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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equities have put in a very solid performance over the last quarter with useful gains almost everywhere. By contrast, high quality bonds have experienced a negative quarter as bond yields have risen from unrealistically low levels. There has been little change in the currency markets although the Swiss Franc has been an exception, rising strongly. Perhaps, ominously, for inflation, oil has risen by over 20%.

The tables below detail relevant movements in markets:

International Equities 29.10.10 - 31.01.11

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+2.7	+4.3	+4.5	+5.9
Finland	+8.0	+6.3	+6.5	+8.0
France	+4.9	+3.3	+3.5	+4.9
Germany	+7.6	+5.9	+6.1	+7.6
Hong Kong, China	+3.0	+2.3	+2.5	+3.9
Italy	+2.9	+1.4	+1.5	+2.9
Japan	+11.9	+9.9	+10.1	+11.6
Netherlands	+7.9	+6.2	+6.4	+7.9
Spain	+1.7	+0.1	+0.3	+1.7
Switzerland	+0.5	+5.0	+5.2	+6.6
UK	+3.9	+3.9	+4.1	+5.5
USA	+9.1	+8.9	+9.1	+10.6
Europe ex UK	+4.4	+4.4	+4.6	+6.0
Asia Pacific ex Japan	+6.6	+8.1	+8.3	+9.8
Asia Pacific	+8.9	+8.9	+9.1	+10.6
Latin America	-1.7	-0.7	-0.5	+0.8
All World All Emerging	+0.2	+0.1	+0.3	+1.7
The World	+7.1	+7.1	+7.3	+8.7

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -2.6%

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

Currency	29.10.10	31.01.11
Sterling	3.08	3.65
US Dollar	2.62	3.38
Yen	0.92	1.22
Germany (Euro)	2.51	3.17

Sterling's performance during the quarter ending 31.01.11 (%)

Currency	Quarter Ending 31.01.11
US Dollar	+0.1
Canadian Dollar	-1.4
Yen	+1.9
Euro	+1.7
Swiss Franc	-4.2
Australian dollar	-1.6

Other currency movements during the quarter ending 31.01.11 (%)

Currency	Quarter Ending 31.01.11
US Dollar/Canadian Dollar	-1.5
US Dollar/Yen	+1.8
US Dollar/Euro	+1.9
Swiss Franc/Euro	+6.2
Euro/Yen	+0.2

Significant Commodities (US dollar terms) 29.10.10 - 31.01.11 (%)

Significant Commodities	30.09.10 - 31.12.10
Oil	+21.5
Gold	-0.4

Markets

International equity markets have turned in a very solid quarter, with returns much less influenced by currency movements than has recently been the case. In local currency terms and sterling terms, the total return on the FTSE World Index was 7.1%, and in euro terms 8.7%. Of the major markets, Japan produced the best performance, with the FTSE Japanese index returning 11.9% in local currency terms and 9.9% in sterling terms. The USA also achieved an excellent performance, with the FTSE USA index returning 9.1% in local currency terms and 8.9% in sterling terms. The returns on the FTSE Europe ex UK index and FTSE UK index, at 4.4% and 3.9% respectively, were less spectacular but still satisfactory. The return on the FTSE Europe ex UK index was the same in sterling and local currency terms. Elsewhere, the FTSE Asia Pacific ex Japan index performed well, returning 6.6% in local currency terms and 8.1% in sterling terms. Unusually, as far as recent history is concerned, Latin American and Emerging Markets underperformed. In local currency terms, the FTSE Latin American Index returned -1.7% and -0.7% in sterling terms, whilst the FTSE All World All Emerging Markets index just made it into positive territory, with a return of 0.2% in local currency terms and 0.1% in sterling terms.

Bond markets, however, had an unhappy experience, with yields on good quality government benchmark bonds rising sharply. UK ten year government bonds saw the gross redemption yield rise 57 basis points to 3.65%, US government bonds 76 basis points to 3.38%, Japanese government bonds 30 basis points to 1.22% and euro denominated German government bonds 66 basis points to 3.17%.

As alluded to above, currency movements were minor by recent standards over the quarter. The main feature was the Swiss Franc, against which sterling weakened by 4.2%. Whilst it hardly changed against the US dollar, sterling rose by 1.9% against the yen and 1.7% against the euro.

In the commodity markets, there was a significant rise in the oil price with Brent Crude ending the quarter up 21.5% at US$101.1 a barrel. Gold was almost unchanged in price.

