meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Following a recovery in markets in July after the June setback, international equity markets showed satisfactory returns over the quarter although, as our table below shows, there were some areas which significantly underperformed. For bond markets, it was a very difficult quarter with large negative returns being shown. In the currency markets, sterling generally eased, although it moved up significantly against a weak Australian dollar. In commodity markets, gold experienced a very poor quarter.

The tables below detail relevant movements in markets:

International Equities 30.04.13 - 31.07.13

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-1.9	-12.9	-15.2	-15.8
Finland	+0.3	+3.7	+1.1	+0.3
France	+6.3	+10.0	+7.1	+6.3
Germany	+4.8	+8.3	+5.5	+4.8
Hong Kong, China	-3.4	-0.7	-3.3	-4.0
Italy	-0.1	+3.3	+0.6	-0.1
Japan	-2.4	-0.7	-3.3	-4.0
Netherlands	+8.1	+11.8	+8.9	+8.1
Spain	+1.6	+5.1	+2.4	+1.6
Switzerland	-0.7	+1.9	-0.8	-1.5
UK	+3.9	+3.9	+1.2	+0.5
USA	+6.2	+9.0	+6.2	+5.4
Europe ex UK	+2.9	+5.8	+3.1	+2.3
Asia Pacific ex Japan	-1.8	-5.6	-8.1	-8.7
Asia Pacific	-2.0	-3.3	-5.8	-6.4
Latin America	-7.5	-14.4	-16.6	-17.2
All World All Emerging	-3.1	-5.9	-8.4	-9.0
The World	+3.4	+4.8	+2.1	+1.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : -4.1%

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

Currency	30.04.13	31.07.13
Sterling	1.65	2.37
US Dollar	1.64	2.67
Yen	0.60	0.80
Germany (Euro)	1.19	1.69

Sterling's performance during the quarter ending 31.07.13 (%)

Currency	Quarter Ending 31.07.13
US Dollar	-2.3
Canadian Dollar	-0.3
Yen	-1.5
Euro	-3.2
Swiss Franc	-2.6
Australian dollar	+13.0

Other currency movements during the quarter ending 31.07.13 (%)

Currency	Quarter Ending 31.07.13
US Dollar/Canadian Dollar	+2.1
US Dollar/Yen	+0.8
US Dollar/Euro	-0.9
Swiss Franc/Euro	-0.6
Euro/Yen	+1.7

Significant Commodities (US dollar terms) 30.04.13 - 31.07.13 (%)

Currency	Quarter Ending 31.07.13
Oil	+4.4
Gold	-10.1

Markets

A volatile quarter, due to uncertainty about the Federal Reserve's policy on tapering its programme of quantitative easing, ended with modest gains, a creditable achievement given the strength of stock markets during the earlier part of the year. In local currency terms the FTSE World Index showed a total return of 3.4%, in sterling terms, 4.8%, in US dollar terms, 2.1% and, in euro terms, 1.3%. If we look at local currency returns first, we note particular strength in the US equity market where the FTSE USA Index returned 6.2%. The returns from the FTSE UK Index and the FTSE Europe ex UK did not differ greatly from the FTSE World Index, with the FTSE UK Index returning 3.9% and the FTSE Europe ex UK index returning 2.9%. There were below average returns from the FTSE Australia Index, -1.9%, the FTSE Japanese Index, -2.4%, the FTSE Asia Pacific ex Japan Index, -1.8%, but especially from the FTSE All World All Emerging Markets Index, -3.1%, and the FTSE Latin American Index, -7.5%. Against most currencies, the Australian dollar being a notable exception as well as some in Latin America and emerging markets, sterling showed a weaker tendency, so sterling adjusted returns were generally higher. In sterling terms, the FTSE USA Index returned a very strong 9.0%, whilst the FTSE Europe ex UK Index returned 5.8%. After severe weakening earlier on in the year as a result of Japan's new economic policy, the yen actually improved slightly against sterling so that the sterling return on the FTSE Japanese Index was just -0.7%. However, significant currency weakness in Australia and Brazil meant negative sterling adjusted returns on the FTSE Australia Index of 12.9% and on the FTSE Latin American Index of 14.4%. The FTSE Asia Pacific ex Japan Index and the FTSE All World All Emerging Markets Index also experienced negative currency movements so that sterling adjusted returns on the FTSE Asia Pacific ex Japan Index and the FTSE All World All Emerging Markets Index deteriorated to -5.6% and -5.9% respectively.

