meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Despite much background economic "noise", like the Greek debt crisis, which has caused a certain amount of volatility in international equity markets, the overall return for international equity investors has been satisfactory. This has been particularly so for investors who account in euros and pounds, where an international equity portfolio has provided them with a useful hedge. The opposite was the case for US dollar based investors who would have incurred a small decline in US dollar terms if their portfolio performed in line with the index. Bond investors were influenced by perceptions of sovereign credit risk, with relative performances depending upon a country's credit standing. Significant currency movements saw the euro and sterling perform badly and the US dollar well.

The tables below detail relevant movements in markets:

International Equities 30.11.09 – 26.02.10

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	N/C	+5.4	-2.2	+7.6
Finland	+10.6	+8.3	+0.5	+10.6
France	+1.7	-0.4	-7.6	+1.7
Germany	-0.8	-2.8	-9.8	-0.8
Hong Kong, China	-0.9	+6.7	-1.0	+8.9
Italy	-4.1	-6.0	-12.8	-4.1
Japan	+6.9	+11.7	+3.6	+14.0
Netherlands	+5.5	+3.4	-4.1	+5.5
Spain	-11.2	-13.0	-19.3	-11.2
Switzerland	+7.1	+8.0	+0.2	+10.3
UK	+3.9	+3.9	-3.6	+6.0
USA	+1.6	+9.5	+1.6	+11.8
Europe ex UK	+0.4	-0.6	-7.8	+1.4
Asia Pacific ex Japan	+0.2	+7.1	-0.7	+9.3
Asia Pacific	+3.3	+9.3	+1.4	+11.5
Latin America	-0.6	+4.5	-3.0	+6.7
All World All Emerging	-1.3	+5.4	-2.3	+7.5
The World	+1.8	+6.6	-1.1	+8.8

Source FTSE World Indices FT Government Securities Index All Stocks (total return): -2.3%

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

Currency	30.11.09	26.02.10
Sterling	3.52	4.03
US Dollar	3.20	3.62
Yen	1.26	1.31
Germany (Euro)	3.15	3.11

Sterling's performance during the quarter ending 26.02.10 (%)

Currency	Quarter Ending 26.02.10
US Dollar	-7.1
Canadian Dollar	-7.3
Yen	-4.3
Euro	+2.3
Swiss Franc	-0.7
Australian dollar	-5.2

Other currency movements during the quarter ending 26.02.10 (%)

Other Currency	Quarter Ending 26.02.10
US Dollar/Canadian Dollar	-0.2
US Dollar/Yen	+2.9
US Dollar/Euro	+10.1
Swiss Franc/Euro	+3.0
Euro/Yen	-6.5

Significant Commodities (US dollar terms) 30.11.09—26.02.10 (%)

Significant Commodities	30.11.09—26.02.10
Oil	-1.1
Gold	-5.2

Markets

Overall, the international equity markets have consolidated the recovery noted in earlier quarters although there has been evidence of bouts of nerves, even if only for a very short time, surrounding events such as the Greek debt problem, tightening monetary policy in China and the symbolic rise in the US discount rate. In total return terms, the FTSE World Index has returned 1.8% over the quarter in local currency terms, 6.6% in sterling terms, -1.1% in US dollar terms and 8.8% in euro terms. As the wide range of those returns suggests, currency factors have been very influential in determining the returns in different currencies.

Looking at local currency returns first, Japan has been the best performer amongst the major markets, returning 6.9% and thus reversing previous underperformance. Within the Europe ex UK market, against an unremarkable return of 0.4% in the FTSE Europe ex UK Index, there have been notably good performances from Finland, +10.6%, Switzerland, +7.1%, and the Netherlands, +5.5%, whilst Spain, reflecting concern about the finances of some of the eurozone countries such as Spain, returned -11.2%, all measured by the respective FTSE World Indices. Unusually, for recent quarters, the FTSE Latin American and All World All Emerging Market Indices were very quiet, with negative returns of 0.6% and 1.3% respectively.

For sterling investors, it was a different story with the pound's significant weakness over the quarter against most currencies, the euro excepted, inflating returns as is evident by the difference in total returns shown in the table between the FTSE World Index in local currency terms and in sterling terms. Nearly every market returned a positive performance in sterling terms with particularly notable performance from the FTSE Japanese Index, +11.7%, and the FTSE USA Index, +9.5%. The FTSE Latin American and FTSE All World All Emerging Market Indices moved from negative territory to quite strongly positive territory with respective returns of 4.5% and 5.4%.

