meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Bonds and equities experienced a positive final quarter of 2014 but it was the U.S. equity market which stood out, giving strong local currency and currency adjusted returns as the U.S. dollar strengthened. Other markets did less well and, to enjoy a modestly positive equity result in 2014, it was necessary to have some exposure to the dominant U.S. market. Others, such as the U.K. and Europe ex UK disappointed over the quarter and the year relative to the U.S.A. The remarkable fall in bond yields continued in the final quarter and their extraordinary decline for the year as a whole is shown in our table. Except against the US dollar, sterling strengthened over the year. The fall on some commodity prices, with oil the most high profile, was remarkable.

The tables below detail relevant movements in markets :

International Equities 30.09.14 - 31.12.14

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+3.2	+0.3	-3.5	+0.7
Finland	+2.4	+2.0	-1.9	+2.4
France	-1.6	-2.0	-5.7	-1.6
Germany	+4.1	+3.6	-0.3	+4.1
Hong Kong, China	+1.7	+5.9	+1.8	+6.3
Italy	-9.1	-9.5	-12.9	-9.1
Japan	+6.8	+1.6	-2.3	+2.0
Netherlands	+3.1	+2.7	-1.2	+3.1
Spain	-4.4	+4.7	-8.4	-4.4
Switzerland	+1.7	+1.7	-2.2	+2.1
UK	-0.2	-0.2	-4.0	+0.2
USA	+4.7	+8.9	+4.7	+9.3
Europe ex UK	+0.1	-0.5	-4.3	-0.1
Asia Pacific ex Japan	+1.0	+0.8	-3.1	+1.2
Asia Pacific	+3.8	+1.2	-2.7	+1.6
Latin America	-6.2	-10.2	-13.7	-9.9
All World All Emerging	-0.4	+0.4	-3.5	+0.8
The World	+3.6	+4.6	+0.6	+5.0

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +6.3%

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

Currency	30.09.14	31.12.14
Sterling	2.43	1.76
US Dollar	2.49	2.17
Yen	0.53	0.33
Germany (Euro)	0.95	0.54

Sterling's performance during the quarter ending 31.12.14 (%)

Currency	Quarter Ending 31.12.14
US Dollar	-3.9
Canadian Dollar	-0.4
Yen	+5.0
Euro	+0.3
Swiss Franc	N/C
Australian dollar	+2.8

Other currency movements during the quarter ending 31.12.14 (%)

Currency	Quarter Ending 31.12.14
US Dollar/Canadian Dollar	+3.6
US Dollar/Yen	+9.3
US Dollar/Euro	+4.4
Swiss Franc/Euro	+0.3
Euro/Yen	+4.7

Significant Commodities (US dollar terms) 30.09.14 - 31.12.14 (%)

Currency	Quarter Ending 31.12.14
Oil	-39.4
Gold	-1.1

PERFORMANCE DURING 2014

International Equities 31.12.13 - 31.12.14

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.7	+2.7	-3.3	+10.1
Finland	+12.8	+5.2	-0.9	+12.8
France	+3.7	-3.3	-8.9	+3.7
Germany	+2.9	-4.0	-9.6	+2.9
Hong Kong, China	+3.3	+9.7	+3.3	+17.6
Italy	+4.8	-2.2	-8.0	+4.8
Japan	+10.3	+2.7	-3.3	+10.1
Netherlands	+8.3	+1.0	-4.9	+8.3
Spain	+9.0	+1.7	-4.3	+9.0
Switzerland	+12.4	+6.9	+0.6	+14.6
UK	+0.6	+0.6	-5.3	+7.8
USA	+13.3	+20.3	+13.3	+29.0
Europe ex UK	+7.6	+0.2	-5.7	+7.4
Asia Pacific ex Japan	+4.2	+5.0	-1.1	+12.6
Asia Pacific	+7.0	+3.9	-2.2	+11.4
Latin America	-1.1	-7.2	-12.6	-0.5
All World All Emerging	+7.2	+7.9	+1.6	+15.7
The World	+9.9	+11.3	+4.8	+19.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +13.9%

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

Currency	31.12.13	31.12.14
Sterling	3.04	1.76
US Dollar	3.03	2.17
Yen	0.74	0.33
Germany (Euro)	1.94	0.54

Sterling's performance during the year ending 31.12.14 (%)

Currency	Year Ending 31.12.14
US Dollar	-5.9
Canadian Dollar	+2.8
Yen	+7.1
Euro	+7.2
Swiss Franc	+5.2
Australian dollar	+2.8

Other currency movements during the year ending 31.12.14 (%)

Currency	Year Ending 31.12.14
US Dollar/Canadian Dollar	+9.3
US Dollar/Yen	+13.9
US Dollar/Euro	+14.0
Swiss Franc/Euro	+1.9
Euro/Yen	-0.1

Significant Commodities (US dollar terms) 31.12.13 - 31.12.14 (%)

