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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

This has been yet another positive quarter for investors both in bonds and equities. In international equity markets there were only isolated pockets of weakness, although currency movements changed the relationship between local currency returns and investors' base currency returns and our table which follows shows the extent of currency movements during the quarter. In the commodity markets, although oil fell significantly, it ended the quarter well off its low point.

The tables below detail relevant movements in markets :

International Equities 28.11.14 - 27.02.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+12.7	+4.8	+3.4	+14.9
Finland	+12.2	+2.3	+1.0	+12.2
France	+13.4	+3.4	+2.0	+13.4
Germany	+14.6	+4.5	+3.1	+14.6
Hong Kong, China	N/C	+1.4	N/C	+11.2
Italy	+10.7	+0.4	-0.4	+10.7
Japan	+8.3	+8.9	+7.5	+19.5
Netherlands	+14.7	+4.6	+3.2	+14.7
Spain	+3.3	-5.8	-7.1	+3.3
Switzerland	-1.2	+1.8	+0.4	+11.6
UK	+4.1	+4.1	+2.7	+14.2
USA	+2.4	+3.8	+2.4	+13.8
Europe ex UK	+9.5	+2.3	+1.0	+12.2
Asia Pacific ex Japan	+4.7	+2.5	+1.1	+12.4
Asia Pacific	+6.5	+5.7	+4.3	+15.9
Latin America	-3.6	-10.5	-11.7	-1.8
All World All Emerging	+2.2	+0.4	-0.9	+10.1
The World	+4.3	+3.4	+2.0	+13.4

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +2.0%

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

Currency	28.11.14	27.02.15
Sterling	1.93	1.80
US Dollar	2.20	2.01
Yen	0.42	0.34
Germany (Euro)	0.71	0.33

Sterling's performance during the quarter ending 27.02.15 (%)

Currency	Quarter Ending 27.02.15
US Dollar	-1.2
Canadian Dollar	+8.1
Yen	-0.3
Euro	+9.8
Swiss Franc	-2.5
Australian dollar	+7.7

Other currency movements during the quarter ending 27.02.15 (%)

Currency	Quarter Ending 27.02.15
US Dollar/Canadian Dollar	+9.4
US Dollar/Yen	+0.9
US Dollar/Euro	+11.1
Swiss Franc/Euro	+12.6
Euro/Yen	-9.2

Significant Commodities (US dollar terms) 28.11.14 - 27.02.15 (%)

Currency	Quarter Ending 27.02.15
Oil	-11.3
Gold	+2.6

MARKETS

It was a quarter of satisfactory growth in most international equity markets. In total return terms, the FTSE World Index returned 4.3% in local currencies, 3.4% in sterling terms, 2.0% in US dollars and 13.4% in euros. Looking at local currency returns first, the stand out areas were the FTSE Australia index which returned 12.7%, the FTSE Europe ex UK index which returned 9.5% and the FTSE Japan index which returned 8.3%. Within the FTSE Europe ex UK index, there were double figure gains in the Netherlands, Germany, France, Finland and Italy whilst the FTSE Switzerland index showed a negative return, -1.2%, after the Swiss National Bank allowed the Swiss Franc to float. There were below average performances from the FTSE UK index of 4.1%, the FTSE USA index of 2.4% and the FTSE All World All Emerging markets index of 2.2%. The worst performance came from the FTSE Latin America index which showed a negative return of 3.6%. However, as in a number of previous quarters, there were some significant currency movements which affected returns for sterling based investors. A slightly stronger yen against sterling made the FTSE Japan index the best performer in sterling terms with a return of 8.9%. Although the Australian dollar was weak, the FTSE Australia index still managed an above average 4.8% return in sterling terms. Although the strong Swiss Franc provided some mitigation to the weakness of the euro, the FTSE Europe ex UK index returned a below average 2.3% in sterling terms. The strength of the Swiss Franc meant that the FTSE Switzerland index moved to a positive return in sterling, +1.8%, not far behind the Netherlands, Germany, France and Finland. The USA and UK both showed an above average return against the sterling adjusted FTSE World Index, returning 3.8% and 4.1% respectively. Weakness in the Latin American currencies meant a very poor performance from the FTSE Latin America sterling adjusted index, -10.5%.

