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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Whilst turbulent stock markets attracted many headlines in the early part of 2016, sterling based investors who had well diversified international equity portfolios experienced an unremarkable quarter as sterling's weakness mitigated almost all of the fall in international equity markets. Bond yields fell as investors moved to the perceived safety of bonds with ten year Swiss and Japanese government bonds standing on negative gross redemption yields. As the tables show, sterling endured a torrid quarter, probably exacerbated by the uncertainty about the forthcoming EU referendum. In commodity markets, oil remained weak but gold came into its own due to the unsettled economic background.

The tables below detail relevant movements in markets :

International Equities 30.11.15 - 29.02.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-5.0	+1.2	-6.4	-9.0
Finland	-11.5	-1.6	-8.9	-11.5
France	-11.3	-1.4	-8.8	-11.3
Germany	-16.0	-6.7	-13.6	-16.0
Hong Kong, China	-8.1	-1.1	-8.4	-11.0
Italy	-22.8	-14.3	-20.6	-22.8
Japan	-18.4	-3.7	-10.9	-13.3
Netherlands	-8.7	+1.4	-6.1	-8.7
Spain	-18.3	-9.2	-16.0	-18.3
Switzerland	-11.1	-0.9	-8.2	-10.8
UK	-3.4	-3.4	-10.5	-13.0
USA	-7.0	+0.4	-7.0	-9.6
Europe ex UK	-12.8	-3.2	-10.4	-12.9
Asia Pacific ex Japan	-3.9	+1.8	-5.8	-8.4
Asia Pacific	-12.0	-1.2	-8.6	-11.1
Latin America	-1.4	+2.3	-5.3	-7.9
All World All Emerging	-6.8	-1.1	-8.5	-11.0
The World	-8.5	-0.7	-8.1	-10.7

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +4.0%

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

Currency	30.11.15	29.02.16
Sterling	1.84	1.46
US Dollar	2.24	1.74
Yen	0.31	-0.06
Germany (Euro)	0.48	0.11

Sterling's performance during the quarter ending 29.02.16 (%)

Currency	Quarter Ending 29.02.16
US Dollar	-7.5
Canadian Dollar	-6.2
Yen	-15.1
Euro	-10.1
Swiss Franc	-10.2
Australian Dollar	-6.4

Other currency movements during the quarter ending 29.02.16 (%)

Currency	Quarter Ending 29.02.16
US Dollar / Canadian Dollar	+1.3
US Dollar / Yen	-8.3
US Dollar / Euro	-2.9
Swiss Franc / Euro	+0.1
Euro / Yen	-5.6

Significant Commodities (US dollar terms) 30.11.15 - 29.02.16 (%)

Currency	Quarter Ending 29.02.16
Oil	-18.8
Gold	+16.3

MARKETS

Sterling based investors with geographically diversified portfolios have weathered international equity market declines relatively well during the quarter as sterling weakness has broadly made up for falls in overseas equity prices. Looking at local currency returns first, we see that the total return on the FTSE World Index was -8.5%. Relative to that, the UK's performance, as measured by the FTSE UK Index, was good, although down in absolute terms, with a return of -3.4%. Australia and the USA outperformed in relative terms with the FTSE Australia index returning -5.0% and the FTSE USA index -7.0%. The FTSE Asia Pacific ex Japan index also held up relatively well with the FTSE Asia Pacific ex Japan index returning -3.9%, whilst the FTSE All World All Emerging Markets index also performed relatively well, returning -6.8%. The market which held up best of all, in contrast to its recent history, was Latin America, where the return on the FTSE Latin America index was -1.4%. Relatively underperforming markets in local currency terms were Japan, where the FTSE Japanese index returned -18.4%, and Europe ex UK where the FTSE Europe ex UK index returned -12.8%.

A dramatic fall in sterling changed the picture significantly for sterling based investors and the negative return in that currency on the FTSE World Index was just -0.7% (in US$ terms, it was -8.1% and, in euro terms, it was -10.7%). In sterling terms, there were positive performances from the FTSE Australia Index, +1.2%, from the FTSE USA Index, +0.4%, from the FTSE Asia Pacific ex Japan index, +1.8%, and from the FTSE Latin American index, +2.3%. The sharp rise in the value of the yen brought the sterling return of the FTSE Japan Index down to -3.7% but it still underperformed the FTSE World Index, as did the FTSE Europe ex UK Index which returned -3.2%. The UK underperformed on a currency adjusted basis.