Currency	Quarter Ending 31.12.14
Oil	-48.1
Gold	+0.6

MARKETS

A very volatile quarter has ended with moderately positive returns for international equity markets overall, although the performance pattern has been mixed with some countries and regions showing negative returns. It has been the strength of the dominant US stock market which has propelled the FTSE World Index higher. In total return terms, that index has returned 3.6% in local currency terms, 4.6% in sterling terms, 0.6% in US dollar terms and 5.0% in euro terms. Looking at local currency returns first, we see above average returns from the FTSE Japan Index (6.8%) and the FTSE USA Index (4.7%), whilst there were below average performances from the FTSE All World All Emerging markets Index (-0.4%), the FTSE Latin American Index (-6.2%), the FTSE Europe ex UK Index (0.1%) and the FTSE UK Index (-0.2%). With some significant currency movements during the quarter, notably the strength of the US dollar and the weakness of the yen, sterling adjusted returns look quite different. The return on the FTSE USA Index rose to 8.9%, whilst that of the FTSE Japan Index fell back to 1.6%. The FTSE Europe ex UK Index moved into negative territory (-0.2%) whilst the return on the FTSE Latin American Index worsened to -10.2%.

The extraordinary movements in the international bond markets continue. Taking 10 year government bond yields as the benchmark, we saw a fall in the gross redemption yield on UK government bonds of 67 basis points to 1.76%, on US government bonds of 32 basis points to 2.17%, on Japanese government bonds of 20 basis points to 0.33% and on German government bonds of 41 basis points to 0.54%.

In the currency markets, sterling fell by 3.9% against the US dollar and by 0.4% against the Canadian dollar, but rose by 5.0% against the yen and 2.8% against the Australian dollar.

In commodity markets, the extraordinary story continued with oil, as measured by Brent crude, falling by 39.4% whilst gold was just 1.1% lower.

Turning now to equity market movements during calendar 2014, we see an outcome which was outside the upper end of our band of expectations following the double digit rises in international equity markets in 2013. In local currency terms, the FTSE World Index returned 9.9%, in sterling terms 11.3%, in US dollar terms 4.8% and in euro terms 19.3%. However, the pattern was mixed and in order to have shown a modestly positive return it was generally necessary to have exposure to the US equity market. In local currency terms, the FTSE USA Index returned 13.3%, a well above average return. The next best performer was Japan with a return of 10.3% on the FTSE Japan Index. There was a satisfactory, but below average, return on the FTSE Europe ex UK Index of 7.6% and, within this, Switzerland was the stand out performer, returning 12.4%. The UK had a disappointing year in relative terms with the FTSE UK Index returning just 0.6%. There was a below average, but still positive, return on the FTSE Asia Pacific ex Japan Index of 4.2%. The FTSE All World All Emerging Markets Index provided a satisfactory but below average return of 7.2% but there was a slightly negative return from the FTSE Latin American Index, -1.1%. However, the significant currency movements during the year meant a big adjustment in sterling adjusted returns. The strength of the US dollar meant that sterling based investors saw a 20.3% return on the FTSE USA Index, getting on for double the return on the FTSE World Index. On the other hand, marked weakness in the yen brought the sterling adjusted return on the FTSE Japan Index down to 2.7%. Weakness in the euro brought the sterling return on the FTSE Europe ex UK Index down to just 0.2%. With the Swiss Franc being slightly less weak than the euro, the FTSE Switzerland Index produced a respectable sterling adjusted return of 6.9%. Weakness in the Latin American currencies increased the negative return in sterling terms to 7.2% but the FTSE All World All Emerging Markets Index saw its return increased to 7.9% in sterling terms.

To our surprise, international bond markets, as measured by ten year government bonds, enjoyed an extraordinary fall in bond yields, in our view heightening still further the overvaluation of bond markets. The gross redemption yield on the UK government bond fell by 128 basis points to 1.76%, on the US government bond by 86 basis points to 2.17%, on the Japanese government bond by 41 basis points to 0.33% and, most extraordinarily of all, on the German Bund by 140 basis points to 0.54%.

In the currency markets, the main story was the weakness of the yen and euro, the flip side of which was the strength of the US dollar. Against the US dollar, sterling fell by 5.9%, against the yen it rose by 7.1% and against the euro it rose by 7.2%. Sterling strengthened against the Swiss Franc by 5.2% and against the Canadian and Australian dollars by 2.8%.

In the commodity markets, amongst other weak commodity prices, oil, as measured by Brent crude, fell by 48.1%, although gold was virtually unchanged, up by just 0.6%.