The bond markets have continued to astonish with certain markets showing negative yields at the short end. Using ten year government bonds as a benchmark, the gross redemption yield on the UK government bond fell by 13 basis points to 1.80%, the US government bond by 19 basis points to 2.01%, the Japanese government bond by 8 basis points to 0.34% and the German Bund by 38 basis points to 0.33%.

As indicated above, there have been some big currency movements during the quarter. The completely unexpected decision of the Swiss National Bank to break its peg to the euro caused turmoil in the foreign exchange markets and some nasty losses but, by the end of February, sterling had recovered nearly all its losses against the Swiss Franc and ended with a fall of just 2.5%. Sterling fell slightly against the US dollar and the yen, by 1.2% and 0.3% respectively, but rose by 9.8% against the euro, 8.1% against the Canadian dollar and by 7.7% against the Australian dollar. Looking at one of the other cross rates, the Swiss Franc ended February up by 12.6% against the euro.

In the commodity markets, although it has recovered quite strongly from its low point, oil, as measured by Brent crude, fell by 11.3% over the quarter whilst gold rose by 2.6%.

ECONOMICS

In economic terms, the quarter has been dominated by the consequences of the Greek general election result, fears about deflation, the Swiss National Bank's decision to let the Swiss Franc float, imminent ECB quantitative easing and negative interest rates. It all comes back to Europe, in general, and the eurozone, in particular. Outside this, and connected with the deflation fear, has been the sharp fall in the oil price. In political terms, Russia has been the main news but, as with so many serious political events in recent times, the market seems to ignore the problem in the Ukraine. As our table at the beginning of this review shows, markets have taken these economic and political factors in their stride. Yet, there is absolutely no room for complacency. As we saw in the final quarter of 2014, when the equity market experienced two sharp setbacks before recovery, events do have the power to shock investors, even if only for a very short time.

We can continue to rationalise the strength of bond and equity markets by reference to continuing very loose orthodox and unorthodox monetary policy. We now have negative short term official interest rates in Switzerland, the eurozone, Denmark and Sweden. If we look at two year government bonds, we see negative gross redemption yields in Denmark, France, Germany, the Netherlands and Switzerland. Stretching the time frame out to five year government bonds, we see negative gross redemption yields in Germany, the Netherlands and Switzerland. Ten year Swiss government bonds also have negative returns and shorter dated high quality corporates, like Nestle, also show negative gross redemption yields. These are indeed extraordinary times.

The advances shown in equity and bond markets over the last quarter reflect the same reasons as those behind the recovery in markets since 2009, namely the very loose monetary conditions which are at the forefront of attempts to kick start the world economy. In the search for yield, investors have looked to alternatives to cash, so bond and equity markets have flourished. The search for yield has inevitably involved increasing the risk in certain cases. High yield corporate bonds have been one choice and another example would be peripheral eurozone debt. The yields on the more highly indebted eurozone sovereigns bear no relation to the potential risks but they assume that there is no possibility of default and that, apart from Greece, most eurozone government bonds are riskless. All of this is a function of quantitative easing and very low or negative interest rates. Furthermore, although interest rates in the USA and UK may start to rise, they will still remain very low, whilst those in Europe are likely to remain roughly where they are now for the foreseeable future. This is, therefore, the reason why markets have performed well but cheap, plentiful and printed money do not represent the best reason for strong bond and equity markets. There has to be something more to build solid foundations which, in the case of equities, would be economic growth, increased corporate earnings and rising dividends.

