meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The relatively modest decline in international equity markets, shown in the table below, belies what has happened subsequently and we go into detail on recent economic events in our review which follows. We also note the strength of the high quality bond markets at a time when weak credits, particularly in the eurozone, have come under significant pressure. There have been extraordinary movements in the currency markets, as our table shows, and this feature has continued into August. In the commodity markets, the oil price eased back, but gold continued to rise as investors continued to worry about paper currencies.

The tables below detail relevant movements in markets:

International Equities 29.04.11 - 29.07.11

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-8.1	-6.3	-7.8	-4.8
Finland	-19.7	-20.9	-22.2	-19.7
France	-6.9	-8.4	-9.9	-6.9
Germany	-4.8	-6.3	-7.8	-4.8
Hong Kong, China	-1.0	+0.2	-1.3	+1.9
Italy	-15.4	-16.8	-18.1	-15.4
Japan	-1.5	+5.2	+3.5	+6.9
Netherlands	-9.4	-10.9	-12.3	-9.4
Spain	-9.6	-11.0	-12.4	-9.6
Switzerland	-11.5	-1.0	-2.5	+0.6
UK	-3.5	-3.5	-5.0	-2.0
USA	-4.8	-3.2	-4.8	-1.7
Europe ex UK	-8.8	-8.4	-9.8	-6.9
Asia Pacific ex Japan	-4.8	-2.8	-4.3	-1.2
Asia Pacific	-3.5	+0.5	-1.1	-4.8
Latin America	-6.9	-4.9	-6.4	-3.4
All World All Emerging	-4.1	-2.9	-4.5	-1.4
The World	-5.4	-3.8	-5.3	-2.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +3.8%

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

Currency	29.04.11	29.07.11
Sterling	3.47	2.87
US Dollar	3.29	2.81
Yen	1.20	1.08
Germany (Euro)	3.24	2.54

Sterling's performance during the quarter ending 29.07.11 (%)

Currency	Quarter Ending 29.07.11
US Dollar	-1.6
Canadian Dollar	-0.7
Yen	-6.5
Euro	+1.5
Swiss Franc	-10.5
Australian dollar	-2.0

Other currency movements during the quarter ending 29.07.11 (%)

Currency	Quarter Ending 29.07.11
US Dollar/Canadian Dollar	+0.8
US Dollar/Yen	-5.0
US Dollar/Euro	+3.1
Swiss Franc/Euro	+13.3
Euro/Yen	-7.8

Significant Commodities (US dollar terms) 29.04.11 - 29.07.11 (%)

Currency	Quarter Ending 29.07.11
Oil	-7.3
Gold	+5.3

Markets

Against a very troubled background of economic news connected with the eurozone sovereign debt crisis and the brinkmanship in the USA over the debt ceiling, international equity markets had shown impressive resilience up to the end of the quarter although August has made a torrid start. It has been a negative quarter, but not dramatically so. In local currency terms, the FTSE World Index has returned -5.4% in local currency terms, -3.8% in sterling terms, -5.3% in US dollar terms and -2.3% in euro terms. In local currency terms, the major market which has held up best has been Japan with a return of -1.5%. The previous quarter had reflected the dreadful natural disaster which hit Japan in March. The USA and UK held up better than average with the FTSE USA Index returning -4.8% in local currency terms and the FTSE UK Index -3.5%. Elsewhere, emerging markets held up better than average, with the FTSE All World All Emerging Markets Index returning -4.1%. The FTSE Asia Pacific ex Japan Index also held up slightly better than average, returning -4.8%. On the other hand, Europe ex UK had a difficult time with the FTSE Europe ex UK Index returning -8.8%, and Australia also underperformed with the FTSE Australian Index returning -8.1%. However, there were some significant currency movements during the quarter, noticeably in the Swiss Franc and yen. In sterling terms, the FTSE Japanese Index returned +5.2% as a result of the strength of the yen. The most dramatic movement of all was in the Swiss Franc and so an equity market, suffering in part from the problems that a very strong currency can cause for exports and the translation of overseas earnings back into the domestic currency, turned a weak local currency return, -11.5%, into a much better -1.0% in sterling terms, moving the market from one of the worst local currency performers to one of the best sterling performers, albeit that it was slightly negative. Elsewhere, the relatively narrow movements against sterling, apart from the Swiss Franc and yen, just mentioned, did not markedly affect sterling returns.

