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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The sell off in international equity markets towards the end of June eliminated the positive trend of prices seen earlier in the quarter to leave markets little changed and, in most cases, retaining most of the gains made in the first quarter. Bond markets endured a poor quarter with markets especially spooked by the possibility of the Federal Reserve starting to taper its programme of quantitative easing. In the currency markets, the commodity orientated Australian dollar and, to a lesser extent, the yen, showed marked weakness, as did some commodity prices, including gold which fell by almost a quarter over the period.

The tables below detail relevant movements in markets:

International Equities 28.03.13 - 28.06.13

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-2.8	-13.8	-13.9	-15.0
Finland	+0.5	+1.8	+1.7	+0.5
France	+2.6	+4.0	+3.9	+2.6
Germany	+2.1	+3.4	+3.3	+2.1
Hong Kong, China	-4.3	-4.1	-4.2	-5.4
Italy	+1.1	+2.5	+2.3	+1.1
Japan	+10.2	+4.4	+4.3	+3.0
Netherlands	+1.0	+2.4	+2.2	+1.0
Spain	-1.2	+0.2	+0.1	-1.2
Switzerland	-0.1	+0.1	N/C	-1.2
UK	-2.0	-2.0	-2.1	-3.3
USA	+2.8	+3.0	+2.8	+1.6
Europe ex UK	+0.4	+0.9	+0.7	+1.6
Asia Pacific ex Japan	-2.2	-7.5	-7.6	-8.7
Asia Pacific	+3.6	-1.9	-2.0	-3.2
Latin America	-8.8	-15.6	-15.7	-16.7
All World All Emerging	-3.7	-7.3	-7.4	-8.6
The World	+1.6	+0.4	+0.2	-1.0

Source FTSE World Indices

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

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

Currency	28.03.13	28.06.13
Sterling	1.78	2.45
US Dollar	1.85	2.49
Yen	0.52	0.86
Germany (Euro)	1.29	1.73

Sterling's performance during the quarter ending 28.06.13 (%)

Currency	Quarter Ending 28.06.13
US Dollar	N/C
Canadian Dollar	+3.5
Yen	+5.6
Euro	-1.4
Swiss Franc	-0.3
Australian dollar	+14.1

Other currency movements during the quarter ending 28.06.13 (%)

Currency	Quarter Ending 28.06.13
US Dollar/Canadian Dollar	+3.6
US Dollar/Yen	+5.6
US Dollar/Euro	-1.4
Swiss Franc/Euro	-1.1
Euro/Yen	+7.1

Significant Commodities (US dollar terms) 28.03.13 - 28.06.13 (%)

Currency	Quarter Ending 28.06.13
Oil	-7.1
Gold	-24.8

Markets

The significant volatility towards the end of the quarter marks a quarter of little change in overall international equity markets although with big variations between the different countries and regions and some market performances for foreign investors greatly distorted by currency movements. The majority of the positive return noted in the first quarter has been held in most cases. Looking at the FTSE World Index in total return terms, there was a 1.6% return in local currency terms, one of 0.4% in sterling terms, 0.2% in US dollar terms and -1.0% in euro terms. Looking at local currency returns first, we note, on the positive side, a 10.2% return from the FTSE Japanese Index, well ahead of other markets on the list, with the market being driven by "Abenomics" about which more later. On the negative side, we note marked weakness in Latin America with the FTSE Latin American Index returning -8.8% and, to a lesser extent, the emerging markets where the FTSE All World All Emerging Markets Index returned -3.7%. Elsewhere, movements tended to be fairly close to the FTSE World Index.

However, it is a different story when we look at currency adjusted returns, particularly against the Australian dollar and the yen. Weakness in commodity markets has been a driver of the weak Australian dollar and, so, a total return of -2.8% in the FTSE Australia Index in local currency terms has become one of -13.8% in sterling terms. Less dramatically, but still significantly, the +10.2% local currency return from the FTSE Japanese Index became of +4.4% in sterling terms, still a very acceptable quarterly return. In regional markets, the FTSE Latin American Index turned a -8.8% total return in local currency terms, as mentioned above, into a -15.6% sterling total return. The FTSE All World All Emerging Markets Index moved from a -3.7% local currency return to one of -7.3% in sterling terms, whilst the FTSE Asia Pacific Index, which includes Japan, moved from a local currency return of +3.6% to a negative one of -1.9%. The FTSE Asia Pacific ex Japan Index moved from a local currency return of -2.2% to one of -7.5% in sterling terms.

Not surprisingly, given their significant overvaluation, bonds experienced a very poor quarter. It was only a matter of "when" and we think there is more to come given their still highly elevated prices. Taking top quality 10 year government bonds as a benchmark, we see that the gross redemption yield on UK government bonds rose by 67 basis points to 2.45%, on US Treasuries by 64 basis points to 2.49%, on Japanese government bonds by 34 basis points to 0.86% and on German Bunds by 44 basis points to 1.73%. These imply a very painful fall in prices for holders of these and other bonds throughout the universe of bonds. The difference between bonds and equities is that those who bought bonds at earlier and lower yield levels, even now, risk obtaining totally unacceptable terms even if the bonds are held until redemption. Those who buy equities are likely to see an acceptable return at the least if held for a reasonable time.

As the differences between local currency and sterling returns, shown in the equity narrative above, suggest, there have been some large currency movements. Against the Australian dollar, sterling rose by 14.1% and against the yen by 5.6%. The Canadian dollar, like the Australian dollar, influenced by commodity prices, performed less badly with sterling rising against it by just 3.5%. Sterling was unchanged against the US dollar and weakened slightly against the euro and Swiss Franc by 1.4% and 0.3% respectively.