In normal times, the serious political worries in the Middle East and the Ukraine would be much more important influences on stock markets and, because of their potential for escalation, could cause periods of weakness and volatility. Whilst we saw examples of both as recently as the final quarter of 2014, normal service was soon resumed, with the final quarter of 2014 producing a positive result. The monetary policy being followed has, at least for the time being, dulled any fears investors may have had about these very serious political events. Complacency about the political risks is dangerous.

Whilst we continue to favour equities as an asset class, we think progress from here will be more modest and will not necessarily be smooth given the serious political and economic problems in the world. There are two reasons why we continue to favour equities as an asset class. The first is what might be called a negative reason which is that alternative asset classes, bonds and cash, look very uninviting. We will come back to bond yields shortly but the comparison between dividend yields and bond yields favours the former. If we look at the ten year government bond yields in the table at the beginning of this review, it is hard to believe that, if theoretically held to redemption, these will be anything but bad investments. One would certainly have to be of a very negative frame of mind to find any attraction in these gross redemption yields. With cash yielding hardly anything or, in several European countries, giving a negative yield, the same applies. One would have to be very negative to feel that cash could be a good investment at the present time.

The positive reason is that, even after their rise, share prices do not look overly expensive, although they were not as cheap as they were given the large rise in 2013 and the smaller rise in 2014. If we look at a prospective price/earnings ratio on 2015 earnings of about 17.5 for the S & P 500, 16.1 for the FTSE 100 and 15.7 for the EuroStoxx 50 of 13.8, according to Bloomberg estimates, they do not look excessive when taken in conjunction with their dividend yields, given that some growth is forecast for the world economy, notwithstanding all of its problems. Others who look at the cyclically adjusted price/earnings ratio, to take into account a longer period and the economic cycles, take a different view, especially for the USA. We prefer to look at the current and prospective position but it is right to note that opinion is divided. Again, on dividend yield versus bond yield, shares come out well. Apart from the USA and Japan, prospective dividend yields in Europe, including the UK, usually start with a "3", way in excess of their relevant ten year government bond yield and this situation is, of course, a reversal of the normal relationship where bond yields exceed those of equities. At the moment, the prospective dividend yield for this year on the S & P 500 index, at an estimated 2.07%, is only a little below that on the ten year US Treasury bond. In the case of Japan, another country with an enormous quantitative easing programme, the prospective dividend yield on the Nikkei 225 is 1.44% and 1.66% on the Topix, according to Bloomberg, way in excess of the yield on the ten year JGB. Notwithstanding low levels of inflation and deflation in some countries, dividends are still being increased. So, even a very modest nominal dividend increase still represents a real increase in a number of countries. It is interesting to note that the three giant Swiss companies, Nestle, Novartis and Roche, have all announced modest dividend increases this year, notwithstanding the problems caused by the Swiss National Bank's decision to allow the Swiss Franc to float freely and its subsequent appreciation in value. So, although we see periodic setbacks in equity markets from which we would hope to take advantage with cash balances which have accumulated, with the monetary background looking fairly predictable, equities look the best value to us.

However, whilst we believe that bonds are seriously overvalued and that, other than for the shortest dated issues, investors run the risk of serious losses or large opportunity costs if the bonds are held to maturity, we have to ask why investors would still buy them. We are talking here about generalisations rather than particular bond issues which, for one reason or another, may be attractive. Let us take the most extreme example first, the ten year Swiss government bond which, at the time of writing, has a gross redemption yield of -0.03%. So, for a purchaser today, using Swiss Francs and who holds the bond until maturity, there will be a loss which may be exacerbated if the taxpayer is liable to income tax on the coupons and is not a gross fund. So, on the face of it, it seems an inexplicable investment, one that is bound to lose money for you. What could make it a good investment? It may be that the investor thinks that gross redemption yields will go even more negative, in which case there could be the possibility to trade out of the bond at a profit. That would seem a high risk strategy, given that the bond appears overvalued in the first place, but it could possibly work. Secondly, a foreign investor may buy the bond on an unhedged basis in the belief that the Swiss Franc will rise and that the currency gain may outweigh any loss on the bond. That, of course, is speculation but it may work. Thirdly, an investor may be so nervous about holding or buying other assets that he or she, or an institution, regards Swiss Franc assets as a safe haven and, given even greater negative interest rates on bank deposits, the tiny negative yield on this ten year Swiss government bond may not look so irrational. Fourthly, the investor may think that deflation is so firmly entrenched in Switzerland (the latest year on year figure is -0.5%), that there will still be a positive real return on this investment as the deflation figure is larger than the bond's negative nominal return to maturity. None of these reasons convinces us that such a purchase will be a good investment, but those who buy such a bond will have been influenced by at least one of these reasons. The big danger is that, at some stage, bond yields return to more traditional levels which will cause a sharp adjustment to bond prices and potentially very heavy losses. At some stage, bond yields will return to more normal levels.