In the bond markets, as measured by ten year government bonds, there was a mixed performance. Concerns about countries with very large borrowing requirements like the UK and USA pushed up bond yields very sharply. In the UK, the gross redemption yield on the ten year gilt rose by 51 basis points to 4.03%, whilst the equivalent bond in the USA recorded a rise of 42 basis points to 3.62%. However, in Germany, problems elsewhere in the eurozone, particularly Greece, caused a flight to quality, and Germany, the eurozone's best credit, saw a small drop of four basis points in the gross redemption yield on the ten year government bond to 3.11%.

In the currency markets, the feature over the last quarter has been the weakness of the euro, in particular, and also sterling whilst the US dollar staged an impressive rebound. Against the US dollar, sterling fell by 7.1%, against the Canadian dollar by 7.3%, against the yen by 4.3% and against the Swiss Franc by 0.7%, the latter rising 3.0% against the euro. The US dollar rose by 10.1% against the euro.

In the commodity markets, oil fell by 1.1% and gold by 5.2% but because these are priced in US dollars, there was a rise in terms of the weaker currencies.

Economics

Against a world economic background which remains very fragile, the centre of attention has turned to sovereign debt, in particular that of Greece but also, by extension, to other particularly vulnerable countries within the eurozone such as Portugal, Spain, Italy and Ireland (although, arguably, it has taken sufficient measures to impress the markets) but also to the UK outside the eurozone. This has been manifested in weakness in the high quality bond market in general but, in particular, the bond markets of those countries perceived to have weak budgetary positions. At its most extreme example within the eurozone, we see the gross redemption yields on ten year Greek government bonds at over double the level of those of Germany, the best credit within the eurozone. Outside the eurozone, we see UK ten year gilt yields nearly 100 basis points higher than those on German government bonds. There is an obvious disconnect here, given that both have AAA ratings.

Although international equity markets have continued to perform satisfactorily despite the very uncertain economic background and, as we have said before, we think that this manifestation of investor preference is correct, bonds have generally performed poorly and we believe that this, too, is a proper assessment of the situation. The sovereign debt risk has enormous ramifications for individual countries, the eurozone, economic performance and the banks which hold sovereign debt which could default. That being the case, we think that we should spend some time discussing the issue as it ultimately affects investors.

Without, at the moment, relating the issue to any particular country or region, let us look at the effects of a sovereign debt default but start first with the symptoms. Obviously, such a candidate will be in a poor economic position which will manifest itself in a large budget deficit accompanied by a large current account deficit. Other things being equal, this will tend to push up interest rates because of the large sales of government debt necessary to finance the budget deficit and increasing fears about the difficulties of financing it. A related factor will be the overall level of public debt outstanding in relation to GDP. If it is low, markets may give the country in question some leeway. The compounding effect of increasing debt at probably increased interest rates will make investors wary. They may also give the country the benefit of the doubt if it has a credible plan to reduce its debt. But, if it does not, it may find it difficult to refinance its debt, even at relatively penal interest rates, let alone to finance new debt. An inability to finance its deficit either directly or through support from an institution like the IMF, will lead to the monetisation of its debt and a weak currency which will increase the cost of its foreign currency liabilities. Default may follow. The country would see serious economic contraction as the government could not pay its bills, businesses would collapse and unemployment rise. Before it got to this position, it may need to seek international support, perhaps, as we have indicated above, from the IMF. But in return for financial support, the country would have to agree to strict conditions to reduce its deficit and give it a chance to return to normality. The UK has relatively recent experience of this, in the late 1970s, when it sought support from the IMF which imposed strict conditions in return for its support. Significant countries with recent experience of default include Argentina which found itself cut out of international debt markets, leading to a major contraction of economic activity and hardship for the people of the country.

Of course, it is better not to get into this position in the first place and it nearly always results from imprudent economic policies having been followed. Normally, this is a reflection of too much government spending and failure to observe basic disciplines in good times which call for restraint to provide the cover for bad times when government revenues are depressed and expenditure on social security payments raised. The temptation for politicians is to keep on spending but there is, inevitably, a price to be paid. We are now seeing this in certain countries.

