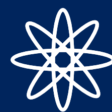

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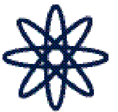
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

The relatively benign movement in the equity indices, shown below, hides volatile conditions in the quarter, with the sovereign debt woes of part of the eurozone casting a long shadow on markets during parts of the quarter before a strong rally at the end. Bond markets diverged according to the perceived qualities of the issues whilst, in currency markets, sterling endured a weak quarter. Although commodities are off their peak levels, the rise in the oil price over the quarter reflected the Libyan situation.

The tables below detail relevant movements in markets:

International Equities 31.03.11 - 30.06.11

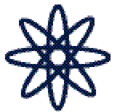
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-4.0	-0.8	-0.6	-2.7
Finland	-8.6	-6.7	-6.6	-8.6
France	+3.6	+5.7	+5.8	+3.6
Germany	+4.6	+6.7	+6.8	+4.6
Hong Kong, China	+1.3	+1.1	+1.3	-0.9
Italy	-4.3	-2.4	-2.3	-4.3
Japan	-2.2	+0.2	+0.4	-1.8
Netherlands	-6.3	-4.4	-4.3	-6.3
Spain	-0.4	+1.6	+1.8	-0.4
Switzerland	-1.1	+7.3	+7.4	+5.2
UK	+1.5	+1.5	+1.7	-0.5
USA	+0.1	N/C	+0.1	-2.0
Europe ex UK	+0.2	+3.1	+3.3	+1.1
Asia Pacific ex Japan	-1.9	+0.4	+0.5	-1.6
Asia Pacific	-2.0	+0.3	+0.5	-1.7
Latin America	-6.1	-3.0	-2.9	-9.9
All World All Emerging	-2.9	-1.8	-1.7	-3.8
The World	-0.7	+0.4	+0.6	-1.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +2.5%

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

Currency	31.03.11	30.06.11
Sterling	3.69	3.38
US Dollar	3.45	3.16
Yen	1.25	1.14
Germany (Euro)	3.37	3.01



Sterling's performance during the quarter ending 30.06.11 (%)

Currency	Quarter Ending 30.06.11
US Dollar	N/C
Canadian Dollar	-0.6
Yen	-2.7
Euro	-2.2
Swiss Franc	-8.0
Australian dollar	-3.3

Other currency movements during the quarter ending 30.06.11 (%)

Currency	Quarter Ending 30.06.11
US Dollar/Canadian Dollar	-0.6
US Dollar/Yen	-2.7
US Dollar/Euro	-2.2
Swiss Franc/Euro	+6.4
Euro/Yen	-0.5

Significant Commodities (US dollar terms) 31.03.11 - 30.06.11 (%)

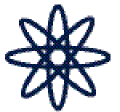
Significant Commodities	31.03.11 - 30.06.11
Oil	+18.7
Gold	+6.6

Markets

Despite everything which has been going on during the quarter, politically, militarily, economically and financially, international equity markets showed little overall movement over the quarter. In local currency terms, the FTSE World Index returned -0.7%, in sterling terms +0.4%, in US dollar terms +0.6% and in euro terms -1.6%. In local currency terms, the movements of the main areas of the world were quite closely bunched together, showing little change. Outside that close bunching, the FTSE Australia index retreated 4.0% and the FTSE Latin American index by 6.1%. However, there were some quite sharp currency movements, with sterling being notably weak, and this altered, sometimes significantly, the return for sterling based investors. In particular, the FTSE Europe ex UK index benefited in sterling terms, returning 3.1%, with the spectacular performance of the Swiss Franc turning a slightly negative performance in local currency terms in the FTSE Switzerland index into an excellent 7.1% return in sterling terms. Japan turned from a negative performance of 2.2% to a slightly positive performance of 0.2%. The strength of the Australian dollar meant that the negative return on the FTSE Australia index was reduced to just 0.8%, whilst the negative return on the FTSE Latin American index was pared to 3.0%.

The unsettled sovereign debt background meant that high quality sovereign bonds benefited from the flight to safety so we saw, using ten year government bond yields as a benchmark, gross redemption yields on sterling bonds fall by 31 basis points to 3.38%, on US government bonds by 29 basis points to 3.16%, on Japanese government bonds by 11 basis points to 1.14% and on German government bonds by 36 basis points to 3.01%.

In the currency markets, weaker growth and a possible suggestion of more quantitative easing in the UK caused sterling to weaken, although it was essentially unchanged against the US dollar. It was spectacularly weak against



a rampant Swiss Franc, falling by 8.0%. Against the yen it fell by 2.7%, against the euro by 2.2% and against the Australian dollar by 3.3%.

In the commodity markets oil rose by 18.7% (Brent Crude) whilst gold advanced a further 6.6%.

