency returns of 5.0% and 6.3% respectively but, in absolute terms, these were very good results by any standard. The biggest underperformers in local currency terms, though still positive, were the FTSE Asia Pacific ex Japan Index (+2.9%), the FTSE Latin America Index (+0.7%) and the FTSE All World All Emerging Markets Index (+3.2%). As sterling was the strongest major currency during the quarter, the overseas returns were reduced in sterling terms. The USA still led the way with the FTSE USA Index returning 7.9% in sterling terms whilst the very mild weakness in the euro and Swiss Franc meant that the FTSE Europe ex UK Index outperformed the FTSE World Index in sterling terms, returning 5.5%. As a result of further significant weakness in the yen, the sterling return on the FTSE Japanese Index was barely positive at 0.1%. The weakness of the Australian dollar pushed the local return on the FTSE Australia Index from a positive 3.8% to a negative 2.9% in sterling terms. Currency weakness pushed the returns on the FTSE Asia Pacific ex Japan Index (-0.9%), the FTSE Latin American Index (-5.3%) and the FTSE All World All Emerging Markets Index (-0.7%) into negative territory.

In contrast to equity markets, bond markets experienced a poor quarter. Taking high quality ten year government bond yields as a benchmark, the gross redemption on UK government bonds rose by 31 basis points to 3.04%. The US Treasury bond's yield rose by 40 basis points to 3.03%, the German Bund by 14 basis points to 1.94% and the Japanese government bond by 5 basis points to 0.74%.

We have already alluded to currency movements. Sterling was the stand out performer in the quarter. Against the yen, it rose by 9.7%, against the Canadian dollar by 5.7%, against the Australian dollar by 7.1%, against the US dollar by 2.4%, against the Swiss Franc by 0.6% and against the euro by 0.5%.

In the commodity markets, oil, as measured by Brent crude, rose slightly by 2.3% but gold endured another poor quarter falling by 9.3%.

Looking back over 2013, equities and bonds showed strongly divergent performances. Looking at international equity markets first, the total return on the FTSE World Index in local currency terms was 27.4%, in sterling terms 22.4%, in US dollar terms 24.7% and in euro terms 19.3%. In local currency terms the feature was Japan where the onset of "Abenomics" propelled the total return on the FTSE Japanese Index to 54.8%. The USA showed an above average performance with the FTSE USA Index returning 32.8%. The only area or region with a negative return in local currency terms was Latin America where the FTSE Latin American Index returned -4.9%. There was only a modest return of 3.9% from the FTSE All World All Emerging Markets Index whilst the FTSE Asia Pacific ex Japan Index returned a below average 11.4%. However, as our table for the year shows, there were some significant currency movements with the yen and Australian dollar being particularly weak. The USA still showed an above average performance in sterling terms with the FTSE USA Index returning 30.4%. The strength of the euro and Swiss Franc meant that a slightly below average return in local currency terms from the FTSE Europe ex UK Index (+23.4%) turned into an above average 25.2% return in sterling terms. Even the spectacular fall in the yen was not enough to bring the FTSE Japanese Index in sterling terms below the performance of the FTSE World Index and it returned an above average 25.0%. Even though the strength of sterling improved the UK market's relative performance compared to the local currency return, its performance, whilst very strong in absolute terms at 18.9%, was below average. The laggards in sterling terms were the FTSE Australian Index where a local currency return of 21.3% in the FTSE Australian Index became one of just 2.6% in sterling terms. The return in sterling terms on the FTSE Asia Pacific ex Japan Index sank to just 2.7% whilst the FTSE Latin American Index returned -15.7% and the FTSE All World All Emerging Markets Index returned -5.3%.

In the high quality ten year government bond market, yield rises were dramatic. Taking the ten year government bond as a benchmark, the gross redemption yield on the UK government bond rose by 119 basis points to 3.04%, on the US Treasury bond by 127 basis points to 3.03% and on the German Bund by 62 basis points to 1.94%. Only the Japanese bond market bucked the trend on the introduction of the extraordinarily loose monetary policy which the Bank of Japan unleashed. The gross redemption yield fell by 5 basis points to 0.74%.