Economics

2011 has started much as it left off in 2010, with the same issues in the forefront of investors' minds. As we see it now, the leading issue is the eurozone sovereign debt crisis and we would be very surprised if it was not one of the main issues exercising investors' minds at the end of 2011. No one should underestimate the determination of those involved in the euro project to keep the show on the road and, despite all of the internal disagreements amongst the eurozone members, the participants appear to be moving towards some sort of consensus. This does not mean that their efforts will be successful because the problem could still overwhelm them.

In terms of fiscal discipline, the Stability and Growth Pact, aimed at limiting budget deficits and the overall level of public debt in relation to GDP, went out of the window long ago. The fact that it had been breached by the two largest eurozone members, Germany and France, in the past, left it short of credibility. Only the severe financial and economic crisis in which the eurozone now finds itself has forced those eurozone economies with deficit problems, most of them, to take serious action to address the problems. The most high profile cases are those which are having to be bailed out, Greece and Ireland, as well as Portugal, widely believed to be an inevitable candidate for a bailout, and Spain, a possible candidate. If contagion moved to Spain, then the crisis would move up a level given that it is a larger economy than Greece, Ireland and Portugal combined.

The main bail out support tool which has emerged is the €750 billion war chest assembled by eurozone members last year. The package comprises the European Stability Facility, which has the capacity to issue bonds guaranteed by European Member States for up to €440 billion (though it will not be able to lend the whole of this amount because of the need to keep a reserve buffer to ensure its bonds' AAA status), a further €60 billion which would be available from the European Financial Stabilisation mechanism (these are funds raised by the European Commission and guaranteed by the EU budget). A further €250 billion would be available from the IMF. So far, a €110 billion loan to Greece and up to €85 billion (some from non eurozone members, the UK, Sweden and Denmark, as well as €17.5 billion from Ireland through its National Pensions Reserve Fund) for Ireland have been agreed. This is obviously not going to be enough if a large eurozone member, like Spain, gets into trouble. Whilst the current thinking might be to expand the firepower of the war chest, there is a limit to what can be made available because of the guarantees which have to be given on the bonds by eurozone members. For example, Germany, the best credit in the eurozone, has a guarantee commitment for the European Financial Stability Facility of almost €120 billion, almost 27% of the potential total of €440 billion. The risks to the guarantors increase with the size of the facility guaranteed and weaken their own credit standing. What the financial and economic crisis has done is to expose the fallacy of convergence within the eurozone. Before the crisis there was quite a narrow spread of yields on eurozone government bonds reflecting the fallacious view that eurozone government credit risks were very low. The crisis has shown how wrong that view was. There is no way that some of the weaker eurozone credits are going to see economic growth at a sufficient level to discharge their debts. If we take ten year government bond yields as a benchmark and observing a gross redemption yield of 3.17% on the bonds of the best credit, Germany, we see Greece's bond showing an equivalent yield of 11.30%. A similar, although less dramatic position, obtains for Ireland, 9.18%, and Portugal 7.07%. Spain's bond currently gives a 5.39% yield, showing how views have changed since the end of 2006, for example, when Spanish bonds traded almost in line with German ones. The Spanish situation could go either way, but the other three countries' bonds are signalling problems for creditors. The sovereign debt position in the eurozone remains unstable and is an issue likely to dominate the economic headlines in 2011 and, from time to time, have an effect on the stock market.

Whilst investors' attraction is focused on the eurozone's sovereign debt crisis, they should not ignore the USA's deficit situation which is very severe and has to be addressed. At this early stage of the year, it seems unlikely to be an issue for 2011, but, at some stage it will be, and investors need to bear this in mind. The pre-Christmas agreement between the President and Congress, which gave the US an extra stimulus through maintaining the Bush era tax cuts and reducing payroll taxes, has been broadly welcomed by the US stock market, but the effect on the USA's public finances is to make a bad situation worse, with the budget deficit for the current year likely to be around 10% of GDP. The US political system, now effectively deadlocked on many issues because the Democrats lost control of the House of Representatives in the mid term elections, makes it difficult to take the tough decisions which have to be made now in order to stop the USA's finances spiralling out of control. If a credible plan is not introduced to put the USA's public finances on a path to deficit reduction, there is a serious risk to US interest rates and the US dollar. Although the problem of the USA's public finances is well highlighted, the USA has obtained a breathing space because investors' attention is more focused on the eurozone and because, as the world's largest reserve currency, many countries have a vested interest in its value, they are less likely to take action which could undermine it. So, whilst this is much less likely to be an issue in 2011 for the USA than in the eurozone, it will, if nothing is done, become an issue at some stage and one cannot rule out the possibility of it being one this year.