Bond markets have experienced a torrid quarter. Severe weakness in bond prices was always going to happen because of their serious overvaluation and the sell off over worries that the USA would soon embark on its tapering of quantitative easing was dramatic. All bond classes were affected but, if we take 10 year government bond yields as a benchmark, we see that the gross redemption yield on UK government bonds rose by 72 basis points to 2.37%, on US Treasuries by 103 basis points to 2.67%, on Japanese Government Bonds by 20 basis points to 0.8% and on German Bunds by 50 basis points to 1.69%.

In the currency markets, as we have just said, sterling generally trended weaker. Against the euro, it lost 3.2%, against the Swiss Franc it lost 2.6%, against the US dollar it lost 2.3% and against the yen it lost 1.5%. On the other hand, marked weakness in the Australian currency, meant that sterling rose by 13.0% against the Australian dollar.

In the commodity markets, oil, as measured by Brent crude rose by 4.4%, whilst gold has been a big disappointment for many, falling by 10.1% over the quarter.

Economics

Although the world economic background remains troubled, there are slight glimmers of hope that better times are round the corner and, after a setback in June, markets have recovered their poise, at least partly. So, by the end of July, international equity markets have shown a positive year to date return. However, many fundamental problems remain which is why the major central banks are having to emphasise, with differing degrees of force, that monetary policy will remain extremely loose. In keeping to this policy, the major market distortions, which we have noted before, continue to exist, bringing their own problems which are being subordinated to the need to try to induce some economic growth. Very loose monetary policy is being used to offset some very tough fiscal policies but is leaving in its wake a trail of losers, including, but not only, those who depend on interest for their income needs. The search for income has distorted markets. Together with quantitative easing, involving central banks buying newly created money government bonds and other fixed interest securities, has been the demand for bonds from income seekers, albeit that the returns are very poor. In the search for yield, investors have been prepared to trade down the quality table to levels where the risk/reward ratio was out of line and, in the market setback in June, holders of such bonds faced a very painful fall in prices. We have no hesitation in continuing to say that bond markets, other than in the short maturities where there is hardly any yield, remain very dangerous territory with the returns on offer along the maturity spectrum being grossly inadequate compared to the risks involved. There are many natural buyers of bonds for regulatory or prudential reasons but, for those investors who do not need to buy them, we feel the equity market offers a better alternative.

The second area which has benefited from very loose monetary policy is the equity market. The unstated aim, although that is not the case now, of very loose standard and non standard monetary policy was and remains to raise asset values to give a positive wealth effect, hoping that this will increase consumers' confidence to spend and raising "animal spirits" in business so that companies feel more confident about investing. Although, as we have often said, this is not the best reason for share prices to rise, it was the best the governments and central banks could have done in the circumstances to try to raise confidence and avert a collapse after the financial and economic crisis of 2008. In this, the authorities have been successful and, although the world economy has severe problems, it is still growing. This is important for equities because, in our view, it supports company earnings and the valuations attached to shares. Our view remains that, on valuation grounds, shares in most countries look reasonable value and, if one looks at dividend yields, they remain attractive against high quality bonds. Certainly, investors have been buying them on that basis and we do not think they are wrong. If one looks at the price/earnings ratio for many European markets and the UK on this year's expected earnings, the majority fall within the 12-13 range (Switzerland is a little more expensive). If we look at dividend yields for these same markets, we see that they broadly fall into the 3.25% - 4.25% range. If we then look at the gross redemption yield on the 10 year German government bond (admittedly the most highly rated eurozone credit), currently standing, as this is written, at 1.69%, we can see the relative attraction of eurozone equities. In the UK, with the estimated dividend yield for 2013 on the FTSE 100 Fund at 3.83% at the time of writing and the ten year UK gilt edged stock yielding 2.48%, there is again an attractive dividend yield difference. We are obviously expecting bond yields to rise and would expect the normal post 1950s situation to return whereby high quality bonds yield more than equities. Unless the economic outlook becomes very poor, such that overall dividend payment levels are in danger, we think that equities can withstand this reversal in yields although obviously not if there is a very sharp rise in bond yields beyond what even we would presently contemplate. A return to, say, a real gross redemption yield of 2% over inflation, in other words nearly 5% in the UK, would inflict serious damage on bond prices but we think equities could withstand this if there was some growth in the world economy which would support profits and dividends. As usual, the US equity market is more highly rated with the estimated price/earnings ratio on the S&P 500 Index at around 15.3 and the dividend yield at 2.10%. The latter is a reversal of the European position with the gross redemption yield on the ten year US Treasury bond at 2.59% at the time of writing. This is a more normal relationship between the two yields unlike the European situation but still a ratio which is manageable given that we are expecting US dividends to continue to grow.