As indicated just now, the feature of the year in currency markets was the weakness of the Japanese and Australian currencies but also, to a lesser extent, the Canadian dollar, the latter two related in part to commodity markets. Against the yen, sterling rose by 23.9%, against the Australian dollar by 18.6% and against the Canadian dollar by 9.0%. Against the US dollar it rose by just 2.0% whilst against the euro it fell by 2.4% and against the Swiss Franc by 0.9%,

In the commodity markets, oil, as measured by Brent crude, was hardly changed, down just 0.2%, but gold experienced a torrid year, down 27.6%.

ECONOMICS

As we enter 2014, we can look back at 2013 and reflect on a mixed picture economically and at least one country which has sprung a surprise, namely the UK. Overall, it has, as expected, not been a great year for the world economy and economic results have been mixed. On the plus side, the USA is showing some encouraging signs of accelerating despite everything which has gone on in Washington and the UK has surprised almost everyone as economists have steadily raised their forecasts for its economy. In Japan, "Abenomics" has stimulated some growth, although the strategy is very high risk. Although the politicians and eurocrats are trying to talk up the eurozone's prospects, and there are some signs of improvement in some of the particularly troubled countries, the zone is mired in relative decline and prospects for 2014 are not encouraging at least in relation to where they need to be to start making inroads into the debt problem. Some of the emerging markets suffered badly when suggestions of the start of tapering of the US Federal Reserve's quantitative easing programme began to emerge last summer. Those which proved to be vulnerable, not unexpectedly, were those with significant current account and budget deficit problems. China, now the world's second largest economy, as is logical, increasingly occupies investors' attention. Concerns about an economic slowdown were somewhat eased towards the end of the year as the third quarter GDP figure showed a modest acceleration although there are concerns about the banking system and a cash squeeze which has, at times, including right at the end of the year, caused short term interest rates to spike sharply.

The result of all of these cross currents, if we take the latest IMF projections, published in October, as indicative, is that world economic growth in 2013 will turn out to have been at 2.9% compared with 3.2% in 2012 and 3.9% in 2011. It is more optimistic for 2014, seeing growth at 3.6%, although this is by no means a strong figure. Economic policy continues to be severely distorted by the extreme monetary policy being followed in many parts of the world. One of its effects, as we have pointed out many times, in these reviews, in on stock markets. As fiscal policies are framed, in many countries, to address budgetary imbalances either through public spending cuts, tax rises, or, more commonly, a mixture, so very loose monetary policy comprising ultra low short term interest rates and, in important economies, money creation by the central bank, has been used to offset the fiscal squeeze. Furthermore, given the signals from relevant central banks in some of the biggest countries or regions, i.e. the USA, UK eurozone and Japan, short term interest rates, even if they are raised modestly, will still remain extremely low by historical standards. As we can see in our table of statistics for the year, longer term government bond yields have risen sharply over the year although they are by historical standards still low, in some cases very low. An important aim of the extreme monetary policy which was initiated in the week of the financial and economic crisis of 2009 was to raise asset prices to increase the fragile confidence levels of businesses and individuals. For businesses, cheap money would either help those which were in short term difficulty or, more positively, encourage others to borrow and invest (the macroeconomic climate has to be right for this to happen, however) and, for individuals, as well as to help with borrowing costs, to create a positive wealth effect, i.e. rising asset prices encouraging more spending. This latter effect may just be beginning to come into play in some countries but it has taken a long time and businesses are proving to be very cautious about increasing capital investment.

Where we can quite clearly see the effect of very loose standard and non standard monetary policy is in the performance of financial assets. Whilst attention tends to be focused on businesses and individuals as borrowers, the plight of savers is, if anything, worse, as there are far more savers than borrowers. Many individuals rely on savings income and the virtual disappearance of interest on bank deposits has forced a reconsideration of investment policy for many investors. The initial popularity of bonds and, latterly, equities, as shown by flows into collective investment funds, reflects the role of monetary policy in shaping investment decisions. Because of the shape of the yield curve with central banks fixing short term interest rates, which are those that they can control, very low, yields on bonds with longer maturities, which they cannot so easily control, proved to be attractive in relative terms, i.e. to short term deposits although not in absolute terms. We have made the point many times that bond yields were fundamentally well below realistic levels and would prove a very bad investment. With high quality bond yields often below equity yields in major markets, the search for income has intensified and investors who might not have been traditional equity investors have been attracted into this asset class. At the same time, as the sense of crisis has abated and with the possibility (and now the reality) of the start of the US Federal Reserve's tapering programme, longer term bond yields have started to rise, as our table for the year at the beginning of this review shows. The significant outperformance of equities against bonds in 2013 has not been lost on investors and some commentators and appreciation at the overvaluation of bonds is now growing. So, in 2013, we have seen a more realistic approach to the distortions created by very loose monetary policy in terms of an appreciation of the attractions of equities over bonds. Traditionally, of course, equities have been considered a much higher risk class than bonds and this view will not be changed officially but, in investment and economic terms (working through the economic consequences of very loose monetary policy), we would argue that it is bonds as a class which will provide the higher risk to investors. It is true that inflation is very low at present and that, if we take ten year high quality government bonds as a benchmark, yields are comfortably above inflation. However, the risks to bonds remain very clear. Where quantitative easing has occurred in the USA, UK and Japan, this will have to be reversed at some stage. If we take the USA as an example where money printing has been running at US$85 billion a month, now reducing to