Inflation is an issue now in countries like China and the UK amongst others. It was not long ago that many commentators were concerned about deflation becoming a problem as a result of the financial and economic crisis, as the recession left a large output gap in some countries, i.e. actual output being well below potential output. Now, whilst a few commentators still hold out on the deflation front, more people are becoming worried about inflation as food and energy prices rocket. Along with other countries and regions, inflation is above target in China, the UK and, now, the eurozone. Some seek to distinguish between core inflation rates, which strip out volatile items like food and energy, and the headline rates. But it seems to us that any validity which the emphasis on the core rate had in the past, is much reduced now. Most people would look at their overall inflation experience and would not isolate the volatile items. To pick and choose seems to be becoming increasingly disingenuous. Food price inflation, or deflation, is largely influenced by non economic factors, particularly the weather, and that has not been kind to crops recently. With increasing populations, demand is going to increase and increasing affluence, causing consumers to trade up, is also a cause of food price inflation, at least in the short term, until supply can respond. Economic growth, particularly in the east, is likely to drive up the demand for energy and, in the oil market, the OPEC oil cartel is having success in raising prices by limiting production. Whilst there are output gaps in many industrialised countries, which may make price increases in non food and energy areas difficult, food and energy prices are likely to remain drivers of inflation.

This is a particular problem in China, the UK and many Asian and emerging markets, as mentioned above and it has the potential to be an investment issue this year. The stock market normally reacts when China raises interest rates or increases bank reserve targets, simply because of the effect that a slowing Chinese economy might have on the rest of the world which derives economic momentum from fast economic growth in countries like China, India, some other Asian economies and Brazil, amongst others, for example. China is very concerned about inflation. Whilst the overall consumer price inflation level is above target at 4.6% year on year, the 9.6% level for food is a real concern because of the potential for it to cause social unrest. As well as raising interest rates and bank reserve requirements, other measures, like sharp increases in some regions' minimum wages, have been awarded to preserve buying power. This itself will have some effect on inflation. Should China become very aggressive about trying to control inflation, we can expect markets to take it badly, even though longer term effects on the world economy may be beneficial. In many economies, not only in Asia, sharply rising food prices offer the potential for social unrest.

Developing and emerging markets countries' governments are well aware of the potential for instability and social unrest which rising food and energy prices can have. They can combine with political grievances to form a combustible situation for governments in these countries. As this is written, an uprising in Tunisia, which few saw coming, has been replicated in Egypt, a much more serious situation, and these "black swan" events, which seem to be more common, can unsettle markets, something which we are now seeing. A spread of disturbances in key strategic areas is a threat for investors in 2011. This is why China is doing all it can to mitigate the threat of rising food prices by raising sharply the minimum wage in some cities and regions because its rulers are terrified of social unrest. If unrest were to spread to major Middle Eastern oil producers, there really would be alarm.

