meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Economic and financial market conditions have weighed on investors this quarter as rising inflation and falling growth rates in some, but not all, areas have been apparent. Bond yields, as measured by those on ten year government bonds, have generally risen. There has been little movement in the currency markets although there was some weakness in the yen.

The tables below detail relevant movements in markets :

International Equities 30.04.08 - 31.07.08

Total Return Performances (%)

Country	Local Currency	£	US$	€
Australia	-10.2	-10.4	-10.4	-10.6
Finland	-11.4	-11.2	-11.2	-11.4
France	-9.9	-9.7	-9.7	-9.9
Germany	-6.9	-6.7	-6.7	-6.9
Hong Kong, China	-13.5	-13.6	-13.6	-13.8
Italy	-14.2	-14.0	-14.0	-14.2
Japan	-4.6	-7.8	-7.8	-8.0
Netherlands	-17.6	-17.4	-17.4	-17.6
Spain	-12.5	-12.3	-12.3	-12.5
Switzerland	-5.5	-6.1	-6.1	-6.3
UK	-10.7	-10.7	-10.7	-10.9
USA	-7.7	-7.7	-7.7	-7.9
Europe ex UK	-10.8	-10.8	-10.7	-10.9
Asia Pacific ex Japan	-12.7	-13.1	-13.1	-13.3
Asia Pacific	-8.7	-10.5	-10.5	-10.7
Latin America	-12.6	-7.4	-7.4	-7.6
All World All Emerging	-12.3	-11.3	-11.2	-11.4
The World	-8.8	-9.0	-9.0	-9.2

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +0.25%

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

Currency	30.04.08	31.07.08
Sterling	4.67	4.81
US Dollar	3.75	3.98
Yen	1.63	1.54
Germany (Euro)	4.12	4.36

Sterling's performance during the quarter ending 31.07.08 (%)

Currency	Quarter Ending 31.07.08
US Dollar	U/C
Canadian Dollar	+1.8
Yen	+3.4
Euro	-0.2
Swiss Franc	+0.6

Other currency movements during the quarter ending 31.07.08 (%)

Other Currency	Quarter Ending 31.07.08
US Dollar/Canadian Dollar	+1.8
US Dollar/Yen	+3.4
US Dollar/Euro	-0.2
Swiss Franc/Euro	-0.8
Euro/Yen	+3.6

Significant Commodities (US dollar terms) 30.04.08 – 31.07.08(%)

Significant Commodities	30.04.08 – 31.07.08
Oil	+10.9
Gold	+5.4

Markets

A weak quarter for international equities and very little change in currency parities meant that the different currency adjusted performances of the FTSE World Index varied very little. The total return on the FTSE World Index in local currency terms was -8.8%, in sterling terms it was -9.0%, in US dollar terms it was -9.0% and in euro terms it was -9.2%. Within the major markets Japan and the USA held up best in local currency terms with negative returns of 4.6% and 7.7% respectively. The UK and Europe ex UK performed relatively badly in local currency terms with negative returns of 10.7% and 10.8% respectively. Unusually, looking at the history of recent returns, Latin America and Emerging Markets underperformed with negative returns of 12.6% and 12.3% respectively. Asia Pacific ex Japan also underperformed with a negative return of 12.7%. Changes in returns on a currency adjusted basis were less than usual. The yen was the weakest of the major currencies which made its sterling adjusted return a fraction less than the FTSE USA index return, -7.8% against -7.7%. The most notable adjustment occurred in Latin America where currency strength improved the sterling return considerably, -12.6% becoming -7.4%, thereby enabling the return to be less weak than the FTSE World Index rather than the reverse in local currency terms.

Bonds, as measured by ten year government bond yields, weakened during the quarter but were off their worst levels. Gross redemption yields on ten year sterling government bonds rose by 14 basis points to 4.81%, those on US government bonds rose by 23 basis points to 3.98% and those on German government euro denominated bonds by 24 basis points to 4.36%. Only on Japanese government bonds did yields fall, down by 9 basis points to 1.54%.

As we have said, currencies moved relatively little over the quarter. Sterling was unchanged against the US dollar. Against the yen, it rose by 3.4% and by 0.6% against the Swiss Franc but against the euro it fell by 0.2%, relatively minor changes compared with what we have seen.

In the commodity markets, oil rose by 10.9% but was well off peak levels and gold rose by 5.4%. However, commodities, according to the Financial Times, experienced their largest monthly fall for 28 years with the Jefferies-Reuters CRB Index falling 10.1% in July. The general issue of commodity prices will be discussed in our review as it is one of the factors central to current economic problems.

Economics

- *The issues concerning the world economy are visible to everyone* ...... food and energy price inflation, the housing market and financial conditions affecting well known financial institutions.
- *Very recently, market sentiment, at least for the moment, has improved* ...... commodity prices, with oil the most high profile, have been falling.
- *Although financial conditions remain poor, investors see some grounds for encouragement* ...... they feel that central banks will be unwilling to let a major commercial or investment bank fail judging by actions on, say, Bear Stearns and Northern Rock and that major banks seem able to attract new capital, even if it is expensive. They have also been effective in keeping money markets from seizing up which they threatened to do, even if they still show signs of stress.
- *Some worry about "stagflation"*...... slowing growth and rising inflation in the west is a concern but China continues to grow strongly making "stagflation" an unlikely global, as opposed to specific, concern.
- *Central banks face difficult decisions because of the type of inflation being witnessed* ...... cost push inflation, which is not susceptible to rising interest rates, is difficult to manage. OPEC is becoming more effective as its share of world oil output recovers to around 40%.
- *Reduced oil subsidies in some countries are a move in the right direction* ...... the price mechanism is the right way to balance supply and demand but the use of oil subsidies in areas like parts of Asia and Latin America creates artificially high demand for a finite resource.
- *Central banks must try to tailor monetary policy in a way which separates in public expectations headline inflation from core inflation* ...... the former is, of course, much higher now than the latter because of the effects of higher food and energy prices. If it is not successful, monetary policy will have to be tougher.