US$75 billion and likely to be reduced further if the economy continues to improve, the increasing absence of a buyer of debt and the buyer's ultimate disappearance is likely to raise interest rates as long as the government still has to fund a budget deficit and refinance bond maturities. Ultimately, it will need to sell the securities it took on to its balance sheet back to the private sector and the presence of a big seller of bonds, at a time when the federal government is still having to borrow money, is likely to keep upward pressure on interest rates. Another possible course of action where quantitative easing has been practised is to require commercial banks to place additional deposits with central banks to limit their ability to lend and this, too, would be likely to push up interest rates. One should not be fooled by present low inflation rates. At the moment, internationally, a general lack of confidence is holding back businesses from investing and consumers from spending (this is a broad generalisation) but when sentiment changes and the money starts to circulate, inflationary pressures are likely to rise. With talk of deflation in the air, this tends to be forgotten but, if and when inflationary pressures start to be seen, bond yields will almost certainly rise and, quite possibly, sharply. The investment lesson from this is that, if there is a big step up in bond yields, the capital loss or, if held to redemption, the opportunity cost resulting from being locked into an unrealistically low gross redemption yield will never be recovered if, as one would expect, shares perform much better. Even if shares go down temporarily, and assuming that the investor does not panic out, dividends will still be received and, on past performance, the shares will recover and move ahead of the level from which they originally fell. This is a point which is often overlooked.

Some impact from monetary policy can be seen in the foreign exchange market although the overall picture is more nuanced. Compared with the rate at the end of 2013, both the euro and Swiss Franc have strengthened against sterling. Neither has used quantitative easing as a policy tool although the ECB has provided liquidity for the banking system when needed. The USA, which has, has seen its currency move very little against sterling compared with a year ago. Sterling has been a relatively strong currency, but against some of the emerging market currencies, the US dollar has been strong as those countries, as we mentioned earlier, which have weak external and internal finances have seen a movement away from their currencies and towards the US dollar on the first mention last summer of a possible start to tapering. So, although the Federal Reserve's balance sheet has expanded enormously from about US$940 billion at the time of the Lehman Brothers collapse in September 2008 to around US$4 trillion now, the move or threat to move to tighten (although this is relative when US$75 billion of assets are being purchased by the Federal Reserve each month) has caused a relative strengthening of the US dollar against countries with weak current account and budget deficit positions. The weakness of the Australian and Canadian dollars can be attributed to commodity prices being slightly weaker than this time last year although, for Australia, iron ore prices have recovered from their dip in the second quarter of 2013. In the case of Australia, a 50 basis point reduction in official interest rates since the beginning of 2013 and a recently reduced growth forecast of 2% - 3% (2.25% - 3.25%) for 2014 from the Reserve Bank of Australia has weakened the previously very strong Australian dollar. In 2013, the Canadian dollar declined by about 7% against the US dollar and the Australian dollar by about 14%.

Gold was a major casualty in 2013 falling by about 28% in US dollar terms and, at the moment, it looks totally unloved. The movement in the gold price is extremely hard to forecast. The traditional reasons for holding it relate to it being a store of value in uncertain times, perhaps political upheaval, and also as an inflation hedge. There has been significant political tension in 2013, the Middle East, North Korea and the Japan / China stand off over the disputed islands, but it has had no effect. We have noted the weak trend in inflation and that will have been unhelpful to gold but investors might have expected markets to look further ahead for the time when quantitative easing might cause significant inflation but, so far, it has not. Because gold provides no income, the opportunity cost of holding it at a time when interest rates are at rock bottom is negligible, but that has not helped either. At the moment, the metal looks completely out of favour but that may simply be a case of extrapolating trends. It remains very hard to assess gold but, for us, it is not a core holding and its inability to react in a reasonably predictable way to economic trends makes it unlikely that it will be.

