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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Overall, results from international equity markets have shown stability over the quarter although, at the beginning of February, markets have experienced a setback, started off by fears about Greek debt levels. Good quality international bonds, as measured by ten year government bonds have shown a mixed pattern with weakness in the US and UK markets but modest strength in the German and Japanese markets. In currency markets, US dollar strength and euro weakness have been a feature.

The tables below detail relevant movements in markets:

International Equities 30.10.09—29.01.10

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-0.8	+0.4	-2.4	+3.6
Finland	+13.6	+10.1	+7.0	+13.6
France	+4.1	+0.8	-2.0	+4.1
Germany	+3.2	N/C	-2.8	+3.2
Hong Kong, China	-3.4	-0.8	-3.6	+2.4
Italy	-0.3	-3.4	-6.1	-0.3
Japan	+1.6	+4.3	+1.4	+7.6
Netherlands	+10.6	+7.2	+4.2	+10.6
Spain	-3.8	-6.8	-9.4	-3.8
Switzerland	+2.9	+2.8	N/C	+6.1
UK	+3.7	+3.7	+0.8	+7.0
USA	+4.4	+7.4	+4.4	+10.9
Europe ex UK	+2.6	+0.1	-2.7	+3.3
Asia Pacific ex Japan	+0.5	+3.3	+0.5	+6.6
Asia Pacific	+1.0	+3.8	+0.9	+7.1
Latin America	+5.5	+3.7	+0.8	+7.0
All World All Emerging	+2.4	+4.8	+1.9	+8.2
The World	+3.2	+4.6	+1.7	+8.0

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -1.1%

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

Currency	30.10.09	29.01.10
Sterling	3.63	3.91
US Dollar	3.40	3.62
Yen	1.42	1.33
Germany (Euro)	3.22	3.18

Sterling's performance during the quarter ending 29.01.10 (%)

Currency	Quarter Ending 29.01.10
US Dollar	-2.9
Canadian Dollar	-3.9
Yen	-2.9
Euro	+3.2
Swiss Franc	+0.6
Australian dollar	-1.5

Other currency movements during the quarter ending 29.01.10 (%)

Other Currency	Quarter Ending 29.01.10
US Dollar/Canadian Dollar	-1.0
US Dollar/Yen	N/C
US Dollar/Euro	+6.2
Swiss Franc/Euro	+2.6
Euro/Yen	-5.9

Significant Commodities (US dollar terms) 30.10.09–29.01.10 (%)

Significant Commodities	30.10.09–29.01.10
Oil	-5.0
Gold	+4.5

Markets

Weakness at the end of the quarter has left markets little changed although with a bias to a firmer trend. In local currency terms, the total return on the FTSE World Index was 3.2%, in sterling terms 4.6%, in US dollar terms 1.7% and in euro terms 8.0%. Looking at particular markets or regions in local currency terms, the USA performed well with the total return on the FTSE USA Index being 4.4%. Elsewhere, the UK returned 3.7%, Europe 2.6% and Japan 1.6%, all measured by the relevant FTSE World Index. As so often in recent times, one of the best performances came from the FTSE Latin American Index which returned 5.5%. On this occasion, the FTSE All World All Emerging Markets Index and FTSE Asia Pacific ex Japan Index were relatively subdued with local currency total returns of 2.4% and 0.5% respectively. If we look at the sterling adjusted returns, there is some change of emphasis. The strength of the US dollar and yen against sterling has boosted the sterling adjusted total return on the FTSE USA Index to 7.4% and on the FTSE Japanese Index to 4.3%, whilst the weakness of the euro has left the sterling total return on the FTSE Europe ex UK Index at just 0.1%. Weakness against relevant currencies on the part of sterling boosted the sterling total return on the FTSE All World All Emerging Markets Index to 4.8% and on the FTSE Asia Pacific ex Japan Index to 3.3% whilst the converse effect caused the total return on the FTSE Latin American Index to fall to 3.7%.