The volatility in equity markets drove down bond yields and Japan joined Switzerland in seeing its ten year government bond yields standing at a negative level, -0.06%, a fall of 37 basis points over the quarter. Also using the ten year government bond yield as a benchmark, there was a fall in the gross redemption yield of the UK government bond of 38 basis points to 1.46%, in the US Treasury bond of 50 basis points to 1.74% and of 37 basis points in the German Bund to just 0.11%.

Currency movements were dramatic with sterling, as mentioned above, taking a heavy battering, probably aggravated by uncertainty over the outcome of the EU referendum on the 23rd June. Against the yen, it fell by 15.1%, against the Swiss Franc by 10.2%, against the euro by 10.1%, against the US dollar by 7.5%, against the Australian dollar by 6.4% and against the Canadian dollar by 6.2%.

Although off its lowest levels, oil, as measured by Brent crude, fell by 18.8% over the quarter, whilst gold, at last living up to its billing as a safe haven in troubled times, rose by 16.3%.

ECONOMICS

This has been an eventful quarter for investors as the new year started off on a bad note with trading being halted in China following a sharp fall in share prices. There was nothing really new to increase investors' concerns but they took their cue from China and in the early days of 2016 adopted a "glass half empty" view of events. All of the main concerns remained such as a slowdown in the Chinese economy, very weak commodity prices, problems in the eurozone, the prospects for deflation and concerns about the high yield bond market where energy issues were under scrutiny. These events have contributed to a reduction in growth forecasts made by the IMF and OECD for 2016. One issue, which has been around since the financial crisis, has been the health of banks, and this issue has risen in importance in investors' eyes so far this year. When negative sentiment is in the ascendancy, banks are often the focus of attention and Deutsche Bank and the German Finance Minister had to issue reassuring statements. The bank, as a show of confidence, announced the repurchase of some of its bonds. Elsewhere, concern about Italian banks, which have a high level of non performing loans, reached an elevated level with the Italian government at loggerheads with the EU about how to deal with the issue. At the end of December in Portugal, major concerns arose when the Portuguese central bank used senior bonds of Novo Banco to "bail in" Banco Espirito Santo, the bank which, in 2015, was divided into a "good bank", Novo Banco, and a "bad bank", Banco Espirito Santo. Five out of fifty two bonds were selected by the central bank for the "bail in" and this has caused a good deal of anger amongst the affected bond holders and damaged the Portuguese bond market. Legal challenges will ensue. To cap it all, some central banks have increased the negative interest rate on deposits placed with them which makes life more difficult for banks in terms of profits which are needed to build up their capital bases. Bank shares have performed poorly so far this year as a result of these concerns.

For sterling based investors, there has been one major development during the quarter and this has been the significant weakness in the currency. In general, where there is no direction otherwise, our portfolios are internationally diversified and unhedged so that recent weakness in international stock markets has been partially mitigated by currency movements. As with most currencies, there are arguments in favour and against and, with hindsight, one can attribute reasons for a currency movement one way or another. In the case of the UK, if one wanted a reason to be negative about the currency, one could cite the UK's large current account deficit, around 5% of GDP, which renders it vulnerable to a change in sentiment. It is fine whilst foreign capital is flowing in but, if sentiment changes, a currency can be left very vulnerable. Now, however, there is an issue which one can pinpoint as almost certainly contributing to the currency's current weakness and this is the forthcoming UK referendum on EU membership. Markets dislike nothing more than uncertainty and we will probably have almost four months more of this unless the opinion polls point to a clear "Remain" lead. At the moment, the split of opinion looks even if the opinion polls are anywhere near correct. This does not prejudge whether it will be better for the UK to remain in the EU or to leave it but, rather, that uncertainty is the enemy of the markets. For sterling based investors, this issue has come to the fore in recent months but particularly since the start of this year. It is possible that sterling will remain vulnerable until the 23rd June votes and maybe even thereafter.