In looking back at our conclusion to this review twelve months ago, our broad conclusions were correct, negative on bonds and positive on equities, which we said were attractive on valuation grounds especially against most competing assets. We also expected volatility and that, too, has occurred. We felt that 2013 would see much of the same as 2012, a year when shares performed well. Whilst we did not put a figure on the return expected from equity markets, we have been surprised at the magnitude of the return. We can rationalise this by reference to the stance of monetary policy which we have discussed at length above. We said at the end of our December 2012 review that the rise in the stock market in 2012 was not for the best of reasons, i.e. being partly driven by cheap and printed money, and the same could be said for the performance in 2013, which is why markets will be susceptible to bad news on occasions. What has happened during 2013 has been that, with little growth in corporate earnings, price/earnings ratios have expanded. There has been some modest dividend growth augmented by some large share buybacks, particularly in the USA, which has been helpful. Whilst shares by definition do not look as cheap as they were a year ago, we do not consider them to be overvalued, especially given that competing assets, mostly notably bonds, look so unappealing. One of the arguments of the bears of the equity market is that, on a cyclically adjusted basis going back ten years, the price/earnings ratio would be much higher. The argument is therefore whether profits are about to fall sharply as a result of margin deterioration and that profits as a percentage of GDP consequently fall and revert to the mean. We do not see this happening. It is true that recent profits growth has largely been driven by companies maintaining a firm grip on costs. Many have been building up large cash balances because they do not feel confident enough to invest, hence there have been some large dividend increases and share buybacks as companies have felt there are better ways to reward their shareholders than to take the risk of ramping up investment only to find that the demand was not there. But, at some stage, companies have to invest as their existing infrastructure and plant becomes outdated or uncompetitive. Before then, "animal spirits" may kick in and provide the catalyst for investment. Consumers may do the same. However it comes about, companies will soon need revenue increases to boost profits because the scope for cost cutting eventually runs out. In other words the "e" in "p/e" needs to increase and validate share prices. At least in the USA, this may happen. The shale oil and gas revolution is likely to prove of enormous benefit to the USA as it lowers costs, encourages investment into the country as opposed to abroad where high energy costs make projects unattractive (i.e. Europe) and encourages "reshoring". Whilst the antagonism between the parties on Capitol Hill and between the Republicans and the President is not going to abate, the recent budget agreement seems to have taken the heat out of the situation for the present and, with the latest quarterly growth figures being revised upwards to 4.1%, there is reason to hope that the tax increases and spending cuts which came into force at the beginning of 2013 have not had a significant adverse effect on the economy whilst achieving the desirable effect of shrinking the size of the budget deficit. This must not hide the reality of serious problems looming later on. Unless the USA addresses its future spending problems and how it is to address them, with the USA expected to grow faster in 2014 than 2013 (the IMF projects 2014 growth of 2.6% against 1.6% this year), the current expectation amongst analysts is that earnings growth from US companies will accelerate in 2014, with the prospective price/earnings ratio for next year at around 15 on the S&P 500 Index and a prospective dividend yield of around 2.1%. After a very strong rise in 2013, and assuming some acceleration in economic growth, a modest rise in share prices is a more realistic expectation, allowing company earnings to make up some ground so that share ratings in the USA do not expand. That would provide a firmer underpinning for future progress. From an economic perspective, the USA does provide one of the more attractive prospects. The risks, as far as one can tell at this stage, look less than elsewhere.