In the international bond markets, which we will discuss in more detail later, there was a weaker tendency, as measured by the gross redemption yields on high quality ten year government bonds. In the UK market, the gross redemption yield rose by 28 basis points to 3.91% and in the USA, the yield rose by 22 basis points to 3.62%. On the other hand, perhaps reflecting the economic woes elsewhere in the eurozone and the move to quality, the yield on German government euro denominated bonds fell by 4 basis points to 3.18%. Japanese government bond yields, showing, as they often do, little correlation with movements in other bond markets, saw their yield fall by 9 basis points to 1.33%.

In the foreign exchange markets, the feature of the quarter was the strength of the US dollar against the euro. The US dollar rose by 6.2% against the euro during this period. Against the US dollar, sterling fell by 2.9%, against the Canadian dollar by 3.9%, against the yen by 2.9% and against the Australian dollar by 1.5%. On the other hand, sterling rose by 3.2% against the euro and by 0.6% against the Swiss Franc.

In commodity markets, oil retreated by 5.0% in terms of a strong US dollar but gold rose by 4.5%.

Economics

As 2010 opens, there is a reasonable expectation that economic conditions will show an improvement on those of 2010. That is not hard, given the depth of the recession in 2009, but, nevertheless, a progression from recession to modest growth is welcome. Numb from the financial and economic experiences of the latter half of 2008 and early 2009, present economic and financial experiences seem almost benign. But this is a relative feeling. Conditions are bad rather than appalling, not that one would deduce this from the performances of international equity markets since last March. As we have often remarked, stock market cycles can work independently from economic cycles as they look ahead. With hindsight, it can be said that international equity markets probably over reacted to the news at the time. It is easy to say that now after a strong stock market recovery because that makes everyone feel better. What stock markets dislike is unforeseen and unpleasant shocks. They can live with bad economic news which is expected but an event as severe as a possible run on the banks and collapse of the financial system, which was not on most investors' radar in 2008, will cause severe falls in the stock market such as we saw in 2008 and early 2009. Conversely, a sense of relief can be experienced when the worst case scenario fails to materialise, a phenomenon reflected in 2009's stock market performances.

So where are we now, and where are the threats and opportunities for stock markets? Following recession in 2009, the West and Japan should experience a very modest recovery but China, India, a number of other Asian economies, Brazil and some emerging market economies should show strong growth this year, helping to keep the world economy afloat. With economic growth comes corporate earnings and dividend growth. After the hit to corporate earnings and dividends in 2009, that will be a welcome relief to investors. Of course, this is a sweeping generalisation. Many banks are paying no or much reduced dividends but, overall, dividends are expected to grow this year and beyond. The second piece of good news is the stabilisation of the banking system as far as depositors are concerned. We need to qualify this remark by saying that many financial institutions still have severe problems but the authorities appear to have worked out a way of ensuring the safety of bank deposits. Whilst investors expect shares to go up and down, they do not expect to have to worry about their deposits. Without appearing to tempt fate, this appears to be the position now and the absence of such a negative is helpful to investor sentiment.