High quality bonds, as opposed to lower quality ones, of which the troubled eurozone countries' bonds are a prime example, performed well, benefiting from a flight to quality. That even includes the USA, where the threat of a default did not stop Treasuries performing well. In the US government bond market, the gross redemption yield on ten year Treasury bonds fell by 48 basis points to 2.8%. In the UK, the yield fell by 60 basis points to 2.87%. In Germany, because of the exceptional problems of the eurozone, there was an astonishing 70 basis point fall in the yield to 2.54%. In Japan, a very highly indebted country, the yield fell by 12 basis points to 1.08%.

In our review of international equity markets' performances above, we have alluded to currency movements during the quarter but, to put figures to the movements, sterling fell by 10.5% against the Swiss Franc and 6.5% against the yen. There were smaller declines against the US dollar, 1.6%, and against the Australian dollar, -2.0%. Only against the euro, of the currencies in the table, did sterling rise, by 1.5%.

In the commodity markets oil, as measured by Brent crude, fell by 7.3%, whilst gold, reflecting concerns about paper currencies and inflation, rose a further 5.3%.

Economics

These are extraordinary times, yet the relatively modest movement in stock markets over the last quarter, but not since, hinted at a resigned acceptance that events, which would previously have been considered unthinkable, are now an everyday part of economic life. Such events might include the threat of default in the USA and the printing of money by the US and UK central banks, as well as the ECB effectively, as well as a full or selective eurozone sovereign default which, until recently, many thought to be impossible.

After the tragic natural disaster in Japan in March, which captured everyone's undivided attention at the time, we said that the one issue which would certainly be with us at the end of the year was the eurozone sovereign debt crisis. There is little danger of this prediction being wrong. As we have said many times before and over many years, the eurozone is not an optimal currency area and, that being the case, we believe that it will fragment. The political nature of the project meant that it was driven forward without any proper thought given to its economic underpinnings. On the same continent, it is difficult to imagine two countries more different than Greece and Germany, and yet Greece was allowed into the eurozone. In the politicians' haste to get the project off the ground and then keep it going once it was up and running, rules were broken or bent, for instance, on the level of public debt to GDP and the size of the annual budget deficit in relation to GDP. Because of this indiscipline, markets are probing obvious areas of weakness such as Italy with its enormous volume of outstanding debt. Before the sovereign debt storm broke over the eurozone, investors might have drawn some comfort from Italy's relatively low budget deficit as a percentage of GDP and were therefore looking at the bottle as half full. Now they have turned their attention to the outstanding level of public debt as a percentage of GDP and the bottle looks more than half empty.

There is going to be no happy ending to the eurozone story. Those who established the framework for monetary union never envisaged a position where the creditworthiness of some eurozone members was called into question and they devised no mechanism for dealing with such problems. The quarrels and diverging views of those involved have made a bad situation worse and there is a complete lack of leadership. Many of the eurozone's politicians seem to be in denial and their statements, so at odds with reality, often make a bad situation worse. As this is written, having reached an agreement on a second bail out for Greece and apparent action to be taken if the contagion spreads, they are already making conflicting statements about what was agreed and the details of the bail out do not appear to have been significantly thought through. The agreement reached towards the end of July has to be sold to many different constituencies but, for monetary union to work, a fiscal union has to be in existence so that funds can be transferred from richer members of the monetary union to poorer members. Not even the most ardent federalists would dare to seek the electorates' approval for such a development. There is a chronic divide between the richer northern eurozone members and the southern eurozone members which is unlikely ever to be bridged in terms of economic performance. Ireland is a special case, having the potential to grow out of its troubles but, because of its banking crisis, it is hobbled by a level of debt which market interest rates say it will be unable to pay back fully and therefore it will be unable to borrow in international markets. The politicians in the richer northern eurozone countries, like the eurozone generally, are emphasising that Greece is a special case and that private investors in other eurozone countries will not be expected to take a loss on their bonds. Realistically, most objective observers will be well aware that, whilst Greece is the most insolvent eurozone country, it is a matter of degree, and that it cannot be distinguished from Portugal and Ireland, and that a firewall around Spain and Italy will be prohibitively expensive. It is very likely that already angry electorates in the northern eurozone countries will not countenance continual fiscal transfers to southern eurozone members. Those southern eurozone countries and Ireland (probably) will be very unhappy about the extent of the loss of sovereignty they will experience as the EU and IMF impose their terms on them. For completely opposite reasons, the electorates from both sides are likely to rebel at what has been decided. All of these consequences need to be factored into investors' thinking as they decide the best way forward.

