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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

For most sterling based equity investors, the quarter has been one of a modest negative return in the face of the Greek crisis and sharp falls in Chinese equities. There has been little change but substantial volatility in some of the bond markets, perhaps an indicator of events to come. The significant strength of sterling was a feature of the currency markets but commodities remained in the doldrums and gold continued to lose one of its historical attractions as a store of value in uncertain times.

The tables below detail relevant movements in markets :

International Equities 30.04.15 - 31.07.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-0.8	-9.1	-7.6	-6.3
Finland	+2.5	-0.5	+1.1	+2.5
France	+2.4	-0.6	+0.9	+2.4
Germany	-0.9	-3.8	-2.3	-0.9
Hong Kong, China	-7.1	-8.5	-7.1	-5.8
Italy	+4.3	+1.3	+2.8	+4.3
Japan	+4.1	-1.0	+0.6	+2.0
Netherlands	+4.0	+0.9	+2.5	+4.0
Spain	-0.5	-3.4	-1.9	-0.5
Switzerland	+4.1	-0.1	+1.5	+2.9
UK	-3.1	-3.1	-1.6	-0.2
USA	+1.3	-0.2	+1.3	+2.8
Europe ex UK	+1.7	-1.7	-0.2	+1.3
Asia Pacific ex Japan	-5.4	-11.6	-10.2	-9.0
Asia Pacific	-0.6	-6.2	-4.7	-3.4
Latin America	-5.2	-15.3	-14.0	-12.8
All World All Emerging	-8.9	-13.3	-11.9	-10.7
The World	+0.4	-2.4	-0.9	+0.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +0.2%

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

Currency	30.04.15	31.07.15
Sterling	1.95	2.01
US Dollar	2.09	2.20
Yen	0.33	0.41
Germany (Euro)	0.37	0.65

Sterling's performance during the quarter ending 31.07.15 (%)

Currency	Quarter Ending 31.07.15
US Dollar	+1.9
Canadian Dollar	+9.9
Yen	+5.6
Euro	+3.9
Swiss Franc	+4.9
Australian dollar	+10.0

Other currency movements during the quarter ending 31.07.15 (%)

Currency	Quarter Ending
US Dollar/Canadian Dollar	+7.8
US Dollar/Yen	+3.6
US Dollar/Euro	+1.9
Swiss Franc/Euro	-1.0
Euro/Yen	+1.7

Significant Commodities (US dollar terms) 30.04.15 - 31.07.15 (%)

Currency	Quarter Ending 31.07.15
Oil	-20.9
Gold	-6.9

MARKETS

International equity markets have experienced a modest setback this quarter, at least as measured in sterling and US dollar terms. In total return terms, there has actually been a very small positive return on the FTSE World indices in local currency and euro terms, +0.4% and +0.5% respectively, but, in sterling and US dollar terms, the returns were negative, -2.4% and -0.9% respectively. Looking at local currency returns firstly, of the major markets, Japan performed best with the FTSE Japan index showing a total return of +4.1%. The FTSE Europe ex UK index showed a slightly above average performance, returning +1.7% and, within that, there were good performances from the FTSE Italy index, +4.3%, the FTSE Switzerland index, +4.1%, and the FTSE Netherlands index, +4.0%. There was also a slightly above average performance from the USA with the FTSE USA index returning +1.3%, but the FTSE UK index underperformed, returning -3.1%. However, there were poor performances from the FTSE Asia Pacific ex Japan index, -5.4%, the FTSE Latin America index, -5.2%, and the FTSE All World All Emerging Markets index, -8.9%. With sterling being the strongest of the major currencies, the picture changed as some positive performances in local currency terms became negative. Relative to the FTSE World Index, which returned -2.4% in sterling terms, Japan, the USA and Europe ex UK all outperformed with returns of -1.0%, -0.2% and -1.7% respectively. Currency weakness in the Australian dollar turned a local currency return from the FTSE Australia index of -0.9% into one of -9.1% in sterling terms. There was still some underperformance in the FTSE UK index relative to the sterling adjusted FTSE World Index. The weakness in the FTSE Asia Pacific ex Japan index, FTSE Latin America index and FTSE All World All Emerging Markets index was exacerbated by currency movements and the respective sterling returns were -11.6%, -15.3% and -13.3%.

Looking at the government bond markets and taking ten year government bonds as the benchmark, we note a move upwards in gross redemption yields. In the case of the UK it was by 6 basis points to 2.01%, in the USA by 11 basis points to 2.20%, in the case of Japan by 8 basis points to 0.41% and the biggest jump of all in German government bonds by 28 basis points to 0.65%.