USA

- *Conditions remain stressed in money markets* ...... there remains a significant difference between official rates and interbank rates. Some borrowers have, therefore, seen borrowing costs rise independently of any change in central banks' interest rates. In terms of subduing demand driven inflation, these higher rates are doing some of the central banks' jobs for them.
- *The first estimate of annualised second quarter growth is 1.9%* ...... positive contributors were the stimulus of the tax cut package, buoyant exports and falling imports.
- *However, there were downward revisions to previous quarters' growth estimates* ...... just slight in the first quarter of 2008, from 1.0% to 0.9%, but significant in the case of the fourth quarter of 2007, to -0.2% from 0.6%.
- *A possible positive feature for future quarters' growth is inventories* ...... the drawdown on them impacted negatively in the second quarter so future stock building should be positive for growth.
- *In normal circumstances, US inflation would justify much higher interest rates* ...... year on year headline consumer price inflation is 5.0% and producer prices are 9.2% higher. The core personal consumption expenditure deflator, watched closely by the Federal Reserve, at 2.3% is, however, only moderately above the top of the Federal Reserve's target range, 1.6% - 2% although that will still be a concern to it.

- *Housing has been at the heart of the USA's economic issues but there are the faintest signs of better news* ...... whilst the majority of the indicators remain negative, data on housing starts, building permits and new home sales provide some grounds for optimism.
- *Most recent economic data provides a mixed picture* ...... but it is not wholly negative and the positive items of news perhaps point to recovery in the US economy.

Japan

- *The Bank of Japan cuts its growth forecast for the year to March 2009* ...... it reduces it to 1.2% from 1.5% estimated last April. For the year to March 2010, it forecasts growth of 1.5% against 1.7% previously.
- *The profile of the Japanese economy is such that its close trading links with the rest of Asia should be helpful* ...... whilst exports to the USA and Europe are falling off, those to China and the smaller markets for Japanese exports, the Middle East and Russia, are buoyant.
- *Whilst the Bank of Japan would undoubtedly like to normalise interest rates, current economic conditions preclude this* ...... however, the long Japanese history of deflation is unlikely to raise people's inflation expectations to the headline rate and therefore influence their actions on pay, for example, which is a worry in Europe.
- *The latest Tankan survey is not disheartening* ...... whilst the latest diffusion indices are less positive than before, they are still in positive territory.

Europe Ex UK

- *The ECB raises interest rates in July* ...... they were up 0.25% to 4.25% although the feeling is that they will not go higher for a while.
- *Current headline eurozone inflation at 4.1% in July is over double the ECB's target* ...... the official ECB interest rate is therefore only very low in real inflation adjusted terms. In normal economic circumstances, one would expect the rate to be higher.
- *Heightened perceptions of different credit risks cause wide differences in yields on eurozone government bonds* ...... Italian and Greek government bonds yield approximately 61 and 67 basis points more than those of Germany. These reflect the difficulties of economic convergence and point to increasing divergence.
- *Having held up relatively well, the eurozone economy is showing weakness* ...... nearly all the short term indicators are negative. The powerhouse of the eurozone, Germany, is demonstrating signs of weakness.
- *Spain and Ireland are being hit by weakness in their housing markets* ...... their booms are unravelling but, being in the euro, they cannot adjust interest rates.
- *Nevertheless, European equities do not look expensive* ...... their low multiples should take into account the difficult earnings outlook.

UNITED KINGDOM

- *The economic outlook is poor* ...... we think the worst of the major industrialised economies.
- *Part of the reason for this is self inflicted* ...... excessive growth in public expenditure in recent years, well beyond the potential growth rate of the economy, has left public finances in no state to cope with the economic downturn. An unpleasant structural deficit has developed and tax U-turns are being financed by additional borrowing.
- *There are significantly negative implications arising from the poor state of public finances* ...... higher interest rates than would otherwise have been the case, higher inflation and a threat to sterling.
- *The size of the financial sector and the importance of the housing market make the UK particularly vulnerable* ...... the news for the housing market is, without exception, poor.

- *The Bank of England faces difficult decisions* ...... higher interest rates could make matters worse, for instance in the housing market, yet inflation is uncomfortably high, the latest CPI figure of 3.8% being almost double the Bank of England's target.
- *Although it is still early in the financial year, the figures relating to public finances are shocking* ...... the deficits so far this year are way ahead of those of last year.

CHINA

- *From a very high level, the economy is cooling slightly* ...... second quarter annualised growth was 10.1% compared with 10.6% in the first quarter.
- *Inflation has been the authorities' main concern* ...... there is some success at the retail level, the latest annual figure was 7.1% for June compared with 7.7% in May. Producer prices rose from 8.2% to 8.8%.
- *The domestic economy is robust* ...... in the year to June, fixed asset investment was up 29.5% and retail sales 15.1%.
- *There is tentative evidence of success in controlling speculative capital inflows* ...... the authorities take measures as a further move to dampen inflationary pressures.

SUMMARY

- *Most asset classes have recently experienced bubbles, some of which are unravelling* ...... not, however, we think equities where valuations look moderate.
- *Globally, the odds are still against a recession* ...... slow growth in the west contrasts with still buoyant growth in China which should help to rescue world economic growth overall.
- *The recent fall in the oil price may offer some welcome relief if it is maintained* ...... some relief from inflationary pressures will be welcomed all round. It is not inevitable that oil prices will go up indefinitely.

The world economic situation has visibly touched everybody on a daily basis, whether it be because of food and energy price inflation, house prices and, for the unfortunate, repossessions, or simply reference in the written and spoken media to the economy, particularly financial conditions and the problems of some of the finance industry. Against such a background, it is easy to become depressed but, as always in investment, it is important to try to take an objective view of matters.