Whilst the significant economic and political issues which have been exercising investors' minds have remained broadly the same, as we stated above, the order of importance changes. One issue which we have referred to in past reviews in discussing policy options is negative interest rates and it is worth expanding on the implications of these. There are facets of this phenomenon, negative gross redemption yields in the bond markets which are a second order effect of the monetary policy being followed, i.e. negative official rates set by the relevant central bank. Dealing with the latter issue first, we have negative official interest rates applied by the central banks of the eurozone, Switzerland, Denmark, Sweden and Japan so that as banks deposit some or all of their reserves with the central bank they are paying for the privilege of doing so. The aim is obvious. With the world economy in slow growth mode, these central banks want to use negative interest rates to stimulate the relevant economies by encouraging banks to lend, and therefore earn some profits for themselves, and bank customers, who are receiving no or negative interest, to spend their money. It is a more extreme version of the monetary policy which has been followed since the financial crisis and complements quantitative easing where applied. However, the side effects are not all good.

Retail customers may withdraw deposits from their banks if the latter impose negative interest rates and keep the money under the mattress, as it were. They may not necessarily spend it, and therefore not stimulate the economy, and a withdrawal of deposits may complicate banks' funding positions. For this reason, banks may not want to penalise their customers with negative interest rates, in which case negative interest rates put pressure on their margins by limiting the rate which they can realistically charge on loans. Banks have been under pressure to increase their capital buffers. New capital has been raised on the markets but the best way for it to be done is by building up retained profits and, for that, banks have to be profitable and, of course, a number of them are not. The danger here is that lack of profitability, for whatever reason it is caused, makes it more difficult for banks to lend, which is exactly the opposite effect to what the authorities intend. To compound this, the vast level of fines imposed on many banks has and is damaging their profitability so the aims of the regulators and courts in imposing figures for misdemeanours and the politicians in trumpeting them run counter to the economic objectives of trying to encourage economic growth. The situation is rich in irony where the central banks are trying to use very active and unorthodox monetary policy to stimulate economic growth, albeit with the margin pressures on banks which are unhelpful, and other forces are working against this objective.

Negative interest rates, reflected in customer accounts, can also encourage excessive risk taking by investors or bank customers. This is really an extension of the problems we have discussed in previous reviews arising from very low interest rates which divert funds into riskier assets. In this respect, we might look at the high yield bond market into which some investors were driven in the search for yield and where there have recently been some sharp price falls. Some US energy stocks fall into this category.

In the bond market, whole swathes of government bonds in the eurozone, Denmark, Sweden, Switzerland and Japan now sell on negative gross redemption yields at the five year maturity level and in Japan and Switzerland at the ten year maturity level. At the shorter end of the market, this reflects official interest rates and some central bank's buying under quantitative easing programmes and, further out, central bank buying again under quantitative easing programmes. But, as an investor, to purchase marketable securities knowing that, if held to redemption, a certain loss will be made, reflects an extraordinarily pessimistic view about investment prospects which one struggles to justify. The "greater fool" syndrome seems to be in place whereby investors hope to sell bonds on an even larger negative yield and thereby make a profit, surely a very dangerous game.

The increasing move to negative interest rates shows that monetary policy is almost exhausted as a tool of effective economic action. One would have thought that they have almost reached their lower bound because of the potential difficulties for banks as outlined above. Further quantitative easing could be undertaken but the effects are likely to be less with the risks of ever expanding central banks' balance sheets and, further out, inflation. So desperate has the argument become that there is talk of "helicopter money" being used to kick start economies. This could mean money being created by the relevant central bank and handed out to people to spend and thereby, hopefully, kick start the economy. There is an important difference between "helicopter money" and quantitative easing as it has been practised by central banks. In the case of quantitative easing, the assets purchased from the private sector can be sold back, thus reducing the size of the central banks' balance sheets and taking out of circulation the money which was created, thereby reducing the inflation risk. "Helicopter money" cannot be bought back. It will have been spent and would threaten to debase the currency through inflation. There is no guarantee that any stimulus created by "helicopter money" will follow through once it has been spent.