The feature of the currency markets was the strength of sterling. Against the Australian dollar, it rose by 10.0%, against the Canadian dollar by 9.9%, against the yen by 5.6%, against the Swiss Franc by 4.9%, against the euro by 3.9% and against the US dollar by 1.9%.

In weak commodity markets, oil retraced a previous partial recovery and, as measured by Brent Crude, fell by 20.9%. Gold remains out of favour with a fall of 6.9% over the quarter.

ECONOMICS

In line with our expectations of an uneven upward movement in international equity markets, this quarter has represented one of the bumps along the road in that path to which we have referred in recent reviews. Markets have tended to shrug off the long stream of unsettling political and economic news but, from time to time, have been unsettled before recovering. It is a question of whether investors are seeing the glass as half full or half empty. If they are seeing the glass as half empty, they will still be unsettled by Greece and the eurozone, the turmoil in the Middle East, the volatility of the Chinese stock market, the significant weakness in many commodity prices and the prospect of a modest rise in US and UK interest rates. If they view the glass as half full, they will take comfort that the world economy is still likely to grow at a modest rate, weak commodity prices represent "good" deflation or disinflation which should encourage consumer and business spending and that, even if interest rates start to rise modestly in the USA and UK, it will be just that and should not represent a threat to equity prices. Meanwhile, an important support to the equity markets, large share buy backs by companies, is likely to continue. At the moment, the glass half empty camp is prevailing but that could easily change as it has done in the past.

It is economic growth which will provide the platform for rising profits and dividends and, in this respect, the OECD and IMF have recently produced their economic updates. In June, in its latest Economic Outlook, the OECD forecast that the world economy will grow by 3.1% in 2015 against 3.3% in 2014 and by 3.8% in 2016. Within those figures, the OECD forecasts that its members will grow by 1.9% this year, slightly higher than last year's level of 1.8%, and by 2.5% in 2016. Amongst the G7 members, it forecasts growth of 2.0% in the USA this year, down from last year's 2.4%, and 2.8% in 2016. Eurozone growth is forecast at 1.4% this year against 0.9% last year with a modest acceleration to 2.1% in 2016. Breaking down the eurozone's numbers, Germany is forecast to grow by 1.6% this year (1.6% last year) and 2.3% in 2016. France, the second largest eurozone member, is forecast to grow by 1.1% this year (0.2%) and 1.7% next year. Italy, the third largest member, is forecast to grow by 0.6% this year (-0.4%) and 1.5% in 2016. Spain, the fourth largest eurozone economy, is forecast to grow by a very respectable 2.9% this year (1.4%) and by 2.8% in 2016. Moving on to Japan, the OECD forecasts growth of 0.7% this year (-0.1%) and 1.4% in 2016. The UK is forecast to grow by 2.4% this year (2.8%) and by 2.3% next year. Moving on to the BRIC countries, Brazil's struggles continue. After hardly any growth in 2014, just 0.2%, the OECD foresees a contraction of 0.8% this year, returning to modest growth of 1.1% next year. Russia, because of the fall in energy prices and sanctions, is forecast to show an economic contraction of 3.1% this year against growth of 0.6% last year and its forecast for 2016 is for growth of 0.8%. However, that must be a very tentative forecast given the economic and political imponderables surrounding Russia. China, which we will discuss later, is forecast to grow by 6.8% this year (7.4%) and 6.7% in 2016, whilst India is expected to grow faster than China at 6.9% for this year (7.2%) and 7.6% next year.