ECONOMICS

In a year end review, it is instructive to look back twelve months at the equivalent review to see how accurate one's thoughts were and to see where the surprises, or lack of surprises, were. In terms of stock market expectations, we thought equities would grind higher but with some difficult periods and some negative quarters. If anything, we were too pessimistic in terms of the outcome, even though we expected it to be positive, but there were certainly some difficult periods with the last quarter, even though there has been a positive performance, experiencing two periods of exceptional volatility. The big surprise was the performance of bonds. Our table at the beginning of this review shows the extraordinary collapse in bond yields to levels we can scarcely credit. We believe more strongly than ever that the bond market is a very dangerous place with yields coming nowhere near to reflecting the risks in the market. One's sense of disbelief is reflected in the decision by the UK Treasury to redeem two irredeemable gilts, the iconic 3½% War Loan and 4% Consols with the further objective of redeeming the remainder of the irredeemable gilts. Given that, at one stage in the past, when bond yields in the UK were exceptionally high, the price of 3½% War Loan and its yield were roughly the same, the sense of disbelief that we could reach the stage when the UK Treasury would find savings from refinancing the issue is palpable. Although the UK equity market shows little change over the year, world stock markets, as we have seen in the tables at the beginning of this review, have moved higher, led by the USA (about half of the world market), so we have a situation where, overall, shares and bonds have been rising in price. They cannot both be right.

As we look back at our review a year ago, where have been the surprises (we have mentioned bonds above) or events which could not have been foreseen? The Russian intervention in Ukraine was obviously one but, whilst there have been localised stock market effects, so far the ramifications have been surprisingly few, apart from in Russia where the oil price collapse has added to the sanctions' problems. Probably the biggest economic surprise was the collapse in many commodity prices, the most high profile being oil for many people but also, less visible, but very important, commodities like iron ore. Economists and commentators are divided on the implications of weaker commodity prices. Those of a pessimistic nature, what we might call the "looking at the bottle as half empty type" would say this is caused by a collapse in demand and therefore presages a global recession and, perhaps, deflation. Those of an optimistic nature, "the bottle half full type" say that it is a supply issue, especially for oil with the growth of fracking in the USA, and that this is a "good" deflation, if it occurs, which leaves more money in consumers' and businesses' pockets for spending and thereby raises the economic growth rate. It is rather more nuanced than that as regards deflation and we will discuss this later in relation to the eurozone but, on balance, we regard the fall in the oil price as beneficial to the world economy. But there will, of course, be losers, notably the oil producers and especially the high cost oil producers. It is very serious for Venezuela which does not have the reserves of Russia to draw upon although the latter is using them fast to defend the rouble and its position is weakening rapidly. The rich Middle Eastern countries such as Saudi Arabia, Abu Dhabi, Qatar and Kuwait can draw upon reserves and the likeliest short term effect for them is that overseas investment may be pared back, perhaps affecting stock markets and property in certain favoured countries. It is speculated that Saudi Arabia's decision not to limit production is guided by its wish to see off some high cost producers, Iran, for example, and some fracking companies in the USA in order to reassert its dominance. Whether this is true or not, current oil prices are very painful for quite a lot of the oil producers whose budgets are predicated on a much higher oil price. On the other hand, oil importers will benefit significantly. Their trade account will improve and, for some countries where oil is subsidised, it will help to limit the cost of the subsidies and make them easier to eliminate, thus helping to improve countries' public finances (India and Indonesia are two countries which come to mind). For consumers, reduced oil prices act as a tax cut and help to boost real incomes through a fall in inflation or even a move to deflation. In so far as they do not use the boost to real incomes to pay off debt but, instead, spend it, this will have a positive economic multiplier effect. Similarly for businesses, depending upon how they react to reduced input costs, they could achieve higher profits and therefore boost spending. The reduced cost of oil imports could boost the currencies of oil importers and weaken the currencies of oil exporters (the Norwegian currency, for example, has been very weak in 2014). The effects will be more complex than the obvious ones described above but we believe that the benefits to the winners will outweigh the costs to the losers. Connected with this is the fall in inflation which was faster than expected although, for those who foresaw the collapse in oil prices, the surprise would not have been so great. To give an idea of a cross section of the latest year on year inflation figures we see the UK at 1.0%, the USA at 1.3%, the eurozone at -0.2% (it has just moved into a negative year on year position), Japan at 2.4% (although this figure is distorted by last April's 3% consumption tax increase - the latest month on month reading is -0.4%) and China 1.4%.

So, we can look back at four surprises, a political event (Russia's Ukraine intervention), the collapse in bond yields, the severe weakness of some commodity prices and a larger than expected fall in inflation and deflation in some countries. Others would add additional issues such as the calm way in which Wall Street took the end of US quantitative easing in its stride after 2013's "taper tantrums". For us, this was not a surprise because markets should have been discounting the end of tapering as it was well flagged.

What did not surprise us in 2014? One outcome was the good performance of the US economy, although recent data would indicate more strength than seemed likely a year ago. We felt that the risks in the USA were less than elsewhere and so it has proved. We think that the political stalemate in the USA, which became more pronounced when the Republicans gained control of the Senate in

November, is no bad thing. The US economy is moving forward quite nicely and the absence of any major political initiatives could be seen as a positive development after all the political infighting that has been witnessed in the USA in recent years. As a broad generalisation, the best thing that US politicians can do is to let the economy grow under its own steam.