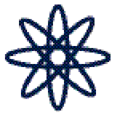
Economics

The convulsions in the eurozone have naturally taken centre stage this quarter. Despite the terrible events of last March, our feeling was that the one issue which would continue to dominate the headlines and not have a happy ending was the eurozone's sovereign debt woes. This has proved to be the case and we will be discussing this issue later in this review. Of all the many economic and financial issues which present challenges, this must be the number one issue. Perhaps the proximity of the epicentre of this financial and economic storm means that we think of little else but, to keep a sense of perspective, we need to consider the position in countries not caught up directly in the eurozone's crisis.

The latest World Economic Outlook, just published by the IMF, gives a balance to the gloom felt in heavily indebted countries, such as a number in the eurozone, the UK and, for additional reasons, in Japan. Whilst the world economy has undoubtedly slowed down in the second quarter, the IMF shades only marginally, by 0.1%, its forecast of world economic growth this year to 4.3%, whilst its projections for 2012 remain unchanged at 4.5%. These are not far below the 5.1% increase recorded in 2010, a recovery year, and, if broadly accurate, they are respectable figures. The growth forecast for this year, 4.3%, is the same as the annualised rate recorded in the first quarter but all the anecdotal and statistical evidence suggests that growth flattened out in the second quarter for a number of reasons. The expectation is that the second quarter will represent a temporary slowdown before growth picks up in the second half of the year. Intuitively, it is possible to see why this might be so. The second quarter is likely to have suffered the main economic effect of the Japanese earthquake and tsunami, which occurred in March, and, perhaps, the main negative effect of the rise in commodity prices which are now off their peak. But, as the IMF points out, there are downside risks to the forecasts. Some are self evident, such as geopolitical events, which could send commodity prices higher, and the eurozone sovereign debt crisis widening to major eurozone economies like Spain and Italy. Others, by definition, we will not guess. Of the positive drivers for world economic growth in the second half of the year, recovery from the supply chain disruption caused by the Japanese earthquake and tsunami seems a realistic view as anecdotal evidence suggests a quicker than expected resumption of normal service. In these days of globalisation, supply chains are spread out worldwide and they are highly interdependent so that an interruption to the supply of even the smallest component can bring industrial production to a halt. Such a system of "just in time" ordering has advantages in controlling costs by sourcing from the most efficient and cheapest supplier and minimising working capital requirements but, when a "black swan" event like this occurs, significant disadvantages are apparent and production losses arising from a shortage of components have been felt in many parts of the world.

If we drill down into the IMF's latest forecasts, we see that it is projecting growth in the advanced economies of 2.2% for this year and 2.6% for next year. Whilst that reflects no change in its 2012 forecast from last April, it is a 0.2% reduction in its 2011 forecast. Japan, not surprisingly, suffers the largest downgrade this year. The IMF forecasts that there will be a 0.7% economic contraction in Japan this year compared with its previous projection of 1.4% growth. Conversely, it expects some of the growth lost this year to be pushed into next year and it has, therefore, raised its growth projections for 2012 by 0.8% to show 2.9% growth. One of the economic consequences of terrible natural disasters or wars is that the subsequent rebuilding programme can be expected to provide an economic stimulus as buildings and factories are restored, or rebuilt from new, and new machinery is ordered. Infrastructure repair also provides a stimulus, but there is, inevitably, a lag before this additional activity is reflected in the figures.

Perhaps, surprisingly, the IMF has raised its forecast for eurozone growth this year compared with the one made with its April forecast. It has raised its forecast by 0.4% to 2.0% this year and just shaded its forecast by 0.1% next year to 1.7%. The main reason for this upgrade is the better than expected growth so far this year for France and



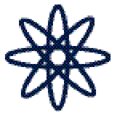
Germany. The IMF now projects growth of 3.2% for this year for Germany and 2.1% for France, reflecting upward revisions of 0.7% and 0.5% respectively compared with its April forecast. Elsewhere, the forecast for the UK this year has been reduced by 0.2% to 1.5%, whilst for the vitally important US economy it has been reduced by 0.3% to 2.5%. Canada, which has been an excellent performer during the recession, is forecast to grow by 2.9% this year, a marginal increase of 0.1% over the IMF's April projection. Other advanced economies are forecast to grow by 4.0% this year, a marginal uplift of 0.1% compared with April and, within that group of countries, the Newly Industrialised Asian Economies are forecast to grow by 5.1%, a 0.2% increase compared with its April projections.

But, of course, the real stars of the show remain the emerging and developing economies where the IMF has raised its economic growth forecast for this year marginally by 0.1% to 6.6% and trimmed it marginally by 0.1% to 6.4% for next year, rates of growth of which the industrialised countries can only dream. If we look at the BRIC countries, Brazil is forecast to grow 4.1%, Russia by 4.8%, India by 8.2% and China by 9.6%. The only reduction in forecast compared with April is for Brazil which has seen its projected growth forecast trimmed by 0.40%.