That markets, at the time of writing, have made some recovery from their lowest levels is certainly related to the sharp fall in the oil price from its very elevated levels but also, although this must be a subjective assessment, because investors can perhaps see a way through the difficulties of large financial institutions which have had issues. This does not mean that they can see an immediate recovery but it does mean that they have greater confidence that a major financial institution will not default, this for two reasons. Firstly, institutions which have needed to rebuild their capital base have generally been able to raise funds, albeit at a price. Secondly, in the USA, UK and Europe, the authorities have been prepared to take whatever action has been necessary to support particular institutions or to keep credit markets working. The probability, but not the certainty, is that investors are unlikely to wake up one morning to find a really major institution has failed in a way which would put an individual or the world economy at risk. That should give investors some sort of confidence and it may be manifesting itself now. There will still be bad news on the financial front but, if investors can have a degree of comfort about the position, they can move on to consider other things which inform their investment policy.

One important scenario which they will be looking out for is "stagflation", a stagnating or very slowly growing economy with high inflation, a state of affairs which is not normally a joyful one for investors. On a worldwide basis, this does not look a likely prospect because of still rapid growth in Asia, particularly, of course, China. Although growth has slowed down a little there, it is from a very high level. But in individual economies in the West, the outlook is difficult with rising inflation and slowing growth.

Nevertheless, as investment becomes increasingly global, it is right to look at the world picture and the increasing economic influence of Asia and the Middle East, for example, is giving support to more slowly growing economies. That is a comfort particularly as the banks in many of the countries in these regions are in a relatively strong position.

Inflation is a subject which is exercising central bankers' minds because of the type of inflation we have and because of the current economic slowdown. It is a more complex issue than normal. Normally, rising interest rates would be expected to do the work of bearing down on inflation as they weaken economic growth and, therefore, inflationary pressures. But the immediate drivers of inflation, energy and food, may not be so responsive. The price mechanism is the best way of bringing supply and demand into balance. On the demand side, consumers will normally respond to higher prices by buying less or using substitutes, if possible, whilst suppliers will respond by raising production, attracted by the higher price. In the case of oil, the position is more complicated. On the supply side, it takes time to raise production and oil is becoming more difficult to find and oil companies are sometimes barred from drilling in certain areas where promising prospects exist. Furthermore, the OPEC oil cartel, which now controls about 40% of production, is in a stronger position to control the price through production curbs. The target price, which OPEC is looking at, consistently rises with the price which has exceeded most people's expectations. For the more militant members of OPEC, oil is seen as a weapon against the West although the moderates are holding sway at present. For moderate oil producers in the Middle East appreciate that, by driving up oil prices so far and so quickly and therefore accelerating the search for alternatives to oil, they would risk damaging the wealth of future generations as the value of the oil still in the ground could diminish. That seems a strange thing to worry about at present with oil at the price it is but it does not reduce the validity of the point. The price mechanism may work in the long term but policymakers cannot afford to think that far ahead. One of the drivers of the oil price has been strong demand from countries like China and India which, by western standards, have very high growth rates. That everyone knows, but the problem of an imperfect price mechanism in these countries and others in Asia and Latin America has also contributed to the present high price of oil because demand has been stimulated by heavy price subsidies. Subsidies are rarely a good idea. The market distortions they introduce misallocate resources and, in the case of a finite resource like oil, stimulating demand, by keeping the price artificially low, makes no sense. That is not to say that one does not understand the reason why they are in existence but, in terms of the international macroeconomic position, they are damaging. The magnitude of the oil price rise has meant that the cost of oil price subsidies in countries like China and India (the latter has a large budget deficit) has become unsustainable and action has been taken to raise the price of oil by cutting subsidies. Having got into the position of subsidising fuel, it is not easy for a government to extricate itself from the situation without risking social unrest caused by the reduction of subsidies. But it is a move in the right direction towards allowing the price mechanism to do its job. Amongst other benefits, would be the incentive to use oil more efficiently. Although the rise in the oil price has been painful for the West, the much more efficient use of oil compared with, say, the 1970's when the oil price rose, has reduced its adverse effects on the economies in question.

What this means for economic policymakers, particularly the central banks on the monetary side, is the need to ensure that higher headline inflation does not influence core price indices and the measurement of the public's inflation expectations is important here. Some central banks carry out research on the public's expectations for inflation as an aid to informing their policy making. Crudely speaking, the higher the public's expectations on inflation, the tougher monetary policy would be. That is a broad generalisation but that would be the thrust of most central banks' thinking.

In previous reviews, we have questioned the validity of emphasising, perhaps for policy purposes, core consumer price indices which have usually revealed a lower rate of inflation than headline rates because of the sharp rises in food and energy prices. After all, consumers have to spend money on food and energy - these are not discretionary items of expenditure. Policymakers would like to separate these two measures of inflation and hope that consumers' inflation expectations are based on "core" rates rather than headline rates. If the effect of high food and energy prices is to raise inflationary expectations by, say, feeding into pay negotiations and earnings increases based on the higher headline figure and spilling into the rest of the economy, policymakers are likely to follow a tougher monetary policy. Measures of inflationary expectations suggest that headline figures are the more important influence on individuals' attitudes. That would suggest the risk of inflation rising in the general economy rather than just sectors more immediately and directly affected by rising food and energy prices.