What did not surprise us is the state of the eurozone which remains in a serious economic state with no obvious way forward without an orderly break up of the single currency, something which the euro's stakeholders will not contemplate. At various stages in the recent past, it has been suggested by euro politicians and senior officials that the crisis has passed but that was never the case for the eurozone because of its fundamental flaw. So, in 2014, the problems flared up again with very low growth, deflation in some countries and for the eurozone as a whole at the end of the year, problems with budget deficits, slow progress in structural reforms and, finally, the Greek political crisis which has blown up in December leading to a problematic general election in January which could lead to the election of a party which says it will dismantle the troika sponsored austerity programme and renegotiate Greece's debt. The election will be held in late January and the anti austerity party, Syriza, is at the moment ahead in the opinion polls although this could, of course, change. We will discuss the eurozone later on in much more detail, suffice it to say that the continuation of its chronic problems in 2014 was no surprise and it is a safe bet that they will continue in 2015 and beyond.

Although the UK economy continues to perform relatively well, despite the ONS's downgrade of recent growth numbers, our main concern was the ratcheting up by politicians and the media of anti business feeling which threatens to be transformed into actions after next May's General Election. It has a wider audience when spread to, for example, foreigners who buy property in London or foreign companies which may be interested in buying UK companies which are also the target of criticism. With only about four months to go until the General Election on 7th May, this negative message is only going to become louder. Again, we will go into more depth on this later on in this review, suffice it to say that the continuation of the anti business message was no surprise.

So how do prospects look for 2015? There are many political and economic variables, it goes without saying, but perhaps developments in Russia and the oil price are two of the issues near the top of any list of uncertainties, together with consequences arising from January's General Election in Greece and one later on in Spain where the left wing Podemos party is polling strongly. The latest forecasts from the IMF and OECD were that world economic growth in 2015 would be 3.8% against 3.3% for 2014. For the USA, it forecast growth of 3.1% in 2015 against 2.2% in 2014, whilst, in the eurozone, it expected growth of 1.3% in 2015 against 0.8% in 2014. Its forecast for Japan was 0.8% for 2015 against 0.9% for 2014. It forecast growth of 2.7% for the UK in 2015 against 3.2% in 2014. Emerging Markets and Developing economies were forecast to grow by 5.0% in 2015 against 4.4% in 2014 and, within the BRIC economies, Brazil was forecast to grow by 1.4% in 2015 against 0.3% in 2014, Russia by 0.5% against 0.2%, India by 6.4% against 5.6% and China by 7.1% against 7.4%. Although October, the date of the IMF's latest forecasts, is not very long ago, one can expect some downgrading of Brazil's and Russia's prospects because of the fall in commodity prices and, in Russia's case, also from the effect of sanctions. On the other hand, as energy importers, India and China stand to gain although other factors may intervene. In its November publication, the OECD saw growth for 2015 amongst its members at 2.3% against 1.8% in 2014. Within those totals, the USA is forecast to grow by 3.1% in 2015 against 2.2% in 2014, whilst the eurozone is forecast to grow by 1.1% against 0.8% in 2014. Japan is forecast to grow by 0.8% in 2015 against 0.4%. For the UK, it sees growth of 2.7% in 2015 against 3.0% in 2014. Turning to the BRIC countries, it sees growth of 1.5% against 0.3% in 2014, for Russia of nil against 0.3% in 2014, in India of 6.6% in 2015 against 5.4% in 2014 and for China 7.1% in 2015 against 7.3% in 2014. Given the economic and political news since the IMF and OECD made their forecasts, one can say that the risks to the downside are Russia (almost certain) and Brazil, that the eurozone has downside risk, especially if there is a Syriza victory in January's General Election with the uncertainties which that will cause, that the USA has upside potential given the very strong third quarter growth figures and that the UK if, as seems probable, there is a messy election result in May, also has some downside potential. The general pattern, however, seems clear with outperformance from the USA, continuing problems in the eurozone, serious difficulties for Russia, difficult times for commodity producers with corresponding benefits for importers of these products, uncertainty in Japan depending how "Abenomics" proceeds and also uncertainty in the UK arising from a hard to read political situation and the possible emergence of an anti business agenda after the election with poor signals for overseas investors and UK businesses.