We know why bond yields and interest rates are so low or even negative. Monetary policy is doing the heavy lifting for economic policy as fiscal policy is tightening in many countries. There is a danger that investors regard these interest rate conditions as semi-permanent and therein lies the risk. Interest rates and bond yields at these levels create severe economic distortions and, although it is certainly not an issue now, the build up of inflation later on will be difficult to control. Risk is not properly priced and this could lead to some large losses. With the US and UK economies performing relatively well, the time is approaching when interest rates will be raised by the central banks of these countries. The key is the perceived level of the output gap, basically a measure of the spare capacity in an economy. If the central banks think that the gap is nearly closed they will become more concerned about inflation and start the process of raising interest rates. Obviously, the eurozone is a long way from this position but, at some stage, the situation will change there on interest rates. In the short term, the start of quantitative easing in the eurozone will mop up a lot of bonds, although banks may be reluctant to part with them, and keep yields low or negative but it does not alter the fact that these levels of very low or negative euro bond yields are not sustainable.

Markets have been dominated by Greece and the cliff hanging negotiations between the troika (the European Central Bank, European Commission and the IMF) and Greece. As has so often happened in the eurozone, the can has been kicked down the road again but one has to believe that the eurozone is running out of road. Despite the short term truce, we are really no wiser as to how the Greek debt problem will work out. It is a clash between a democratic mandate to renegotiate the previous deal and the realities of Greece's financial position, namely that it and its banks will run out of money without support. The stakes are high for both sides. Whilst it may seem that Greece's hand is very weak, in many ways it is like the story of someone owing his or her bank one pound and he or she has a problem, but owe the bank one million pounds and the bank has a problem. The stakes are very high for supporters of the euro project because, whatever they might say, a Greek exit from the eurozone would be very serious for it because markets may then focus on what is perceives to be the next weakest link. Once the precedent has been set, particularly if Greece were to make a success of its own currency regime, it would be difficult to convince markets that Greece was a one off. If Greece eventually wins much softer terms, then other countries with weak finances will want the same treatment, establishing another difficult precedent. Furthermore, with the Spanish counterpart of Greece's Syriza party, Podemos, polling strongly and a general election due in Spain later this year, those running the eurozone will be very concerned because Spain would be a far bigger problem than Greece, being the fourth largest eurozone economy. For the moment, we must see if the Greek parliament backs the short term agreement to qualify for the first €7.2 billion instalment due from the troika. Greece is due to make payments to its creditors in each month from March to August and, in June, must agree a new long term strategy with its creditors. Keeping the coalition together in Greece will not be easy given the promises which were made and the concessions required to obtain funding. Whilst this is an enormous economic issue, the stock market has been strangely disengaged. Nevertheless, it has a chance of blowing up at any time and there is no room for complacency.