Currently, investors' attention is on Greece, in particular, but also some of the other eurozone members mentioned above, as well as the UK and USA. So, as Greece is the main centre of attention at present, we will start our discussion with Greece, in particular, and the eurozone, in general, because the problems of Greece have raised questions about the status of the latter.

European Monetary Union was always a politically driven project not supported by any credible economic framework. As such, there was always going to be a serious problem at some stage and recent events in Greece suggest that it is now. The politicians of the eurozone remain in denial. It is just too embarrassing to admit that the project has a fundamental flaw. So, it will be interesting to see how the politicians address the issue. At present, the eurozone members seem to disagree about the best way forward. This is not surprising because they do not share a single agenda. The financial discipline to achieve economic convergence was to be a limit on the size of current budget deficits as a proportion of GDP and overall public debt levels as a percentage of GDP. In isolation, these disciplines were one part of the building blocks to monetary union, but not the complete structure. Limits of the kind detailed above are helpful in reassuring markets about a country's creditworthiness, but they are only part of the story. In the case of Greece, we now know that the figures presented to the other eurozone members as its entry pass into the euro (it was not one of the original members) were not what they seem and, furthermore, the newly elected government has sharply revised upwards the previous government's estimate of the budget deficit, sparking off the crisis in the Greek government debt market. Whilst monetary policy, in the form of official interest rates, was set centrally by the ECB, fiscal policy, within the limits of the budget deficit parameters of the Stability and Growth Pact, was left to each country. Therefore, not having the levers of both monetary and fiscal policy compromised the project from the start and the fall out is now being seen. Some would like economic policy to be controlled centrally. Those proposing this would be the most ardent federalists but their wishes are not those of the majority of the population of the eurozone it would seem. Monetary union would demand that inflation remained comparable in the countries of the eurozone to give the "one size fits all" interest rate a chance of being appropriate. But countries like Greece, Spain, Portugal, Italy and Ireland, all of which have various forms of debt problem, have found their costs rising faster than those of, say, Germany and they have become increasingly less competitive. For these countries, interest rates were set too low by the ECB, causing inflation and property bubbles in countries like Ireland and Spain. Loss of competitiveness and property crashes have ultimately affected government revenues, leading to the weak budgetary positions currently evident in these countries and calling into question their creditworthiness. As far as international investors are concerned, they are spoilt for choice in international debt markets, given the vast amount of money which has to be borrowed following the financial crash which decimated most governments' finances. With quality of paramount importance, weaker credits have suffered, hence the wide spread of yields in the eurozone government bond market.

So what are the options for Greece and perhaps other weaker members of the eurozone? One option is to produce a serious plan for deficit reduction which reassures markets and, through the deflationary impact of the measures taken, helps to restore the country's competitiveness. The closing of the gap between public expenditure and government income which will, in practice, be implemented by a combination of the two, will depress economic activity and, through that, costs. But it will be an immensely painful process and, in certain countries, lead to serious social unrest as we are starting to see in Greece. It is difficult to see politicians having the stomach for such a protracted process which will bring them no kudos with their electorate. One can see governments being brought down by the hostility of the electorate to such policies. Acting more decisively to improve competitiveness by cutting real wages would almost certainly lead to very severe social unrest, worse than through more general deflationary policies.

Countries like Greece, which have enormous debts to roll over, let alone finance further borrowing, would normally be a candidate for financial support from the IMF, but on terms which would dictate government policy to restore the country's finances. Eurozone governments seem very keen to avoid the IMF being called in, except perhaps on an advisory basis, because it would be a political embarrassment for them. But it would also be very embarrassing for the eurozone if any of its members defaulted on their debt as it would cast a cloud over the currency. We have seen recently how the euro has been affected by the Greek problems. The table at the beginning of this review shows how weak the euro has been against the other significant currencies. There is no real mechanism for the eurozone to deal with this issue. If one or more members of the eurozone were to default on their debt, it would trigger further problems in the banking sector, another headache for the authorities.