The negative issues for the world economy remain very significant. The build up of debt, public and private, and the need to reduce these levels and the means by which this is done, are crucial to economic prospects in the future. That the world economy is expected to show some recovery this year is due to the massive orthodox and unorthodox monetary and fiscal stimulus given to it since the economic and financial crisis began. This has helped equity markets in 2009 but is not what might be termed a high quality stimulus. All the stops have been pulled out but at an enormous cost. On the fiscal side, budget deficits were allowed to let rip and, whilst investors were fixated with the problems in the banking sector, the consequences of enormous budget deficits were not in the forefront of their minds. As we move towards the slightest semblance of normality, more conventional concerns are gaining investors' attention. On page 7 of last October's economic and financial review, we detailed the IMF's estimate of general government fiscal balances. Before the crisis developed in 2008, such figures would have been scarcely believable with, amongst the G7 countries, the UK, Japan and USA being the worst culprits in terms of current budget deficits in relation to GDP. What made the figures even more shocking was that proportion of the deficits which were structural as opposed to cyclical, in other words which were chronically built into the economy. Cyclical deficits, in combination with cyclical surpluses, are well understood and valuable contributors to economic stability but structural deficits are malign with, amongst the G7 countries, the three countries just mentioned and France the worst culprits, but all seven and many more are guilty. Politicians have been far too keen to keep on spending in good times, when they should be saving for a rainy day, and now face the consequences of their reckless actions. As this is written, much attention is focused on Greece whose finances are in a parlous state. Years of overspending and hiding the true size of the deficits (worsened by the fact that the size of military spending is a secret) have culminated in the present crisis where a combination of large current budget deficits and a high overall level of public debt in relation to GDP has led to a collapse in the price of government bonds where yields on benchmark ten year Greek government bonds are over twice those of the best eurozone credit, Germany, and the credit rating is at the low end of the investment grade range. The size of the adjustment needed in the Greek economy to move the deficit from about 13% of GDP to the EU limit (completely unobserved by most members of the eurozone) of 3%, is so large that it is difficult to see how it can be done without major social unrest, signs of which we have already seen.

Whilst on this matter, we might slightly digress to the related issue of the sustainability of monetary union in Europe. This is a topic which we have touched upon in our reviews over the years since the eurozone was established. Whatever the politicians may say, the euro is a political rather than economic project. With such a disparate group of members, there was scant chance of the various economies converging economically, as was the plan, and, quite obviously, they are now diverging at a rapid rate. Objective support for this statement is shown by the varying degrees of yield premium required by investors to buy eurozone government bonds measured against the yield of the highest quality credit, Germany. If one country, Greece, has to borrow at over twice the interest rate of Germany, there is no possible chance of economic convergence. The Stability and Growth Pact for eurozone members is already discredited and it is almost totally irrelevant. With no option to devalue, being part of the monetary union, the only way to restore competitiveness within the eurozone for those members in difficulty, particularly Greece at the moment, but we could also mention Portugal, Spain, Ireland and Italy, is to cut real wages and institute a severe economic squeeze. Whilst this may be possible in Ireland, which appears to have grasped the nettle, it is doubtful whether this would be possible in Greece and some other eurozone countries, which are in trouble, without major social unrest. Because of the political nature of the euro project, it is certain that every stop will be pulled out in order to contain the problem. It would be very costly for a country to leave the eurozone because its new currency (perhaps called its old name) would be devalued, thus raising the servicing and redemption costs of its debt and default risks would therefore increase. Equally, staying in could involve impossible adjustments to the economy. We believe that there remains a good chance that the eurozone will fragment and the Greek crisis will be a good litmus test for one can see that, if the situation is not resolved satisfactorily, contagion could spread to countries like Portugal, Spain and Italy. We think that eurozone problems could be a feature of this year both in respect to measures imposed upon recalcitrant members and the sustainability of monetary union.

To move back from this diversion to the problems of the eurozone, but relevant to this area and elsewhere, is the effect on the world economy of tackling the debt issue and the means by which this is done. All methods will have a depressing effect on economic growth in the short term but, depending upon which method or combination of methods is used, the correct method may lay the foundation for more sustainable economic growth.

That public debt in many countries must be reduced on a current and overall basis is not in doubt. If the problem is not addressed, the problems in the Greek debt market will be just a starter. If investors are prepared to fund a recalcitrant country's deficit at all it will be at a significant yield premium (the Greek premium was discussed earlier) and the corresponding effect of interest servicing costs will be crippling. But it would not be at all certain that additional debt would be funded if investors felt that the risks were too great and this would lead to a financial crisis and inflation through monetisation of the debt. Whilst some governments may prefer tax increases to spending cuts or to give greater weight to tax increases, that is not generally a desirable way to address the issue. Whilst it will have much the same short term effect as cutting public expenditure, i.e. reducing spending power in an economy, the longer term effects of tax increases will be more malign in that they will act as a disincentive for the wealth creating part of an economy and thus compromise the future tax base. If the private sector has to bear the cost rather than the public sector, there is a danger of the private sector being "crowded out" by the public sector where demand for funds in the credit market raises interest rates and thereby dampens activity in the private sector. The Greek example is a perfect case of this where current borrowing (about 13%) of GDP) causes interest rates to rise, thus increasing the financial burden on the wealth creating private sector. It goes without saying that this is a highly undesirable state of affairs and very dangerous for the future prosperity of a country.