The very difficult issue for those in charge of monetary policy to resolve is whether lower economic growth, which we are now experiencing, will be sufficient at least to restrain inflation if not reduce it. This might work at two levels. For companies, it is a question of whether they have sufficient pricing power to pass on cost increases or whether competitive pressure and/or customer resistance makes this difficult. For wage negotiators, it is a question of whether deteriorating economic conditions, which are a threat to the jobs market, contain pay pressures. The judgement is a fine one because raising interest rates may exacerbate the economic slowdown and even cause a recession whilst failure to act may leave the economy with sufficient buoyancy for companies to have sufficient pricing power, or wage negotiators sufficient bargaining power, to raise prices or achieve inflationary pay awards. In the public sector, pay awards linked to whatever rate of inflation is used as a benchmark may not be directly inflationary in that goods and services are not generally sold by the public sector but they can act as an important benchmark for the private sector, at least in terms of aspirations. An example of what we are talking about appears in an article in the Financial Times of 1 August which says that the trade union, Unison, is seeking to reopen a three year deal in the health services because of rising inflation which it says will be higher than the basis on which it negotiated a three year pay deal. A further factor for the UK government in trying to limit public sector pay increases is the effect on already overstretched public finances but it is the inflation issue which will concern the Bank of England. In the eurozone, the ECB will be watching particularly carefully what happens in Germany where some large public sector pay increases have been justified on a "catching up" basis for past restraint. There has also been some private sector industrial action. But the ECB, which has recently raised interest rates to 4.25%, is unlikely to be impressed.

Central bankers will be keen to try to get on top of inflation through monetary policy and will be keen to see, for example, if they are given a lifeline by an extension of the recent fall in commodity prices which could have a favourable effect on the year on year headline rate of inflation. We have not mentioned the Federal Reserve here because its policy, shaped by the much greater latitude which it has to conduct monetary policy, has been in complete contrast to that of the Bank of England and, in particular, the ECB. It has used monetary policy aggressively to try to stimulate the US economy, with inflation taking second place. That will not always be the case, of course, because inflation is a major concern for it but, in the present circumstances, it has used monetary policy to try to help financial markets and stimulate the US economy.

Although the various central banks and governments have acted to keep money markets from seizing up, sometimes through unorthodox methods, conditions remain stressed as can be seen from the difference between official rates and inter bank rates. It states the obvious to say that banks, some more than others, and the financial system have experienced a severe shock. There are some obvious consequences of this, some of which we are now seeing. It is becoming much more difficult to obtain finance and, where it is available, the cost is higher. One high profile victim of this development is the housing market. In the UK, one sees a sharp drop in the volume of transactions and prices falling. Secondary consequences include a negative wealth effect. Consumer confidence falls and the consequences of this multiply throughout the economy. At least until the lessons of what has happened have been forgotten, and this should be a long time, a reversion towards more traditional banking can be expected. The problems of the financial system are having, and will continue to have, a contractionary effect on the world economy. We do not mean by that a recession but lower growth than might otherwise have occurred in the short term. However, and this is important for investors, growth should be more solidly based which should lessen risks to the world economy. It will not only be self help by financial institutions which will lead to a more conservative approach, regulators will ensure it. Everyone involved in banking has experienced a nasty shock, not least regulators, central banks and governments and they will not want it to happen again.

In a perverse sort of way, the consequences outlined above are helping the job of the central banks as far as inflation is concerned. Higher interest rates, although not officially driven by central banks, except in the case of the ECB, are helping to slow down the economy, as is the lack of availability of finance. A higher value will be placed on employment at a time when unemployment is starting to rise in a number of countries. Absent a further sharp rise in oil prices and also food, this should help to subdue inflationary pressures. A chastened financial sector, more zealous regulators and more interventionist governments should ensure a return to more traditional banking values and eventually more moderate growth than we have seen in recent years but it should be better quality growth. But we have to reach that stage first so we will now look at where we are in the world economy, starting with the USA.

The first estimate of US growth, just published, shows a rate of 1.9% annualised in the second quarter. This growth was assisted by the tax cut package, which took effect in the second quarter and stimulated spending, as well as by buoyant exports and falling imports. However, there were downward revisions to the previous two quarters' growth estimates. In the case of the first quarter, it was minor, the downwards revision being from 1.0% to 0.9% but the revision for the final quarter of 2007 was substantial, the revision being to -0.2% compared with the previous estimate of +0.6%. One factor depressing second quarter growth which may be helpful in succeeding quarters is that there was a rapid drawdown of inventories which may make it necessary for companies to rebuild them and thereby contribute positively to economic growth. Another continuing negative contributor is the housing market which we will come to shortly. Figures showed the housing sector contracting at a rate of 15.6% during the quarter. Given the reduction in previous quarters' figures, there is nothing here to make the Federal Reserve feel it should begin to normalise interest rates, however much it would like to do so.

Until the problems in the financial markets dominated the Federal Reserve's attention, inflation was its prime concern and why it would, other things being equal, set interest rates considerably higher than they are at present in the USA. The latest consumer price index for June showed a month on month increase of 1.1% and a year on year increase of 5.0%, a seven year high. The relevant core consumer price inflation figures were 0.3% and 2.4% respectively. At the producer price index level, June's monthly increase was -1.8% and the year on year increase was 9.2% whilst the core figures were 0.2% and 3.0% respectively. The annual rate of increase of the personal consumption expenditure deflator in the second quarter was 4.2% compared with 3.6% in the first quarter but the core rate, closely watched by the Federal Reserve, fell from 2.3% to 2.1%, still slightly above the top of its target range, 2.0%. The year on year level in June was 2.3%. The influences on the Federal Reserve's interest rate decisions are therefore conflicting. Economic growth figures argue for keeping interest rates low, inflation for their being higher with the clinching argument in current conditions being the dislocation in financial markets. However, a target federal funds rate of 2%, with annual inflation at whichever of the above levels one looks at, is obviously a sub-optimal level and, in mid July, Ben Bernanke said that quelling sharply rising inflation was a "top priority" for the Federal Reserve with indications from the Federal Reserve's June meeting that the next move in interest rates is likely to be upwards. In the context of a 2% rate, that is almost bound to be the case since, with stress still in the money markets, borrowing rates for many are much higher relative to official rates than they would normally be. A lower federal funds rate would be unlikely to have a significant impact and the effect of monetary policy with ultra low interest rates is likely to be minor. In talking to the Senate Banking Committee in July, Mr Bernanke said that the Federal Reserve's rate cutting programme was failing to contain the crisis affecting the economy. So, on monetary policy, it seems fairly safe to conclude that, at the first opportunity, the Federal Reserve will be likely to raise interest rates but that opportunity is not likely to be just yet.