Whilst the risks may be on the downside, the forecast, if reasonably accurate, would not normally be a cause for concern. A curate's egg, certainly, but, overall, satisfactory. Inevitably, what makes the news is the negative stuff but investors are more likely to be rewarded by standing back and taking a balanced view. It is easy to be influenced by the "noise" around one and, being based close to the eurozone, the "noise" is very loud, but the further away one gets from it, the less alarming the news and, in some places, it is positive, as these forecasts for developing and emerging economies show. One will see this in company results from companies based in the slower growing industrialised economies. Whilst results domestically or in, say, the eurozone, may be sluggish, these companies, if they are internationally based, will very often be reporting faster growth from their Asian, Latin American and emerging market businesses. When the news background seems unremittingly gloomy, as it may seem to those near or in the eurozone at present, it is worth standing back to take in the whole world economic picture. It is not all bad, and a sense of perspective is likely to produce better investment results because being overly influenced by short term sentiment is often unwise.

Having said all that, the big investment story is eurozone sovereign debt concerns, particularly that of Greece, but also Ireland and Portugal, with Spain causing a certain amount of concern and Italy getting a mention, not so much because of its budget deficit but because of its high level of outstanding public debt as a percentage of GDP. Current ten year bond yields, an arbitrary benchmark, say that these countries are unlikley to be able to pay off their debts in full, with Greek yields telling us, what we already know, that Greece will almost certainly default on its debt. But we also know that eurozone governments and the ECB do not want Greece to default. Besides the effect which this would have on holders of Greek sovereign debt, such as eurozone banks, it might trigger credit events in the CDS (credit default swaps) markets with unknown consequences. It would not only be the banks and other private holders of Greek sovereign debt who would suffer, it would also be the ECB, a large holder of Greek sovereign debt which it bought in the markets to provide liquidity and which it took as collateral from Greek banks which were unable to fund themselves. Given the plunge in Greek bonds, it will be sitting on heavy losses which would mean that the ECB would have to be recapitalised, an unwelcome development for eurozone governments struggling with their deficits. The ECB has been providing liquidity for banks which have been unable to finance their operations (those from the troubled eurozone periphery) and has been accepting collateral, obviously with a margin against the provision of liquidity. Whilst it has been reducing its quality requirements in the face of the crisis, it can obviously not accept collateral which is in default. Greeks have been moving deposits out of Greece, creating more problems for the Greek banking system.

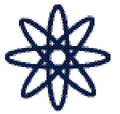
The EU and eurozone participants and the ECB have been speaking with many different voices and addressing many different constituencies. Their activities do not create a good impression or give much confidence that they have a plan to extricate themselves from these problems. In a sense, they do not because a sovereign debt default within the eurozone was never envisaged nor was the possibility of a country or countries leaving it. So everyone involved is having to think on their feet and one has the impression of sticking plaster being applied to



problems as they arise, which might give short term respite but provide no long term answer. The immediate issue is that Greece requires funds shortly to retire maturing sovereign debt. The latest tranche of €12 billion from the original bailout was dependent upon the Greek parliament approving the latest austerity package, which it did. Because Greece will not be able to raise funds in the markets next year, a second bailout will be necessary. Although good money is being thrown after bad because Greece faces not only a liquidity problem, which could be fixed, but a solvency problem, which cannot. If one had to guess what is in the authorities' mind (in so far as they have a collective view), it would be to maintain the pretence that Greece has not defaulted so that European banks can prepare themselves better for the write offs when they eventually come. The exposure of foreign European banks to Greek sovereign debt is estimated to be €103 billion, with France and Germany particularly exposed. If Greece goes, everyone connected with the EU will be concerned about the knock on effect on other European banks. They will be considered to have been weakened, so their ratings might well be reduced by the credit rating agencies, confidence in them is then reduced further and so it goes on. So, although the authorities will not say it and, although they know that good money is being thrown after bad, they feel that they have to maintain the pretence because it is the least bad option and may buy some time.

Paradoxically, however, the impossibility of the Greek situation gives it some leverage on the rest of the eurozone through the effect on the European banking system, which we have mentioned above. Who will blink first? Shocking though the situation is in Greece, it is a relatively small economy, but its problems could have a disproportionate effect on the rest of the eurozone through the banking system. It is a game of poker played to the wire. If Greece feels that the austerity measures imposed upon it are so severe that they have nothing to lose by defying the IMF and EU, they might just bring the house down.