Here, we have to emphasise what we have said before, that it is essential to distinguish between the travails of eurozone countries and the companies based within them. There are many world class eurozone based companies which can still perform well because of their exposure to fast growing areas and investors should not be put off holding their shares.

However, as we say, we do not think that the eurozone story will end well and investors will need to be prepared for continuing bad news which should not always be reflected in adverse stock market movements. The eurozone's politicians are trying to make out that the agreement reached on the 21st July had sorted out the problem. Nothing could be further from the truth. The second Greek bail out, and associated measures, were merely a larger piece of sticking plaster applied to the problem. The ECB was strongly opposed to involving private bond holders in the bail out because of the consequences of a default or selective default on banks which hold Greek debt and because the ECB could not take as collateral from a bank debt from a country in this position. On the understanding that this situation would apply to Greece only, the ECB relented. But once the precedent has been set for one country, it is almost inconceivable that the markets will view Greece as an isolated case, whatever the politicians and central bankers might say. So, what the ECB would have been fearful of, namely that the private sector will be scared off buying the debt of heavily indebted eurozone countries, will almost certainly come to pass. After the initial very brief euphoria, we now see the yields of Italian and Spanish bonds rising to uncomfortably high levels and another crisis developing. Such worries can become self fulfilling.

The politicians are almost certainly being unrealistic about the attitude of their respective electorates. Because of the fundamental flaws in the structure of EMU, those countries which have become chronically uncompetitive in the southern eurozone will require constant transfers of money from the richer eurozone countries, in other words the eurozone will also need to become a transfer union. It is hard to believe that this will be acceptable to electorates on both sides of the divide. There is already considerable resistance in Germany to the idea of supporting those eurozone countries in trouble. The more these weaker countries are supported through bailouts, the weaker the credit rating of countries like Germany will become. Support for the eurozone is not so strong in countries like Germany, the Netherlands and Finland that the electorate is willing to see its money at risk to support the wider cause. On the other hand, those countries which have received bailouts will see their electorates rebel at the way their sovereignty has been compromised as their creditors dictate the terms of their rescue and their insistence that they stick to the bail out agreement. What is happening on the streets of Greece does not bode well for the implementation of the austerity plans forced upon the country. In our opinion, investors cannot rely upon the austerity measures in countries like Greece and Portugal being successful.

There are so few options, none of them attractive, for the authorities, that we see monetisation of the debts as the ultimate action of the ECB. Greek bank deposits have fallen significantly as customers have moved their money away from Greece. Greek banks, in return for collateral of uncertain value placed with the ECB, have been provided with liquidity by the ECB. In this way, the liabilities of the Greek banking system get transferred to the

ECB. One of the reasons why the ECB was so opposed to the private sector taking a haircut on its holdings of Greek debt was that a default by Greece would prevent it from accepting Greek government debt as collateral. It has already lowered its rating threshold to accommodate the present problems. Furthermore, the ECB is believed to be holding nearly €50 billion of Greek debt and, should it have to write all or part of it off, the ECB would need recapitalising. The advent of the euro led to over complacency on credit risks within the eurozone. At the end of 2006, for instance, before the financial crisis blew up, Spanish ten year government bonds were yielding just 3 basis points more than those of the best eurozone credit, Germany, whilst Greek bonds yielded just 25 basis points more. Had the countries which are now in trouble retained their own currencies, the markets would not have allowed them to get into this situation because their currencies would have fallen sharply and interest rates increased in the face of their borrowing position. The major consequence of this is that eurozone banks, wrongly reading the credit risks because the market signals were originally inaccurate, are now large holders of the debt of troubled eurozone countries, one reason why those connected with the eurozone are trying to deny the extent of the problems and doing everything they can to keep Greece in the eurozone. But if the contagion spreads, we would expect the ECB to accept collateral from troubled countries, which is well below its normal quantity threshold, simply because it has run out of options. What Greek bank depositors are doing in terms of moving deposits out of Greece, others in weaker countries are surely doing, and the liabilities of the relevant country's banking system are gradually being transferred to the ECB.