We will come back to these areas in more detail now starting with the best performing major economy, the USA. After a poor start to the year when bad weather in January and February resulted in negative growth for the first quarter, the US economy has strengthened as the year has progressed. In the latest reading, the annualised third quarter growth rate was 5.0%, up from the previous estimate of 3.9%. The closely watched Purchasing Managers Indices also show a strong economy. The December reading for the manufacturing PMI was 55.5 and for the non manufacturing one 56.2 lower than November's reading but still quite strong. The November industrial production index showed a rise of 1.26% over that for October. Employment numbers have been very strong with the unemployment rate falling to 5.6% in December. The Conference Board's leading indicators rose by 0.6% in November compared to October. Retail sales were also strong in November, up by 0.7% over the previous month. Perhaps the most subdued part of the economy is the housing market where, for example, the latest S & P/Case-Shiller Composite Index for twenty cities showed a rise of 4.5% in October continuing a steady fall this year in the year on year rate of increase in prices. The strength of the US economy is reflected in the downward trend of the US budget deficit as a percentage of GDP. For the twelve months to 30th September 2014, it fell to 2.8% of GDP compared with 4.1% in the previous fiscal year. At its very worst in the financial crisis in 2009, it was 10.1%. The Congressional Budget Office forecast in August that the deficit would fall further to 2.6% of GDP in the current fiscal year to September 2015. With the turnround in the USA's energy production, the USA's current account deficit stands at 2.3% of GDP reflecting an improving trend in the deficit.

As we can see from the table at the beginning of this review, the US dollar has performed well in 2014 and, whilst currency movements are notoriously difficult to forecast, there seem to be plausible arguments for expecting that this trend will continue in 2015. Political stability is one. This might seem a strange argument to use given the hostility between the Republican controlled Congress and the Democrat President but there is not much that needs doing in the short term and, as we can see from the statistics, the US economy is motoring along well. The stalemate is not a bad thing in this context. This state of affairs contrasts with the eurozone and UK, although not perhaps with Japan after Mr. Abe's overwhelming re-election in the recent Japanese poll. The USA is likely to remain the best performing economy of the major ones in 2015 and interest rates are likely to be raised by the Federal Reserve as it becomes less reluctant to start the process of regular 25 basis point increases in interest rates.

To move on to the eurozone is to discuss an outlook which is as discouraging as the USA's is encouraging. The problem arises from the inability of countries in the eurozone to have flexibility with their currencies so that those which have lost competitiveness within the eurozone can regain it through currency depreciation (although this spells longer term economic problems). With these countries' finances in a poor position, the eurozone's policy of forcing austerity on countries to improve their competitiveness (through internal devaluations) and their budgetary position is reinforcing cyclical trends. They are not allowing automatic stabilisers to work which help to reduce the effect of cycles on an economy. Effectively, monetary union can only work if there is political and fiscal union and that is not likely to happen. The eurozone itself runs quite a large current account surplus (over 2% of GDP) and Germany a very big one (around 7% of GDP) and this may partly account for the currency having held up as well as it has done against such an unpromising background even though in absolute terms it has been weak. However, Germany refuses to turn on the spending taps because of its balanced budget objective, laudable in its own right but unsuitable in the context of looking at the wider interests of the eurozone. There is, therefore, very little chance of a demand stimulus coming from within the eurozone if the strongest country is not prepared to provide it. One of the major impediments to raising the longer term growth potential of the eurozone is the structural rigidities to be found in many of the countries in their labour and product markets. Employment regulations are, in some countries, an enormous impediment to job growth whilst, in product markets, the single market is yet to be properly implemented. Of the larger members of the eurozone, these problems are particularly acute in France and Italy. Although attempts at reform are being made in these countries, they are facing great opposition from vested interests and are really only scratching at the surface. Because of the different viewpoints of eurozone governments and resistance in countries like France to meeting budget deficit commitments in view of the level of austerity required, a great deal is being expected of the ECB in terms of flows of funds to banks, interest rate decisions and purchases of assets with the hope that it will instigate quantitative easing in 2015 to increase the size of its balance sheet. But even with negative interest rates for banks' balances at the ECB and low borrowing costs for many companies, the environment has to be right for companies to borrow. If the economic outlook is poor, even the prospect of cheap money cannot make the business case for borrowing for investment stack up. The outlook, as the IMF and OECD projections show, remains one of low growth in the eurozone with fiscal policy having a contractionary effect and we do not believe that even more extreme monetary policy actions from the ECB, such as full blown quantitative easing, will start growth accelerating from its current overall very low level in the eurozone. This assumes that the ECB will undertake quantitative easing. It is a very divisive issue within the eurozone with Germany opposed and it would possibly be unconstitutional in Germany. The Advocate General of the European Court of Justice is due to give a preliminary judgement in January on the legality of central bank purchases. So, there remain significant doubts.