In July, the IMF published its latest World Economic Outlook update. It reduced its forecast for world economic growth for 2015, made in April, from 3.5% to 3.3% and kept it unchanged for 2016 at 3.8%. It reduced its forecast for Advanced Economies for 2015 from 2.4% to 2.5% and kept its 2016 forecast unchanged at 2.4%. Within the Advanced Economies sector, the 2015 forecast for the USA was reduced sharply by 0.6% to 2.5% and marginally reduced by 0.1% in 2016 to 3.0%. There was no downgrade for the eurozone this year. The IMF's forecast remained at 1.5% but it was marginally raised by 0.1% for 2016 to 1.7%. Within that eurozone forecast, the IMF made no change to its April forecast for Germany and France, with growth forecast for this year at 1.6% and 1.2% respectively. For two of the countries which have struggled in the eurozone, Italy and Spain, the third and fourth largest economies, the IMF has raised its forecast for economic growth this year. It now sees growth in Italy at 0.7%, 0.2% higher than its April forecast, and for Spain at 3.1%, a substantial 0.6% increase on its April forecast. It has also raised its 2016 growth forecasts for both countries, in the case of Italy by 0.1% to 1.2% and for Spain by 0.5% to 2.5%. The projections for Japan, the Japanese government and central bank will find disappointingly low. The IMF has reduced 2015's estimate by 0.2% to 0.8% and left 2016's figure at 1.2%. Although the forecasts for the UK compare relatively well with elsewhere, both 2015 and 2016 have seen downgraded forecasts. For 2015, the forecast has been cut by 0.3% to 2.4% and for 2016 by 0.1% to 2.2%. Resource rich Canada has suffered a significant downgrade by 0.7% this year to 1.5%, although the forecast for 2016 has been shifted slightly upwards to 2.1%. Moving on to Emerging Markets and Developing Economies, there has been only a very slight reduction in this year's growth forecast by 0.1%, whilst next year's forecast is left unchanged at 4.7%. Within this category of countries, the BRIC economies offer a sharp contrast in fortunes. Brazil continues to experience very difficult economic conditions. The IMF has sharply reduced its forecasts compared with last April. For 2015, it has reduced its forecast by 0.5% to -1.5% and by 0.3% next year to 0.7%. For Russia, there is actually an upgrade for both years, although the result remains dire and, for political and economic reasons, it remains a very difficult economy to forecast. 2015's forecast has been increased by 0.4% to -3.4% and 2016's by 1.3% to 0.2%. India, on the other hand, whilst the IMF has not raised its forecasts, still sees robust growth of 7.5% for this year and next. The IMF's forecasts for China also remain unchanged at 6.8% for this year and 6.3% for next year. Again, this is a difficult economy to forecast given the economic transformation to a more consumption based economy which the government is trying to engineer.

Overall, however, the two organisations do not see a significant difference in the outcome this year to what was experienced in the previous three years. The OECD is slightly more pessimistic for this year than the IMF and the forecasts for 2016 are the same. If they are correct, the outlook for companies is good enough to provide support for share prices but pointing to no more than moderate, but still satisfactory, returns in a low inflation environment. For the latter is what both organisations see. The OECD sees inflation at 0.7% this year and 1.7% next year, whilst the IMF sees consumer prices in Advanced Economies at zero this year and 1.2% next year and in Emerging Market and Developing Economies at 5.5% and 4.8%. The inflation forecasts point to no more than modest official interest rate increases where they occur at all.

Whilst the almost certainty of a prolonged period of ultra low short term official interest rates may give support to asset prices, particularly equities, it does point to the distortions in monetary policy and the future inability of economic policy makers to use monetary policy as an effective tool of economic management. If interest rates were at a more normal level, then a significant cut in interest rates could be effective. As it is, monetary policy offers very little more in terms of being able to stimulate economic growth. If the world economy is only able to show modest growth with interest rates flat on their back, it does not augur well for the resumption of consistently respectable growth rates nor for the distortions in the financial and economic system caused by current very low or negative interest rates. The simple view of the current interest rate situation is that it is good for borrowers and bad for savers and at the basic level that is most obviously the case. However, digging more deeply, we can see how potentially dangerous the position is. At a national level, very low servicing costs of the national debt can lead to a false sense of complacency for heavily indebted countries, Japan and Italy being just two such examples. Most of the highly indebted countries are adding to their debt levels. When interest rates move towards more normal levels, servicing costs will gradually build up. There will be a lagged effect as much of the debt will have interest rates already fixed but, as new borrowings are added and existing maturities refinanced, the costs will build up, thereby adding to budgetary pressures and, probably, credit risk. For individuals, the attraction of low interest rates can lead to imprudent borrowing, one area being the housing market where rising house prices driven by low interest rates can lead to boom and bust, causing difficulties for individuals and the institutions which have lent to them. For individuals on the other side of the fence, the savers, the search for income, previously available from fixed interest securities or cash, can lead to higher risk options being taken, perhaps resulting in losses. In the business world, there can be malign consequences as zombie companies are kept alive by low interest rates to the detriment of more dynamic companies and, by extension, economic growth. The famous Austrian American economist, Joseph Schumpeter, talked about "creative destruction" and, prima facie, it appears to be quite a brutal expression. That businesses can be destroyed does not sound good but, if one takes the thinking a step further, it can be seen that keeping zombie companies alive is negative for an economy. The potential markets for fast growing companies with products which will sell are reduced by the sales of zombie companies kept alive by low interest rates. The fast growing companies are, therefore, crowded out of the market to some extent and growth and employment prospects limited until they have a clear run. So, what, on the surface, sounds a good thing, companies being able to remain in existence only because of low interest rates, in fact can deny growth and job opportunities to many more people. If the price of credit is correct and not artificially reduced as it is with current monetary policies in many countries, then the market will work in favour of those whose financial position enables them to borrow at normal rates. Overall, this should benefit an economy as the positive effect for the viable and faster growing companies outweighs the loss of the zombie companies.