The position in the UK with regard to inflation is particularly problematical. The latest year on year increase in the consumer price index is 3.7% and, on the previous measure of inflation, the Retail Price Index, 4.7%. Thus, a ten year UK gilt edged security showing a gross redemption yield of 3.65%, as this is written, shows a negative real return. In more normal circumstances, it could be argued that a base rate of about 5 ½ % would be appropriate, i.e. a real rate of around 2%, instead it is around -3 ½ %. Anyone who was unaware of the international economic background and, in particular, those countries affected by the financial crisis, would have been astonished by such a low official interest rate which would seem to be taking an extreme risk with inflation. For example, the property crash in Ireland and Spain owed a great deal to the ECB fixing euro interest rates at too low a level for these two countries, resulting in severe property price inflation and a boom which has had a disastrous conclusion for these countries. Conventional theory would suggest that the UK is stoking up trouble for itself by having such low official interest rates and such large negative real official interest rates. Why might this risk be mitigated now? As elsewhere, severe measures on the fiscal front to address the crisis in the UK's public finances will leave many people feeling much poorer this year. If very loose monetary policy can stimulate economic activity, the thinking goes that this will provide some offset to very tough fiscal policies, although it is important to reflect on the fact that many savers' purchasing power has been badly affected by the lack of any meaningful interest rate on bank deposits. Conspiracy theorists suggest that allowing inflation to rise will erode the value of debt in real terms. Because of the severity of the UK's economic position and, now, because the first estimate of fourth quarter UK GDP has shown a 0.5% contraction over the previous quarter, it is likely that monetary policy will remain very loose. However, the minutes of January's Monetary Policy Committee meeting show that instead of one member voting for an interest rate increase, we now have two. The minutes show a concern that the risks to inflation had increased so there is the beginning of a change of sentiment within the MPC, albeit not enough to raise interest rates. One member still wants to restart quantitative easing, therefore being positioned at the other end of the spectrum. One of the strange things in recent times has been the optimism on the inflation outlook which the MPC has shown. Intuitively, this did not seem correct as there was evidence all around of inflationary pressures at work. The MPC is still sanguine about inflation retreating next year. We shall see, but one does not feel optimistic at this stage. Whilst the UK equity market can take a moderate rise in short term interest rates, we feel, because they stand at such an abnormally low level, an emergency increase of significant proportions would be destabilising. Once inflation has taken hold, it is very difficult to contain it. Whilst the inflation situation, amongst other factors, makes the yield on UK government bonds look very inadequate, holders of equities need to watch how the inflation story unfolds. This is not likely to be a significant issue for UK equity holders this year, but must be kept in mind. Although current inflation levels in the UK make conventional bonds look unattractive and yields have risen very sharply since last summer and autumn, depending upon the maturity, they have not risen enough to make UK equity yields unattractive. The crisis led to equity yields being higher than top quality government bond yields in markets such as the UK, a reverse of the crossover position which occurred in the 1950s. Now they have reverted to a more normal position. But the relationship is still favourable for equities given that dividend growth is likely this year and next.

What equity holders have to watch out for in the UK, and elsewhere, is a sharp rise in interest rates caused in bond markets by investors taking fright at the economic outlook in a particular country or region and pushing bond yields much higher. In our view, bond yields are generally far too low for the risks facing bond investors, which could be inflation prospects or credit risks or currency risks. Whilst equity markets have taken the recent rise in bond yields in their stride because they have risen off such an extraordinarily low level and are still low, a further sharp rise which left equity yields seriously trailing bond yields would be another matter. Administered rates, i.e.

short term ones set by the monetary authorities, currently make equity yields very attractive by comparison and are one reason why the equities have risen as money searches for a better return. Whilst the main industrialised countries will want to keep short term interest rates very low for the reasons we mentioned earlier, i.e. as an offset to the fiscal squeeze taking place, a serious inflation or currency crisis could force relevant central banks to raise interest rates sharply. This is obviously not a path which central banks would want to follow, but the simple assumption that the size of the output gap would lead to a deflationary environment, to us always seemed, and still does, dangerous. The amount of quantitative easing which has taken place in the USA and UK and provision of bank liquidity in the eurozone, whilst a necessary short term policy to prevent a meltdown, stores up inflationary possibilities for the future and will need to be reversed. Money cannot just be printed with impunity.

So, our view on equities is that they can absorb the current rise in bond yields as well as a further moderate increase but, should good quality bond yields rocket upwards, for the reasons just mentioned, then equities should be challenged. Again, this is something to look out for in 2011.

At this stage, although our concerns are limited to the medium and long term inflationary threat arising from quantitative easing, it has, undoubtedly, been one reason why equity markets have performed well since it was introduced in 2008. An interesting insight into the effect which it is believed to have had in the USA was recently provided by Janet Yellen, Vice Chairman of the Federal Reserve. She said that Federal Reserve research indicated that inflation is 1% higher and there will be 3 million more jobs in 2012 because of the Federal Reserve's asset purchase programme. The effective printing of money results from the electronic crediting of the consideration for the bond purchases to the bondholders' bank accounts. She reported that, if the Federal Reserve had cut interest rates to zero in 2008 and had not bought assets, the US economy would now be close to deflation and the unemployment rate in 2012 would be 1 ½ % higher. She also estimated that last November's new quantitative easing programme of US$600 billion of asset purchases will speed the creation of 700,000 jobs. The simulations assume that US$600 billion of assets are purchased within a year, maintained for the next two years and then unwound over the following five. As a result, the ten year Treasury bond yield would be lowered by 25 basis points compared with what it would have been and would bring forward the creation of 700,000 jobs.