Monetisation of debt is the opposite of everything which the ECB stands for and would have been allowed to do, but desperate times call for desperate measures. But the effect on equity markets need not be malign despite what has happened since the quarter end. As we saw in the aftermath of the financial crisis in 2008, when interest rates were reduced to negligible levels and quantitative easing took place, asset prices, after their sharp fall, recovered strongly. After the recession of 2009, the world economy started to recover. There are enormous dangers arising from the monetisation of debt, for example currency debasement and inflation, but holders of shares with involvement in real businesses and decent prospects look to be in a much better situation than holders of fixed interest securities. In the case of the latter, if one very simplistically puts oneself in the position of a fund manager without constraints, could one feel comfortable with investing clients' money in a number of the eurozone's sovereign bonds? At every stage, those responsible for eurozone decision making have been behind events and many of the judgements made, especially by the politicians, lack credibility. Investment managers know from experience that they would be very unwise to base their investment decisions on politicians' judgements. One bail out for Greece was supposed to be enough. Now there is a second one, involving the private sector, even if it is voluntary, and who is to say that a third bail out will not be needed, so high are Greek debt levels. Who can believe that private sector involvement in the haircuts will not only affect Greek debt? It would be a naive investment manager who ignored market signals. At present, Irish and Portuguese government debt, as measured by ten year government bonds, yield over 10%. It is impossible for these two economies to grow quickly enough to be able to pay this level of interest rate on their debt. Furthermore, one cannot just put a firewall around Spanish and Italian debt and say that it will be alright. As this is written, the gross redemption yield on ten year Spanish and Italian bonds is over 6%, a very difficult level, given the poor growth prospects in both countries, and investors' concerns have now caused another serious bout of market weakness. Those yields are at least 350 basis points higher than those of German bonds. These yields become a self fulfilling prophecy of trouble and will scare off investors. So, if one had to choose, simplistically, between a soundly financed company based in any of the troubled countries with a good spread of international business and that country's sovereign bonds, one would feel more comfortable with the former.

However, the eurozone's sovereign debt woes have competed for attention with the political stand off in the USA over raising the debt ceiling to accommodate August's federal borrowing needs, as revenues were expected to lag expenditure considerably, thus putting borrowing up against its permitted ceiling.

The world looked on with astonishment at the extraordinary spectacle that was playing out on Capitol Hill. That politicians would put their own economy and credit rating at risk (since this was written Standard & Poors has downgraded the USA's sovereign debt to AA+), not to mention the potential damage to the world's financial system, in the name of personal and political vendettas, defied explanation to many people. In fact, it represents a fierce debate at the heart of US politics, which is whether the country wishes to move to a big government higher tax economy with a stronger welfare system, more in line with the European model, or whether it wishes to be a small government low tax economy. The debate is not helped by the vicious personal animosities which prevail at the top of US politics, nor by some fairly extreme elements who seem to have little idea of the US dollar's place in the world financial system and the effect which a default by the USA could have on that. As this is written, it looks as if the USA has pulled back from the brink, but the episode has undoubtedly shaken confidence in the USA. The USA has some tough decisions to make because it cannot go on as it is, running up enormous budget deficits of around 10% of GDP and, whilst the original checks and balances between the executive and the legislature may have been appropriate, the system is now a real impediment to swift and decisive decision making. With the two houses of Congress split between Republicans and Democrats and a Democrat as President and, given the personal animosities which prevail, rational decision making was always going to be difficult. One hopes, after all that has happened, that the task of starting to restore the USA's finances will not be marked by the bad feeling at the top of American politics which has been so evident in the debt ceiling negotiations.

Although attention has focused on the federal government, down at state level, where balanced budget rules often apply, a foretaste of the tough measures necessary to restore financial order has been provided with shutdowns, layoffs, IOUs and other measures affecting pay and entitlements of state employees. Many of the USA's states have very serious financial problems, of which perhaps California is the most high profile, and remedial action has to follow more quickly than at federal level where, at the end of the day, money can be printed. In fact, it is one of the ironies of the debt stand off in the USA that, at a time when one would think that investors would take a cautious attitude to US government debt, yields on US Treasuries have plummeted, although it is true that yields on very short term debt did spike upwards as worries about prompt repayment surfaced during the tense negotiations. But, as we have often mentioned before, the USA has one crucial advantage over the struggling eurozone countries which is that it can issue its own currency and, if necessary as it has done, print its own money to reinforce monetary policy as it did with its quantitative easing programme. Allied with the US dollar's position as the world's largest reserve currency, which gives the USA's creditors reason to retain it for fear that large sales of US dollars will damage the value of their remaining holdings, the USA has some advantages. However, short term advantages give way to longer term problems. Weakness of the currency is an obvious one, allied to higher interest rates necessary to finance its deficit. Struggling eurozone countries, trapped in monetary union, are unable to issue their own currency.