If those with influence in the eurozone, whether they be politicians, bureaucrats or central bankers were completely frank with themselves, they would admit that the euro project is fundamentally flawed by virtue of it not being a fiscal union as well so that it lacks a mechanism to transfer funds to those eurozone members in need. So, it is unlike the USA, where this can happen. Although this is in a sense what is happening now with the bail out for Greece, it is meeting with significant hostility in creditor countries like Germany, the Netherlands and Finland, and a formal transfer union would almost certainly be opposed by most electorates already turning eurosceptic. Investors might say that this is all very interesting but what does this mean for the stock market? These hypothetical scenarios somehow have to be translated back to the reality of markets. Let us look at one which we do not think is likely but, if it came to pass, could have some long term attractions for investors. In a currency union, it goes without saying that the traditional method of increasing competitiveness in the short term, a devaluation, cannot happen. That would be the traditional recommendation of the IMF, along with austerity measures, if a country were to receive financial help. A country needs to grow out of its problems and a currency devaluation will help its competitiveness. Of course, it has its disadvantages, notably creating inflationary pressures which have to be restrained by strict restraint on wages. In a currency union, this policy tool is obviously not available to a country in trouble. The alternative, which is what is being forced on Greece, Ireland and Portugal, is savage deflation to restore the competitiveness which has been lost since the start of the euro or when they joined, as the case may be. One of the fundamental reasons why the euro project is in trouble is that, rather than converging, economies have diverged and, as manifested in rising unit labour costs relative to Germany as a yardstick, this has been a disaster. It has led to widening current account and budget deficits and, being part of a common currency, these countries felt that they could get away with it. Of course, that was never possible for long, as we now see. So, if these countries cannot restore their competitiveness by devaluation what can they do if they stay within the currency union? The IMF and EU are insisting that these countries bring their costs back into line in two ways. The first is by pay and entitlement cuts in the public sector which, if successful, make it easier to be followed in the private sector, although market pressures may have had that effect already. The second is by supply side reforms, to increase the productive potential of the economy. In the case of Greece and Portugal, the rigid labour markets and stultifying bureaucracy put a real brake on their economies and bloated public sectors crowd out the private sector. For those who have



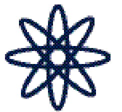
benefited from these features, the current austerity programmes have come as an unwelcome shock, hence the violent protests in Greece, in particular. Similarly, resistance to privatisation reflects a fear that these companies, instead of being a source of patronage, will have to reflect the realities of living in the private sector which would make these companies more efficient. However, if we reflect for a moment on what a successful outcome of a long period of austerity and supply side reforms might bring, it is a more competitive and successful economy, which could be attractive to investors both in the stock market but, also, direct investment. The convergence upon which the currency union was predicated would be restored and these countries, mainly the southern eurozone economies, would have many more of the features of the more successful northern eurozone economies. This would be a good outcome and one of the "benefits" of the current eurozone crisis is that the pressures imposed upon the countries in trouble could, if successful, improve the long term economic outlook immeasurably.

However, we regard this outcome as a long shot. We do not think that the electorates and, ultimately, the governments of these troubled countries will wear these measures. Apart from anything else, in the absence of a stimulatory devaluation, the severity of the austerity measures snuffs out the economic growth potential of the relevant economy and that growth is necessary to provide the revenue to get on top of the debt problem. If there is no growth, not enough growth or a decline, the country remains in a debt spiral.

If that is, theoretically, a good position for investors in the longer term, what about, in our view, the more likely situation where the eurozone fragments? On paper, this looks an unpromising situation. The new currencies, for example new drachma, new escudo or new punt, would be devalued currencies against what remains in the euro. If liabilities remain in euros, then creditors are going to lose out because the debts cannot be serviced or repaid or, if they are redenominated in the new successor currencies, they will suffer currency losses, even if principal and interest are paid. It is estimated that foreign European banks exposure to the sovereign debt of Greece, Portugal and Ireland is about €650 billion, so it is a major issue. As happened after the Lehman collapse, the authorities would have to be innovative and step in to avoid contagion, presumably by providing whatever liquidity the market needs against collateral it would not previously have considered. The euro would be likely to fall and money flee from the countries next in line. The countries which left the euro would be able to issue their own currency, although the situation would be highly inflationary. Whilst the problems would be enormous, it would give them a chance to start all over again, with a currency at a competitive level and some chance of economic growth. If the scaled down eurozone was felt to be stable, the euro might become a stronger currency as it would be more dominated by Germany and felt to be more like the old Deutschmark. With a lower currency, the countries which left the eurozone might be felt to offer better investment opportunities, both through the stock market and in terms of foreign direct investment. On the other hand, although it would not be likely to detract too much from the attractions of those countries which remained in the euro, the relative strength of their currency could be expected to affect exports, where they were price sensitive, and reduce the value of overseas earnings translated back into euros. The weakness of the euro has helped a country like Germany because its discipline with its own costs since the euro was created has made it a super competitive economy. The assumption that some countries would remain in the euro could well be optimistic. It could break up completely.