The woes of the eurozone were finally too much for the Swiss National Bank which caught the market off guard in January when it announced that the Swiss Franc would be freed from its unofficial peg to the euro. This caused financial grief for some investors and foreign exchange dealers because it had contradicted what the SNB had been saying only a few days previously, namely that the link was very important. In retrospect, one can see that the policy of keeping a floor of €1=CHF1.20 was untenable in the medium term and probably in the short term, given the ballooning in the size of the SNB's balance sheet. The SNB was creating Swiss Francs to buy euros but this posed a large risk to its balance sheet if the euro weakened, so it was not a policy which could continue indefinitely. The SNB is hoping that the policy of negative interest rates in Swiss Francs will deter speculative flows. The adjustment in the value of the euro against the Swiss Franc (the Swiss Franc rose against the euro by 12.6%) over the last quarter is very difficult for many Swiss manufacturers whose costs are denominated in Swiss Francs but should be less of a problem for the giant Swiss based multinationals, with the big three, Nestle, Novartis and Roche, all increasing their dividends modestly which for many non Swiss based investors will mean a bigger increase in local currency terms. Despite the problems for Swiss companies, we continue to favour this market as a safe haven in a difficult continent economically.

The big worry for eurozone policymakers which finally forced quantitative easing on the ECB is deflation. The latest eurozone inflation rate is -0.3% compared with -0.6% in January but the concerns about the effects of deflation, which we have articulated before, remain. Unless a country is growing very rapidly, if it is in a deflationary situation, it is almost certain that its debt ratio in relation to GDP will increase and that the risks of moving into an unsustainable debt position increase. The fear is that falling prices will discourage individuals and businesses from spending on discretionary items, thus exacerbating an economy's downward spiral. However, it is right to be sceptical about the likely effectiveness of quantitative easing in the eurozone when bond yields are so low or negative. The reduction in yields is likely to be so small that it will not turn marginal borrowing decisions into clear cut ones and the decision of an individual or business is much more likely to be influenced by the economic environment. At the moment, in the eurozone, it is not attractive.

The major problem for a currency union made up of economies as diverse as those in the euro is that changes in competitiveness cannot be reflected in the relative exchange rates because there are none apart from the euro. Thus, countries like France and Italy, for example, which have steadily been losing competitiveness against Germany, can only regain competitiveness by reducing their costs relative to those in Germany. That involves painful choices which they may not be prepared to make. However, as a currency zone, the weakness of the euro against the US dollar and sterling, for example, will be helpful and we do see flashes of hope emerging, although these will not be enough to make meaningful inroads into the currency zone's fundamental problems. Some straws in the wind, which give rise to some modest short term hopes, are the latest eurozone purchasing managers indices. The latest reading for the services sector is 53.7 against 52.7, for manufacturing 51.0 against 51.0 and a composite index of 53.3 against 52.6. Unemployment, although very high and shockingly so in some eurozone countries, has edged down from 11.3% to 11.2%, whilst the latest quarter on quarter growth in GDP is 0.3% (0.2%) and the year on year GDP growth is 0.9% (0.8%). The weakness of the euro will be helpful to many eurozone based companies not only in increasing the competitiveness of their exports but also the value of their foreign earnings translated back into euros where those currencies have been strong against the euro. So even though impressive gains in eurozone share prices have been pared down in sterling terms, the quarter's returns in the latter currency have still been quite acceptable.