It is against this background that the latest OECD Interim Economic Outlook is relevant. Like the IMF in January, it has reduced its growth projections in 2016 and it now sees world growth at 3.0% this year, the same as for 2015 and a reduction of 0.3% from its November 2015 forecast. The OECD's forecast for 2017 is 3.3%, 0.3% lower than last November's forecast. Looking at the individual components of its forecasts, there has been a significant reduction in the forecast for US growth, particularly this year. Against growth of 2.4% in 2015, it now forecasts 2.0% growth this year, a reduction of 0.5% from its forecast last November, and, for 2017, it now sees growth of 2.2%, a reduction of 0.2% from its November forecast. The eurozone has seen a sharp reduction in its forecast growth rate, especially for 2016. The OECD now sees the eurozone expanding by 1.4% in 2016, a reduction of 0.4% on its November forecast and 1.7% in 2017, a reduction of 0.2%. The 2016 forecast, if accurate, would suggest a slight slowdown on 2015's 1.5% growth rate. Of the three largest eurozone economies, the OECD has made particularly large reductions in its forecasts for Germany and Italy this year. Germany is forecast to grow by a slightly lower rate of 1.3% which compares with 1.4% last year. The forecast for this year represents a reduction of 0.5% compared with its November forecast. Next year's forecast for Germany has been pulled back by 0.3% to 1.7%. For the third largest eurozone economy, Italy, the OECD has reduced its forecast for this year by 0.4% to 1.0% compared to 0.6% last year. It has left its 2017 forecast unchanged at 1.4%. The forecast for the second largest eurozone economy, France, has been pulled back only slightly, by 0.1%, for this year to 1.2%, a very slight increase on last year's level of 1.1%, whilst next year's forecast of 1.4% is unchanged. The outlook for Japan also looks difficult. The OECD forecasts growth of just 0.8% this year, a reduction of 0.2% on its November forecast, compared with growth of 0.4% in 2015. The OECD has actually raised its forecast for Japan for 2017 by 0.1% to 0.6%. The commodity orientation of Canada has meant a sharp reduction in the OECD's 2016 growth forecast by 0.6% to 1.4%, just a little higher than 2015's rate of 1.2%. Next year's forecast has been trimmed only slightly by 0.1% to 2.2%. Although the OECD has reduced the forecast growth rate of the UK by 0.3% to 2.1% for this year, if its forecasts turn out to be accurate, it will be the fastest growing G7 economy this year. The sharp reduction in the OECD's forecast for the USA means that, if correct, the UK will grow slightly faster than the USA this year. Next year's forecast for the UK has been trimmed back by 0.3% to 2.0% which would put it behind the USA and Canada, both forecast to grow by 2.2%. However, 2017 is a long way off and much can happen before then.

Whilst, of the BRIC countries, Brazil and Russia are suffering very badly with the OECD reducing the forecast for Brazil's growth rate this year by -2.8% to -4.0% and by -1.8% to 0.0% for 2017, China's and India's forecasts have been left largely unchanged from last November. In the case of China, the forecasts are completely unchanged at 6.5% for this year and 6.2% for next year against 6.9% in 2015. In the case of India, there is very little change, a minor upward revision of 0.1% for this year to 7.4% and a minor reduction of 0.1% to 7.3% for next year. The growth rate for 2015 was 7.4%. For the Rest of the World, the OECD has reduced its forecast for 2016 growth to 2.5%, down by 0.3%, compared with 2.1% last year and by 0.2% to 3.1% next year.