In this very unusual economic position in which we find ourselves, we do not have any precedents upon which to draw. By this we mean that the combination of issues including an enormous monetary stimulus achieved by non standard methods, huge public and private debt levels and the possibility of a large monetary union break up leaves investors having to think on their feet. Investors have to put their money into something even if it is cash but the drawback there is that with current levels of short term interest rates, there is going to be a negative real return. So, as an investment as opposed to a short term repository for an opportunist investment (say if the equity markets fall sharply), cash can only be for those who are prepared to lose money in real terms rather than take any risk with any other type of asset. For the reasons we have given, an investment in bonds on any normal investment time horizon is likely to involve unpleasant losses given what we believe to be the extent of the current overvaluation of that asset class. Commodities in moderation are obviously a possibility but they are a volatile class and exposure should always be moderate given the unpredictability of the class, gold being an excellent example, at present. That leaves shares which, without the potential negative just mentioned, stand up well within their own right in our opinion.

At the end of the day, whilst monetary policy is having an important influence on markets, the trend of the world economy is of paramount importance because it will determine the fortunes of companies. As we said above, our view on shares is predicated on the belief that the world economy would provide some growth, thus enabling companies to show earnings and dividend growth.

In its 9th July World Economic Outlook update, the IMF trimmed its growth outlook for 2013 and 2014 by 0.2% for each year to 3.1% (the same as the outcome for 2012) and 3.8% respectively, not a major change. With this forecast, Advanced Economies are forecast to grow by 1.2% this year and 2.1% next year, reductions on its April forecast of 0.1% and 0.2% respectively. With this group of economies, the USA is forecast to grow by 1.7% this year and 2.7% next year, reductions of 0.2% for each year. Unsurprisingly, the forecasts for the eurozone have been reduced to -0.6% for this year and 0.9% for 2014, reductions of 0.2% and 0.1% respectively. Within the eurozone, there is a halving of Germany's growth forecast in 2013 to 0.3% and a slight reduction of 0.1% in 2014 to 1.3%. The second largest eurozone economy, France, is expected to grow by -0.2% this year and 0.5% next year, whilst the forecasts for the number three economy, Italy, are even grimmer, -1.8% and 0.7% respectively. For Spain, the number four eurozone economy, the forecasts are -1.6% and 0.0% respectively. By contrast, Japan, fired up by Abenomics, is forecast to grow by 2.0% this year and 1.2% next year. For the UK, the figures are 0.9% and 1.5%, an uplift of 0.3% this year and, for Canada, the other G7 member (Spain is not one), the forecasts are 1.7% and 2.2% respectively.

Helping to push up the overall growth forecasts are the Emerging Markets and Developing Economies where the latest IMF projections are for growth of 5.0% this year and 5.4% next year, reductions of 0.3% in each case from its April forecast. As one would expect, the catalyst for this area is Developing Asia, projected to grow by 6.9% this year and 7.0% next year. This sub section of the above area also sees a reduction of 0.3% in each year compared with the February forecast. Within this sub section, China is forecast to grow by 7.8% this year and 7.7% next year, a reduction of 0.3% for this year and 0.6% for next year. Even so, the IMF's forecasts are at the top of the range, at least for this year as economists have become more cautious about Chinese growth rates, something we will touch upon later. Looking at other members of the BRIC economies besides China, the IMF is projecting some pick up in the Indian growth rate this year to 5.6% from 3.2% last year and 6.3% next year, relatively modest reductions on its earlier forecasts of 0.1% and 0.1% respectively. For Russia, the prospects are not so good with the IMF forecasting growth this year of 2.5% after 3.4% last year and 3.3% next year. The forecasts for this year and next year for Russia have been reduced very sharply by the IMF from its April forecast by 0.9% and 0.5% respectively. As for Brazil, the economy slowed sharply last year, growing by just 0.9% (2.7% in 2011). For this year, the IMF is currently projecting growth of 2.5% and 3.2% next year, again very sharp reductions on its April forecast of 0.5% and 0.8% respectively. Temporarily, at least, Brazil has been eclipsed by Mexico where growth last year was 3.9% and where the IMF forecasts growth of 2.9% this year and 3.2% next year and these are 0.5% and 0.2% respectively below the figure last year.