Partly for reasons of embarrassment, the other option, leaving the eurozone, has been routinely dismissed by proponents of the euro. Of course, it would be difficult, but then there are no easy choices in this position. In the past, the easy option for countries which have lost competitiveness is to have their currencies devalued, although with the medium and long term disadvantage of raising the inflation rate. It does, however, provide a short term fix. The advantage of leaving the eurozone and perhaps reuniting with the name of the previous legacy currency is that competitiveness would be broadly restored giving some impetus to economic growth and making the transition to a more stable budgetary position easier. The disadvantage would be that the burden of euro denominated debt would be immediately increased by the devaluation, thereby increasing the chances of default, although IMF support would be a possibility if credible debt reduction plans were put forward. In truth, neither of the options is very palatable, but it may be that leaving the eurozone might be the less unpalatable if only because, in most of the most problematic economies of the eurozone, it is hard to see severe debt reduction measures, which do not include a devaluation, being carried out without serious social unrest such as we are starting to see in Greece. Such is the political capital invested in the euro project that one cannot expect those involved to admit to such an option, and it would have great difficulties, but one only has to look at the alternative to see that it must be considered as a possible outcome.

Before we go on to look at the debt situation in the UK, we must try to determine the investment consequences of current eurozone problems. For the government bond markets, the overall picture is bad. The general issue is the sheer volume of debt which has to be issued almost everywhere. If investors become less risk averse, either with regard to the general economic situation or to other asset classes like equities, the lure of "safe" assets like government bonds will be less. This is what we are tending to see now. Within the spectrum of eurozone bonds, we see German government bonds, the best credit within the eurozone, significantly outperforming weaker credits in the eurozone. So, within what we regard as an unattractive asset class, one can see relative performance of a particular country's bonds depending upon the perceived quality of the credit. The flight to quality in, say, German government bonds, could continue in those circumstances. Between bonds and euro cash, even though the yield on the latter is minuscule, we think cash is the safer investment. Not only is the sovereign credit risk an issue within the eurozone, but there is also the possibility that the Greek problems, which might perhaps extend to other eurozone countries, will continue to tarnish the currency which might also affect the investment decisions of non euro investors. In such a case, whilst euro cash could lose some of its international purchasing power, it could be that the overall return from euro denominated bonds would be worse.

In these circumstances, shares within the eurozone remain, in our view, the general preferred option. Why should this be so when the euro project is under threat as the currency and bond markets suggest? Investors are buying a stake in real businesses, many of which have substantial overseas interests either directly or through exports and, for some of these businesses, exposure is to the fastest growing parts of the world economy, such as Asia. These businesses are used to operating in an uneven international economic environment with exposure to economies in difficulties and those which are prospering. They are used to managing currency risks and, with a well diversified portfolio of businesses, may be expected to post higher growth rates in revenue and profits than if purely exposed to a sluggish domestic economy. Furthermore, should the euro continue to weaken, such companies could be regarded as a currency hedge. Even with all the general economic problems affecting the world economy and the problems of the eurozone in particular, good dividend yields and moderate valuations provide a solid background for investors.

If we turn to the UK, where sterling is the currency in which most of our clients account, a number of the issues which apply to what we have said about the eurozone are also relevant to the UK. However, the UK has one significant advantage in that, not being part of the eurozone, it enjoys a floating currency. So whilst countries such as Greece, Spain, Portugal, Italy and Ireland, which have suffered a reduction in competitiveness since they became part of the monetary union, have to take severe deflationary measures if they are to stay within the eurozone, the UK has more leeway in that the pound's recent significant devaluation has kept the UK more competitive and avoided, at least for the time being, even worse pain than has and is being suffered. This is very important but is about as far as we can go in a positive assessment of the UK at present. The disadvantage of devaluation is that it leads to inflationary pressures. The UK's relatively high current inflation rate is partly a function of the devaluation of the pound in 2008. Furthermore, with export markets such as Europe weak, the benefits are reduced. Not being part of a currency union whilst, overall, being an advantage, does leave the currency more exposed, as we are seeing at present.

Our clients will know that, for a long time, and well before the financial crisis which developed in 2008, we were concerned about the problems that the rapid growth in public spending, way above the capacity of the UK's potential economic growth rate, would cause for the UK economy. Of course, we did not foresee the severe problems which occurred in the banking sector in 2008 and 2009, but it remains the case that the relatively poor budgetary position of the UK going into the crisis has led to the appalling state of public finances, which is now there for all to see. When the economy was performing well, in terms of growth, funds should have been put aside for bad times. As it was, the automatic stabilisers which should have been allowed to work, were not, and the UK is now on a par with Greece in terms of its current budget deficit, at something like 13% of GDP, although its overall level of public debt as a percentage of GDP is well below that of countries like Greece and Italy, but it is rising fast. It is difficult to overstate the seriousness of the problems with the UK's public finances.