In normal circumstances, cutting back on the budget deficit will entail lower borrowing costs and therefore benefit both the public and private sector. That would provide some offset to the depressing effects of public spending cuts and/or tax rises, at least for those who borrow. But this is a very delicate balance as the current situation in the UK shows. Pretty well everyone agrees that the level of the current budget deficit (around Greek levels in current terms but not nearly as high in terms of the level of outstanding public debt in relation to GDP) is far too high and must be addressed. Accepting that the issue has politicians tiptoeing around the subject very carefully because of the imminent General Election, the broad dispute is between those who say decisive action to cut the deficit has to happen now and those who say that, whilst they agree that action must be taken, to do it too soon risks reversing any recovery that has taken place. Whilst one can understand the arguments of the latter camp, it is a highly risky course of action to take, in our view, for it rests on the assumption that a country's creditors, potential government debt buyers and the foreign exchange markets will understand and accept the arguments and continue to buy newly issued government debt on still historically low yields and buy sterling which is at a higher level than at the end of 2008. In a different yet, in a way, related context, we have noted in our foreign currency table at the beginning of this review that the euro has weakened against the US dollar, yen and sterling this quarter, yet, overall, the level of current debt as a percentage of GDP in the eurozone is less than in each of the three countries representing these currencies. But the problems of Greece appear to have been reflected in the euro, even though the eurozone's largest economy, Germany, has a far superior current budgetary position (though in absolute terms it is not good) than the USA, Japan and UK. To us, that shows the risk of waiting to take or announce effective action to reduce the deficit. By waiting, the issue could be taken out of a country's hands at any time and no government should assume that it has the luxury of time. Finessing the risk of early action to reduce public deficits which could possibly put an economy back into recession against the risk of a debt crisis, is difficult, but the latter would be a far harder position from which to recover.

Running down private sector debt will also be an issue in many countries. The scare given to individuals by the financial and economic crisis is causing many to be wary of taking on any more debt and to be focused on repaying debt. Quantitative easing, which was aimed at stimulating demand, has not had the desired effect in the consumption field as monetary growth generally remains subdued with many private borrowers choosing to pay down debt. For heavily indebted countries in both the public and private sphere the drag of debt will subdue the relevant economies.

Watching over this with a stern eye will be the rating agencies which have already downgraded or threatened to downgrade the sovereign debt ratings of several countries. These ratings matter and the threat of downgrading a country's rating, particularly in the present febrile environment, should concentrate the most reluctant deficit cutting finance minister's mind. The consequences of a downgrade will inevitably be serious.

If the fiscal challenges are daunting so are those on the monetary side, where timing correctly the reversal of the extraordinary monetary stimulus given to the world economy will be very difficult. In fact, in countries like Australia, which weathered the financial and economic storm relatively well because of the previous prudent management of its country's finances and because its banks, like those in Canada, emerged relatively unscathed, monetary tightening has already begun as interest rates have been raised in two stages, starting back last October. However, countries like Australia are an exception. In most countries, interest rates are still at their lowest levels which, in some cases, like the USA, are effectively zero. In countries such as the UK and USA, there is an added dimension, quantitative easing, to take into account. The very pleasing recovery in share prices, dating back to last March, partly owes its occurrence to this extraordinary combination of monetary stimulus but none of us should be complacent. This is not the best reason for shares to rise because, at some stage, the stimulus will have to be withdrawn. Although it is obvious why continuing such a policy indefinitely is highly undesirable, it is still worth enumerating the reasons.