The conclusion for investors, assuming that the forecasts prove to be near the eventual outcomes, is that there is enough growth in the world economy to support the overall level of company earnings and to help them to grow slightly. This is at the overall global level but there will, of course, be variations between countries, sectors and companies. The reason that the satisfactory outlook for corporate earnings is important is that those who are negative about the prospects for shares say that profits and profit margins are unsustainably high and will revert to mean. This is not our view, based on the economic outlook, even with all its risks, which we currently see and also we believe that companies will be able to continue to do a good job in keeping costs under control although they will need revenue to grow because there is only so much cost cutting which can be done without affecting companies' long term prospects.

If the IMF's forecasts are reasonably accurate, we can say that the USA, whilst growing at a very modest pace, is at least growing which one cannot say for the eurozone (negative growth of 0.6% for this year and growth of only 0.9% next year forecast by the IMF). The big issue for investors, as the events of June showed, is the timing of the start of the exit from QE. It was surprising that the markets reacted so nervously to Ben Bernanke's answer to a question about the timing of the start of an exit from QE. He did not really say anything new and the timing will depend on economic news on unemployment and inflation. This was underlined by the latest FOMC minutes which emphasised that Ben Bernanke was trying to give more clarity on the conditions which would signal the start of the Fed's tapering of QE. Tapering does not mean ending QE, just a reduction in its rate of application from the current US$85 billion per month. He did not say that tapering was imminent for that will depend on the economic numbers mentioned above. The FOMC minutes showed a range of views on QE, the overall thrust of which was "no change" at present. The economic numbers which have recently emerged from the USA are consistent with modest growth. The payroll numbers have been quite good although July's were below expectations with 162,000 jobs being added and a downgrade of 26,000 for the previous month. The unemployment rate dropped from 7.6% to 7.4%, the lowest level since 2008. The quality of the fall in the unemployment rate was, however, good with a rise in employment and a falling in the numbers unemployed rather than people leaving the labour force. The latest Purchasing Managers Indices in the USA show an increase in the index from 49.0 in May to 50.9 in June and for the much larger non manufacturing sector from 52.2 to 53.7. The housing market, the source of the original problems which led to the financial crisis, is showing continuing signs of improvement. As homeowners move from a negative equity position, so the positive wealth effect should kick in as well as improving the bank's financial positions. The year on year S&P/Case-Shiller index covering twenty US cities shows a year on year price rise of 12.17%, the fastest recent year on year rate of increase. The latest year on year increase is the level of US home sales showed at 15.9%, again the fastest recent year on year rate of increase. The latest year on year rate of increase in pending home sales was 9.08%, well off its recent peak but still an encouraging increase. As this is written, we have the first estimate of second quarter economic growth in the USA which came in at a higher than expected annualised quarterly growth rate of 1.7%.

There is a more general point to be made about investing in the USA which is that, notwithstanding all of its economic problems of which the budget deficit is the biggest, it does have much more of an economic growth bias in its culture. One current topic which brings this to the fore is the benefit of cheaper energy in the USA brought about by the exploitation of shale oil and gas reserves. Cheaper energy is already having significant benefits for the US economy in making US industry more competitive and there is evidence of manufacturing capacity being redirected back to the USA from countries like China where the large increase in officially mandated wages is reducing China's competitive advantage. Of course, size helps so fracking can take place in sparsely populated areas. The point, however, is that this bountiful source of energy is being welcomed and exploited to the benefit of the USA's growth prospects. Take the contrast between the USA and much of mainland Europe as well as the UK just in the area of fracking alone. We are not making a judgement on the rights and wrongs of fracking, just commenting on the economic consequences of not developing the resources available. Incidentally, we could also be talking about other reforms and initiatives which could improve the supply side of the economies in question. Again, we are not making a judgement on the rights and wrongs of, say, expanding nuclear power, expanding Heathrow or significantly loosening planning constraints, just making an observation on the economic consequences of, say, power shortages which are a possibility in the future because of the closure of coal fired power stations and the absence of new capacity. Preventing movement on these and other projects is basically an anti growth policy and stands in contrast to what is happening in the USA. It almost certainly means that the USA's long term potential growth rate is higher than that for the UK and Europe. The consequence of that is that US corporate earnings are likely to grow more strongly and the market to remain more highly rated. We also note an increasing hostility to business in the UK and parts of Europe which gives an unhelpful perception abroad. All of these factors are relevant to an evaluation of stock markets and are a reason for backing stock markets like the USA where there is much more support from politicians for policies which enhance economic growth.