It is important to discuss events which might disturb markets in 2011 to dispel any complacency which might be affecting investors following two positive years for international equity markets in 2009 and 2010. As the steadiness of markets after last year's second quarter blip shows, investors are finding encouragement from economic and financial developments.

As the sense of economic and financial crisis has gradually passed, investors have gradually become less risk averse. As often happens, confidence rises on the back of a stock market recovery. Some bond investors have switched to equities which, with short term interest rates so low, have provided attractive returns for those who have an equity tolerance. Others, realising that bond yields were unrealistically low, held down by a flight to quality in the aftermath of the financial crisis and the effects of quantitative easing where relevant, moved out of bonds on fundamental grounds. As we all know, and, as indicated earlier in this review, there are many problems, but the good news is that economic growth in the world economy is quite healthy overall, albeit with wide divergences of performance.

The IMF's latest World Economic Outlook projections, just published, show a slight increase in its forecast for 2011 growth, with world output now expected to be 4.4% higher in 2011 than 2010 compared with the previous forecast of 4.2%. Its estimate of growth for 2012 remains unchanged at 4.5%. The contrast between its expectations for economic growth in advanced economies, 2.5% this year and next, contrasts with its projections for emerging and developing economies where growth of 6.5% in both 2011 and 2012 is expected. In the latter category, the stand out countries, as one could expect, are China and India, with respective forecasts of growth this year of 9.6% and 8.4%, respectively, and 9.5% and 8.0% next year. It is the powerful growth expected from emerging and developing economies as well as, to a lesser extent, the Newly Industrialised Asian economies, which investors hope will support overall world growth at a time when some advanced economies, notably in the eurozone, are struggling. For example, although Germany is expected to perform relatively well again in 2011 and 2012, if not at the excellent level of 2010, 3.6%, the other major eurozone economies are likely to continue to struggle so that the IMF's current projections are for growth in the eurozone of 1.5% this year and 1.7% next year. However, at a time when this divergence of economic performance has been recognised by the superior performances of many developing and emerging markets, developed markets, with companies exposed to countries of high economic growth, remain a low risk way to benefit from these economic trends, as ratings in emerging markets have caught up with those in developed markets.

We now turn to look at some of the industrialised countries and regions, starting with the USA, where, with some exceptions, the news has been encouraging. The IMF's latest projection, to which we have referred above, significantly raises its forecast for US growth this year, from 2.3% last October to 3.0%, with the further stimulus arising from the President's agreement with Congress, in December, causing the uplift. The flipside of this, as discussed earlier, is that the stimulus makes a dire financial position even worse, with no sign of any serious moves to tackle the debt mountain. The other main negative remains the US housing market, which continues to be weighed down by the housing debt crisis which manifests itself in a number of ways. Between November and December, housing starts fell by 4.3% to be 8.2% lower than a year earlier. The S & P/Case Shiller price index of houses in the twenty biggest US cities fell by 0.5% in November, to be 1.6% lower than a year previously. The National Association of Realtors reported that 36% of home resales in December related to distressed homes. US pending home sales rose by 2% in December, but fell by 14.2% in 2010. Even the one good item of news on the housing market, that new home sales rose at a seasonally adjusted 17.5% in December, was believed to have been artificially boosted by the 31 December 2010 expiry of California's tax credit for new home purchases. Purchases of existing US homes rose by 12% in December, but total sales fell to their lowest in thirteen years. But, elsewhere, news from the USA has tended towards the positive, although certainly not giving cause for outright exuberance. The first estimate of fourth quarter annualised GDP growth was 3.2%, a little below expectations, but certainly quite satisfactory if not revised downwards in subsequent estimates. The make up of the GDP growth figure was quite encouraging. Exports rose by 8.5% whilst imports fell and there were increases in personal consumption, up 4.4%, and investment to set against a fall in inventories. The strength in personal consumption is shown by a 0.6% increase in retail sales in December, nearly 8% upon a year previously. The Conference Board's consumer confidence index rose to an eight month high of 60.6 in January compared with 53.3 in December and an eight month high, again supporting this trend.