One of the factors restraining economic growth, as we detailed in the brief analysis of the second quarter's economic growth estimate, was, of course, the housing market. Although the news overall is bad, there are tentative indications that better news may lie ahead. The National Association of Realtors reported that pending home sales in May fell by 4.7% to the third lowest level on record and 14% lower than a year ago. US housebuilders' confidence, as measured by the National Association of Home-builders/Wells Fargo housing market index, fell in July to the lowest level since the survey began in January 1985. US existing house sales fell to a ten year low in June to an annualised figure of 4.86 million compared with 4.99 million in May, 15.5% lower than in June 2007. Weakness in house prices is still evident. The S&P/Case-Shiller index of twenty US metropolitan areas showed a fall in home values of 15.8% in May compared with a year earlier. There were two items of news on the sector which may justify just the most modest feeling of optimism. Housing starts rose by 9.1% in June and building permits rose by 11.6%, although it is believed that a change in New York City's building code might have flattered the trend. Nevertheless, both figures were strongly positive, albeit from a weak base. Very modest optimism is also in order on the data for sales of new homes. In June, they fell by 0.6%, less than expected, suggesting that the pace of the fall may be bottoming out. Maintaining an equilibrium between supply and demand for houses is important for stabilising the market. It has been suggested in the past that about six months' supply represents an equilibrium level. It is now at ten months' supply in June but has been falling since March. So we may be seeing some straws in the wind. We should not expect a sudden turnround in the data but changes in trend are marked by the onset of more mixed signals rather than ones which unambiguously point one way or another. This may be what is happening in the USA.

This, too, goes for the general run of economic data produced for a country or region and here, too, amongst the negative data are some positive signs from the USA which suggest that it may be the first major economy to show an upturn. Again, caution is in order because there is plenty of negative data. May saw weakness in factory orders. They rose by just 0.6%, weaker figures than for March and April. Retail sales grew only weakly in June. They were up by just 0.1% compared with 0.8% in May. As measured by the IBD/TIPP economic optimism index, consumer confidence has failed to rise from record low levels in July. It stood at 37.4 in July, 14.5 points below its average. The Philadelphia Federal Reserve Bank's index of business activity came in at -16.3 in July, the eighth successive negative monthly reading. There was a slight fall in the Conference Board's index of leading US economic indicators. The index fell by 0.1% in June to give a year to date fall of 0.9%. In its latest survey of the US economy, the Federal Reserve suggests that the economy has slowed in the last few weeks.

On the positive side, the ISM's purchasing managers' index for manufacturing in June showed a rise into expansion territory, moving up from 49.6 to 50.2. The Reuters/University of Michigan's index of consumer confidence rose in June from 56.4 to 56.6 and the preliminary indication for July is that it rose to 61.2 helped by the fall in the oil price. Also, encouragingly for the Federal Reserve, it suggested that longer term inflation expectations had fallen. June also saw a strong rise in US industrial production, 0.5% on the month and the largest increase for a year. There was a 0.8% increase in durable goods orders in June. The competitive level of the US dollar is a help here. Another index of consumer confidence, that from the Conference Board, saw a rise from 51.0 in June to 51.9 in July.

The point of detailing these various positive indicators is to suggest that the outlook is better than may have assumed. Whilst it is natural for the media to latch on to all the negative news, of which there is plenty, there is also some positive data which could augur well for later this year. August's data will be particularly interesting.

As we can see from the performance table at the beginning of this review and, as we mentioned in the earlier narrative, Japan has held up relatively well, particularly in local currency terms. Whilst the weakness of the yen against major currencies has helped sentiment, the economy does maintain some advantages over others.

In the middle of July, whilst unsurprisingly keeping its interest rate unchanged at 0.5%, the Bank of Japan cut its growth forecast for the year ending March 2009 to 1.2% from the 1.5% it had estimated last April. It also raised its headline inflation forecast from 1.1% to 1.8%. For 2009/2010, it forecast growth of 1.5% against its earlier forecast of 1.7% and slightly raised its inflation forecast from 1.0% to 1.4%. To quote the Bank of Japan, "economic growth is slowing further, reflecting weaker growth in business fixed investment and private consumption against the backdrop of high energy and material prices". One of the attractions of the Japanese economy and, by extension, the stock market is its close trading links with economies which are still growing relatively quickly and, here, one thinks of China and other Asian economies. At the moment, the advantage is relative rather than absolute as exports to the USA and Europe fell in June by 15% and by 10% in the first half of 2008. Exports to Europe, which had held up quite well fell by 10.3% in June. On the other hand, exports to China continued to rise, by 5%, and there was strong growth in smaller markets for Japanese exports such as Russia and the Middle East. In this difficult environment for exports, this is why it is correct to say that the advantage is relative. But it is important. As far as one can tell, Asia is likely to continue to grow faster than the west and, therefore, Japan, because of the profile of its exports, is likely to be well placed.

As with the Federal Reserve in the USA, the Bank of Japan is keen to normalise interest rates but deflation has prevented it from doing so and, now, the international financial and economic environment precludes it. Whilst the validity of trying to centre monetary policy around core inflation rates in the west is questionable, especially because of the magnitude of the gap between headline and core rates, households in Japan have become so used to deflation that it is a step too far to adjust immediately spending or wage claim patterns to, by Japanese standards, quite a high headline rate. Because the core inflation rate is nearer to the deflation experience which has gone on so long in Japan, it is likely, for the foreseeable future, to carry more weight with consumers and households. That is why the Bank of Japan can be more relaxed about having an official interest rate which is negative in real terms when measured against headline inflation. From the Bank of Japan forecasts just indicated above, we can see that, unless it raises interest rates, it expects this situation to continue. In June, the monthly headline rate of consumer price inflation was 0.5% and the year on year increase was 2.0%. The consumer price index, excluding fresh food, had a monthly increase of 0.4% in June and a year on year increase of 1.9% while the consumer price index, excluding food and energy, rose just 0.1% in June. Wholesale prices showed an annual increase of 5.6%, up from 4.6% in May.