The longer the current situation of ultra low or negative interest rates lasts, the greater the danger of the mispricing of credit risk leading to dangerous economic consequences. A prime example is the eurozone government bond market where the compression of yields between the best credit, Germany, and the highly indebted countries is dangerously low. The nature of the monetary union is such that the highly indebted governments are adding to their debt levels because their low or negative levels of economic growth, partly brought on by the budget deficit rules of the eurozone, preclude bringing down the overall levels of outstanding public debt in relation to GDP.

A critic of this point of view might say that there is no prospect of the ECB raising interest rates and stopping quantitative easing before next year. So what is there to worry about? The answer is that there is plenty to worry about. It is an equivalent argument to the zombie company one above in relation to the private sector and it is particularly pertinent to those countries in a monetary union like the eurozone. The ability to borrow at a rate of interest which disregards a country's credit rating takes the pressure off a country to put in place conditions for faster economic growth. In the eurozone, the Stability and Growth Pact is meant to deal with this issue but it has been overtaken by events, however hard the rules are attempted to be enforced. But, at some stage, interest rates are going to rise and it may be for a number of reasons. Inflation is one of them. It is easy to be lulled into a false sense of security by current low, nil or negative inflation rates but it would be wrong. Commodity prices will not remain low for ever. Market forces will, at some stage, pull them higher. In the difficult economic environment which has existed since the financial crisis of 2008, business investment has remained subdued. If productive capacity is not maintained and, ultimately, increased, countries will come up against capacity constraints and, when that happens, inflationary pressures will start to grow. In its economic outlook, the OECD gives its estimate of output gaps in different countries. Amongst its members, it foresees an output gap, the difference between actual and potential GDP of 1.9% this year and 1.2% next year. At its peak, in 2009, when the economic storm hit, the output gap was 3.6% but it has been drifting down. As might be expected, the output gap for the eurozone is higher than average, according to OECD estimates, at 2.7% this year and 1.7% next year, down from a recent peak of 3.3% in 2013. So, even here, if the OECD estimate is correct, the gap is closing. At some stage, if productive capacity is not increased and, assuming only a modest increase in economic growth in the eurozone, the gap will be closed leading to potential inflationary pressures. In normal circumstances, a central bank would be raising interest rates to head off the problem and the bond market would be reflecting higher inflation expectations in the form of rising yields. The position in the eurozone is currently complicated by the ECB's quantitative easing programme which is running at €60 billion a month from last March and which is intended to continue until at least September 2016, meaning that at least €1 trillion will be involved. However, the presence of a vast bond buyer in the form of the ECB does not guarantee that bond yields will not rise, witness the enormous volatility in eurozone government bond prices this year. However, if interest rates are artificially suppressed, inflation risks rise. Although this is not such an immediate issue in the eurozone as, say, the UK, it will arise. Also helping to raise inflation is the weakness of the euro caused by quantitative easing amongst other factors. As an area, the eurozone is running a current account surplus which, in certain circumstances, could be an argument for a stronger currency, but the creation of a vast amount of euros is helping to weaken the currency. This might stimulate the eurozone as its goods and services become more competitive but, if it leads to a rise in inflation, bond prices will be vulnerable given the current very low level of yields. As interest rates rise at the medium and longer dated end of the market, so credit quality concerns will rise as investors focus in the sovereign and corporate bond market on the ability of countries and companies to service and repay their debt. If inflation does rise, then even the ECB, with all the problems affecting the eurozone, could not be impervious to the risks being run by keeping interest rates too low. When we look at the yields on, say, ten year government bonds, as shown in the table at the beginning of this review, we do not think that they reflect the risks associated with medium term inflation risks and credit risks of some over-indebted countries and companies. One would have to be very negative about the prospects for the corporate sector to think that the returns currently available on bonds would compare favourably with those of shares over the medium and long term. There are, of course, large numbers of buyers of bonds who have no choice, whether for regulatory or liability matching reasons, for example, but it is hard to see that returns are going to be satisfactory in an investment context. In a practical market sense, the regulatory issue is important as the balance sheet costs for banks become expensive in terms of holding the level of bond inventories which they would have held in the past. This means that, if investor sentiment towards bonds turns sharply, the rush for the exit could cause very sharp movements in bond prices. This is a concern which is being widely expressed. The combination of official policies to try to make banks safer, together with the extraordinarily loose monetary policy which has left bond yields historically very low and the consequent risks which a change of sentiment may bring, has led to the risks of instability in the bond market. This is a risk which investors should factor into their thinking.