Quantitative easing is the modern way of printing money, although these days it is created by the key stroke on a computer. In the UK, for example, the Bank of England buys a gilt edged stock from a bank and creates a deposit at the Bank of England for it. The creation of new money, just like that, which chases a finite number of goods and services, to put the matter very simplistically, will inevitably lead to inflation, if not reversed. It was a daring and desperate move to try to stave off a depression arising from the recession, but it has to be withdrawn, otherwise inflation will follow and the currency will be debased. However, in countries where it has been used, the USA and, particularly, the UK, the budgetary positions of the countries are particularly bad. If we take the UK, the level of quantitative easing, which has been authorised up to £200 billion, is not far short of the quantity of gilts the Debt Management Office has to sell to finance this year's expected budget deficit and maturing gilts. In a roundabout way, we can broadly say that this year's deficit has been financed by printing money. At the time of writing, the Monetary Policy Committee has announced that the policy is to be halted, although it could be restarted if conditions dictate. It is already in dangerous territory at this level as credibility is strained and, whether or not it starts again later on, it has to be reversed at some stage as it is a threat to inflation. The UK's inflation rate is already rising faster than expected and justifying such loose policy on the basis that no threat to inflation is posed because of the size of the output gap, the gap between actual and potential production, is disingenuous. The UK is beginning to see the lagged effects on inflation arising from the sharp depreciation in sterling in 2008. If economic policy is considered unsafe, a further setback to sterling could easily occur. The Bank of England can set very short term interest rates but further out on the yield curve it is at the mercy of markets. It has managed to keep yields below what they would otherwise have been by buying in gilts and the problems of funding such an enormous level of government borrowing have therefore not yet come to the surface. But there are two steps in stopping and reversing quantitative easing. Firstly, there is the stop to buying gilts from the private sector as the limit is reached. This is what will now happen in the UK. By removing natural buyer from the market, there is a strong chance that gilt yields will rise. The next stage is reversing the purchases of gilts, assuming the withdrawal of quantitative easing is done this way, which will create a large seller at the same time as the Debt Management Office is issuing vast quantities of new gilts. This is another threat to bond yields as buyers demand higher interest rates. Hence we come back to "crowding out" the private sector whether it be of businesses or individuals. It is a similar situation in the USA where the Federal Reserve has been buying mortgage backed securities from the private sector but its programme is coming near to its end. Only in the most exceptional circumstances can the printing of money be justified. One could argue that the circumstances were exceptional but one of the challenges investors, particularly in bond markets, face this year is the withdrawal and reversal of quantitative easing. It is, in our view, a significantly negative issue for bond markets.

The other monetary issue is the low level of interest rates prevailing, the other part of the policy of trying to stave off a depression. The benefits for borrowers are obvious if the interest rate reductions are passed on, but the disadvantages for savers of whom there are far more, are equally obvious and their purchasing power is reduced. One of the effects of quantitative easing and very low interest rates has been a distortion of financial markets creating diversions from deposits to alternative assets offering better yields such as bonds, shares and, in certain cases, property. Such a distortion is undesirable for it risks creating bubbles, the bursting of which in recent years, as we have seen, can create very nasty side effects. We would argue that, in the UK bond market, the combination of monetary measures used to support the economy has created a dangerous bubble. Bond yields have certainly been kept below what they would otherwise have been but, in our view, the yields offered are unrealistic in view of the risks faced. Furthermore, if we look at real short term interest rates in the USA and UK, as measured by official interest rates, they are negative and such a state of affairs poses a risk to inflation. Admittedly, those who borrow money may be paying a positive real interest rate, depending upon their perceived creditworthiness but the issue of official short term interest rates below inflation is relevant and not normally a desirable situation.

These extreme monetary measures have to be reversed and one of the issues facing investors in 2010 is what will be the effect on stock markets. For bonds, we feel a high degree of confidence that it will be negative. Where quantitative easing is in place, the absence of a big bond buyer in the market itself should push up yields, together with the substantial new debt issuance arising from the large budget deficits being run by most governments. But even if quantitative easing, in particular, and ultra low interest rates in cases where real interest rates, as measured by official interest rates, were negative, were not reversed, the credibility of monetary policy would bound to be increasingly challenged as investors weigh up the considerable inflationary risks being run and demand higher yields.