However, the big immediate issue is Greece. With January's General Election comes a huge risk for Greece and the eurozone. For Greece, the risk is that, if Syriza forms the next government and carries out its plan to reverse austerity measures, its banks will find their funding cut off and that the country will be expelled from the eurozone. In our view, it was a mistake for Greece to join the euro and it would be better outside it in anything but the short term with a freely floating currency if all this could be negotiated. But this will not happen given that the power brokers in the eurozone will not contemplate the split up of the eurozone voluntarily. Therefore, a Greek departure from the eurozone could be forced and very messy and cause great hardship to the country in the short term even though it could work out better in the long term because of the return of economic decision making to the country and the adjustments of the currency to reflect economic conditions. The Prime Minister, Mr Antonis Samaras, will be warning the electorate of the very serious consequences of breaking the agreement with the troika and trying to renegotiate the debt, as well as the serious problems the breakdown would cause for the Greek banking system. Syriza, led by Alexis Tsipras, will argue that Greece has suffered enough from austerity and that it will regain its economic sovereignty following Syriza's policies. However, the risk is not all one way and Mr Tsipras will be hoping to call the troika's bluff given that the consequences of a further write off of Greek debt and departure from the eurozone threaten serious consequences for the eurozone. The authorities may feel confident that any contagion can be contained, and this seems to be their current message, but once a precedent has been set, investors will be looking for the next weakest link and there are quite a number of these in the eurozone. Although eurozone bond yields, apart from those of Greece which have risen sharply since the Prime Minister failed to have his candidate for President elected, are extraordinarily low, most do not take into account credit risks which abound. Debt levels are still piling up and there comes a time when lenders will feel that the risk/reward ratio is not worth it. The market is so distorted that if one looks at the yields on two year government bonds, we see negative yields in France, Germany, the Netherlands and, outside the eurozone, Switzerland (more understandable) and Denmark. One other factor which strengthens Syriza's hand is that Greece is now running a primary budget surplus, i.e. a surplus before interest charges so that its immediate need for funding is limited if it does not pay the interest on its debt.

Adding to the eurozone's concerns is the threat which deflation or very low inflation poses to the debt dynamics of the troubled eurozone countries. If nominal GDP is falling or unchanged whilst outstanding nominal public debt is rising, the creditworthiness of a country lessens. In the troubled eurozone countries there does not seem to be enough economic growth potential in the foreseeable future to prevent a worsening of these countries' debt dynamics. In this way, the credit risks rise and, in our view, the extraordinarily low yields of a number of eurozone countries' bonds do not reflect this factor. These levels of yield would reflect the negative interest being offered by the ECB on banks' deposits with it. The risk remains in 2015 of a fracture in the eurozone for economic or political reasons. Whether or not this happens in 2015 or later is difficult to say but the present situation of unemployment levels which are at completely unacceptable levels in the eurozone in general and certain countries in particular cannot continue indefinitely and one of the reasons for this unemployment tragedy is the economic policies being followed in an attempt to sustain the unsustainable, the euro. At some stage, it is likely that an anti euro party, and there are plenty of them in the eurozone, will assume power and instigate the fracture of the eurozone and a return to national currencies.

Such an outcome would clearly be unwelcome news for holders of euro denominated bonds in the affected countries since the new national currencies could be expected to weaken against the euro. For shares in eurozone based countries, the implications would be more nuanced. Those with substantial overseas business would be more competitive, at least for a while, and their overseas profits would be worth more in the new national currency terms so they would be likely to be the best investment to hold in the affected countries, whilst bonds would be the worst.

Whilst the eurozone's leaders would deny that there exists any possibility of the eurozone breaking up, that is a political posture. The immediate threat is Greece, the threat further out is that anti euro parties gain further traction and move into government, whilst the longer term threat is an economic one, namely that the economic contradiction of the single currency will cause the eurozone to fragment and implode because of these impossible economic contradictions. So, in our view, the eurozone remains a major cause of concern for 2015, whereas the outlook for the USA, looks benign for 2015.

Looking at some of the data from the eurozone, particularly the latest purchasing managers indices which are considered a good barometer of economic activity, the December reading for the eurozone's composite index is 51.4 and that for manufacturing 50.6 and services at 51.6. If one looks at the data for the two largest eurozone economies, Germany and France, we note that, whilst the figures for Germany closely reflect those for the eurozone as a whole, its composite reading is 51.4, its services sector reading 51.4, the manufacturing reading 51.2, those for France continue to show an economy in difficulty with the figures pointing to recessionary conditions. The French December Purchasing Managers Indices showed a composite reading of 49.1, a manufacturing sector reading of 47.9 and a services sector reading of 49.8. France and Italy, where the latest Purchasing Managers Indices are slightly better than those for France, have significant economic issues to deal with and are finding it difficult to implement really significant structural reforms. Their problems are slightly different but both serious. Italy has a very high ratio of outstanding public debt to GDP, over 130% against a figure of approximately 100% for France, but a smaller budget deficit than France (roughly 3.0% against 4.4%). Importantly, politically, anti euro parties are strongly represented in both countries.