There are, as we see above, some quite meaningful reductions in the OECD's forecasts and these follow on from downgraded forecasts from the IMF in January. The OECD makes a call for urgent action in terms of a policy response to very modest growth forecasts. It makes the point, as we have discussed before, that monetary policy alone cannot restart the world economy. We pointed out that monetary policy was losing its potency because of the level of interest rates and therefore the scope to make a meaningful reduction and that quantitative easing was becoming less effective. The OECD advocated that fiscal policy and structural reform must be deployed more actively. Dealing with the latter policy tool first, structural reform is not likely to make much progress. Where it is needed, particularly in Europe, there are strong vested interests opposing it. In France, where it is desperately needed, it is progressing at a slow rate with nearly every attempt to make reforms is being opposed by vested interests. In one country, where there has been some success, Spain, the recent election stalemate is likely to bring reform to a halt and, in Portugal, the new government plans to undo some of the reform measures of the previous government. It is probably safe to rule out structural reform as likely to make a big difference to international growth rates. This is unfortunate because a flexible and open labour and product market paves the way to increasing a country's long term potential growth rate and can also help in the short term as we have seen in Spain where unemployment has fallen from a very high level and growth has picked up sharply. There are still major problems for the Spanish economy but there has been a noticeable improvement. The election result will make progress much more difficult. Structural reform faces major obstacles in the eurozone and also in Japan where vested interests are strong. The OECD points out that fiscal policy is contractionary in many major economies. This is because these economies are over-indebted or have excessive budget deficits which need attention or where action is mandated in the case of the eurozone. High levels of indebtedness are placing a brake on economic growth but it is a Catch 22 situation. If governments use fiscal policy to try to kick start their economies either by tax cuts or increased public spending and have a high level of indebtedness, creditworthiness is lowered, relative interest rates rise and, in extremis, a Greece type situation emerges. Countries which can do this, like Germany, have no appetite for such measures.

So what will happen? It is highly likely that the emphasis will remain on monetary policy. It is the line of least resistance by politicians to pass the buck to central bankers. If they feel they cannot use fiscal policy or accelerate structural reform for whatever reason, allowing central banks to use the interest rate or quantitative easing tools seems so much easier and that is what we think will happen. It is highly unsatisfactory and creates troublesome distortions which will have to be unwound at some time and the policy will be less effective as time goes on. Underlying the thinking behind very low or negative central bank interest rates is that very cheap borrowing rates will encourage individuals and businesses to borrow and spend and stimulate the economy by so doing. However, cheap money by itself will not encourage this type of behaviour by individuals or businesses. Individual circumstances, such as high indebtedness, may preclude spending money or there may not be sufficient confidence in an economy even with the lure of very cheap money. This is one of the problems at the present time.

One of the reasons for the current very low inflation levels now prevailing is the fall in commodity prices and, in particular, oil. Given that, in July, 2008 the price of Brent crude reached US$146 a barrel and now stands at not much more than one fifth of that level and recalling the anguish that the high price of oil caused, it seems strange that so many people are now worried about the low oil price. Constructing a negative story would be that it reflects a collapse in demand as a result of marked weakness in the world economy, that it will cause serious economic damage to commodity producing countries, that it will depress wages and therefore the spending power necessary to accelerate economic growth and that, if deflation is reached, it might spark off a downward spiral in economic activity. Just taking the point about commodity prices and particularly oil, the transfer of purchasing power from producers to consumers has been enormous. One of the side effects is that countries with vast financial reserves like Saudi Arabia are having to liquidate assets to meet their budget shortfalls. This could be one of the reasons why markets have been volatile recently as some of the different countries' more marketable securities have been sold. For other oil producers, such as Venezuela, which have severe financial problems, the fall in the oil price is catastrophic and the country's international bonds reflect this reality. But, for the majority of countries, the weakness in the oil price reflects a tax cut, placing more money in the hands of individuals and businesses. So far, the money appears to have been saved or perhaps used to pay down debt but the optimists would hope that the money will feed through to economic growth. On balance, we view the fall in the oil price as positive for the world economy with the winners outnumbering the losers and the winners having a higher marginal propensity to consume than the producers.

Turning now to discuss individual areas of the world, we start with the USA where perhaps the most interesting topic at present is the country's political outlook. We have noted in past reviews that politics, and not only in the USA, has become more polarised. The emergence and staying power of Donald Trump for the Republicans and Bernie Sanders for the Democrats has been a big surprise and, if either were to become President and prove able to implement their proposals, the market reaction would surely be negative. As this is written, it looks almost certain that Donald Trump will obtain the Republican nomination and Hillary Clinton the Democratic nomination. Whilst Mr. Trump may energise the activists, it would be surprising if he was successful in a straight fight against Hillary Clinton. Although Mrs Clinton has had to tack towards the party's left wing activists, she has experience at the highest levels and would probably frighten the markets less than Mr Trump or Mr. Sanders. Then there are the checks and balances in the constitution so that Congress could stymie extreme Presidential proposals. The conclusion at this stage is that the surprising developments in the race to be the next US president are not yet a market factor and that, after November's elections, the USA is not likely to take an extreme course of action politically, even though business will face some additional political headwinds. However, investors have to monitor the position closely.