In its latest minutes, the FOMC was reasonably sanguine about inflation, although nodding in the direction of higher commodity prices. It referred to longer term inflation expectations remaining stable and measures of underlying inflation trending downwards. It is true that the US economy is a relatively closed one, with trade accounting for about 20% of GDP, and therefore it is more insulated than most from imported inflation, but it cannot be left entirely untouched by trends in global food and energy prices. The Federal Reserve's main barometer of inflation is the core price index for personal consumption expenditures which, in November, was just 0.8% higher than the twelve months preceding. It was not so optimistic about the US economy that it excluded a further batch of quantitative easing although, obviously, it did not say so explicitly. It referred to increased household consumption, to which we referred above, but pointed out the constraints on the consumer, notably "high unemployment, modest income growth, lower housing wealth and tight credit". So, we would say that qualified optimism is the order of the day as far as the USA is concerned, with those who are given to excessive optimism advised to take note of the non partisan Congressional Budget Office's forecast of a US$1.48 trillion budget deficit for this year, 9.8% of GDP, and the largest level on record and a figure about which US policy makers should be seriously concerned.

At the micro level, fourth quarter company earnings being reported have, so far, come in better than expected and, with decent US economic growth being expected this year, a price/earnings ratio on 2011 earnings on the S & P 500 Index of around 13.5, does not look expensive. Many US companies are well placed to benefit from exposure to the fastest growing parts of the world economy.

We have discussed the eurozone at length, but what was noticeable about the performance of the different country markets within the eurozone last year was how closely correlated they were with the perception of each country's financial and economic strength. Even in the three month rolling data to the end of January, this is apparent, although not so marked. So, for example, Germany, the strongest eurozone country, showed an excellent performance during this quarter, returning 7.7% in local currency terms whilst Spain, which is in a very difficult position, returned 1.7%. In smaller markets, Finland, a strong credit, performed well, whilst Italy, with a very high public debt to GDP rates, performed only slightly better than Spain.

There are a number of reasons why the German economy performed so well last year and is expected to outperform the eurozone this year, with the IMF projecting growth of 2.2% this year and 2.0% next year, after 3.6% in 2010, the fastest pace of growth since reunification. The growth expectations are not stellar but, compared with its overall eurozone area forecast of 1.5% growth this year and 1.7% next year, are relatively good and far above the growth forecast for the second, third and fourth largest eurozone economies, France, Italy and Spain. At a time when many developing and emerging economies are growing rapidly, Germany's high value added manufacturing goods are much in demand. Since the start of the euro, it has maintained a disciplined approach to costs, whilst some of the eurozone members have experienced a rapid loss of competitiveness for which they are now paying the price. The weakness of the euro as a currency, the value being dragged down by the problems of its weaker members, has added a further competitive edge to Germany's manufactured products. Although Germany's budget deficit is too large, it is still seen as the benchmark by which other eurozone countries are measured and its credit costs have remained low. So Germany remains in a sweet spot.

With some influence from Germany, a number of recent eurozone inductors have been surprisingly positive, notwithstanding that the third quarter eurozone GDP growth estimate was revised down slightly from 0.4% to 0.3%. The Markit purchasing managers index for manufacturing rose in December to 57.1 from 55.3.

New industrial orders in October rose by 1.4%, which took the annual rate of increase to 14.8% from 13.5% in September. According to a European Commission index, confidence in the eurozone economy rose by 1.1 to 106.2 in December, which was the highest level since October 2007. Eurozone industrial production rose by 1.2% in November with, interestingly, the fastest growth in France, 2.3%, and Spain, 1.2%. The overall Purchasing Mangers Index for the eurozone rose to 56.3 in January from 55.5 in December and industrial orders by 2.1% in November following October's 1.4% rise, although there were falls in orders for durable and non durable consumer goods.

As one would expect, given the good economic performance, the balance of economic data coming out of Germany has been good. Industrial orders in Germany rose by 5.2% in November, following a 1.6% rise in October. Interestingly, and backing up the point about the favourable profile of German exports, orders from outside the eurozone rose by almost 15%. The ZEW index of optimism amongst German investors rose to 15.4 in January from 4.3 in December. The Ifo Institute said that its business climate index rose from 109.8 in December to 110.3 in January which, it reported, was the highest level since it started tracking sentiment twenty years ago. The composite Purchasing Managers Institute for Manufacturing and Services rose at the fastest rate since June 2006. Its reading of 61.0 was the second highest on record. The GfK consumer sentiment indicator predicted a better than expected rise to 5.7 in February. Even in France, an economy with many difficulties, INSEE reported that its manufacturing sentiment index rose by 6 to 108. This was the biggest monthly rise since mid 1998.