Eurozone politicians and officials continue to try to talk up the prospects for the eurozone and there is some evidence that, in certain countries, the data is less bad. However, the fundamental position remains unsustainable and, in the absence of a further crisis before Germany's September election, nothing much is likely to be done. What follows after that will depend, firstly, on the German election result, secondly on the Constitutional Court's judgement about the cases brought before it and, thirdly, what developments occur in the weakest eurozone countries. Certainly, action is going to be needed to be taken.

Mr Draghi's promise, to paraphrase, to do what it takes to save the euro is about one year old and it has been remarkably effective in bringing down the bond yields of the troubled eurozone countries, all this without a single bond being bought under the OMT (Outright Monetary Transactions) scheme, no country having applied for a bail out since that time. But it does not mean that the problem is over, far from it. Countries with high levels of public debt as a percentage of GDP need to grow in order to stabilise their debt and to be able to service capital and interest payments. Besides Greece, concerns on this front surround Italy, Portugal, Spain and Ireland. There can be no certainty that those countries frozen out of the capital markets will be able to re-enter it and the creditor countries, in denial at present, will have to explain write offs on some of the debtor countries' banks to their electorates. France, which appears to lack the will to tackle its indebtedness and the necessity of cutting back on the size of its public sector, is of increasing concern, particularly as it is the second largest eurozone economy. Although its bonds sell at a yield premium over those of the highest quality eurozone credit, Germany, the absolute level, taking the French 10 year government bond yield, is low, currently 2.45%, even though it is at a 46 basis point premium over the equivalent German bond.

The policy tool of the troika, the IMF, European Commission and European Central Bank, is internal devaluation in troubled eurozone economies to restore their competitiveness. Whilst it is showing some success in narrowing the unit cost gap with the most competitive eurozone economies, it comes at a terrible price in unemployment and hardship and it exacerbates the downward economic spiral of the countries in question and makes debt servicing and repayments even more difficult.

These fundamental problems will not go away, however much the politicians might like them to because they represent flaws in the system. How they are dealt with will largely depend on what happens in next month's German election and the reaction of the new government. At present, it would be electorally dangerous for the Chancellor to extend largesse to the troubled countries of the eurozone because of firm resistance domestically. After the election, depending on the outcome, Germany might or might not feel more accommodative towards the debtor countries and, if it does feel more accommodative, it might come up against the constraints of the Constitutional Court and the Bundestag. It has not been formally admitted in Germany that it will lose money in eurozone sovereign debt write offs but, although many Germans suspect that this will happen, it will cross a line with many Germans. So we are in a hiatus at present which means that, unless a crisis occurs before the German election, the action is likely to take place afterwards. But we should note social unrest and/or resistance to reforms in Greece, Portugal, Spain and Italy which could cause trouble in markets at any time. It should be noted that Standard & Poors downgraded Italy to BBB in July, almost at junk status and this for a member of the G7.

Against this fundamental flaw in the monetary union's construction, there are some tentative signs pointing to more optimism, although these do not carry the weight of the problems already discussed. One example is the Markit Composite Purchasing Managers Index for the eurozone for July, which showed a reading of 50.5 compared with 48.7 in June. Although France's reading was below 50, at 49.1, and therefore still signalling contraction, Germany's reading was 52.1 up from 50.4 in June. In Spain, as a specific example of a country which has been blighted by unemployment, there was, at least temporarily and, perhaps, for seasonal reasons, a fall of 225,000 in the number of people unemployed. This brought the unemployment rate down by 0.9% to a still shocking 26.3%. The estimate of Spain's second quarter GDP was for a decline of 0.1%, the slowest rate of decline in almost two years.