Whilst all this may seem academic and not directly relevant to the stock market, it is, in fact, very important. In terms of the international bond market, what has happened with the US debt ceiling negotiations and the eurozone's sovereign debt crisis has, in one sense, been rational, a flight from the weaker credits to the stronger ones, but it has also caused a huge distortion in investment values. Oversimplifying enormously, money earmarked for bonds has been very credit rating sensitive and moved to the highest credit rated issues, irrespective of what fundamental value there may be there. Of course, it has benefited those countries which have attracted investors such as the UK, USA and Germany because they have been able to fund their borrowing cheaply and at attractive maturities. For those who have bought them, or had to buy them, it is difficult to see any investment value. The UK is perhaps the best example because of its high inflation. Even for the longest dated conventional issues, one is currently investing for a negative real return and it would be a brave person who said that current inflation levels in the UK of over 4.0% were abnormally high and likely to fall back for any length of time. These market distortions do provide interesting opportunities for equities. Whilst a low or lowish economic growth rate in the west (a generalisation, because some economies, such as Sweden, are performing well) might seem to favour fixed interest securities over equities, there are three things going for shares. Firstly, dividend yields are often attractive relative to fixed interest yields, even with the proviso that the distortion in the bond markets, mentioned above, has pushed some countries' bond yields to artificially low levels. Secondly, since the financial crisis broke in 2008, companies have been retrenching and hoarding cash, in many instances, rather than investing, and are in a good position to withstand any economic headwinds which may arise as a result of the eurozone's problems and the debt ceiling standoff in the USA. Thirdly, partly as a result of this second point, dividends are moving ahead, a very important fundamental for equities. In the UK, where inflation is a particular problem, the rise in dividends off an already reasonable dividend yield base (3.6% on the FTSE 100 Index) provides solid fundamental support for share prices and the same point is applicable elsewhere.

With equity dividend yields attractive, compared to those on bonds, in markets where bond yields have not been inflated by solvency or funding fears, an additional positive factor is that monetary policy is likely to remain very loose. Very low interest rates have superficially not only enhanced the attraction of longer maturities but also equities, commodities, perhaps properties in some, but certainly not all, countries and areas of faster economic growth where flows of money into these countries have caused unwelcome problems such as a rising currency and asset price inflation. Whilst these ultra low interest rates prevail as some offset to the very tough fiscal policies being followed in many countries, they enhance the attractions of equities. But equities as a class of asset win in another way in that they appear to be the most attractive asset class by default, with cash certain to lose one money in real terms and bonds unattractive for the reasons mentioned. The current circumstances are so extraordinary that one can make a positive judgement even if it is for negative reasons like the one just stated.

Away from the theorising, current economic data confirm that the second quarter witnessed an economic slowdown and, realistically, the issues in the eurozone and events in the USA are not going to make people or businesses feel more optimistic in the short term. The economic spillover from the Japanese earthquake and tsunami will have affected economic activity in many countries in the second quarter and, in the normal course of events, one would expect some of the growth lost in the second quarter to be transferred to the second half of the year. That should still happen but the dent to confidence influenced by the debt ceiling standoff and the eurozone debt crisis will surely have an effect so that previous growth rate estimates may have to be pared back.

Against this background, we will look at some of the economic indicators from various countries and areas of the world, starting with the USA. The most important short term piece of news from the USA is the hard fought agreement to raise the debt ceiling sufficiently to carry the USA through to 2013. There are no tax increases but spending cuts are locked into the agreement. US$917 billion will be cut from discretionary spending over a ten year time frame. A further US$1,500 billion of spending cuts over the next ten years is to be identified by a new Congressional committee. Should this committee fail to reach an agreement, there will be automatic spending cuts to guarantee US$1,200 billion in deficit reduction of which US$500 billion will come from defence and the rest from across the board with some exceptions. In terms of raising the debt ceiling itself, the first tranche of the authority will be passed immediately and the second tranche will be enacted once the joint Congressional Committee's recommendations are passed with a back stop procedure for raising the debt ceiling if the committee fails. Although everything about the confrontations on the debt ceiling has been unsatisfactory and a fundamental plan to deal with the USA's choice budget deficit is still lacking, at least the short term position seems to have been fixed and investors do not have the twin concerns of the USA and the eurozone, just the latter at the moment.