Following the recent general election in Japan in which Mr Abe's LDP was returned with almost the same number of seats as before, whilst his ally, Komeito, gained more, Mr Abe has four years to implement "Abenomics" in order to re-energise the Japanese economy, in particular the third arrow of "Abenomics", structural reform. This becomes even more important given that the second stage of the planned rise in consumption tax, from 8% to 10%, was due to take place this October and has now been put back to April 2017 because of the weak economic data. The need to improve the long term potential growth rate of the Japanese economy has never been more apparent and structural reforms in the labour and product markets are vitally important, given Japan's horrendous level of public debt in relation to its GDP and very poor demographics. Accelerating economic growth will be a necessary ingredient in tackling Japans' problems on these fronts. Mr Abe will face strong vested interests as he attempts to implement his "third arrow" (the other two are monetary and fiscal arrows), and it is vital that he is successful. The effect of last April's consumption tax increase can be seen by the sequence of quarterly growth figures for Japan in 2014. In the first quarter, as consumers anticipated the tax rise, the quarter on quarter growth rate was 1.5%, in the second quarter -1.7% and, in the third quarter, -0.5%. If one annualises these quarterly growth rates, we see figures of 5.8%, -6.7% and -1.9% and, by the end of the third quarter of 2014, the year on year growth rate was -1.3%. Whilst it was expected that the second quarter would be difficult, the outcome for both the second and third quarters was worse than expected and led to the decision to postpone the second leg of the consumption tax increase which had been due in October 2015. Meanwhile, monetary policy is aimed at getting inflation up to 2.0% to encourage spending in the economy. We talked about deflation earlier in a eurozone context and the Japanese experience is one reason why the eurozone is keen to avoid deflation. Apart from the negative implications for debt dynamics, the expectation of lower prices can cause rational consumers to hold off discretionary purchases and thus reinforce a downward economic spiral. As well as the vast monetary stimulus administered to the Japanese economy by the Bank of Japan, the government is exhorting companies to increase pay levels which have not kept pace with consumption tax induced price increases which still show up in the year on year inflation figures, the latest figure for November being 2.4%. Although, as our table at the beginning of this review showed, the yen weakened in 2014, the resulting effects on inflation are being mitigated by the collapse in the oil price so, for the months of October and December, we have seen month on month price falls of 0.3% and 0.4%. In our view, Japan is a high risk/high reward market, worthy of a modest exposure in portfolios. Relative to Japanese bonds, Japanese shares offer good value and a much better yield (the dividend yield is approximately five times the level on ten year Japanese government bonds). Mr Abe now has the opportunity of a long period free of elections to try to revive the moribund economy and to give him a chance to deal with the level of government debt and, longer term, the negative economic implications, including those on public finances, of a poor demographic outlook.

Another potential cause of concern is China and how it manages the transition to a more consumption orientated economy and less of an investment led one. As we see from the forecasts earlier on in this review, the absolute level of growth which China will achieve in 2015 is one of which western and the Japanese economies can only dream but it still represents a slowdown on the double digit growth rate of earlier years. Internally, growth at a sufficient rate to ensure social cohesion is important and, externally, it is important as a catalyst for the world economy, China being the second largest economy in the world. The vast amount of resources devoted in recent years to fixed asset investment gives rise to concerns about the effects this will have on the banking system because of the implications for bad debts arising from unprofitable investment. A weak property market underlines the concerns. The latest Purchasing Managers Indices from China show quite a delicate balance. The PMI for manufacturing is barely in positive territory at 50.1, but that for services shows a healthier reading at 54.1. The year on year increase in industrial production was 7.2% in November with the month on month increase being 0.52%. China will be concerned about the strength of the US dollar and it has allowed its currency to weaken against it so as not to compromise its competitive position unduly. One important advantage which China enjoys is that it can move swiftly to implement changes in economic policy. As with the eurozone in a different context, China will be concerned about the prospect of deflation. In the past, it has been concerned to dampen down inflationary pressures because of the dangers it potentially causes for social cohesion, particularly in respect of food prices. Now, the problem of deflation would be an issue for the banking sector in terms of the ability of borrowers to repay or service loans. The latest year on year consumer price index for November was 1.4% higher than a year earlier. The Chinese stock market is very unpredictable. Having been a poor performer previously, 2014 turned out to be a stellar year for the market which returned 58.0% as measured by the Shanghai Composite Index. At the time of writing, attention is mostly focused on the eurozone but China remains a very important influence on the world economy because of its size.

For the UK, 2015 will be a critical year. Although the OBR has revised down recent growth figures to show year on year growth at 2.6% at the end of the third quarter, it remains one of the best performing economies in terms of economic growth and employment levels. However, the UK cannot be insulated from the effects of what is happening in the eurozone, given the importance of trade with the area, and the latest Purchasing Managers Indices, whilst still relatively robust, do point to a deceleration in growth in the UK economy. The composite PMI for December stood at 55.2 against 57.6 in November, still a satisfactory reading but quite well below the peak reading of 59.3 in August. Within that composite reading, the manufacturing PMI stood at 52.5, the much more significant services sector reading, given the overwhelming importance of services to the UK economy, showed the index at 55.8 (58.6) whilst that for construction stood at 57.6 (59.4). The unemployment level stood at 6.0%, still too high, but almost half the level of that in the eurozone, 11.5%. As we saw from the IMF's and OECD's forecasts earlier on in this review, the UK economy is still expected to perform relatively well amongst those of the major economies.