As for the US economy, it is moving along at a modest pace. The final quarter of 2015's GDP has been revised upwards to 1.0% compared to the first estimate of 0.7%, still a sub par figure. As we have seen, the OECD has revised downwards is forecast growth rate for this year down to 2.0%. Whilst that part of the US economy tied to the energy industry will be depressed by the low price of oil, most parts of it should benefit and one would hope to see that carried through to stronger consumer and business spending. As a relatively closed economy, the US should be less affected by external events than many other countries. Important high value indicators like the purchasing managers indices are not strong. The latest index for manufacturing stands at 49.5 implying an economic contraction whilst that for the non-manufacturing sector stands at 53.4 indicating modest growth and this is a much more important part of the US economy. The unemployment rate has dipped below 5.0% standing at 4.9% albeit that the USA has a low participation rate in the labour market which means that the good news must be qualified somewhat. There has been a slightly better trend recently. The paradox is that, at this unemployment level, one would expect wages to be rising more strongly than they are but the latest figures remain disappointing. The latest personal consumption expenditure price index indicator of inflation, favoured by the Federal Reserve, stands at 1.7% and it may be that the low level of inflation in many countries is setting the expectation for pay negotiations. All this is making the Federal Reserve's task of setting interest rates more difficult. In December, when it raised interest rates, expectations were that the federal funds rate might stand at a mid range of 1.375% by the end of 2016. Now those expectations seem less solidly based because of the uncertain start to 2016 in world stock markets. The economic news for the USA could suggest that the previously expected level of interest rates at the end of 2016 was reasonable because there is sufficient strength to support it but fears of the international repercussions of further rises in US interest rates may stay the Federal Reserve's hand.

Times have become tougher for US companies as they have faced currency headwinds with fourth quarter year on year earnings under pressure and showing a decline. Once the reporting season is out of the way, there may be a pick up in share buy backs which have been an important support for share prices in recent years. US companies continue to raise their dividends, important at a time when interest rates and bond yields are so low and in the context of keeping the asset class attractive. M & A activity is buoyant which suggests that companies retain some confidence in their prospects. Being a relatively closed economy, the USA can generate some of its own growth independently of what happens elsewhere. It appears to have less risk than most markets, although investors will have to watch the politics given that they have become less predictable in the USA with maverick forces on the march. It still remains one of our favoured markets at present.

The fundamental problems for Europe remain and are unlikely to improve but, as we have often pointed out, it is very important to distinguish between the sovereign and companies based in Europe and the eurozone in particular. The purchasing managers indices, which are important indicators on the state of an economy or region, are satisfactory although not strong. The latest composite PMI for the eurozone stood at 53.0, suggesting modest economic growth. The readings for services, manufacturing and construction were fairly close together around the composite figure and seem to tie in with the latest eurozone fourth quarter growth figures of 0.3% quarter on quarter growth or 1.1% annualised and 1.5% year on year growth. But there are many weak signs. For example, the latest industrial production figures show a 1.0% month on month decline and a 1.3% year on year decline. Year on year inflation remains well below the ECB's target level of just below 2%, currently at -0.2% which is having a depressing effect on wages and the ability of consumers to drive economic growth. It remains difficult to see how the eurozone is going to get out of the bind in which it finds itself. The expectations are on the ECB but monetary policy is surely near the end of its ability to have a significant effect on economic activity. Whilst there may be more quantitative easing and steeper negative interest rates (but note our comments earlier about the difficulties these cause for banks) it is difficult to see this having much effect. Any marginal reduction in interest costs for borrowers is unlikely to change potential borrowers' perceptions of the advisability of taking on more borrowing for consumption or investment. With the straitjacket of fiscal requirements, monetary and fiscal policy are pulling in opposite directions. There are a number of specific concerns as well. Greece looks to be back in recession and electorates are arguing about the pain they have had to take. Ireland is the latest manifestation of this with an inconclusive election result and anti austerity parties are on the rise. A lot of the blame for these problems falls on the euro, a political construct without any proper economic underpinning or rationale. It remains our view that the currency union will break up at some stage because of its inherent contradictions. Forcing internal devaluations on countries is a recipe for social unrest. Losing the essential safety valve of a flexible currency in an area with so many political and economic differences has caused immense economic damage. There are, however, many excellent companies based in the eurozone and stock markets in the area are characterised by some attractive ratings and dividend yields, the latter a particularly relevant point when so many eurozone government bonds stand in negative yield territory.