In this context, one asks what may be a trigger for a change in sentiment? We have discussed some of these above. One could be that inflation expectations change. With cost pressures quite weak at the moment because of low or no growth in a number of countries, particularly in the eurozone, and the weakness in commodity prices, especially high profile ones like oil, inflation is not looming large in many people's minds. If the outlook for inflation changes at any stage, this could be one trigger for investors. Sometimes sentiment changes for no particular reason. It could be that, although many people realise that bonds are very expensive and carry risks, they are hoping to leave the party before others do. If, collectively, investors realise this, then the market could turn quite sharply. Many people, including regulators, tend to regard bonds as low risk but, in our view, except at the very short end of the market, they are anything but low risk. In a bond context, except for lower grade bonds, the risk is not likely to be qualitative, although rising bond yields will cause casualties in the lower grade area, but, rather, the volatility risk as prices adjust, which will cause the problems. In last month's review, we gave an indication of just how much money could be lost in the bond market in a short time. This was at the long end of the market, the most risky. We noted that in the thirty year maturity area, the fall from the highest to the lowest price at that stage was 14.7% for the UK, 25.4% for Germany, 24.5% for Italy and 18.2% for the USA. The volatility lessens as the maturities shorten but, even at the ten year maturity area, the movements would have been unsettling for many investors.

In the case of the UK, the movement was 7.7%, for Germany 8.2%, for Italy 10.8% and, for the USA, 4.8%. In a different context, and not exactly analogous but still making the point, one saw in China a huge rush into equities recently, causing enormous rises in prices and then a rush out of them. The point is that the herd mentality can come into play and we consider this a significant risk for bond markets which many, including ourselves, believe is seriously overvalued.

If we look for an event which might trigger this significant fall in bond prices, it could be the start of the process of raising interest rates in the USA and, to a lesser extent, the UK. Although the UK is a smaller market, it is still very important and we think that the case for the Bank of England to start the process of raising interest rates gradually is increasing, as we will discuss later. The same is true in the USA. The output gaps in both countries, according to the OECD, are set to continue narrowing and the Federal Reserve and Bank of England will not want to be behind the curve. By that we mean that they will not want to be reacting to events like a rise in inflation but, rather, to be proactive, moving interest rates upwards before inflation becomes a problem and, by doing so, controlling its level. Given the subdued state of the international economy and fragile sentiment, the danger is that the central banks will feel more reluctant to act in case they damage confidence and, hence, economic growth but at the risk of losing control of inflation. We can see that some members of the FOMC and the Bank of England's Monetary Policy Committee are moving towards advocating higher interest rates and we think it will take some unexpectedly bad news to prevent the process from starting. Given that this would not be a surprise, one would hope that markets would have discounted this but, as we saw with the "taper tantrums" of 2013, markets can still take this type of news badly. Furthermore, there are two stages in normalising monetary policy. One is restoring interest rates to more typical levels, which we have just discussed, and the second is reversing quantitative easing where it has been applied. In its simplest form, this would mean central banks selling back to the private sector the assets which they had bought from it as part of their emergency measures to address the economic crisis. With central banks' balance sheets greatly expanded, the risk is that, once the money created gets moving round the relevant economies, inflationary pressure will rise, hence the need to offset the earlier money creation. This is further down the line and, in the eurozone, unlike the USA and the UK, the ECB will not even be looking at stage one. So, we can say that, whilst the aggressive monetary policies followed by many central banks to address the financial and economic crisis have stabilised the world economy for the time being, the harder part, in terms of policy, remains how the policy is unwound without causing instability in markets, the bond market being the main one we have in mind.

However, we cannot decouple equities, our favoured asset class, from the fortunes of bonds. As we saw with the "taper tantrum" in 2013, the equity market can be affected, if only temporarily, by concerns about the course of monetary policy. If one were optimistic, one could say that a tentative start to the process of normalising interest rates should be welcomed as evidence that the economy was moving off the life support of very low interest rates and electronically created money towards more normal conditions where money was properly priced and distortions to the system, which we mentioned earlier, have started to be unwound. At the moment, we can support our view of equities as our favoured asset class by the expectation of continued modest economic growth as evidenced by the IMF and OECD economic forecasts and relatively attractive valuations against bonds where dividend yields in many markets exceed those of ten year government bonds and dividends are still expected to grow.