However, notwithstanding the UK's relatively good economic position amongst the major economies, especially compared with the eurozone and Japan, it still has major problems to deal with. A consumption and housing led recovery is not the best quality one, leaving a big debt hangover, rather one led by business investment and exports would be much healthier but, when the country's largest export market is in such a difficult situation, that is going to be difficult. Growth has been unbalanced. The UK economy faces two major problems, the budget deficit and the less talked about, but very important, current account deficit. The budget deficit, running at a rate of over 5% of GDP, is proving very hard to control. Notwithstanding a creditable economic growth rate, it has not so far translated into a tax rich recovery which one would normally expect given the increase in employment levels. It seems that the increase in personal allowances is one reason for this. At approaching £100 billion a year, the level of borrowing is unsustainable. Although the UK has the inestimable advantage of not being a member of the eurozone and can therefore print its own currency, a budget deficit ballooning out of control threatens currency debasement and is not sustainable. It threatens to "crowd out" the private sector and therefore limit the economy's long term growth potential. If interest rates return to more normal levels, as they will at some stage, the servicing costs of the debt will gradually increase, threatening an even worse situation. So far, because the Chancellor of the Exchequer has allowed the economy's automatic stabilisers to operate, the growth of the economy has been relatively good but at the expense of a slippage in the target for balancing the books. That was probably the right thing to do but there must be no let up in the attempt to balance the books. The second of the twin deficits, the current account deficit, does not receive as much attention as the budget deficit but it should do because, if the UK's ability to finance this deficit is compromised, the consequences could be very serious with marked weakness in the currency and the resulting threat to inflation, although that may seem to be a long way away with the latest consumer price index showing a month on month fall of 0.3% in November and a year on year increase of just 1.0%. These two deficits represent the Achilles Heel of the UK economy and it is important that policymakers pay full attention to them.

It is in this context that the forthcoming UK General Election on 7th May is critical, the most critical factor for the UK market, we would argue. At the moment, the opinion polls suggest a change of government although one without an overall majority and in need of support from one or more of the smaller political parties. Politicians' time horizons tend to be much more short term than they ought to be for the proper running of the economy. In the UK, because of the serious budget deficit situation and the paramount importance of addressing it, politicians in the election campaign need to tell voters how they plan to deal with it and that means some unpalatable truths which voters may not want to hear and politicians will not want to speak. Confidence is vital and, as the weak current account position shows, the UK needs foreign buyers of its assets and investment. If foreign confidence in the UK falls, then the consequences for the UK economy and currency are severe. As we have mentioned in previous economic reviews, one of our concerns about the UK has been the sharp rise in anti business sentiment. We all know what happened with the banks but it does not change the fact that banking, in particular, and finance, in general, are very important sectors for the UK economy. Similarly, the UK's energy position is precarious and investment in the sector is vital for the UK, so policies toward the sector must be ones which encourage investment rather than repel it. With such a division of policy between the major parties, the outcome of May's General Election is likely to be an important market influence.

In looking ahead to likely outcomes for 2015, we maintain our view that the asset class which looks best value remains equities but, after their long period of strong performance since their low point in March 2009, investors must expect periods of weakness even though we would expect the trend of prices to be upwards. As we have emphasised in this review, there are many areas of potential danger for markets and, as we have seen in 2014, there have been periods of significant volatility. The main positive support for equities is the continued growth of the world economy, led by the USA, with the fall in the oil price being, on balance, beneficial to growth, even though it will cause serious problems for some countries. As a result, corporate earnings should rise and, whilst shares are not as cheap as they were, even in the USA, we do not see their valuations as too stretched. Cheap money should also continue to support asset prices and make the dividend yield on shares relatively attractive. Notwithstanding this, there are significant risk factors which, from time to time, will almost certainly adversely affect markets and these include the eurozone, deflation risks, Russia, the UK General Election, possible sovereign defaults and a more pronounced slowdown in the Chinese economy than expected and there will be others which, we cannot foresee. Although the strength of bond markets in 2014 surprised us, it does not alter the fact that they remain, in our view, seriously overvalued. Deflation may make nominal bond yields look less extreme but deflation raises the credit risk of some borrowers. As and when bond yields start to move towards more normal levels, there are going to be some big price adjustments and these will not be recovered or, at the best, if the bond scare held to redemption and bought on a positive gross redemption yield, will almost certainly incur a significant opportunity cost compared with holding other assets like shares. A long term holder of shares can weather the fluctuation in markets as the dividend stream continues and share prices are likely to recover and exceed previous levels. The problems for equity investors in terms of performance is if shares are sold at depressed prices as a reaction to negative sentiment, say, as expressed in the media, and only bought back when confidence returns but at higher prices . Unless shares fall again, that loss of profit cannot be recovered. Our view, therefore, is that shares are likely to grind higher overall in 2015 but that there will be periods of weakness, leading to the odd negative quarter, and the increased volatility which we have recently witnessed is likely to be a feature in 2015 given all the political and economic problems which exist.