As we saw from the OECD's latest forecasts, Japanese economic growth is very disappointing. In the final quarter of 2015, quarter on quarter growth was negative at -0.4% or an annualised rate of -1.4% whilst year on year growth was just 0.5%. Whilst Japan's current account has benefited enormously from the fall in the oil price, the collapse in price has hindered the Bank of Japan's efforts to push inflation towards 2%, a level at which it was hoped that consumers would be encouraged to spend and so move the economy to a higher growth trend. So, whilst the fall in oil prices is good news for most oil importing countries, it is a mixed blessing for Japan which has forced the Bank of Japan to move to negative interest rates only to see the unexpected happen and for the currency to rise, a development which means a tightening of economic policy. The rationale for the rise in the yen's value was that, with more countries pursuing this negative interest rate policy, the reasons for the yen's relative weakness would disappear and it would have a "safe haven" status. The latest consumer prices index would have been disappointing for the Bank of Japan. January's year on year prices were flat whilst the month on month figure was -0.4%. With the Bank of Japan determining negative interest rates on a graduated basis for bank reserves and ten year government bonds showing a negative gross redemption yield, there does not seem to be much expectation that the Bank of Japan will reach its 2% inflation target. The last thing the Bank of Japan and the Japanese government want is for the deflationary mindset to remain entrenched in Japanese consumers' minds with its negative connotations for growth. One thing which would help to drive inflation would be weakness in the yen but, as our table at the beginning of this review shows, the negative interest rate policy, although fairly new, has not worked in the way expected on the currency which, over the past three months has been the strongest of the major currencies. A competitive negative interest rate policy is a zero sum game and so, in extreme circumstances, if all the major central banks followed a negative interest rate policy, some currencies would be strong and others would be weak. Again, as we see from our performance table at the beginning of this review, the Japanese equity market in local currency terms significantly underperformed the FTSE World Index and one reason would have been the strengthening currency which would impact negatively on many Japanese manufacturing companies. A good deal of that relative underperformance disappeared for sterling investors but the perceived "safe haven" status of the yen in uncertain times, and this is one of them, is unhelpful to the Japanese authorities' economic policy aims. In many ways, this "safe haven" status is ironic since Japan has a horrendous debt problem and a yawning budget deficit as well as very poor demographics. As elsewhere, although it may not seem obvious at the moment, the large dose of quantitative easing being administered by the Bank of Japan could debase the currency in time which would certainly help the inflation concern, although this is not likely to happen in the foreseeable future. A more immediate issue is coming into sight, the second stage of the consumption tax increase, due in April 2017, which, if implemented, would take the level from 8% to 10%. Japan's estimated budget deficit for 2015 is around 6.8% of GDP according to estimates in The Economist and its outstanding level of public debt in relation to GDP is around 240%. The Finance Ministry would be very keen to garner the extra tax revenue to address the budget deficit problem but others would worry that, as before, a consumption tax rise would stall the economy. We continue to consider the Japanese economy a high risk/high reward one but time is running out for "Abenomics" and one would certainly want to see more of the third arrow, structural reform.