By contrast, news from the USA has been relatively uneventful, which is how one likes to see it. With the politics deadlocked, with the Republicans holding both houses of Congress and the Presidency in the Democrats' hands, nothing much can get done and, from the stock market's point of view, that is not a bad thing. The main point of interest now is the timing of the Federal Reserve's move on interest rates which will be a function of how it views the size of the output gap, the prospects of achieving its inflation target and the unemployment level. Certainly, job numbers have been strong in recent months with the latest unemployment figure falling from 5.7% to 5.5%. Although the latest GDP numbers were revised downwards, with the last quarterly annualised growth rate estimated at 2.2% against the previous estimate of 2.6% and the year on year rate down to 2.4% against 2.5%, almost all of the evidence points to an economy in steady, but not spectacular, growth mode. The latest monthly consumer price index shows a decline of 0.1% to give a year on year increase of 0.8%. The low headline inflation figure may stay the hand of the Federal Reserve for a while but generally the conditions are coming together for a rate rise in the summer. As we mentioned earlier, it is unhealthy to keep interest rates at these abnormal levels indefinitely because of the distortions and risks which build up. In anticipation of this, one might expect the US dollar to continue to strengthen making life more difficult for US manufacturers in their export markets and affecting the profits of their overseas subsidiaries on translation back to US dollars. But it is only a translation effect. The closely watched Purchasing Managers Indices show an economy moving steadily, but not spectacularly, forward just like the GDP figures. The latest manufacturing Purchasing Managers Index shows a reading of 52.9 against 53.5 the previous month and that for non manufacturing 56.9 against 56.7. One sector which has been more subdued than most is the housing sector where price increases have been showing a moderating tendency. For example, the latest S & P/Case Shiller Composite Index of 20 cities shows a rise of 4.46%, actually slightly higher than the previous month's figure of 4.29%, but lower than in the earlier months of 2014.

The question for investors is how markets will react to an upward movement in interest rates, however well flagged they are and, certainly, no one should be surprised to see the Federal Reserve make a move. The reality may come as a temporary shock but, just as in the case of the taper tantrum in 2013, something which was obviously going to happen did temporarily upset the market. A rise in interest rates from these very low levels reflecting economic recovery and the start of a return to normality should be welcomed by investors. Given the political and economic problems elsewhere in the world, the US market looks to have less risk in those spheres than many others, which is why we continue to favour it, albeit that it would be unrealistic to expect the returns achieved from US equities in 2014.

As we see from the tables at the beginning of this review, Japanese equities provided an excellent return over the last quarter, including for sterling and particularly euro investors a currency benefit as well, a reversal of the position last year. There is not a lot which is new to say about Japan. The Abenomics experiment goes on. Disappointing economic growth after last April's consumption tax increase caused the postponement of this year's second increase of 2% to 10% until 2017. The Bank of Japan is pursuing quantitative easing on an enormous scale to try to get the economy moving and inflation to its 2% target. Whilst consumer prices are up 2.4% on a year ago, this reflects the 1st April 2014 consumption tax increase and will soon drop out of the figures. The latest month on month figure shows consumer price inflation of -0.2% in January against 0.1% for the previous month. So the plan to reach 2% inflation looks behind plan. The fall in the oil price, whilst very beneficial to a large oil importer like Japan, has not helped the inflation target cause. It may seem strange to be concerned about the undershooting of an inflation target but the Bank of Japan wants to change consumers' mindset where one of holding off from discretionary purchases seems to be sensible in a deflationary environment to one where it is sensible to make the purchases in an inflationary environment. It takes a long time to effect this change but reducing savings and increasing consumption is one desired way of stimulating the Japanese economy. The government is exhorting companies to increase employees' pay with the same aim in mind. The latest purchasing manager's indices in Japan point to very modest growth. The manufacturing index stands at 52.2, that for services at 51.3 and the composite index at 51.7. The GDP figures will still be distorted by the delayed effects of last April's consumption tax increase. The latest year on year GDP figure from the fourth quarter of 2014 shows a decline of 0.5%. The fourth quarter GDP was 0.6% above that of the third quarter with the fourth quarter annualised quarter on quarter growth rate of 2.2%. We maintain our view that modest exposure to the Japanese market is desirable and that it is a high risk/ high reward market. To kick start the Japanese economy, an extreme economic policy is being pursued. Japan faces daunting debt and demographic problems which it has to address. Kick starting economic growth will be a good starting place for making inroads in a debt problem. The budget deficit of approximately 8% of GDP is unsustainable even for a country which can print its own money.