If inflation, on whichever measure, takes hold in Japan, it could induce a change in the spending habits of consumers. Whilst the corrosive effect of inflation is widely recognised, deflation can also be highly damaging. If consumers expect prices to keep falling, they will hold back from purchases thus causing recessionary influences in the economy. The reasoning behind the view that a little bit of inflation is good for an economy is that instead of excessive savings building up because households are holding off purchasers, the reverse happens and spending gives some forward momentum to the economy. This would be a desirable state of affairs domestically and internationally as Japan's increased import requirements would give a boost to other economies. So, at some stage in the future, the introduction of a very modest amount of inflation could be positive for the stock market. However, there is still some way to go as consumer confidence is very low in Japan. The Cabinet Office's quarterly consumer sentiment index fell in June to the lowest on record to stand at 32.3 compared with 36.5 in March.

The latest Tankan survey could have been worse. The diffusion indices, although less positive than before, were still in positive territory. The index for large manufacturers fell from 11 points to 5 points and that for large non manufacturers fell from 12 to 10. Although there were some areas of weakness, shipbuilders and steel and motor manufacturers, capital expenditure plans at large manufacturers remain reasonably firm. The last published data for industrial production in May was quite good, up 2.8%.

Japanese banks appear largely to have avoided problems which have affected some of those in the USA, UK and Europe. That is a plus point for the economy and gives them a competitive advantage. At an individual level, many Japanese companies have raised their dividends and bought back shares. At government level, a recent Cabinet office paper extols the virtues of foreign investment. Foreigners have long complained about the obstacles put in their way in Japan, for example on takeovers of Japanese companies. If there is a more welcoming environment for foreign investment in Japan, it will be a positive factor for the Japanese stock market.

We turn now to the eurozone where the ECB has been the most "macho" of the central banks raising its official interest rate by 0.25% in July to 4.25%, although the feeling is that this will be as far as the ECB will go for a while. At the time of this last ECB meeting when interest rates were raised, eurozone inflation, year on year, was 4.0%. The figure for July, just released, was 4.1%, over double the target rate. Yet with the ECB interest rate only fractionally higher than the inflation rate, one would normally suggest that interest rates were still too low.

Although, with the euro a strong currency, one would not normally have thought its credibility was at stake, it faces some difficult problems. The least difficult, if the most noisy, is political pressure to reduce interest rates. Not surprisingly, perhaps, France is in the vanguard of protests here but it faces a firm adversary in the form of Germany with its historic attachment to low inflation. It did not give up the Deutschemark to have the euro politicised and, therefore, its inflation credentials compromised. The rules surrounded the euro are governed by very firm parameters and this is a battle France is unlikely to win.

Another problem for the eurozone now, both fundamentally in the concept of the monetary union and in day to day issues, is investors' heightened concerns about different credit risks within the eurozone. On a number of occasions we have pointed to the widening spreads on ten year government bond yields as an example of this phenomenon. The most highly rated credit is that of Germany. If we take a sample of other eurozone countries and their ten year government bonds we see the following premia measured in basis points over German ten year government bonds — Netherlands 19, France 20, Finland 26, Austria 29, Spain 32, Belgium 38, Ireland 44, Italy 61 and Greece 67. The stresses in financial markets are putting the divergence concept, implied by monetary union, at risk. Whilst there is still the one currency and the single official interest rate, the practical effect of the wide divergence in credit ratings seen above is that the market is imposing different interest rates within the eurozone. In the past, there has also been anecdotal evidence that consumers appreciate the difference in credit ratings. There were stories of individuals only wanting to hold euro bank notes issued by Germany because they were perceived to be safer than those issued by some other countries. We think that the strains can only get worse and that the one interest rate will become less and less suitable. We may expect political pressure on the ECB to intensify and it is hard to see how every member of the eurozone can be satisfied with the monetary policy being followed. It is almost impossible to believe the convergence line upheld by monetary union.

By way of background, there was a slight reduction in the latest estimate of first quarter growth in the eurozone. Eurostat revised down its estimate from 0.8% to 0.7%. At the same time as the growth rate estimate was revised down, the ECB President was expressing his concern about the effects of the oil price rise on inflation through second round effects in the employment market. Hourly labour costs in the eurozone rose by 3.3% in the year to the first quarter of 2008 which is the fastest rate since early 2003. The rise in the ECB interest rate is a warning shot across the bow even if the ECB has hinted that it is, for a while, pausing on interest rates. But a year on year 4.1% consumer price inflation level and a 7.1% year on year producer price index increase in the eurozone, following a 1.2% increase alone in May, will keep the ECB vigilant.

The eurozone economy held up relatively well when the US economy went into a downturn and we have seen that economic indicators in the USA have moved from generally negative to mixed, giving the possibility of economic recovery towards the end of the year. In Europe, however, short term indicators have become mostly negative.

In the USA, the competitive level of the dollar has boosted exports, which are buoyant and provided some offset to weaker areas of the economy, such as housing, which have been dragging down growth. In the eurozone, the high level of the euro has been unhelpful to industry. There have been a number of examples in the last month of weak economic data emanating from the eurozone. The June purchasing managers index for manufacturing fell below 50 with May's reading of 50.6 moving down to 49.2. That for the services sector fell to 48.3 in July from 49.1 in June. There were upward revisions to earlier eurozone unemployment data with the May level now at 7.2%. May saw industrial production fall by 1.9% compared with April, this being the sharpest monthly decline since December 1992. We know that there has been particular weakness in the housing market in Spain and Ireland but more general weakness is perhaps presaged by a slowdown in eurozone lending for the housing market. The annual rate of increase in June fell to 4.4% from 5.6% in May. The EC's eurozone economic sentiment indicator fell to 89.5 in July from 94.8 in June. This is the lowest level since May 2003.