If the politicians, in particular, have their way, this make believe scenario, which we witness day by day, will continue. The banks may have their arms twisted to roll over debt, although it will be "voluntary" so that no default or credit event occurs. But they will know that they hold debt which may never get repaid and they will take this into account with their business plans. They will become more cautious in their lending and this will have economic effects. What may seem a good idea to get out of one problem can lead to another. In the saga of the eurozone, the law of unintended consequences can be expected to prevail.

Whilst any discussion of European stock markets has to be dominated by the sovereign debt problems of Greece and others, we should not lose sight of the fact that there is some very good value in the European stock market. There is a large number of multinational companies based there selling their products not only in the developed markets but also in the faster growing ones. It is true to say that a number of these companies are in a better

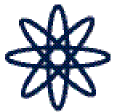


shape than the countries in which they are registered. It is easy to equate the problems of the eurozone with their relevant stock markets but they should be separated. Whilst domestically overstretched companies may well be affected by problems in their own economies, multinationals can rise above this, and a cheap currency can benefit their profits through an increased volume of exports and / or better margins, together with a translation benefit from their overseas profits being converted into euros.

The politics of this are mostly bad for incumbent governments which are experiencing or have experienced the wrath of their electorates for what has happened in the eurozone. The Irish and Portuguese governments have lost elections badly and some incumbent governments in creditor and debtor nations are under pressure, with France, Germany, Spain and Italy coming to mind. From the debtor side, it is easy to see why the relevant governments are being punished. From the creditor side, it is the electorates' annoyance that their country is involved in bailing out what they would regard as feckless countries which have brought these troubles upon themselves. Whilst bankers often bear the brunt of the opprobrium for what has happened and, of course, the financial crisis caused many problems, much of the blame for what is going on in the eurozone at present must lie at the hands of a flawed currency union. The "one size fits all" monetary policy has been disastrous. Countries like Greece, Ireland and Portugal had interest rates set too low and borrowed as if normal financial disciplines went out of the window. In many cases, it financed unproductive developments like a larger public sector. Lenders did not distinguish between the various credits, treating the eurozone as a homogenous area which, whilst that might have been the theory, was not the practice, as we now see.

Whilst on a subject which has heavy political overtones, we have seen, in June, the surprise announcement by the International Energy Agency that it has agreed to release 60 million barrels of oil in the coming month, ostensibly to make up for the shortfall of 1.5 million barrels a day of high quality Libyan oil which is not being produced whilst the civil war continues. This follows OPEC's failure to agree on a quota increase, with hardliners blocking an increase which was favoured by Saudi Arabia and other moderate OPEC oil producers. In practice, Saudi Arabia is pumping more oil, although it is of a different quality to Libyan crude. However, this move is seen as highly political, as the existing conditions do not reflect the emergencies for which the stockpiles have been built. They have been used twice before, firstly in the 1991 Gulf War and, secondly, in the aftermath of Hurricane Katrina. Although the oil price is high, there is not a supply shock and, using this nuclear option, which appears to an outsider a tool of economic management, seems wrong in the context of the reason why the stockpile was started in the aftermath of the Arab Israeli War of 1974. One day, the stockpile might really be needed for a true supply shock. Over politicisation of institutions reduces the quality of economic management. In this case, being cynical, it could be seen as a ploy to put some money back into consumers' pockets to kick start economies held back in the second quarter by rising oil prices and the supply disruptions caused by the Japanese earthquake and tsunami. For investors, this is a signal of how desperate the politicians are to kick start economies again and, although monetary policy is in central banks' hands, we can be fairly sure that really the only tool which they have left to them to try to stimulate the economy, monetary policy, will remain loose.

Turning now to look at individual areas of the world we start with the USA, where the wrangling over measures to avoid exceeding the debt ceiling continues. It is a very depressing situation and shows politicians at their worst, fixated upon the next elections at the expense of good economic management. The USA, as in other countries such as some of those in the eurozone, is running a chronic structural deficit which needs to be addressed as a matter of urgency but, in front of elections, politicians are frightened to make hard decisions for fear of upsetting the electorate. It is perhaps true to say that, in the USA, there is a greater appreciation of the danger of running up large deficits but Congress and the Administration are seriously divided about the means of dealing with the problem, with the Republicans generally opposed to any tax increases and looking to spending cuts to address the issue, whilst the Democrats want to include tax increases in the package. It is a highly ideological debate, marked by a general lack of goodwill between the parties. Whilst investors are well aware of the magnitude of the problem which is building up in respect of the USA's financial position, the even greater and far more immediate problem