Looking at specific data from the USA, we noted earlier that the third quarter's GDP estimate had been raised to an annual rate of 4.1%. The US Department of Commerce reported that the increase in real GDP in the third quarter primarily reflected positive contributions from private inventory investment, exports, residential fixed investment and state and local government spending that were partly offset by a negative contribution from federal government spending. Increased imports detracted from growth. It added that the acceleration in the third quarter's real GDP growth was primarily due to an acceleration in private inventory investment, a deceleration in imports and accelerations in state and local government spending and in personal consumption expenditure which were partly offset by a deceleration in exports. The closely followed purchasing managers indices were both safely in positive territory, especially that for manufacturing which came in a 57.0 in December against 57.3 in November, both strong figures. That for non manufacturing came in at 53.2 compared with 53.9, slightly down but satisfactorily over the 50 level which divides expansion from contraction. The unemployment rate fell sharply in November, down to 7.0% from 7.3%. The low participation in work puts a gloss on the figures but they, nevertheless, reveal a positive trend in the US economy. The downward trend in unemployment will heighten expectations of a continuation of the Federal Reserve's tapering programme. In its latest statement on 18th December, the FOMC said that it sees the improvement in economic activity and labour market conditions since the start of its current asset purchase programme as consistent with growing underlying strength in the broader economy. It also noted the risks to economic performance from inflation persistently remaining below its target level of 2%. The current year on year increase in consumer prices is 1.2%, so the inflation and employment data may be pulling in opposite directions as far as the outlook for tapering is concerned but, as we said previously, quantitative easing, if not pulled back at some stage, risks inflation later on. With inflation below target, this is a problem for another day.

Although there are efforts to talk up prospects for the eurozone, and certainly some of the troubled members of the currency bloc have shown signs of improvement from a very low level, its problems remain as intractable as ever and it remains a threat to world economic recovery. Some recovery is predicted for 2014. For example, the IMF projections are for growth in the eurozone of 1.0% in 2014 compared with economic contraction of 0.4% in 2013. It projects growth in the largest four members, 1.4% for Germany, 1.0% for France, 0.7% for Italy and 0.2% in Spain. In Germany, after lengthy talks, a Grand Coalition has been formed between the CDU and SPD, the CDU's previous allies, the market friendly FDP, having failed to cross the 5% threshold necessary to continue representation in parliament. The paradox is that Mrs Merkel's party, having performed very strongly in the election but just falling short of an absolute majority, has had to agree to some of the SPD's demands which have undone some of the previous supply side reforms which have benefited the German economy. Grit has been put in the wheel and Germany is likely to be less economically effective as a result. All things are relative, of course, and the strength of the German economy will continue to dominate the eurozone. Because of its size as the number two economy in the eurozone, the performance of the French economy is important for the success or failure of the eurozone's monetary union experiment and, in this respect, it is a cause for concern. At around 57% of GDP, the highest in the eurozone, the state is dominant in the economy. Inevitably, this has a tendency to "crowd out" the wealth creating private sector. The French approach to the budgetary disciplines required as a member of the eurozone has been to concentrate on tax increases rather than spending cuts, the opposite of the policies recommended by outside observers. France much values its economic and social model of high taxation and high spending but it looks quite out of date in current times and its economic performance tends to support this view. It has consistently lost ground in recent years to its main rival, Germany, as its competitiveness has diminished and this is reflected in a declining current account performance. Having been elected on an anti austerity ticket, the President, who enjoys record unpopularity, is in a very difficult position. Encouraging the private sector with more competitive tax levels and reducing the size of the public sector is not something that will come easily to him and his supporters but most independent observers know that this has to happen if France is to restore its position. With current account and budget deficits to contend with, membership of the eurozone, as we have seen with several countries, does not protect a country from the consequences of deficits. Standard & Poors, in November, lowered its credit rating on France from AA+ to AA on the slow pace of economic reform. Although France can still borrow at historically low levels (the current ten year French government bond yield is 2.45%, a year ago it was about 2.0%), it continues to accumulate public debt. At some stage, markets will react if there are no signs of serious action to address the country's imbalances. With increasing hostility to tax increases in France being manifested in demonstrations, 2014 is going to be a very difficult year for the country and this will have important significance for the eurozone. By way of one example of the difficulty France is experiencing, the latest Markit Purchasing Managers Index for France has fallen well into negative territory at 47, whilst Germany stands at 54.3 and the reading for the eurozone as a whole is 52.7. This is just one example but it is symptomatic of France's relative economic decline.