Besides the obvious appeal of assets like equities, which have a relatively attractive dividend yield at a time of low inflation and a low return on competing assets such as bonds and cash, low interest rates and caution about investing by companies have triggered huge share buy back programmes especially in the USA and this has been an important support for equity prices. The theory is that, if share buy backs are undertaken on the right terms, companies' earnings per share will be enhanced with the benefits which this is perceived to have in terms of earnings growth and share price rating. With money on the balance sheet earning very little and the cost of borrowing very small, the mathematics of share repurchases, depending on the relevant company's valuation, are favourable. Many companies undertake share repurchases to offset the dilution caused by employees exercising share option awards. To give an idea of the scale of the buy backs, Bloomberg estimates that, last year, companies in the S & P 500 bought back US$550 billion of their own stock, boosting earnings per share growth by 2.3%. This year, the figure is likely to be much larger again and it seems that companies which have bought back their stock have been rewarded with a better share price performance as evidenced by the performance of the S & P 500 Buyback index. With the US economy now largely past the problems caused by the financial crisis in 2008 and the banking system seemingly in good order, there is some pressure from certain investors for companies to ease back on the share buy backs and invest instead. As the output gap in the economy narrows, one would expect US businesses to accelerate their capital investment programmes in order to manage increased demand.

We now look at various areas of the world economy, starting with the USA where the first estimate of second quarter GDP has been published. Quarter on quarter annualised growth is estimated to have been 2.3% and that for the first quarter has been revised to a positive figure, 0.6%. Year on year GDP growth is estimated at 2.3% compared with 2.9% at the end of the first quarter. As we touched upon earlier, the USA, along with the UK, will almost certainly be the first two of the larger economies to raise interest rates and the voices are getting louder in the USA and the UK for this course of action. It seems that the Federal Reserve will try to signal, as clearly as it can, the pace of rises and that they will be in graduated steps to reduce the risks to the market. It will be a delicate task as it will be in the UK when the process starts there. The latest Purchasing Managers Indices from the USA for June were consistent with a moderate pace of expansion and will do nothing to dissuade expectations of an interest rate rise quite soon. The index for manufacturing stood at 52.7 (53.5) and that for non manufacturing at 60.3 (56.0), a very strong figure. The unemployment level rose by 0.1% to 5.6%, the latest figures being less strong than expected. Industrial production in June turned positive after a number of negative months although the rise over the previous month was small at just over 0.2%. The Conference Board's index of leading indicators continued its series of steady rises, rising by 0.6% in June. One disappointing area was retail sales which fell by 0.3% in June compared with the previous month. Consumer price inflation remains negligible with the latest year on year rate standing at 0.1%. A difficulty which many companies have noted is the headwinds they have faced from the stronger US dollar, so making earnings gains is difficult. As noted earlier, US companies continue to announce large stock buy backs which should help to support share prices in this more difficult earnings environment. The US stock market has shown little movement so far this year but we see it as one with relatively little risk politically or economically. We would not be surprised to see the US dollar strengthen on the expectation and occurrence of an interest rate rise.

As we have noted earlier in this review, both the OECD and IMF expect the eurozone economy to grow faster this year than last, and faster still next year, although we are not talking about fast growth. For 2016 the IMF projects 1.7% and the OECD 2.1% but still a much better rate than in recent years. The Greek crisis remains the main story in the eurozone and is likely to be for some time. There is a lack of reality on display. What has happened in the past cannot be undone and those in what was previously called the troika (ECB, EC and IMF) have to accept that Greece cannot repay its debts and admit as such. The fact that this is deeply embarrassing to the eurozone countries is not relevant except in terms of presentation. The position is further complicated by reports that the IMF will not become involved in the next bail out. As it is not supposed to advance funds if it does not believe it can be repaid, this makes life very difficult for the other two parties, the ECB and EC. The euro project is bedevilled by being so political to the extent that practical measures to deal with the situation like giving Greece help to leave the eurozone cannot be taken because of the amount of political capital being expended to keep the eurozone intact. The saga is likely to continue for a long time, affecting the stock market from time to time but with the stock market continuing to shrug its shoulders for most of the time. In terms of investment, we continue to believe that it is important to distinguish between the sovereign and the companies in which one invests in the eurozone. There are many world class companies based in the eurozone with major international interests and with a lot of experience of handling currency management. The weakness of the euro will help many companies' competitive position.

The latest eurozone purchasing managers indices are consistent with modest growth. The composite index stands at 53.7 and, within that, the manufacturing component stands at 52.2 and the services component at 53.8. Inflation remains subdued with the year on year headline rate standing at 0.2%. Unemployment remains at 11.1%.

Whilst the eurozone may see growth accelerating slightly, politics may become more of an investment factor. A revolt by the electorate of Greece in the form of the election of an anti-austerity government could spread even if such radical governments are not elected elsewhere. Elections are due in Spain and Portugal. In Spain, the parties are fragmented and the Catalan situation adds further uncertainty but the radical new party, Podemos, takes some inspiration from Syriza in Greece. In Portugal, the main opposition party rejects austerity.