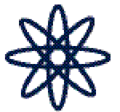


of the eurozone debt crisis captures all of the attention. But unless the warring parties can take decisions which transcend party politics, we are surely witnessing a slow motion financial train crash. The USA has more options, none of them really satisfactory, for dealing with the situation but, in the absence of a fundamental rebalancing of revenue and expenditure, none of them will be benign, although they will not have the dramatic immediacy of the Greek disaster. If the USA cannot finance its deficit, it can monetise its debt, unlike Greece, which cannot print its own currency. The majority of the world's foreign exchange reserves are held in US dollars, which gives it the advantage of time as foreign holders will not want to shoot themselves in the foot by dumping US dollars in a large way. However, changes in emphasis in reserve holdings can take place over time, as has happened, and, with the USA needing to borrow heavily, the danger for interest rates and the currency is obvious. However, as we have often mentioned before, the obvious thing is that all currencies with problems cannot fall together and, at any point in time, the USA's problems may be seen to be less pressing than others, albeit at a high level. The USA has already had a warning shot across the bow from the credit rating agencies about its AAA rating, the loss of which to any country is a serious issue, with a cost in terms of additional interest payments. The most likely way in which a lack of serious action to address the USA's public finances will manifest itself is in a gradual loss of confidence in the US dollar and rising relative interest rates. The irony of the present crisis in the eurozone is that the US dollar is seen as a safe haven with Treasury bond yields being driven down to levels which cannot be justified on fundamental grounds. For equity investors in the USA, this debt issue is not an immediate source of concern but is something to monitor. At present, notwithstanding the relatively low dividend yield on US equities compared with elsewhere, although we need to take into account that US companies have been buying back their own shares, low Treasury bond yields are helpful, whilst a weak US dollar will boost the earnings of many US companies with overseas earnings. The prospective price/earnings ratio on the S&P 500 index of around 13 is not expensive.

So, whilst the serious public debt problem of the USA is the major background issue and the debt ceiling its associated short term problem, what about the short term indicators from the USA?

The latest estimate of first quarter US growth has been revised slightly upwards by the Bureau of Economic Analysis. The estimate is now 1.9% annualised against the previous estimate of 1.8%. In the fourth quarter of 2010, the annualised rate was 3.10%. There were conflicting forces at work in coming to this final adjustment. There was an upward revision in inventory investment but a downwards revision in business investment. Export growth and government expenditure represented negative adjustments but the latter has to occur if the US economy is to be rebalanced. The latest outlook from the Federal Reserve was quite downbeat, reflecting the slowdown in the rate of growth of the US and world economy in the second quarter. The Federal Reserve pointed to slower than expected growth and higher inflation. Its language was more negative on the inflation outlook, with the core annualised rate of inflation running at 2.5% in the quarter to the end of May. Whilst it indicated a rise in recent inflation levels, it expected price rises to "subside to levels at or below those consistent with the Committee's dual mandate as effective past energy and other commodity price increases dissipate". The FOMC referred to the fact that the US economy was growing more slowly than it expected and that the labour market was also weaker than it had expected. The FOMC expected that the slowdown would be temporary, attributing it, amongst other factors, to the aftermath of the Japanese earthquake.

In terms of policy, it indicated that interest rates would continue at the present level for an "extended period" and that once QE2 ended on 30 June, it would reinvest in its securities portfolio which, in practical terms, would mean its balance sheet remaining at the current level. This represents an intermediate stage in ending quantitative easing. The most dramatic move, short of selling the securities acquired under the programme back to private investors and, therefore, reducing its balance sheet at an accelerated pace, would have been not to reinvest principal repayments back into the securities market but allow the repayments to shrink its balance sheet gradually. However, with no new quantitative easing programme announced, major buyers of government securities will have had discounted this. The pessimistic view would be that bond yields, having been depressed

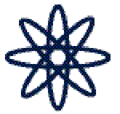


below the level that they would have stood at in the absence of Federal Reserve buying, will now revert to a higher level. It will also depend upon how risk averse investors are. If investors are sufficiently worried about events outside the USA, US Treasuries might seem a safe haven even if they do look expensive on normal considerations.

In a snapshot of the US economy, the latest Federal Reserve Beige Book confirmed evidence of a slowdown, but not a halt in the US economy. Part of the reason for the slowdown was the disruption to the supply chain resulting from the Japanese earthquake but at least some of that should be made up in the second half of the year. The impression is that the US economy is progressing at a very modest pace. One area which remains weak is the housing market. In this respect, the latest S&P/Case Shiller index showed that the average price of a house in the twenty largest American cities fell by 4% in the year to April. There was a rise in housing starts of 3.5% in May but, at the same time, sales of new US homes fell by 7,000. Elsewhere, evidence of sluggish growth in the US economy came from several sets of data. The ISM's purchasing managers index for May fell sharply from 60.4 to 53.5. This still suggests growth but at a more modest pace than in the first quarter. Payroll growth in May was lower than forecast, coming in at just 54,000, with the unemployment rate rising by 0.1% to 9.1%. Retail sales fell in May by 0.2%, the first monthly fall for eleven months. Consumer sentiment has dropped, with the Thomson Reuters/University of Michigan consumer sentiment index falling from 74.3 in May to a preliminary figure of 71.8 for June. For the figures for consumer spending, the Commerce Department reported that personal consumption expenditure rose just 0.1% in May, following a downwardly revised fall of 0.3% in April. In real terms, there was a decline of 0.1% in May.