The best way for the eurozone, and anywhere else for that matter, to tackle its debt problems is through economic growth which will boost tax revenues and help to limit some items of government spending. Notwithstanding these slightly better figures, and the above examples are just two items out of many more which point in different directions, the eurozone's economic policy is generally not conducive to economic growth for the recovery. Our investment view of the eurozone remains unchanged. Certain equities remain attractive. Being domiciled in the eurozone should not put investors off from investing in the region if companies have exposure to attractive businesses or faster growing areas of the world economy. Eurozone shares are generally reasonably rated and look far better value than bonds of either the top rated credits or the weaker ones within the eurozone. One of the biggest dangers to the eurozone stock markets (and elsewhere) is growing hostility to business and the financial sector, in particular, as politicians try to embrace populist causes. Bankers, hedge funds and private equity are favourite targets of politicians, often as diversionary tactics from their own failings. For example, the creation of a non optimal currency zone is the root cause of the eurozone's problems but one will not find many politicians or bureaucrats prepared to admit this. One of the most ill conceived ideas to come from eurozone politicians is the proposed Financial Transactions Tax which is likely to prove electorally popular in the short term but, if implemented, enormously damaging in the medium and long term. We will not go into detail at this stage because it looks as if implementation has been put back and increasing concerns are being raised in the eleven eurozone countries which have adopted it which might, at least, result in it being watered down to lessen the damage it will cause. This is a tax, it is admitted, which will reduce economic growth. Further comment is superfluous.

The Japanese economy is in the early stages of Abenomics, a major but very risky attempt to stimulate the moribund Japanese economy through a huge monetary expansion and the attempt to reach 2% inflation in an economy which has been used to deflation. Targeting a higher inflation figure (previously 1%) is aimed at encouraging people to spend more before prices move higher and therefore stimulating consumption. The latest inflation figure measured by the core Consumer Price Index, which excludes fresh food, was 0.4% higher in June than a year previously. The month on month figure was unchanged. There was also some encouragement from the Bank of Japan's latest assessment of the Japanese economy. It said that, for the first time in more than two years, conditions in the Japanese economy were recovering modestly. The latest Purchasing Managers Index from Nomura/JMMA gave a reading of just over 50.0 at 50.7 against 52.3 in June so this suggests that at present the recovery is modest. An important indicator of the state of Japanese manufacturing is machinery orders and here there was good news with May's orders 10.5% higher than in April. Whilst that is good news, we mentioned earlier in this review that the government has embarked on a very risky strategy. Japan's problems are severe. It has by far the highest level of outstanding government debt of the G7 nations and it is running a very large budget deficit. This has enabled it to finance its debt at very low rates of interest but, were that situation ever to change, financing the deficit would be very problematic. It is true that most of the government's outstanding debt is held internally and that it can print its own currency, unlike the troubled eurozone countries but that is the road to currency debasement with all the problems which that brings with it. Another problem is the rigidity in the labour and product market. Employment regulation makes it very difficult to adjust labour costs in difficult times so that the economy has lost out to other Asian economies in some manufacturing areas. For this reason, Japanese companies find it difficult to be as nimble as in some other countries although Japanese companies have, of course, built a lot of capacity overseas. Demographic trends are very much against Japan which is going to make the country's financial problems even worse in the future.

So, the Japanese government is faced with the need to overcome deflationary trends from which Japan has been suffering for a long time and thereby stimulate growth. The huge expansion in the monetary base which is planned is aimed at stimulating the economy but it is highly risky as it would debase the currency thereby causing inflationary problems which is a strange comment to make about Japan given its deflationary history. Against this, the government has to be aware of the shocking state of Japan's public finances. The budget deficit is likely to be of the order of over 8% in the current year which is a dangerously high figure. In an attempt to deal with the mismatch between government revenues and expenditure, it was agreed previously between the main parties that consumption tax, currently at the very low rate of 5%, would rise to 10% in two stages by 2015 with the first rise from 5% to 8% due next year. This is the dilemma for the government. Government finances are unsustainable yet the economy must grow. In the same way as we have in the USA, UK and eurozone, where very loose monetary policy is being used as an offset to tighten fiscal policy, so, in Japan, if the rise in consumption tax goes ahead, we would see a more extreme form in Japan. There is, however, now a discussion about the advisability of proceeding with the consumption tax rise. Government forecasts suggest that the Japanese economy would only grow by 1% in the fiscal year starting next April if the tax increase went ahead against a revised forecast of 2.5% for the current year to next March.

Japanese equities are obviously not without risk, given the extreme economic policy being followed in Japan, but, just as in the west after the financial crisis began, the authorities followed a very aggressive monetary policy to push up asset prices. The same principle applies in Japan. Furthermore, the weakening of the currency, whilst causing a lot of anguish in countries like South Korea, is helpful to Japanese company profits where external business is conducted. On balance, we take a favourable view on the outlook for Japanese equities given better profits prospects but we would expect significant volatility.