The latest economic growth figures from the eurozone do not make good reading even though, the IMF forecasts, for example, a return to modest growth is expected in 2014. If we look at the four largest members of the eurozone's third quarter growth figures, we see that Germany grew by 0.3%, France contracted by 0.1%, Italy was flat and Spain grew by 0.1%. If we look at the third quarter year on year figures, we note that Germany grew by 1.1%, France grew by 0.2%, Italy contracted by 1.8% and Spain contracted by 1.1%. In terms of addressing the budget deficit and public debt issues, this is not a good place to be. Stagnant or declining economies increase the pressure on public finances, having a negative effect on government revenue and expenditure and pushing up the level of outstanding debt as more has to be borrowed each year. If something is not done about this, even the largest economies will, at some time, face a crisis of confidence affecting its lenders. Italy is a concern in this respect because although its budgetary position is not as bad as those of some other eurozone members, its level of outstanding public debt as a percentage of GDP is approaching 130% and growing all the time. Even if the IMF's growth projection for 2014 for Italy of 0.7% is correct (its forecast for 2013 was -1.8%), this is not enough growth even to stabilise the position of outstanding public debt. Piling austerity upon austerity, as is the eurozone's favoured policy method to address the problems of the eurozone's public finances, just creates a vicious circle of decline which offers no promise of resolving the problems of some eurozone countries' public finances. However, critics of austerity within the eurozone have to put forward constructive ideas to deal with the eurozone's budget deficit and outstanding public debt to GDP ratio problems. It is not enough just to criticise austerity since, if the issues which it is meant to address, i.e. deficits, continue, there will be a crisis as lenders refuse to buy the relevant sovereign debt. Nearly everywhere where there is a problem it is excessive public spending but reducing that has an economic contraction effect in the short term. The real issue which the politicians and eurocrats fail to face up to is that the absence of flexible exchange rates takes away the one policy tool which could make a difference. If we take the case of France, it has steadily been losing competitiveness against Germany as its relative unit costs of production have risen against Germany's. This is manifested by a deterioration in its current account. Prior to the introduction of the euro, this loss of competitiveness would have been offset by a decline in the value of the French franc against the euro. Now this cannot happen, the only realistic alternative which has been imposed on Greece, Portugal, Spain and Ireland is internal devaluation, i.e. taking measures to reduce unit costs of production which, in practice, has meant wage cuts and associated unpleasant remedies. In France, the government has taken some limited measures to relieve employers of some of the cost burdens of employment. This is hardly a practicable solution to France's competitive problems. The trade unions would simply not accept it. It is true that there have been some agreements on costs in companies like Peugeot but cutting wages and many employment costs is not a realistic option in France. We have repeatedly argued that the euro is a flawed project because of the "one size fits all" interest rate straitjacket and the inability of countries to devalue. One should not be lulled into any sense of overconfidence about the state of the eurozone. Things may have gone quiet but the euro's fundamental flaws may surface at any time and we maintain our view that it will break up at some stage. The European elections this year are almost certain to produce a big increase in the representation of eurosceptic parties in the European parliament covering the whole political spectrum.

As we have noted in our performance tables at the beginning of this review, the Japanese equity market has experienced a spectacular year, albeit that the weakness of the yen has reduced the returns for foreign investors to still very good levels. The utilisation of an extreme quantitative easing programme, a fiscal stimulus and a 2% inflation target, together with the inevitable weakening of the yen and consequent uplift in corporate profits, have excited investors. There is a third arrow of "Abenomics", which is structural reform, and that is vital for the success or otherwise of "Abenomics". The Japanese economy is beset by rigidities in the labour and product markets and, if these are not addressed, the aim of increasing the long term potential growth rate of the Japanese economy will not be realised and modest inflation, a desirable objective, may lead to much higher inflation, an undesirable objective. Japan's budget deficit and public debt to GDP ratios are extreme with gross public debt at around 220% of GDP. Japan's interest rates have been very low and against a historic background of deflation that is understandable but, should Japanese interest rates rise sharply, the cost of servicing the debt will cause severe budgetary problems. That is the tightrope which Japan is walking. Structural reforms are very difficult to make in a country with strong vested interests but it is vital that they are made because they are the necessary complement to the monetary and fiscal arrows of "Abenomics". The latest quarterly growth rate in Japan at 0.3% showed a slowdown from the previous two quarters (1.5% in the first quarter and 0.9% in the second quarter) but the year on year growth rate accelerated to 2.4% as the comparison was boosted by the final two quarters of 2012 which showed negative growth. The latest Nomura/JMMA Purchasing Managers Index for December was at a year's high for 2013 at 55.2, well into expansionary territory. The latest Tankan survey for manufacturing stood at 16, the highest reading since the fourth quarter of 2007 whilst that for non-manufacturing stood at 20, the highest reading since the third quarter of 2007. The Tankan reading for small manufacturers was barely in positive territory at 1 but this, too, was the most positive reading since the fourth quarter of 2007. For the small enterprise non-manufacturing sector, the reading of 4 was the first positive reading for many years. Even when the Tankan surveys for large and small manufacturing companies and large service companies were positive in the fourth quarter of 2007, the reading for this sector was -12. In its latest projection, the IMF forecasts growth of 1.2% in 2014. Japan will need to grow more quickly than this if it is to address its public finance problems. Uncertainty about the rate of growth in 2014 arises partly from the rise in consumption tax next April from 5% to 8%. This rate of indirect tax is low by international standards and is an efficient way to raise revenue. Although it has been long planned and had bipartisan support in the last parliament, the new administration agonised about its implementation at a time when it was trying to stimulate economic growth. The