We have to put all this in an investment context by trying to work out how the UK's problems will be sorted out. It is very unfortunate that this crisis in the UK's public finances comes on the eve of the General Election. The politicians are generally in denial about the seriousness of the state of public finances and the measures which will have to be taken to rectify them. To put the problem into context, the level of the current budget deficit is something like double the level it was in the late 1970s when the IMF had to come to the UK's support. The adjustment needed to move from a deficit of 13% of GDP to, say, balance, is enormous, and will involve a lot of pain as cuts in public spending and taxation rises eat into people's disposable incomes. Unemployment will rise, particularly because of the shakeout which will have to occur in the public sector. But, whilst objective observers know that this is going to happen, the politicians do little more than play lip service to it. We know that after the General Election, if one party achieves a working majority, the whole tone of the argument will change as the politicians adopt a more realistic stance. However, if, as is quite possible, there is a hung parliament, there could be very serious problems with the perception of the UK because, on the present evidence of the antipathy between the UK's political parties, it would be difficult to see common agreement on measures to address the position. In such a case, the foreign exchange and credit markets could force reluctant politicians to take action. With troublesome internal and external deficits, it would not take much to cause a crisis in the foreign exchange or credit markets. As clients know, we have long held a negative view on the sterling bond market. In the eye of the financial storm, when there were concerns about the security of some bank deposits, government bonds were seen as a safe asset but, as risk aversion lessened, their returns proved to be inferior to those of other asset classes. Yields on UK government bonds were and still are, in our view, inadequate for the risks involved.

At the moment, despite negligible official short term interest rates (although these do not translate into negligible commercial rates for borrowers) and £200 billion worth of quantitative easing, the UK economy is flat on its back and appears to be underperforming most, if not all, G7 economies. There is even the possibility that quantitative easing may be resumed in due course. But creating money to buy government bonds (nearly all the QE money was used for this purpose), whilst it may temporarily have kept down gilt edged yields below what they would otherwise have been and, therefore, helped corporate bond issues at the margin, is not a sustainable policy as, further down the line, it threatens inflation and currency debasement, both of which considerations will be in the mind of foreign creditors of the UK.

Even in the best case scenario, the UK faces a long haul to recover its reputation for sound finances. A credible path for, firstly, reducing and then eliminating the structural deficit (estimated by the IMF at somewhere around 9% of GDP) must be mapped out. Whilst the markets may, and one can put it no higher than that, be prepared to suspend judgement on the UK in front of the forthcoming General Election, they certainly will not after it unless serious measures are announced to address the debt issue. The best case is that this will happen but, under the weight of the various measures to reduce the budget deficit, the UK will experience a long period of below average growth. That may not seem to be an exciting prospect for UK equities, but the UK stock market has the advantage of having many companies, especially the large ones, which derive a significant proportion of their business from overseas. It is difficult to envisage that sterling will be a strong currency for the foreseeable future, and this may be an additional benefit to holding UK equities with this type of profile. This is in addition, of course, to our substantial non UK exposure in client portfolios which diversifies the risk and which we would deem desirable in any case. If the worst case occurs and foreign creditors are not satisfied with the UK's progress on its deficit reduction resulting in a significant fall in the pound (the present trend is ominous), as in 2008, then the indirect currency hedge would be helpful, as it was then, by reducing, in that particular year, the negative performance of equity markets in sterling terms. Notwithstanding the reasonable dividend yield and price/earnings ratio of the UK market, equities also seem to be a good default position against other asset classes, particularly bonds (other than short dated ones). Because the economic and financial position of the UK is so fragile at present, investors have to look at the best way to protect themselves, in the way that one might take out an insurance policy. So investors who account in sterling have to invest in a way which prepares them for the worst whilst hoping for the best and the best is that credible measures are announced to address the UK's appalling public finances which will allow for slow growth in UK GDP in the forthcoming years.