Reverting to individual items of news in the USA, there have been some disappointing GDP numbers and some unfavourable backward adjustments to data already presented. In the second quarter, the Bureau of Economic Analysis reported that its first estimate of second quarter growth was 1.3% at an annualised rate, but there was a significant downward revision of the first quarter rate to 0.4% compared with the last estimate of 1.9%. Going back further, it revised the 2008 GDP data to show that the economy contracted by 0.3% from the last estimate, which was that it was flat and, in 2009, growth was revised downwards to -3.5% from the last estimate, -2.6%.

A breakdown of second quarter growth shows that just 0.1% was due to consumption, with the aftermath of the Japanese earthquake and tsunami affecting this contributor to growth. Business investment accounted for 0.7% of the growth, whilst government spending took 0.2% from the figure. The data from the minutes of the FOMC, in July, was also interesting, in that they show a high degree of uncertainty about the course of the economy and what further action might be necessary. The minutes, published in July, relate to the meeting which took place in June. Some members of the committee felt that, if softness in the economy continued and if inflation did not misbehave, then additional monetary accommodation could be made. This would imply further quantitative easing, since there is no further room to lower interest rates. The more hawkish members of the FOMC were concerned that the rise in inflation and slower growth suggest that there might be less slack in the jobs and products market than had been thought, which would imply that the economy has less potential to grow and could hit a ceiling, at which point inflationary pressures would emerge. In the same way, the FOMC was uncertain about the course of the economy and what to do about the situation, other than wait and see if a clear pattern develops. The following day, in talking to the House Financial Services Committee, the Chairman of the Fed, besides giving a strong warning about the controversy over raising the debt ceiling and the effects which this would have on the USA, did hint that it was possible there would be further monetary easing. But he also hedged his bets the other way with a comment about inflation having picked up. One of the other warnings about the USA's financial position came from Standard & Poors which said, at around the time of Mr Bernanke's comments to the House Financial Services Committee, that there was a 50% chance the USA would lose its AAA credit rating and that has since happened, as mentioned earlier. The ISM's figures for both the manufacturing and service sector have been displaying signs of weakness and these are figures which economists look at closely. Equally, whilst unemployment figures do fluctuate from month to month and are difficult to forecast, the June figures were disappointing, with employers hiring only 18,000 people against an expectation of about 90,000, and this raised the unemployment rate to 9.2% from 9.1% (the latest month's figures, just released, were better). The FOMC's minutes, which we briefly touched upon just now, did hint at concerns about rising inflation, something which would militate against a further bout of quantitative easing. In the normal course of events, printing money, which is what quantitative easing is, would be expected to trigger inflationary pressures later on and, to print more money at a time when inflation is rising, would not be in most economists' text books. The core rate of consumer prices rose at an annual rate of 1.6% in June and, between May and June, it rose by 0.3% or over the past three months an underlying rate of 2.9%. This is well above the Federal Reserve's target, which is a fraction under 2%, as generally recognised. In terms of company results which have been announced, they have generally been satisfactory. Obviously, companies point to more difficult conditions in many cases but most are in robust condition. Consumer staple stocks, for example, face rising input costs and, sometimes, difficulty in passing on price increases. But the financial position of many US companies is strong. They have built up substantial amounts of cash and shareholders continue to benefit from rising dividends. Should US companies become more confident, they will be an important catalyst to economic growth. As we have just mentioned, in relation to the first estimate of second quarter growth, business investment contributed well to the overall modest rise in economic growth.