The German economy, which has been the powerhouse of the eurozone, has started to weaken. May saw manufacturing orders fall by 0.9%, the sixth consecutive monthly fall. The ZEW research institute's gauge of economic sentiment, which measures expectations for the German economy in six months' time, fell to -63.9 in

July from -52.4 in June. The Ifo's index of business confidence fell from 101.2 in June to 97.5 in July. Industrial production fell by 2.4% in May following a 0.2% fall in April. In the second largest eurozone economy, France, the short term news has not been good. Production fell by 2.6% in May. The French Finance Minister now predicts that growth this year will be closer to the bottom end of the already revised down 1.7% - 2.0% growth forecast (prior to that the forecast had been for growth to be in the 2.0% - 2.5% range compared with the same time the previous year). Housing starts fell 28.2% in the second quarter. Industrial output was down by 2.6% in May. Real wages were under pressure falling by 0.1% in the first quarter of 2008. This will affect consumer spending in the economy which was down by 0.4% in June. Consumer confidence is also depressed with Insee's index falling to -48 in July compared with -46 in June.

Like the UK, Spain experienced a major housing bubble which is now unravelling. Buoyed by low interest rates as a result of being in the euro but without its central banks being able to put a brake on the boom by raising interest rates appropriately, it is now unable to use interest rates independently to help the housing market. In fact, even if it could do so now, the Bank of Spain might feel that the level of inflation in Spain inhibited it from doing so. With relatively high inflation, 5.1%, Spain has been losing competitiveness and has an exceptionally large current account deficit at around 10% of GDP. Outside the euro, this would almost certainly have spelt some sort of currency crisis. As it is, Spain, having shown relatively fast growth in recent years, now shows low growth and high inflation. First quarter growth was just 0.3% and the government is now predicting 1.6% growth for this year (previous estimate 2.3%) and 1.0% next year (previous estimate 2.3%). In 2007, it had been 3.8%. The extent of the weakness in the housing market is shown by the fact that the number of homes sold in May was 34.3% lower than a year previously. Because nearly all mortgages are at variable rates, recent moves in interest rates will impact negatively. Ireland has many of the same sort of issues.

Whilst it is easy to be gloomy about eurozone economic prospects, it does not do to translate this into a view on the European equity market where ratings are very low and, in our view, take into account a difficult earnings outlook for many companies whilst economic growth slows down.

In our view, the economic outlook in the UK is the worst of the major industrialised economies. Whilst global events are blamed for the UK's present economic difficulties, the truth is that a large part of the problem is self inflicted. Before the problems in financial markets blew up a year ago, we had written many times about the massive increase in public spending, well beyond any reasonable potential growth rate of the UK economy. As a consequence of this, we described the growth being seen as of low quality and the benign economic background hid, at least to some observers, the problems which were being stored up for the UK economy. The figures told no lies. Each year the Treasury consistently underestimated the size of public borrowing with the figures coming in over the original estimate, all this at a time when the economy was growing quite strongly. What should have been happening was that money was being put by for a time when reflationary measures were needed, such as now. The UK has developed an unpleasant structural deficit and now, as the economy slows down, public finances will go dangerously into the red. The government's political weakness has resulted in a number of reversals of policy, the most spectacular being on compensation for the abolition of the 10p income tax rate, announced in the 2007 budget where the money to provide for the raising of personal allowances has been borrowed, completely undoing the arithmetic and the stance of the 2008 budget.

The serious state of public finances in the UK has negative implications. It is likely to be inflationary. Fiscal policy is too loose and although public expenditure cuts, not higher taxes, would be the chosen course to tighten it, it is not going to be possible politically. A large increase in government borrowing is likely to push interest rates above where they would otherwise be as larger quantities of government stock are sold. There has been recent evidence of a loss of appetite from foreign investors for gilts. The UK already has a large current account deficit which has been a threat to sterling for some time and the combination of this plus the doubts about the UK's control of domestic financial policy, as shown by the ballooning level of government borrowing, are not likely to elicit confidence in sterling. In the current external and internal finances of the UK lie the seeds of further sterling weakness. Although the EU cannot impose sanctions on the UK because sterling is not in the eurozone, it has put in motion an embarrassing excessive deficit enquiry and the UK is being given six months to bring its budget deficit below 3% of GDP, an almost impossible task. Because of the importance of the housing and financial sectors to the UK economy, it is feeling the turbulence in financial markets particularly hard and is perhaps the worst placed of the major industrialised economies in this respect.