We now look at another country with troublesome deficits, the USA, where, according to projections from the IMF last October, its general fiscal balance would show a deficit of 10.0% of GDP in 2010 and a structural deficit of 5.3% of GDP. These were not as bad as its respective forecast deficits of the UK of 13.2% and 9.6%, respectively, but still shockingly bad and now might be worse. Voters in the USA tend to be frightened by large deficits and the political wind is blowing against big government, but the US political system makes it more difficult for decisive action to be taken. In the UK, if the government of the day can carry its party with it within the House of Commons, it can implement its plans, in this case for the various measures necessary to improve public finances.

However, the USA has more breathing space than the UK and troubled countries within the eurozone area, by virtue of the US dollar being the world's largest reserve currency. It has to be held in countries' foreign exchange reserves and, whilst countries with large foreign exchange reserves like China and Japan may refine the balance of their reserves, wholesale switching out of US dollars, resulting in a fall in the currency's value, would be cutting off their nose to spite their faces. So this advantage gives the USA some leeway with its deficit problems but that is all and, it must be said, as things stand, one cannot feel overly optimistic that the USA can get to grips with its deficit problems. However, the investment implications are the same because the USA's voracious appetite for borrowing makes bond yields look unrealistically low and the argument for equities, as opposed to bonds or cash, is broadly the same as for the areas above which we have just discussed.

It has been the received wisdom that the US dollar would continue to decline but recent events suggest that the recent recovery in the currency may continue. It is a zero sum game. Not every currency can go down. Even if every country is in economic difficulty, some are in worse trouble than others and this may be reflected in relative currency movements. The fracture in the structure of the eurozone and the severity of the condition of the UK's public finances cast the US dollar into a more favourable light. If the dollar's relative strength continues, it may make foreign investors revisit the attractions of US securities although, for overseas earners based in the USA, the effects will be negative.

In the background are the ratings agencies whose rating decisions will be very important in determining relative bond yields. Certain eurozone countries have seen their credit rating reduced and there is no certainty that the USA and UK will retain their AAA ratings. The market has already made a judgement on some of the AAA rated countries' debt securities. If one looks at ten year government bonds, the AAA rated UK pays more for its money than the AA- rated Italy. AAA rated France pays nearly 30 basis points more than AAA rated Germany for its ten year money. AAA rated USA pays about 50 basis points more for its ten year money than Germany. So many judgements are being made on individual countries' relative creditworthiness.

We have not mentioned Japan in this context. In many ways, it is a law unto itself in that it is a country running a large budget deficit and having a high level of net public debt in relationship to GDP. On the other hand, it is a very large creditor country and has the second highest level of foreign exchange reserves after China. For this reason its international debt is rated AAA whilst its domestic debt is rated AA. Because Japan has traditionally had very low interest rates, debt servicing costs have not been the burden which might have been expected for a country, estimated by the IMF last October to have a level of net debt as a percentage of GDP of 115.0% in 2010. The dangers to Japan arise from a prolonged period of deflation which will raise the real cost of its yen denominated debt or, unlikely as it may seem at present for Japan, a rise in interest rates. So, whilst Japan has obvious problems and its demographic profile is also unhelpful, it does not look anywhere near the front of the queue of problem countries at present.

It may seem obvious what are the issues for investors to consider over the course of the year. Sovereign debt security, which we have discussed at length above, is clearly one of the top issues. Another one is the time frame for, and method of, the removal of quantitative easing in the USA and UK, and removal of special measures generally, such as liquidity provision for the banks in the eurozone. In the USA and UK, the process of the central banks buying in mortgage securities or gilts, has either nearly run its course or it has done, although, as mentioned earlier, the Bank of England has left open the option of renewing the programme later on.

It is in the UK that the most aggressive quantitative easing has taken place and perhaps where the most difficult decisions have to take place. Further QE to try to stimulate the economy increases the risks of future inflation whilst, if it is withdrawn too early, it risks weakening the economy still further. However, the former is the greater risk to our mind. At the moment, the halt to further QE removes a buyer of mainly gilts from the market which might be expected to raise bond yields since the amount set aside for QE roughly represents the amount the government has to borrow in this fiscal year. A tightening of monetary policy anywhere risks nipping any nascent recovery in the bud, yet the bigger risk is inflation and the debasement of the currency. So, this will be a challenge for investors and may cause periods of nervousness in markets. However, it is desirable that the present distortions in the markets, caused by minuscule interest rates or deposits diverting money to higher yielding assets like bonds, equities and property, are eliminated as soon as possible for they risk causing a bubble, the bursting of which would cause problems such as we have seen in the past. We believe that there is evidence of a bubble developing in bond markets, even though they have not performed well recently, because yields look unrealistically low on fundamentals but investors have been attracted by the superior yield against cash. That is a risky basis upon which to buy bonds.