Turning now to the eurozone, all the detailed data seem of low relevance compared with the existential crisis which has engulfed the euro. We have discussed this at great length and this overall cloud over the eurozone is far more significant than any detailed item of economic news affecting the eurozone and other members of the EU, which are not part of the euro. It goes without saying that the crisis in the southern member states of the eurozone, and Ireland, is depressing demand and, therefore, the overall growth prospects of the EU will be affected. Even the star performer, Germany, which is very well placed to benefit from rapid growth in Asia and elsewhere, has seen a slowdown in the second quarter. Germany has been performing extremely well, with its many world class companies making high value added goods in a sweet spot, as far as the areas which are growing rapidly in the world economy. Although there has been some positive news from Germany, and the overall position of the economy remains relatively good, these have been outweighed by short term negative indicators suggesting an economic slowdown. On the positive side, industrial orders rose by 1.8% in May following a 2.9% increase in April, and this was a better figure than expected. Also, in July, the number of unemployed people in Germany fell by 11,000 following a fall of 8,000 in June. On the negative side, there was a fall in retail sales of 2.8% in May following an unchanged level in April. The ZEW index, which measures investor confidence, fell to -15.1 in July which is the lowest level since January 2009. In a sense, an index like that is bound to reflect current market conditions and sentiment and is influenced by what has happened recently. In the export area, where Germany has been doing well because of the nature of its manufactured goods, there was a small fall in the Ifo business climate index of export sentiment, in July, which came down to 112.9 in July from 114.5 in June. For the foreseeable future, all the focus is bound to be on the eurozone sovereign debt crisis, and, in the short term, the Spanish and Italian situation, because the contagion which is spreading through the third and fourth largest eurozone economies, is of a different order to Greece, Ireland and Portugal. We have discussed earlier in this review how we think things might unfold, with effective monetisation of the debt high up on the short term options, even though it would go against everything which the ECB stood for and the latest news on 7th August, saying they are going to buy more sovereign bonds, presumably those of Italy and Spain, suggests that this is going to be the case.

The spectacles in the United States and eurozone only go to emphasise how far these areas have declined relatively to the new economic powers of which China is the greatest. With economic power shifting rapidly to the east and to countries like Brazil, investors have to reflect this in their thinking. In the mindset of some, there still appears to be a feeling that the west is all powerful, but the opposite is true as its spending and borrowing sprees have weakened its creditworthiness and increased the power of its creditors, notably China, and many other Asian economies and, as we have said, countries like Brazil. So, in China, the portents are rather different. Inflation is its big worry, especially food price inflation, because of the potential for rising prices to cause social unrest. We have already seen this in North Africa this year, and the authorities are doing everything they can to subdue inflation. This, of course, is not so easy as far as food is concerned because of the different factors which have been causing rising food prices but, elsewhere, China has been using all its levers to try to clamp down on inflation in the housing market and to dampen down fixed investment. So, in July, China again raised interest rates. This was the third time this year and they rose by 25 basis points to 6.56%. Bank reserve requirements have also been raised in an effort to curb lending. Inflation, in June, reached 6.4%, with food prices being 14.4% higher than a year earlier, driven by a 57% annual increase in the price of pork. The Prime Minister, however, appears confident that inflation has been tamed, as he wrote in the Financial Times. For the west, the economic growth figures are ones of which it can only dream. In the second quarter, the Chinese economy grew at an annualised rate of 9.5%. Industrial production rose 15.1%. Retail sales in June were 17.7% higher than a year earlier. Some success is being seen in controlling property prices. In June, housing prices in seventy big cities were up just 0.1% from a month earlier, compared with 0.2% in May. Property prices rose 4.2% year on year, which was lower than the annualised 6.4% rise in consumer prices.

The sheer magnitude of China's foreign exchange reserves demonstrates how important an economic influence it now is. At the end of June, China's total foreign exchange reserves stood at US$3.197 trillion. In the second quarter, they increased by US$153 billion alone. With this financial strength comes economic power which China will increasingly use. But, at a time when western and Japanese economies are subdued, the rapid economic growth of China and other countries does provide an outlet for its goods and provides reason for optimism about the prospects of many companies involved in these areas. In due course, as China is moving rapidly up the value added chain of goods it produces, it will pose a threat to many advanced companies in the west and Japan, but, at the highest value added level, that it not yet the case. However, moves into civil aircraft manufacture, as one example, show the shape of things to come.

In Japan, where many companies report that they are recovering better than expected from the tsunami and earthquake in March, the Japanese parliament has approved a further Y2,000 billion (US$25.5 billion) budget for disaster relief which will pave the way for bigger reconstruction spending. In an unfortunate way, because of the reason for it, this will give some boost to the economy but will involve more borrowing. It is instructive to note that Japan, with a far higher level of overall public debt as a percentage of GDP at the gross level, over 200%, than Italy, has not been affected by worries that have engulfed the latter, a country with a very high debt level also, about 120% of GDP. The reasons for this are, firstly, that almost all of Japanese debt is financed internally so Japan is not dependent on foreign purchases. Secondly, as for other highly indebted countries like the USA and UK, Japan retains its own currency although, for the moment, the worry is the strength of the yen and the Bank of Japan has been intervening to try to stem its rise. Our table at the beginning of this review showed how much effect the rise in the yen had had on the performance in sterling terms, of Japanese equities during the last quarter. Nevertheless, whilst the short term effect might have been to boost the sterling value of Japanese equities, a strong yen, like a strong Swiss Franc, makes life very difficult for Japanese companies which are exporters. For the moment, Japan is only involved indirectly in the fire storm, although importantly because of the currency, and so far investors show no concern about the high level of Japanese borrowing. As in the USA, this issue will have to be addressed, but it is not on investors' radar at present.