All eyes remain on China to see if it can manage its transition to lower but higher quality economic growth. The aim is to reduce the proportion of GDP represented by fixed asset investment, much of it unproductive and therefore risky for the banks, in favour of consumption. The country wants to move up the value added chain. The target growth rate has been reduced to 7.0% for 2015, well down on the double figure growth rate of previous years and moderately down on last year's 7.4%. It is a delicate balancing act and the rise of the US dollar has been unhelpful so it is noticeable that the renminbi has been weakening slightly against the US dollar which will be a part of the authorities' plan to limit the effect of the rising US dollar on Chinese competitiveness. China can act more quickly than most economies to changing economic circumstances and there have been modest moves recently to ease monetary policy. The housing market remains a major concern against the background of a sharp fall in prices. Recent GDP figures show fourth quarter year on year growth at 7.3%, the same level as that of the previous quarter. Fourth quarter growth at 1.5% was below the previous quarter's level of 1.9%. The latest purchasing managers indices are not that strong, with that for manufacturing below 50 at 49.8 compared with 50.1 the previous month. That for non manufacturing was stronger at 53.7 compared with 54.1. As in the eurozone, the authorities will be concerned about the prospects of deflation. The latest year on year consumer price inflation index registers a gain of 0.8% with the month on month figure being 0.3%, well below target levels. For the banking sector, deflation would be a concern as borrowers find the real cost of their debt rising and this would lead to more bad debts for the Chinese banks. Indebtedness is at an enormous level in China. Investors will watch how China achieves its difficult transition but, meanwhile, international investors will watch its growth outcome not only for the implications for China internally but also because it is such an important influence on the world economy. Notwithstanding the fact that China has growth rates of which developed economies can only dream, the country faces major economic issues which require delicate handling.

For investors in the UK, the forthcoming General Election on the 7th May should be the main focus of interest. The gulf in policies between the two main parties is enormous. The opinion polls, at this stage, suggest a very messy outcome, with the probability of a change in government, but one which will need the support of smaller parties. Our main concern is the ramping up of anti business rhetoric which could be transformed into policies which the market perceives as damaging to the UK economy. It is important to remember that, whilst the UK economy, along with that of the USA, has been performing relatively well, the twin deficits, budget and current account, are a serious concern for the UK. The current account deficit is running at a rate of about 6% of GDP, which is potentially in the danger zone. That deficit has to be financed and, if the policy framework in the UK is felt to be hostile to business or certain individuals, business and private investment into the UK could be adversely affected. The pound could be vulnerable. The level of the budget deficit, at over 5% of GDP, also remains a concern. If, as seems likely, there is to be some sort of coalition as a result of the General Election, it is possible to envisage a scenario of weakened budget discipline as politicians, perhaps particularly of the smaller parties, feel that there will be no votes for them in supporting continued austerity, there being a long way still to go in putting the UK's finances right. On the economic side, although for the next few months we think it is the political side which will be a more important influence on markets, the news remains quite good, notwithstanding the headwinds coming from the UK's important trading partner, the eurozone. Fourth quarter GDP increased by 0.5% with the year on year growth rate at 2.7%. The employment numbers have been strong with the unemployment rate falling to 5.7%. The Purchasing Managers' Indices remain well into positive territory with the latest index for manufacturing at 54.1 (53.1) and for services at 56.7 (57.2). Generally, the momentum in the economy seems quite strong, although with indications that the travails of the eurozone are having a minor effect on activity, but there is clearly no room for complacency. Were it not for the General Election, we would rate the UK equity market as one of the more attractive ones but the high level of uncertainty over the outcome and the toxic anti business feeling which is being stirred up in the UK, make this market, in our eyes, to be quite high risk at the moment.

In summary, our view remains much as before. There is absolutely no room for complacency even though monetary policy remains likely to support asset prices. We must expect some difficult quarters and the level of recent returns is not sustainable. The political and economic risks remain and perhaps the major challenge for markets is how they will adjust to a gradual tightening in monetary policy in the USA, in particular, and perhaps to a lesser extent in the UK. Of the different asset classes, equities remain our favoured one, with the caveat mentioned above, and bond markets remain highly vulnerable to a change in sentiment, given the extent of the overpricing in the sector.