For equities, the risks are much more balanced and, as we assess them at the beginning of 2010, not sufficiently dangerous to dent our modest optimism for international equities this year. Firstly, let us look at the negative issues which current fiscal and monetary policy poses or, rather, the reversing of these policies to show a movement towards normality. In the fiscal sphere, public spending cuts and/or tax increases subdue activity in an economy. As a generalisation, that will affect demand for the goods and services of domestically orientated companies with consequential effects on profits and, in some cases, dividends. On the other hand, in more normal cycles, if effective steps are taken to reduce budget deficits, the actions themselves should reduce inflationary risks and be helpful in lowering interest rates because the negative influences of an inflationary threat and large debt issuance are reduced. This cycle is rather different as we have been indicating above. The inflation threat at the moment is perceived rather than actual but convincing attempts to address budget deficit problems could improve the perception of the inflationary threat. With the monetary policy issues mentioned above, it could improve the outlook for bond yields compared with what they would otherwise be. Beyond that, reductions in budget deficits should help to reduce the “crowding out” effect on the private sector because of a reduction in the demand for money to fund budget deficits and the longer term beneficial effects on interest rates. These are helpful (if they occur) for the longer term. The benefits for companies and, by extension to their shareholders, would arise from short term pain leading to longer term gain. Another possible negative for companies and equities is if, instead of cutting public spending, governments choose to raise the tax burden on companies. One would hope that most governments would not choose this course of action, but, if they did, it would be a negative for equities in the relevant country. The biggest negative would be if, despite the enormous fiscal and monetary stimulus, the world economy relapsed into a serious worldwide, as opposed to localised, recession. Given the economic firepower already used to avoid this, one would not consider that there was much left. Further extensions of quantitative easing risk debasing currencies and risking inflation, perhaps not immediately but further down the line. But this is not the expectation at present and there are signs of modest recovery in most western economies and Japan and rapid growth in Asia, particularly China, Brazil and some or the emerging markets. In this context, we give excerpts below from the latest IMF projections, just published, which for 2010 everywhere, except Japan where there is no change, are an upgrade on its October 2009 projections.

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 IMF projections, if they turn out to be broadly accurate, offer some positive pointers for international equity markets. At the simplest level, it should mean that company profits and dividends start to recover. Some of this progress has obviously been discounted as equity markets have risen. For those companies based in western economies and Japan, where projected growth out of the recession in the next two years is expected to be modest as the weight of the necessary fiscal adjustment bears down on growth, there is some positive news if they are well placed to benefit from growth elsewhere. The fast growth rates projected in the east and elsewhere will be of considerable benefit to those companies which, through exports or direct investment, have important exposure to these areas. For those companies based in countries where the exchange rate may weaken as a result of sub average economic growth, or because international confidence in the country's ability or desire to restore order to public finances is weak, profits could receive an additional benefit and may prove to be an attractive haven against all the economic storms facing the particular country in question or other asset classes in general. This may seem to be a strange thing to say, for equities might be considered to be a risky asset in those circumstances. However, in countries where creditworthiness is in doubt because of a perceived inadequate response to the need to address the debt issue, bonds would be a particularly unattractive asset class. Yields would rise and the currency might fall, although, in the case of the latter, if the relevant country is a member of the eurozone, it might just be the former situation (i.e. Greece). However, the problem could also contaminate the euro as a whole. Cash, whilst holding its nominal value, would see, if it was a depreciating currency, its international purchasing value and real value at home decrease. This could also affect the domestic property market. In these circumstances, shares with significant overseas interests could be regarded as a good insurance policy, providing a currency and inflation hedge (as a result of the knock on effects of a depreciating currency).