Where applied, the rolling back of QE is going to be a challenging issue for all concerned whether they be central banks, governments or investors. Whilst the whole venture carries risks, withdrawing it too soon risks causing the economy to move back into recession, and withdrawing it too late risks inflation and currency debasement. In the background is the general principle that creating money is a dangerous policy which will cause a country's creditors to become very wary of buying or holding that particular country's debt. As we have seen recently, when the Federal

Reserve raised the discount rate (a symbolic gesture only) or when China increased the bank reserve requirement, any move towards the normalisation of monetary policy can cause a short term adverse reaction in markets even though it has subsequently been reversed, at least in the short term. But, on anything other than a short term perspective, investors should welcome any return to a semblance of normality. The current extremely loose monetary policy being followed in the aftermath of the financial crisis is not desirable other than as a purely temporary measure.

We have mentioned China. How Chinese economic policy evolves this year will be an important investment issue. In these difficult economic times, the rapid growth of China, India and certain other countries has been helpful in limiting the economic damage brought on by the financial crisis of 2008. Whilst the IMF estimated in its January 2010 World Economic Update that the output of advanced economies declined by 3.2% in 2009, that of China rose by 8.7% and of India by 5.6%. Largely as a result of this, the decline in world output was limited to 0.8%. Whilst the overall IMF forecast for advanced economies' growth this year is 2.1% and that for world output 3.9%, China is forecast to grow by 10.0%, India by 4.5%, the Middle East by 4.5% and Brazil by 4.7%. The other member of the "BRIC" countries, Russia, which was estimated to have contracted by 9.0% last year, is forecast to grow by 3.6% this year. China gave a massive stimulus to its economy during the crisis. It needs to grow rapidly to accommodate those moving into urban areas from rural areas, to ensure social harmony, but, on the other hand, it does not want an inflationary explosion brought about by over rapid bank lending. With the currency being at a lower level than the state of China's current account surplus would suggest and, therefore, not providing the brake on inflation which would arise from a stronger currency, measures like a tightening of bank reserve requirements with the central bank are a policy tool to cool down bank lending, the excessive growth of which could lead to over investment in fixed assets with consequent financial problems for the companies involved and, through that effect, to bad debts for the banking system. So, China will be watched very closely this year by investors but the general issue is that a reversal of extreme economic measures and a movement towards more semblance of normality is to be welcomed. However, a tightening of economic policy in such an important country as China is bound to induce market nerves from time to time.

The monetary policy aspect of overall economic policy is going to be important for investors this year. This is building on a theme we have been discussing earlier in discussing the sovereign debt issue and the withdrawal of the extremely stimulative monetary policy measures. We must distinguish between short and long term interest rates. The central banks can usually control interest rates at the very short end of the market but, further out on the maturity spectrum, interest rates are at the mercy of the market, with bond prices being a function of supply and demand. There is one qualification here, namely that the aspect of quantitative easing involving government bond purchases such as that operated by the Bank of England may keep yields below what they would otherwise have been for a time, but not indefinitely. As a result of short term interest rates remaining very low but longer term yields, as evidenced in the bond market, rising, the yield curve has steeped significantly. This is where the judgement of the market will be felt as Greece is already finding out. Whilst the level of short term interest rates makes the appeal of much higher yielding assets look attractive, judged just on yield differences, and in most countries yields on bonds further out on the maturity spectrum do not pose a threat to equities since they are still relatively low, a sea change in yield levels caused by a funding crisis would, prima facie, pose a threat to much lower yielding assets, like equities. Although it is possible to argue that, in such circumstances, equities with significant overseas interests may be a good hedge against a declining currency, the counter arguments, and more traditional ones, of the adverse affect of very high interest rates and, if not part of a currency union, currency weakness, which may cause overseas holders to sell equities of the country in question, would probably be stronger. If we look at Greek equities, for example, notwithstanding Greece being part of a currency union, the equity market has been relatively weak as the crisis has unfolded, and so has the Spanish one, with Spain being an area of worry as well. As well as the depressing effect of a very sharp rise in bond yields, the possibility that Greece may also leave the eurozone, leading to foreign investors suffering currency losses on Greek investments, will also have been in investors' minds.