The pressure on disposable income caused by the tick up in inflation is making its presence felt. Consumer price inflation rose by 0.2% in May, having risen by 0.4% in April. Core inflation, which excludes volatile food and energy prices, rose by 0.3% in May. Overall, however, at this stage, it is the expectation that, with the supply disruptions following the Japanese earthquake ending, some of the lost activity in the second quarter will be pushed forward into the second half of the year. The possibility of a QE3 looks remote at this stage with inflation ticking up. Apart from the inflationary risks involved later on, it is likely to have a diminishing effect on spurring economic activity.

We have discussed the eurozone at length, with the sovereign debt crisis surrounding Greece dominating the scene. Following a 0.8% increase in eurozone GDP in the first quarter, the evidence, as in the USA, points to a slowdown in the second quarter. There was a sharp drop in the eurozone's purchasing managers indices in June, with a number of issues mentioned above in respect of the USA also being relevant to the eurozone. The two largest eurozone economies, Germany and France, performed well in the first quarter but are slowing down in the second quarter. For example, in Germany, industrial output fell by 0.6% in April. In that month, German exports experienced their largest decline since 2009. They fell by 5.5% compared with March. Industrial production fell by 0.6% in April. Given the problems of the southern eurozone and Ireland, it may seem perverse to be talking about the possibility of the ECB raising interest rates, but it is the central bank most likely to do so next out of those of the UK, USA, eurozone and Japan, none of which are at the moment showing strong economic growth. The ECB, of course, has already raised interest rates once by 0.25% to 1.25% and, given the fragility of the eurozone sovereign debt markets, it might seem a strange move to be contemplating. The latest eurozone consumer price index for May showed an annual increase of 2.7%, slightly below the 2.8% level for April but, nevertheless, well ahead of the target of close to but below 2.00%. However, interpreting the remarks of the ECB President after the June meeting of the ECB's governing council, an increase in July appeared to be in prospect. Mentions of "strong vigilance" and inflation risks being "on the upside" and the need to avoid rising oil and commodity prices "giving rise to broad based inflation pressures" have given a strong hint. Because of the fluid nature of the financial background, such confidence in such an outcome at the July meeting must be tempered, but the ECB is the central bank which is most likely to adhere to its mandate. Even though official rates are incredibly low at present, any rise will be unhelpful to weaker members of the eurozone. In fact, just as this review is being printed, the ECB on 7 July raised its interest rate by 0.25% to 1.5%.

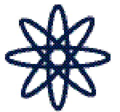


However, we must repeat what we have often said before which is that it is necessary to distinguish between economies and the companies within them. Whilst the former may look risky because of the state of its public finances, many companies within them can disengage to various extents from their economic fortunes by virtue of the nature of the business or their geographical diversification. For many countries in Europe, the market ratings of their shares are low, very typically around ten times earnings for the current year and probably falling into single figures next year. At the same time, dividend yields are attractive, averaging around 4% and a premium to the yields of the best rated eurozone government ten year bonds, for example. One market, outside the eurozone, we should mention, in particular, is Switzerland. The contrast with the chaotic eurozone could not be more stark and the strength of the Swiss Franc reflects its traditional safe haven status. International investors in Switzerland have benefited from its currency strength and it is the home of many world class companies. Set against that, the strength of the Swiss Franc is very unhelpful to many of these companies engaged in export activity.

Any economic numbers which come out of Japan at present will be difficult to interpret in the aftermath of March's tragic events. Intuitively, one would expect the second half of the year to benefit from the catch up from production lost in the first half of the year, but the extent is difficult to forecast. For what it is worth, the latest Japanese industrial output figures show a rise of 5.7% in May following a 1.6% rise in April. This was below the government estimate of 8.0%, but such issues must be more imprecise than usual given the circumstances. The long term problem for Japan is that it will have to deal with its horrendous public debt levels, over 200% of GDP at the gross level. Whilst the USA's saving grace in the short term might be its status as the world's largest reserve currency, Japan's equivalent would be that almost all of its public debt is funded internally so that it does not have to rely too heavily on maintaining foreign confidence. Very low interest rates also help, but these cannot be counted upon indefinitely. Issues arising from the earthquake and tsunami surround the future of nuclear power in Japan and whether there will be any diversion of business from Japan arising from the supply disruptions which the disaster caused. If we had to guess, the reorganisation of the supply chain facilities within Japan, following the lessons learned from the disaster together with the quality of Japanese goods, are likely to minimise the medium and long term economic danger to Japan. Before the disaster, foreign interest in the Japanese stock market had been increasing because in terms of valuations and the dividend yield, the market looked historically attractive. At the very least, this fact would normally warrant some exposure to Japan, home of many world class companies.