Whilst the UK is one of only many markets in which we invest, most of our clients are sterling based, and therefore, even if most of a portfolio's assets are located outside the UK, clients' liabilities, used in the very loose sense of the currency in which outgoings are denominated, are mostly in sterling. Therefore, what happens to sterling matters. As clients know, where we invest internationally in equities we do not do so for currency reasons but rather for prudent diversification. We do not believe that we should give preference to a particular market because a portfolio is based in that currency. Sometimes the currency effect is positive, sometimes it is negative but, for long term investors, these tend to balance out.

However, of all the major economies in the world, that of the UK concerns us most, and we consider the UK to be a high risk economy. The situation is blighted by the imminence of the General Election due, at the latest, by early June. The politicians are very frightened of spelling out to the electorate the consequences of the need to reduce the budget deficit, but they cannot rely on foreign investors in sterling and UK government bonds continuing to understand their tactical problems. Politicians cannot ignore events in Greece as if they could not happen in the UK. They can. It is true that the level of overall public debt in Greece is far higher than in the UK but, on the other hand, at least for the moment, membership of the euro prevents a focused attack on their currency since it is indivisible from that of other eurozone members. Sterling, which has, quite rightly, been kept out of the euro, can face an attack in the currency markets. This could make the problem of selling the vast amount of government debt needed to finance the budget deficit very difficult. Foreigners might balk at buying sterling denominated bonds, whilst foreign and domestic investors might require a more realistic interest rate. All the time the ratings agencies will be breathing down the necks of the authorities and the AAA rating of UK sovereign debt must be seriously at risk. Whichever party wins the next General Election will have to lay out its plans as to how it is going to reduce the budget deficit to manageable levels rather than provide investors with their aspirations but little detail.

If these plans have credibility, the UK may retain its top credit rating and finance its debt at a reasonable rate of interest. Failure to put forward credible plans could lead to a debt financing crisis which engulfs the pound. But there is absolutely no assurance that the UK has a breathing period whilst investors wait for the election to take place. The fundamentals are very poor and, as this is written, the market is testing the resolution not only of Greece but also Spain and Portugal. The UK is in a dangerous position and, as this is being written, the pound is under pressure.

For us, having significant overseas exposure either in foreign shares or UK companies importantly exposed to overseas markets either directly or through trade is an important insurance policy. Many countries are performing less badly or even quite well relative to the UK as the table of the IMF's forecast show. With reasonable yields and moderate valuations, shares look to provide some insurance against major problems in the UK.

One may ask why one should dwell on the UK when the USA also has a very serious budget deficit problem which looks equally intractable. So it does, but the USA has one major advantage over the UK in that the US dollar is the major reserve currency. If major creditors of the USA were to dump their dollars, they would be cutting off their nose to spite their face since it would damage the value of their remaining US dollar assets. The UK does not have that advantage. Furthermore, with all the inherent contradictions contained within the eurozone, which is certainly not an optimal currency area, a lot of attention will be directed to that area, which will also take attention away from the US dollar. So, by default, it may be the strongest currency with the yen always difficult to call. As this is written, the US dollar is moving ahead of sterling, in particular, and the euro.

As this review is written at the beginning of February, markets have taken fright at the Greek debt situation, with its implications for other eurozone countries like Portugal and Spain, where there are doubts about the relevant governments' resolve to tackle their respective debt problems and also, perhaps, to the UK where sterling is weak against the US dollar. Equity markets, in the current economic and financial environment, are bound to be nervous about threats to economic stability. Concerns about some eurozone countries' and UK debt levels are not new. We consider that shares, such as those of the internationally orientated companies we have discussed above, provide the best refuge against current uncertainties based on the sort of levels of international growth which the IMF's latest projections show. In their own right, most international equity markets look reasonably rated or, at least, not expensive and, in addition, almost win by default, so unattractive do we believe the outlook for bonds, other than those of the shortest duration, to be.

There is much more we could talk about at this time, such as the international banking system and proposals to ensure that it is more stable in future, but we have concentrated on the level of debt, particularly public debt, as we believe the ways in which the problems of excessive debt are addressed have most relevance to international securities markets.

January 2010