Of course, the turbulence in the international stock markets in the early week of 2016 was set off by the sharp fall in the Chinese stock market on the opening day of 2016, igniting again fears which arose last August when the central bank widened the trading bands for its currency which pessimists considered to be a devaluation, caused by fears about the Chinese economy, rather than a technical change paving the way for admission of the Chinese currency to the Special Drawing Rights basket of the IMF. The official figures do show some slowdown in growth, but not much, although some people believe the actual growth rate is rather lower than published. Fourth quarter growth in 2015 compared with a year earlier came in at 6.8% and quarter on quarter growth at 1.6% for an annualised increase of 6.6%. Industrial production in December was 5.9% higher than a year previously, a slowdown on the previous month's figure of 6.2% and the month on month figure just 0.41%, excellent by western standards but low by Chinese standards. The closely watched purchasing managers indices, whilst on average over 50 are not by much. That for manufacturing stands at 49.0 and for non manufacturing at 52.7. The stimulus provided last year which is showing in increasing bank loans should soon start to show through giving some hope of more buoyant data as the year progresses. One of the concerns has been the fall in the level of China's foreign exchange reserves. China runs a significant current account surplus, around 3% of GDP so a significant run down in the size of China's vast foreign exchange reserves suggests a major level of capital flight. Whilst the central bank can use its reserves to support its currency, this cannot last indefinitely. Whilst the Chinese stock market has performed poorly this year, it is unlikely to be a major influence on the Chinese economy given the stock market's modest size in relation to GDP. The transition away from investment and exports towards consumption and services was always going to be a delicate task. China has more tools to achieve such a transition successfully than most. In the near future, a reduction in the level of bank reserves maintained at the central bank would free up more credit for the economy and this tool is being used by the central bank now. As the world's second largest economy it will continue to be watched closely by investors and, as this is written, there is certainly a calmer atmosphere than at the beginning of the year.

As we said earlier, one of the features of the latter part of 2015 and so far this year has been the weakness of sterling and we surmise that a lot of this is due to uncertainty about the outcome of the EU referendum on the 23rd June. Currencies are notoriously hard to predict and retrospective rationalisation of currency movements is easy. In the case of the UK, the positive case for the currency for part of last year would have been that, with the UK economy growing relatively fast, although not in absolute terms, the UK would be one of the first, along with the USA, to raise interest rates and therefore attract funds into sterling in search of a better return. That, however, does not look to be the case now but it was an argument at the time.

The negative argument would be that with large current account and budget deficits, the UK was always vulnerable to a loss of confidence. The current account deficit at 4.3% of GDP is very large and therefore confidence in the UK has to be maintained if that deficit is to be financed easily. This leads on to the EU referendum. With nearly four months still to go, there is a lot of uncertainty about the outcome which, as we said earlier, is something that markets do not like. In the early days of the campaign we have seen some fanciful scare stories flying around which do nothing to settle investors' nerves. Although, as this is written, the pound seems to have stabilised slightly, it would not be surprising to see it weaken further as the weeks pass by. Whilst the currency may be weak if this uncertainty continues, some companies will benefit. Until recently, the strength of sterling has adversely affected many UK companies but now they should obtain some relief and, with the majority of the FTSE 100 companies' business being directly or indirectly overseas, this should boost corporate earnings. There are plenty of economic issues to consider in the UK, particularly signs that the budget deficit is proving harder to tame than the Chancellor thought and we will find out more in the Budget. For the moment, though, the EU referendum is the dominant issue. Our policy of holding significant investments outside the UK is, we feel, a good insurance policy at this time.

Our table at the beginning of this review shows that emerging markets are showing some relative recovery. It is easy to be negative about them, citing low commodity prices, over-indebtedness in foreign currencies and, related to this, a concern that the US dollar could rise causing currency outflows and problems servicing foreign currency debt, perhaps most of all in US dollars. But it would be wrong to get too pessimistic. These economies, on a purchasing power parity basis, account for over half of the world's GDP and, relating the size of these economies to the percentage of the share of emerging markets in the world stock market capitalisation, there is a big mismatch. At some stage, the factors which have weighted on these markets will reverse and it is wise to hold modest exposure in these areas.

It is important that investors do not allow the recent turbulence in markets to distract them from their long term policy objectives. We do not believe any news emerged in the early days of 2016 which should have caused investors to change their policy. As we have seen recently, markets have recovered strongly. The media hype is all one way with scary news headlines about however many billions have been wiped off share prices. When the reverse happens, it scarcely ever makes the news. The danger is that dramatic negative news headlines can intimidate some investors and lead to expensive investment mistakes. Our view remains that bonds are extremely dear and that equities remain the best asset class. Our expectations, on the evidence before us, and at this early stage of the year, is that equities will grind higher this year but unevenly with some periods of weakness. For sterling based investors, international diversification remains as desirable as ever in front of the EU referendum.