The main concern in China revolves around inflation, something we have discussed earlier. The Chinese authorities are very anxious that it is controlled and food price inflation is the main concern because of the danger that it could spark social unrest. In the final quarter of 2010, the Chinese economy expanded at an annual rate of 9.8% to leave the year showing 10.3% growth. The year on year rate of inflation actually fell to 4.6% in December compared with 5.1% in November. Food prices rose by 7.2% for the year. So, control of inflation is the big issue for China and, by extension, to investors worldwide.

Obviously, the main recent news about Japan concerns Standard & Poors' downgrading of domestic and foreign debt ratings of Japan from AA to AA-. As with the USA, a very serious debt problem is not yet exercising investors' minds fully whilst attention is focused on the eurozone but, in both cases, it is inevitable that the focus will turn to both countries' debt problems and what action they propose to take to deal with the issue. Japan, although it does not enjoy the USA's advantage of having its currency as the world's largest component of foreign exchange reserves, does have other advantages, which Standard & Poors pointed out. It has a strong current account position, unlike the USA, which is in chronic deficit, and it is the world's largest net external creditor, with foreign exchange reserves second only in size to those of China. Also, the vast majority of its debt is held by domestic investors. But, with gross outstanding public debt at over 200% of GDP, this is not an issue which can be postponed indefinitely. Japan is not usually a favoured area amongst international investors, although its performance over the last quarter has been good. The attraction of Japan lies in its array of technologically advanced companies which happen to be based in Japan but whose business has international appeal.

We have dealt at length with the economic woes of the UK, arising from its dreadful public finances. For reasons which we have articulated, we believe that the coalition government is absolutely right to be tackling the deficit resolutely for, as the Chancellor of the Exchequer has pointed out, to abandon it would risk a run on the currency and much higher interest rates. The country's top AAA credit rating would almost certainly be lost which would increase the relative cost of borrowing and might eventually lead to external assistance being required. But, of course, everyone and every institution or service which is affected by the cuts or higher taxes blames whatever action they have to take to deal with the situation on the cuts. Quite understandably, they see the difficulties through their own eyes without having to take into account or be responsible for dealing with the country's deficit position. The government's resolve will be severely tested as the media will be full of stories about the effect of the cuts and unemployment will inevitably rise. The concern for investors in the UK stock market would be if the government lost its nerve. Having economic policy taken out of a government's hands, as has happened in Greece and Ireland, would make the investment background much worse. The UK is going to face a very difficult few years even though this need not be bad for investors in UK equities, especially for those companies with significant overseas interests which will benefit from fast growth in certain economies which we have touched upon in this review. There is one further risk we see in the UK which arises from political grandstanding about the UK financial sector, in particular the banking sector. We all know what happened in the banking sector but we are where we are. Antipathy towards bankers has reached a level seemingly not reached anywhere else. The financial services sector is of vital importance to the UK economy and if measures are taken against banks or bankers which make the UK an unattractive place in which to base key parts of the businesses then a flow of business away from the UK could have profoundly damaging long term effects on the UK economy. Investors should keep an eye on this for the effect of, say, an important bank relocating away from the UK could be quite traumatic for markets. To end on a more positive note, UK manufacturers are quite buoyant. The January Purchasing Managers Index for manufacturing rose to a twenty year high of 62 compared with 58.5 in December. The January Purchasing Managers Index for the important services sector rose to 54.5 in January compared with 49.7 in December. That for the construction sector rose to 53.7 from 49.1 in December. The EEF said that manufacturing is set for a second strong year boosted by solid export growth, especially to emerging markets. It forecasts 3.5% growth for manufacturing this year at 3% next year compared with its forecast of 2.1% and 2.6% growth for the UK economy. It makes the usual caveats but, at least, this is one sector (albeit small nowadays) which is performing well.

This is not an easy background for investors to come to a conclusion about the policy they should be pursuing. Circumstances are so unusual. It is easier to say what are not likely to be good investments and bonds stand out in this respect. Very large cash holdings in relation to total assets are only likely to be suitable for the very risk averse for they yield very little. Although we have pointed out in this review many of the potential troublesome issues in 2011, we think that, whilst they will adversely affect markets from time to time, the good value still apparent in many equities will hold sway and we expect them to return a satisfactory performance this year on the information which we currently have available.

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