Although the EU is the UK's most important trading partner and therefore what happens in the eurozone is of critical importance to the UK, it has been able to stand aside somewhat. On the plus side, and this is very positive, the decline in UK gilt yields, as shown in the table at the beginning of this review, is a big vote of confidence in the UK's deficit elimination plan. Without it, the UK would undoubtedly be seeing much higher government bond yields and a lower pound and a possible crisis of confidence. That is why suggestions that the UK should proceed more slowly with its deficit cutting plan are so dangerous. Even if, in theory, it sounds a good idea, in practice it would be disastrous because the markets would feel that the UK lacked the will to address its very serious debt problems. It is going to take a very strong amount of willpower by the coalition to stick to its plans, which face criticism from almost every quarter as so many people, businesses and other organisations will be affected including, of course, the public sector in a big way, but there really is no alternative and events in Greece, Portugal, Ireland and now Spain and Italy, show that the dangers of being unable to fund a country's deficit are frightening. The most important recent news is that the UK economy grew by 0.2% in the second quarter, taking annual growth to 0.7%, the lowest since the first quarter of 2010. There is a suggestion that, because of one off factors like a greater than usual number of holidays, the figures are abnormally low but, be that as it may, there is no doubt that the UK is growing slowly and that events in the USA and eurozone will make it unlikely that the UK's growth target will be achieved this year. On the face of it, this has given ammunition to opponents of the deficit reduction and elimination programme but, as we have just said, their plan to go more slowly would almost certainly end in economic disaster for the UK. All the government can do, given that there is no money available, is to produce the right environment for the private sector to grow with a range of supply side reforms. Perhaps because of coalition politics, these do not appear to be forthcoming and, indeed, regulations are being increased in a number of areas. This is not conducive to growth, so it is going to be a tough time in the UK with all sorts of interest groups ranged against the government but, realistically, its policy is the only possible one at the moment and events elsewhere underline the necessity to eliminate the structural deficit. In this slow growth environment, however, we are seeing encouraging results from UK companies and useful dividend increases because, as in the eurozone and in the USA, multinational companies with important interests in faster growing areas of the world can offset some of the weakness in the developed markets and this is what we are seeing. So, with low ratings on UK shares and some interesting dividend yields available, the fundamentals look alright for equities but day to day news, as we have seen in August, will not spare them from the buffeting seen in international markets. Nevertheless, for long term investors, there appears obvious value in the UK as in many other markets.

When this review first started to be written, we were merely noting a negative but not significantly negative quarter. Since then, the markets have endured a battering and a roller coaster ride in intraday performances. The issues which have caused this action so far in August have been widely anticipated, i.e. the US debt ceiling negotiations and the sovereign debt problems of the eurozone but, nevertheless, the reality is that investors were shell shocked when the issues came to a head, with negotiations over the debt ceiling going to the wire in the USA and contagion quickly spreading to Italian and Spanish bonds in the eurozone with yields on ten year government bonds going over 6% in those markets. These days, programme trading can be a big influence on market movements both ways and, undoubtedly, there have been forced sellers of securities for different reasons, such as margin calls, insufficient collateral and over leveraging, and these factors have contributed to extreme market volatility. The uncertainty around the economic frameworks of Europe and the USA looks increasingly compromised by the political pressures to which sovereign governments and their leaders feel subjected. So the recent examples in the USA of moderate leaders in both parties having to take into account the more extreme views of their activist members and in the course of this risk a major financial crisis and, in the eurozone, of leaders torn between their European ideals and the scepticism of their electorates have caused these recent world market gyrations. Nevertheless, at times like this, it is important to stand back from the emotions of the markets and to look for value. Economic growth overall is still occurring and it is possible to invest in companies which will benefit from this. Ratings of equities are generally modest, notwithstanding that the events of the past fortnight will have some detrimental effect on short term economic growth. This is where the value appears to lie.