The deterioration in the housing market reflects not only the bubble conditions in which it has existed for some time but, more immediately, the credit crunch which has reduced the supply of finance considerably and, where it is available, it has become more expensive and lending conditions have been tightened. Various examples of data show the difficulties in the housing market. In July, the RICS reported that construction workloads in the three months to June fell at the fastest rate since 1995. Mortgage equity withdrawal fell in the first quarter of 2008 to a seventeen year low. Although new mortgage lending rose slightly in May, it was 44% lower than a year previously, according to the Council of Mortgage Lenders. The RICS reported that the number of house sales completed in June fell to a thirty year low. The balance of surveyors reporting falling rather than rising prices was 88%. The Council of Mortgage Lenders reported that gross lending in June was nearly a third lower than in June 2007. HMRC reported that 45% fewer houses were sold in June compared with a year previously. The British Bankers Association reported a sharp fall in mortgage approvals for house purchase in June with the figures 67% below those of a year previously. Net mortgage lending rose £3.8 billion compared with the six month average of £5 billion. The Bank of England reported that the number of mortgage approvals in June fell to 36,000, the lowest level since July 2002. In terms of some of the measures of house prices, the Department of Communities and Local Government reported that prices were 0.3% lower in May compared with April and 3.7% higher than a year previously. The Halifax reported that average house prices in the three months to June were 6.1% lower than in the same period the previous year and, according to the Halifax, prices are now 10% below their August peak. The Land Registry reported a fall of 1% in house prices in June compared with May. The annual increase on its measure of house prices was 0.1%. Nationwide reported that prices were down by 1.7% in July compared with June and its year on year measurement of house prices showed a decline of 8.1%. So the housing picture is pretty clear. The bubble is being unwound in quite a brutal manner and, in its wake, it will leave some economic problems which will affect individuals, lenders and the government. The consistent theme of these effects is one of contraction for the economy. Normally individuals will respond to the probability of more difficult economic times by raising their level of savings. So indebted have many individuals become that savings rates are still falling, the savings rate being 1.1% in the first quarter. Many households are not prepared for the difficult times ahead. If the Bank of England was guided solely by this data, it would surely reduce interest rates. But, of course, it is not and the big ogre is inflation. In June, producer prices increased by 0.9% over the month and 10.0% over the year. The consumer price index rose by 0.7% over the month with the year on year increase being 3.8%. This was a sharp jump from the previous month's 3.3%. The Retail Price Index, for most a more realistic index, rose by 0.8% over the month and 4.6% year on year. The CPI increase is, therefore, almost double the top of the range being targeted. It is not likely to get any better for a while. The latest CBI industrial trends' survey said that price pressures were at their greatest since 1980 with rising costs leading companies to raise their prices at the highest level since April 1995. Paradoxically, households' inflation expectations have fallen in the latest monthly survey by YouGov for Citigroup, reported in the Financial Times at the end of July. Over the next year, inflation expectations have fallen from 4.6% in June to 4.2% in July. The five to ten years level of expectation has fallen from 3.8% to 3.6%.

We have discussed above the poor state of the UK's domestic finances and, although the financial year is not far advanced, the figures so far paint a disturbing picture. In the first three months of this financial year, public sector net borrowing was £24.4 billion, £10 billion more than in the same period last year. The current budget deficit stood at £20.4 billion compared with £12.5 billion in the same period a year earlier. No wonder the government is looking to revise its fiscal rules which have already proved to be very flexible. Economic credibility in the UK is low at present. The two weak quarters of economic growth experienced so far this year at 0.3% and 0.2% to give a year on year growth rate of 1.6% respectively will be followed by more and it is going to be a long haul for the UK to recover so significant exposure to overseas stock markets where prospects are relatively better should be helpful.

As always, one must distinguish between companies and the countries in which they are based. In the USA, we are seeing how companies with significant overseas business through exports and/or overseas subsidiaries are benefiting from the weak currency and the same will be the case in the UK for similar types of company. But, overall, exposure to the UK market should still be at a cautious level. Recently, the idea of a windfall tax on energy companies has been doing the rounds with the government reported to be considering the idea. The latest stories in the newspapers suggest it has been dropped and it is to be hoped that this is the case. Whilst populist politicians might see advantage in it, the idea is so crass that even mention of it in government circles can cause damage to the perception of the UK and, by extension, to investors in the stock market. Capricious and retrospective taxation deter investment and cause long term damage to an economy and, with it, the stock market. In these days of economic problems in the UK, investors must be wary of actions which threaten the kind of damage posed by taxes such as so called "windfall" ones.

Now to turn to China where the problem has been one of excessive growth leading to inflationary concerns for the authorities and previous actions to cool down the economy which now seems to be happening in a modest way anyway. But it is only modest. Second quarter annualised growth was down to 10.1% compared with 10.6% in the first quarter, the fourth consecutive quarter of a declining rate of growth, albeit from a very high level. By slowing down growth, the authorities hope to get on top of inflation which was exacerbated by the rise in the price of pork last year which drove up the inflation level. At the retail level, inflation has been falling. June's figure was 7.1%, down from 7.7% in May. However, in the other direction, producer price inflation rose from 8.2% to 8.8% and this would have been spurred by rapidly increasing import costs. The domestic economy of China remains robust. Fixed asset investment, which the government had been trying to restrain, has been robust. The latest figures suggest that, in the year to June, it rose by 29.5% compared with 25.4% in May. Retail sales were up 15.1% year on year in June compared to 13.1% in May. These figures compare with generally drab figures in the west and show that there is still some growth impetus in the world economy.

As well as using interest rates and increasing bank reserve levels as ways of trying to dampen down excessive economic growth and restrain inflation, China is trying to discourage speculative capital inflows which can also pose an inflationary threat. In early July, the country's foreign exchange regulator said that exporters would be required to park revenues in special accounts so that the authorities could check that the money resulted from genuine foreign trade. Possible evidence of success in containing the flows of "hot money" into China shows in the slowdown in the build up of foreign exchange reserves which, in June, increased by less than would have been expected, given the size of the trade surplus. It is too early to be able to be sure but the authorities may take some tentative encouragement from this trend. In the other direction, there was a substantial increase in overseas investment by Chinese companies in the first half of 2008. It tripled to US$25.7 billion. In every way, Chinese influence on the world economy continues to grow month by month.

In these difficult times for investors, it is important to be guided by valuations of different types of asset class. The one which does not seem to be in a bubble is equities. Given the inflation outlook generally and the level of borrowing in particular countries like the UK, the low level of bond yields does not seem realistic. A flight into safety has at times in the past year brought yields to levels that bear no relation to reality. The housing market, not only in the UK and USA, is or has unravelled. There are problems in Europe, too. Excess credit growth and easy availability drove up prices to unrealistic levels. The valuations of shares is most countries is moderate and the economic outlook, although very uncertain, is not sufficiently poor to warrant taking valuations even lower despite the difficult earnings outlook for many companies. Indeed, there may be some good news if the current weakness in the oil price continues. A reduction in inflationary pressures really would be a positive development.

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