There is little new to say on Japan. The jury is still out on Abenomics and the third arrow after the monetary and fiscal ones, structural reform, will be very important since money and fiscal policy alone will not set Japan off on the right path. It is necessary to increase the long term productive potential of the Japanese economy through structural reforms affecting the labour and product markets so that the long term potential growth rate of the economy can be increased. That will be a real test for the Prime Minister who will have to face up to vested interests within his own party, the farming sector being an example where high tariffs on imported rice become a test case of supply side reforms. Corporate governance has been a weak spot in Japan and the news of the accounting scandal at Toshiba highlights how this has to improve. We have mentioned in recent reviews that the government's attempt to develop more of an equity culture could be positive for equity markets and the authorities' instructions to government or government related funds to raise their equity holdings at the expense of bonds is encouraging if it can help to develop more of an equity culture in general. Besides the effect of boosting the demand for shares, it should raise the pressure on companies to be more open and transparent. In its latest annual assessment of Japan, the IMF emphasises the importance of structural reforms and the stalling of the reforms to be a significant threat to the Japanese economy.

Recent news from Japan has been less encouraging. In July, the Bank of Japan cut its forecast for growth in the year to April 2016 from 2.0% to 1.7% and cut its inflation forecast from 0.8% to 0.7%. It still forecasts growth of 1.5% for next year. It most circumstances, a downgrade in an inflation forecast would not be seen as a bad thing but it is different in Japan with the Bank of Japan trying to stimulate inflation to 2%. This is to reverse the deflationary mindset of the public which has encouraged consumers to hold off spending in the hope of purchasing items at lower prices, thereby weakening economic growth prospects. By targeting what for Japan is a high rate of inflation, it is hoped to reverse the deflationary mindset and encourage spending. The Bank of Japan's core inflation forecast for 2016 is 1.9% against 2.0% in its April forecast with growth forecast at 1.5% for next year. Japan's purchasing managers' indices show a country in positive but slow growth. The latest composite index stood at 51.5 and, within that, the services index stood at 51.8 and manufacturing at 50.1.

There is a concern that Mr Abe is becoming side tracked in the quest for the vital structural reform by constitutional and security issues. With so many problems facing Japan, whether it be the debt dynamics or a very difficult demographic problem to name two, investors will want to see progress on the third arrow of "Abenomics" reform. This remains a high reward (if Mr Abe's reform programme is successful) / high risk market (if he does not).

If one looks at the two issues dominating the investment headlines, Greece and China, one would say that the latter is beginning to come to the fore and it would have been there already were it not for the Greek drama. The gyrations in the Chinese stock market have been enormous and, as this is written, hold centre stage. As the second largest economy, investors naturally watch the position very closely to monitor any economic fallout. Leveraged investment is dangerous and Chinese retail investors have been borrowing money to invest so that the sharp fall in the Chinese equity market develops momentum as positons are closed out to minimise the losses. So, the question is whether the sell off in the Chinese stock market is likely to damage the Chinese economy. Although the Chinese stock market is very large, there are other economies where it is relatively more important in relation to the size of the economy and this means that the impact on the Chinese economy arising from the stock market's fall is likely to be limited and, of course, the market is still higher than this time a year ago. Reported economic growth was 7.0% year on year for the second quarter, the same as that for the first quarter, whilst the quarter on quarter rate was 1.7%. These figures puzzle some commentators because they seem at odds with, for example, the significant weakness in commodity prices, some of which is put down to lower Chinese demand. As China tries to rebalance its economy away from fixed asset investment to consumption, the Chinese answer as to why commodity prices are weak seems plausible and, in this context, the second quarter's published growth rate seems surprisingly high. However, the latest industrial production figures do provide some support to the GDP figures with the year on year figure for June up by 6.8% and the month on month figure up by 0.64%, in both cases higher than the figure for May.

What has concerned many outsiders is the Chinese authorities' response to the stock market turmoil. One of the attractions to foreign investors of the new regime was its announced intention to elevate the role of the market in its economic policies. What has unnerved outsiders has been the interventionist approach to the stock market volatility with bans on sales for shares for certain categories of shareholder and IPOs and market intervention to stabilise prices which has not so far worked. This is clearly not helpful to sentiment. What we have seen as a strength for China, namely its ability to effect economic decisions very quickly, does lose its attraction if the measures do not work. Despite all of this, the Chinese stock market is still higher than a year ago. So much depends upon China that there is anxiety about the way matters are developing.