As discussed previously, for China the main issue at present is overcoming the inflation problem. In an article in the Financial Times, the Chinese Premier was bullish about inflation, saying that he was confident that it will be firmly under control this year and that China's policies had worked. By way of anecdotal evidence, the latest Chinese Purchasing Managers Index showed, in one of its sub sets, that the index for import prices had fallen sharply in May to 60.3 compared with 66.2 in April. Although the overall PMI fell slightly to 52.0 in May from 52.9 in April, this was considered quite a good result because it normally falls more in May. Although stock markets internationally worry when there is a threat of a Chinese slowdown because of its potential threat for the rest of the world, a resurgence of Chinese inflation would be even more of a worry because of the potential for social unrest. As we have seen elsewhere in the world, food price inflation can be a catalyst for political unrest, which the Chinese government obviously wants to avoid at all costs.

In the UK, as elsewhere, second quarter growth has been subdued, causing some to argue that the government should slow its deficit reduction plans so that the economy receives some sort of stimulus which will give a payback to public finances. Prima facie, these siren voices might sound compelling but, in practice, they are high risk suggestions. The UK's budget deficit is one of the worst around and is unsustainable. In the real world, some imaginary leisurely path to a sustainable budgetary position is a risk which the UK cannot afford to run. The markets sense weakness and the fact that ten year gilts yield only around 3.3% reflects the downpayment from the UK's creditors on the policy path to the elimination of the structural deficit over the life of this parliament. Given what has happened to some countries' cost of borrowing in the eurozone, one only has to realise the devastating costs to the UK's debt servicing bill of a rise in interest costs if there was some backsliding on the



target. When a country is in as serious a financial position as the UK, the measures needed to restore confidence in the country's creditworthiness are bound to be unpopular but, as those in Greece, Ireland and Portugal are finding, the alternative is much worse. So, for investors in the UK stock market, any sign of backsliding by the government would be a negative influence on it. The UK has the inestimable advantage of having retained its own currency so that an adjustment to the value of sterling can occur which can give some offset to the tough measures which have had to be taken to address the deficit issue. Growth forecasts for the UK economy are being pared back for this year. The IMF, for instance, now forecasts economic growth of 1.5% compared with April's forecast of 1.75%. Its forecast for 2012 is 2.3%. The UK's deficit reduction stance has generally been given support by outside observers. The IMF, for example, says "there is no need to slow deficit reduction since weakness of the recovery is caused by temporary forces, high energy and commodity prices, which are beyond the government's control". It maintains that austerity is essential to achieve a more sustainable budgetary position. For the UK, notwithstanding very large negative real interest rates, as measured by the difference between the Bank of England's repo rate, 0.5%, and the consumer price index, 4.5%, it seems that monetary policy will be used as the offset to the tight fiscal policy being followed in the UK. This, together with a weak exchange rate, can be expected to give a measure of offsetting stimulus to the UK economy. There is even a hint in the latest minutes of the Monetary Policy Committee that further quantitative easing could be considered. Whilst accepting that the consumer price index could soon exceed 5%, a change of tone was apparent in the minutes with greater concern about economic weakness as against the problems of high commodities prices and inflation. Some members believed that the Bank of England may have to consider more quantitative easing.

Notwithstanding the soft patch which the UK, like some other countries, is expecting, the background for UK equities, in the absence of any economic development which we cannot presently foresee, is still supportive. Dividend yields are attractive, with the yield on the FTSE 100 index only slightly lower than that on a ten year gilt edged security, and dividend growth looks likely to occur in the UK as elsewhere. The prospective price/earnings ratio on the FTSE 100 index is just over ten, which is not high. Additionally, there are a number of major UK multinationals with exposure to faster growing areas of the world which provide attractive yields and good defensive qualities.

So, our stance remains the same as before. With all the problems for the world economy, one can understand a point of view which said that securities should be shunned, even though the obvious alternative, cash, would be providing negative real returns. But, as we have tried to show, not everything is bad in the world economy and there is quite reasonable overall economic growth. It is just that, in the West, we do not see much of it. Nevertheless, as we have indicated through the international reach of many western and Japanese companies, investors can gain exposure to rapidly growing economies and the ratings of shares generally look undemanding, whilst dividend yields in many cases are appealing. We still see no value in the bond market. Although the volatile conditions in the latest quarter are not reflected in the market indices, which ended the quarter little changed from the beginning, we must emphasise, as before, that whilst we see good value in most equity markets, the news background remains likely to give rise to volatility so it is not likely to be a smooth path.

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