China remains a big influence on world stock markets and for good reason. Whilst the major industrialised countries were struggling in the aftermath of the financial and economic crisis, China stood out because of its financial and economic strength. For this reason, investors are fearful of a slowdown in the Chinese economy because, although world economic conditions overall appear to be improving slowly, China, as the second largest economy, remains very important.. There has been some uncertainty but the policies of China's new leaders, especially after the recent sharp spike in short term lending rates aimed at the shadow banking sector, have caused some uncertainty. Their aims, we think, can be summed up as moving the emphasis of the economy more towards consumption and away from fixed asset investment including property, and exports. The authorities are fearful of the effect bad debts could have on Chinese banks. This will involve some slowing down of the economy but not too much since the Chinese authorities must always be aware of the problems low growth might cause in fomenting civil unrest. The recent IMF report on China warned of some of these issues at a time when it issued fairly bullish growth forecasts for China of 7.7% this year and next above the general consensus.

Whilst investors in the UK must certainly not get carried away, some "green shoots" do seem to be appearing. They could, of course, disappear, particularly if we have another crisis in the eurozone which affects UK trade and slows growth. However, looking on the positive side, the first estimate of second quarter GDP growth was 0.6% meeting most of the best expectations and some growth forecasts are being raised. For example, the IMF has raised its growth projection for the UK this year from 0.7% to 0.9%. Whether it is right or wrong, it makes a pleasant change from all the downgrades which have occurred to UK growth forecasts in recent years. On top of this, there has been much interest and speculation surrounding the arrival on 1st July of the new Governor of the Bank of England, Mark Carney. His arrival coincided with the turbulence which had hit stock markets in June following fears that the Federal Reserve might soon start its tapering of QE. In early July, the Bank of England, like the ECB, indicated that interest rates would remain at a very low level for a very long time. The Bank of England said that market movements suggesting an end to super low interest rates in 2015 was "not warranted". That reassurance should be important for markets. Its future strategy will include guiding market expectations.

The trend of the data being released in the UK has been overwhelmingly positive. The Markit UK Services Purchasing Managers Index rose in July to a strong reading of 60.2 from 56.9 the previous month, whilst the equivalent manufacturing index rose to 54.6 from 52.9. The ONS has announced that, in June, manufacturing output rose 1.9% compared to the previous month, whilst the broader production output measure rose by 1.1%. For the quarter as a whole, factory output increased by 0.7%. The BCC reported, in July, that export activity is at its highest level since 2007. News on the employment front remains relatively encouraging, at least against what is happening in the eurozone. Between May and June, claimants for the jobseekers' allowance fell by 21,000 to 1.48 million, with the overall unemployment rate unchanged at 7.8%. Although there is very much a two tier housing market between London and the rest of the country, the RICS survey pointed to higher sales activity and price rises in England and Wales. But, set against this set of positive data, investors should not lose sight of the necessity of getting public borrowing under control. Difficult economic conditions in recent years, the eurozone being a case in point as a very important trading partner, have rendered the government's original targets obsolete. The UK has the important advantage of having retained its own currency and, therefore, monetary policy, and, by staying the course at least in its intention to tackle the deficit, has received credit in international debt markets, notwithstanding the loss of its AAA credit rating. So far, in the first three months of this fiscal year, the UK's underlying borrowing level is at the same level as last year's and starts at 74.9% of total income, up from 71.6% a year earlier, not a good position to be in although not as bad as some of the eurozone countries' overall debt levels.

As far as the UK equity market is concerned, it retains its attraction as being reasonably rated and offering an attractive dividend yield, certainly against cash and top quality bonds. Although emerging markets and parts of Asia are slowing down, the wide international diversification of many large UK companies is an attraction in diversifying the risk of being based in one of the more slowly growing economies.

Our policy remains unchanged, namely that the relative attractions of equities against very overvalued bonds is clear. Whilst the distortions in financial markets caused by quantitative easing, where applied, and very low interest rates are likely to remain, they will at some stage have to be unwound. Whilst central banks can control short term interest rates, it is much more difficult to control longer term interest rates, as we have seen from recent moves in the bond market, and, such as the extent of the overvaluation, that the further away along the yield curve investors are invested, the greater the losses will be. We still live in a dangerous situation economically and, against a background of what we expect to be rising equity prices, we expect some quarterly setbacks. In other words, we expect an uneven move upwards.