Bank of Japan and government with their respective monetary and fiscal stimuli, have taken a big gamble on the economy in an effort to get things moving. Even though the vast majority of Japan's debt is financed internally, the risk of not going ahead with the proposed rise in consumption tax was a loss of confidence amongst buyers of Japanese government debt that the government lacked commitment to tackling the country's debt problems. So, much as we have elsewhere, the idea is that very loose monetary policy can provide some offset to a tightening of fiscal policy which a rise in consumption tax means. Doubts about Japan's growth rate in 2014 arise because of the extent of the interaction between these two conflicting forces. At least Japan has moved into inflationary territory as aimed at by the Bank of Japan's policy remit. The latest year on year consumer price index shows a rise of 1.5% moving towards the Bank of Japan's target of 2.0%. We recognise that the Japanese economic experiment is high risk and that this has implications for the markets both ways but we think that modest exposure remains desirable.

All eyes remain on China which remains an important driver of world economic growth even if its reduced rate of growth and some recovery elsewhere, notably in the USA, means that the balance of forces driving growth has shifted modestly. The main interest last year was what would be the market effect of the new Chinese leadership and what we could learn from the recent plenum. State controlled companies will remain important but markets will have a greater part to play. The war on corruption continues and conspicuous consumption is not encouraged. There is a concern about the banks given the scale of their lending for fixed investments and also about the shadow banking system. The Chinese authorities are keen to balance the economy away from fixed investment towards consumption with less emphasis on exports. The result of this is likely to be slower but better quality growth, at least that is the aim of policy. So all eyes are on the latest Chinese economic data. Third quarter 2013 year on year GDP growth was at 7.8% up from the previous quarter's 7.5%. Third quarter GDP growth was 2.2% over the second quarter. The latest purchasing managers index for manufacturing stood at 51.0 against 51.4 in November whilst that for non manufacturing stood at 54.6 against 56.0 in November. The inflation figures in China are perhaps more important than elsewhere and, within the overall figure, food prices are particularly important because, as a major component of expenditure, rising food prices have the potential to cause social unrest. One can therefore expect the authorities to embark on quite an aggressive monetary policy if the threat of much higher inflation looms. The current consumer price index increase at 3.0% year on year, less than half of its peak level in 2011 but nearly double its trough in 2012, is not yet a cause for concern but it will be watched closely for policy implications which may impact on growth. November's CPI index actually fell 0.1% month on month. Despite an economic growth rate which is the envy of developed countries (although they could not possibly grow as fast without causing serious inflation), the Chinese stock market has been a very poor performer with sufficient domestic concerns to put off investors. It seems to be paradoxical that a country which grows so quickly can produce such a poor stock market performance and an area, such as the eurozone, which produces such a poor economic performance, can, as in 2014, produce a very good stock market performance, but stock market and economic performances do not necessarily correlate well. As the number two world economy and one which eventually will be the largest, we can expect its influence to increase and for its fortunes to be watched closely by investors to provide a guide to investment policy. At the moment, it is modestly positive but the USA may be more important in the short term.