This recent crisis started off, of course, in the banking sector and we should not finish without looking forward to what 2010 may bring in this sector. As noted before in these reviews, one of the reasons why the stock market recovered so strongly in 2009 was, we believe, that depositors' confidence in banks recovered on the back of decisive action by governments and central banks to secure the safety of bank deposits. Whilst investors expect stocks and shares to go up and down, they do not expect to have to worry about the security of their deposits. The sense of relief that this concern had been addressed was, we believe, one catalyst for the stock market's advance last year. But will there be more trouble and, if so, where might it arise? As we have seen from the results of some of the big banks, where serious trouble threatened, there are still severe difficulties. Although some improvement in the world economy this year will be helpful, the start of an economic improvement can be a stressful time for companies' finances as companies require more working capital to finance increased production and finance customers. This can cause financial difficulties and so the continued relatively depressed state of the world economy, even if it is showing a very modest recovery, combined with this issue, is likely to make loan write offs still significant. In the personal sector, such as in the UK, where there is a high level of personal indebtedness, business like credit card advances are likely to prove problematical. If the sovereign debt issue becomes serious with defaults arising, then the banking sector will be highly exposed. European banks, for example, have heavy exposure to Greek debt. In these circumstances, the "too big to fail" issue will be relevant and one cannot see the eurozone authorities allowing this to happen. It will, however, be a serious issue for stock markets. This is not to say that such an issue will arise, because the political commitment to the euro project is so great that all avenues will be explored. However, significant sovereign debt defaults cannot be excluded this year and, if major ones occur, this will be another challenge for stock markets.

As things stand, the expectation is that after the significant recession in 2009, there should be a modest recovery this year, although it must be noted that the European economies, including the UK one, do not appear to have started the year very strongly. We note below excerpts from the IMF World Economic Outlook Update of January 2010 detailing projections for economic growth in 2010 and 2011.

IMF Projections (world output year over year % change)

	2009	2010 (projection)	2011 (projection)
World output	-0.8	3.9	4.3
Advanced economies	-3.2	2.1	2.4
USA	-2.5	2.7	2.4
Eurozone	-3.9	1.0	1.6
Germany	-4.8	1.5	1.9
France	-2.3	1.4	1.7
Italy	-4.8	1.0	1.3
Spain	-3.6	-0.6	0.9
Japan	-5.3	1.7	2.2
UK	-4.8	1.3	2.7
Canada	-2.6	2.6	3.6
Newly Industrialised Asian economies	-1.2	4.8	4.7
Russia	-9.0	3.6	3.4
China	8.7	10.0	9.7
India	5.6	7.7	7.8
Middle East	2.2	4.5	4.8
Brazil	-0.4	4.7	3.7

Source: IMF World Economic Outlook Update - January 2010 (excerpts)

The improvement in industrialised economies, which is expected this year, results from the enormous fiscal and monetary stimulus given to the world economy to ward off the threat of depression, plus an end to destocking, a phenomenon that is capable of reversing an economic downturn, at least temporarily. At this stage of the year, the query would be about the eurozone for the reasons mentioned above. A sovereign debt crisis would be expected to depress growth. The world economy will continue to get important impetus from the economies towards the end of the list, whilst those at the top are only expected to produce modest growth. Nevertheless, if these projections are broadly correct, they will provide the background to the start of the expected recovery in corporate earnings and dividends which should continue in 2011.

It goes without saying that economic and financial conditions remain very unusual with no exact precedent. Although the recovery in international equity markets dates back to almost exactly a year ago and has been very sharp, equities are still our preferred asset class for the reasons given above. But we must certainly not become complacent. There remain many risks to the world economy and the performance of equity markets contrasts with the dismal situation in the world economy. However, in the absence of events which we cannot currently predict, exposure to real businesses which do not look excessively valued, looks the default position for investors, given the large risks which we continue to see in bond valuations.

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