Finally, we turn to the UK. Three months ago, the main concern was the General Election of 7th May. All the evidence from a large number of opinion polls was that it was going to be an indecisive result and, from an economic perspective, depending upon how the seats were divided up, an unsatisfactory one. With a still serious debt position and the two large twin deficits, budget and current account, the compromises and temptation to populist measures which could have resulted from a coalition might not have played well overseas. With a current account deficit running at around 6% of GDP, it was, and remains, essential that foreign confidence is maintained in the UK as that deficit has to be covered. With a ramp up in anti business rhetoric a strong theme in the time running up to the General Election, we regarded the UK market as high risk, on the basis of the indecisive outcome which the opinion polls predicted. As it was, of course, for whatever reason, the opinion polls did not represent the actual outcome and the UK has a majority government. Strangely enough, the UK equity market has underperformed the world stock market over the past three months (mining and oil stocks have not helped), although the pound, another possible casualty of an indecisive election result, has been very strong. The latter could be explaining the former, post election, as the strong pound is unhelpful to many businesses. Unshackled from coalition government, the Chancellor of the Exchequer produced an emergency budget in July which was generally thought to be clever politically in that it encroached on territory traditionally occupied by the Opposition, but was not greeted with universal acclaim for its economics. On the macro front, the timetable for the elimination of the budget deficit has slipped by a year to 2019/20. That is unlikely to upset sentiment towards the UK but, freed from the constraints of coalition, there is probably a reasonable chance that this target can be met. The Office for Budget Responsibility's glide path for deficit reduction is that the budget deficit will fall to 3.7% of GDP in 2015/6, 2.2% in 2016/7, 1.2% in 2017/8 and 0.3% in 2018/9, whilst looking for a surplus of 0.4% in 2019/20 and 0.5% in 2020/1. To have a chance of meeting these targets, it is important that the UK economy delivers growth. The OBR's growth forecasts for UK economic growth are 2.4% for this year, 2.3% in 2016, and 2.4% between 2017 and 2020. Very tough public expenditure decisions are going to have to be made and, politically, it is sensible to set out the path early in the term of a new government. But the Chancellor has taken risks with measures that may appear popular but could damage the economy. Interventions in the wages market will almost certainly cost jobs and the property market and the UK generally will become much less attractive to foreigners. Whilst the effect on London property prices from foreign buying is well known, the economic multiplier effect of foreigners' expenditure is bound to be significant and this is at risk, plus, of course, that large current account deficit has to be financed, which it partly has been through individual foreign investors' purchases of property and business.

As the twin deficits show, the UK economy is very unbalanced. The UK faces an uncertain external situation. The eurozone's continuing woes are very unhelpful for the UK, given the importance of the European market for the UK's exports and, in this context, the strong pound does not help. Notwithstanding the UK's problems with its twin deficits, its growth prospects are better than those for most developed countries and it is one of the better ones in which to do business. Like the USA, the level of political risk is fairly low.

To draw these different strands to an investment conclusion, even though July was a better month, the uncertain performance of equities over the quarter is part of a pattern in previous reviews that we have indicated would occur. There are always concerns for investors and they have to decide if they are sufficiently serious to derail their medium and long term expectations for returns and, if so, whether to reduce their equity positions in the face of this. They also have to weigh up the possibilities of their being wrong. It is a big call to reduce equity positions at present when one considers the factors which are still positive for equities. These are, as per the OCED's and IMF's expectations, slightly accelerating economic growth next year, the expectation of continued very low interest rate levels, even if they start to rise in the USA and UK, share ratings, although not as attractive as they were, which still leave some room for further share price growth on the back of modest increases in company earnings, dividend yields which are attractive relative to those from bonds and cash and continued support for equities from share buy backs. The danger of moving out of the equity market or reducing exposure because of excessive attention to short term negative factors is that if prices rebound or continue to move ahead whilst the liquidity is in place, there may not be another opportunity to purchase at or below the exit price. Repurchasing at a higher price when confidence has returned is frustrating and costly in terms of opportunity cost. The loss of profit cannot be made up. For bonds, however, we continue to believe that the story is quite the opposite. If we take the ten year UK government bond yield, illustrated in the table at the beginning of this review, and, theoretically, hold it to redemption, it is hard to see that a return of around 2% can be considered the least bit satisfactory. Maybe if one foresaw a long period of deflation but we think that this is unlikely. If we return to more normal yields, say 4% - 5%, the costs are going to be painful and the further one goes along the yield curve, the more pronounced the pain will become. Equities can bounce back but the returns from bonds will be poor. We therefore see a modest rise in equity prices, interspersed with negative quarters, and serious risks in bonds.