As we said before, the UK has been the surprise of 2013. Whilst talk a year ago was of a triple dip, it turns out that there was not a dip at all as measured by quarterly year on year rates. The Chancellor was under pressure to have a Plan B rather than sticking to Plan A, which was to try to tackle the UK's very serious budget deficit, and, because of that deficit, a rising stock of outstanding public debt as a percentage of GDP. But Plan B which was essentially to borrow more in the hope that additional government borrowing would stimulate the UK economy to such an extent that the additional borrowing would pay for itself through increased tax revenues. When a country has a budget deficit as high as that of the UK, that would have been a very high risk approach which could have weakened sterling severely and caused interest rates to rise causing a severe recession. In fact, the Chancellor was not as tough as his words suggested. The economic climate was far more difficult than envisaged in 2010 when the deficit reduction plans were drawn up, with the turmoil in the eurozone damaging the UK's very important export market. The Chancellor has allowed the automatic stabilisers to come into play whereby budgetary policy does not try to be pro cyclical, i.e. taking measures which will exacerbate the trend such as raising taxes further than anticipated or cutting government expenditure more than anticipated to try to make the budget deficit figures come in as they would have done if economic conditions had been as anticipated. Nearly all the economic figures now coming out are positive. The balance is not even marginal. The latest estimate of third quarter 2013 GDP shows a quarter on quarter increase of 0.8% to give a year on year increase of 1.9%. The latest Purchasing Managers Index for the manufacturing sector in December stands at 57.3, well into positive territory which implies expansion. That for the services sector stands at 58.8 and, for the construction sector, at a very high 62.1. Purchasing managers Indices have a high value for followers of economic news and for formulating economic forecasts. The unemployment rate is now down to 7.4%, still too high, of course, but moving quite fast in the right direction. Inflation, too, so long above Bank of England targets has moved down towards that target for a year on year increase of 2.1%. That is important because real wages have been falling as pay increases have not kept pace with price increases. Any improvement in the relationship between the two is likely to stimulate more spending. The savings ratio has been falling which is the reason why consumer spending has held up well and also at a time when record numbers are in employment. As so often, when trends shown by economic statistics change, so do forecasts. In the case of the UK, as the economic numbers have been almost all good, so have growth forecasts for 2014. In October, in its projections, the IMF was forecasting growth of 1.9% for the UK in 2014. Most forecasters producing their forecasts since that time expect much better than that. The latest OBR forecast published in December suggested growth of 2.4% in 2014 as measured by its central forecast. Of course, nobody should be carried away about the prospects for the UK in 2014. The eurozone, a large trading partner, remains in deep trouble and that is not good news for the UK's exports, nor is the strength of the pound. Public debt remains a serious problem for the UK and its burden on the UK economy will take years to correct. The UK's recovery is lopsided. It would be desirable if it were driven by exports and business investment but growth, however achieved, is better than no growth. Very importantly, the UK has the inestimable advantage of not being in the eurozone.

There are, however, nasty clouds developing in the UK and these arise from the toxic anti business sentiment being whipped by populist politicians and others. The scandals in the banking sector, in particular, have provided the springboard these people need but it has got completely out of hand. The financial sector is vital to the UK. Ideally, there should be some rebalancing with the manufacturing sector, not by stopping the financial sector from growing but by encouraging conditions such that manufacturers can prosper and grow at a faster rate than the financial sector and the services sector in general. But as manufacturing is now a small, but very important, part of the economy, this is a long term process and might not even be achieved. The witch hunt against business, which has gained currency, often led by populist politicians who either do not understand that the message they are sending out, perhaps particularly to overseas, is intensively negative and likely to cost the UK investment and jobs or, even more worryingly, do not care, is highly damaging to the UK. Perhaps the most worrying development has been the fierce hounding of the energy industry. Statements are made about profiteering without any serious evidence being produced. Already the effect can be seen in the fact that policy promises of a price freeze, or suggestions of a windfall tax on the energy companies from a former British Prime Minister, have raised the cost of capital. At a time when the UK is running a very fine line on its energy supplies, this kind of talk and policy proposals will scare off much needed investment. If electricity supplies have to be curtailed in the future, it goes without saying that the effect on the UK economy will be very serious. Anti business rhetoric from politicians can translate into dangerous policy decisions and, at the moment, we regard the anti business sentiment which is being whipped up as a potentially significant stock market factor which could offset the better economic prospects which are now apparent in the UK but which can so easily be derailed by the politicians.

After a year of double figure returns from most equity markets, it would be quite unrealistic to expect a repeat performance Economic conditions remain difficult in many countries and the expansion of price/earnings multiples now needs some support from more robust earnings growth. After a year in which share prices have risen ahead of earnings growth, equity markets will be vulnerable to shocks, perhaps from the eurozone. Our best estimate is that 2014 will end with equity prices higher but with difficult periods and some negative quarters. Where we have cash which has built up awaiting investment we could look to use such an opportunity to add to positions. For the reasons we have outlined, we consider the bond market still to be very vulnerable even though yields have risen during the year. There is still a lot of scope for losses or large opportunity costs being incurred in that market. It is important that investors are not influenced by double figure equity returns in 2013. The world remains a very difficult place in an economic context.