Commodities endured a generally poor quarter, one influence, but not the only one, being fears about a slowdown in the Chinese economy. Oil, as measured by Brent crude, fell 7.1% and gold by an enormous 24.8%. This does not suggest that investors are too concerned by inflation, whilst the threat of the tapering of quantitative easing in the USA which could raise interest rates would make the cost of holding gold more expensive given that it yields nothing. Of course, one good by-product of lower commodity prices is that it takes less out of the pockets of consumers and businesses, thereby boosting spending power and helping economic growth.

Economics

The same issues, as mentioned in many previous reviews, continue in the world economy but with some different nuances which have caused much higher levels of volatility in the second quarter than we have witnessed in the strong first quarter of the year. Investors appear to have become more confused by the economic policy being followed, particularly in the USA and Japan, or at least its implications. As we have often pointed out, the huge economic and market distortions caused by very aggressive monetary policy will have implications for investors in the future, particularly for their bond holdings. Nearly every professional investor realises this but many either have to maintain their bond holdings for regulatory or prudential reasons or are hoping to hang on a little longer before the party stops. But stop it will do, for we consider that current bond yield levels across almost every market are unrealistic in relation to the risks even after the rise in yields in the second quarter. It requires strong nerve to remain with an investment that is almost certainly overvalued and which one does not have to hold. So when the President of the Federal Reserve, Ben Bernanke, indicated, in answer to a question, that the quantitative easing policy in the USA might be tapered before it stops, the markets took fright, at least temporarily.

He was merely replying to a question and the context was the economic outlook for the USA. The FOMC minutes, published in early May, indicated that QE may be increased or decreased depending upon the economic numbers. It will be recalled that the Federal Reserve was targeting a reduction in unemployment to 6.5% in making its policy decisions, consistent with inflation being at satisfactory levels. At present, the level of unemployment is 7.6% and inflation is behaving itself being 1.1% on the Federal Reserve's favoured inflation measure, the PCE deflator. Ben Bernanke's answer was therefore hypothetical but such was the febrile state of the market that it resulted in an instant reaction in share and bond prices. What appeared to have occurred is that investors, faced with a very real possibility of which they were aware, but had ignored, took fright. This spilled over to all bond markets hitting more lowly rated bonds and those issued in emerging markets particularly hard. These had been markets which had benefited from the search for yield and the international effects of quantitative easing which had encouraged investors to seek additional yield in emerging markets or more lowly rated corporate debt. Our view has been that shares remain the most attractive asset class and bonds the least attractive. There are two reasons, one relative and one absolute. The relative one is that bonds (the high quality sovereign issues in the table at the beginning of this review are a good example) look very unappealing. If we take UK gilts, as one of the examples, to buy a ten year gilt, theoretically held until redemption, to obtain a gross redemption yield of just over 2% suggests, with that yield below the current inflation rate, a very negative view of other asset classes. The exception would be if we entered a deflationary period which would raise real returns on bonds but, if that happened, it would increase the liabilities in real terms of borrowers, thus increasing the possibility of default. The positive case for equities is that they look reasonably valued on ratings grounds. Those who are negative about the prospects for equity prices cite the high level of pre-tax profit margins and profits as a percentage of GDP, believing these levels to be unsustainable. We do not think that this will be the case. Having successfully reduced their operating costs, companies do now need top line growth and, in such a difficult economic environment, this is not easy to achieve. However, there is some growth in the world economy, enough to believe that profit margins will not collapse and earnings forecasts are still for a modest increase this year and next in most countries. If this view is correct, price/earnings ratios and dividend yields do not look expensive, in our view.

However, as the recent volatility in markets has shown, the big test for the different asset classes will come when quantitative easing is reined in and here it is important to understand the definitions surrounding quantitative easing. The recent volatility was caused by fears of a tapering of QE in the USA. Tapering simply means reducing the rate at which assets are purchased by the Federal Reserve. It does not mean that asset purchases are being halted or, in the next step, being reversed with the Federal Reserve selling assets, which it has purchased, back to the private sector and thereby sucking the money back out of the economy. In the short term, as the FOMC said in early May, QE could go either way depending upon the economic data coming out of the USA. It could be increased or reduced. So, where QE is being practised, the ultimate chain of progression is likely to be, firstly, a tapering, then a halt and, finally, a reversal. Given the very subdued economic environment at present and generally low inflation levels, this process is likely to be protracted, as it is very much easier to instigate QE rather than reverse it.

The dangers of quantitative easing arise from the monetising of debt. If QE is not sterilised, i.e. the money is not withdrawn from the private sector by the central bank selling the previously acquired assets back to it, then the subsequent monetising of the debt (if it is government bonds which were bought with the QE), meaning that the central bank is financing the government deficit by printing money, will lead to currency debasement. Moving from the present position in those countries where monetary easing has taken place to the situation where it will have to be completely unwound will be a very long and tortuous journey and it will cause politicians great difficulty even though it will be the central bank which is responsible. In a sense what happened to markets towards the end of the quarter was a useful exercise in shaping expectations. The rise in world stock markets this year may have reflected excessive complacency about the reversal of quantitative easing with investors preferring not to think about it. They will now be more prepared for it. Although the reversal remains some way off, it is worth thinking about how this may play out in the stock markets.

The starting point for any discussion is that, although quantitative easing was a necessary policy action to reflect the extreme financial and economic conditions prevailing from 2007/08, in the medium and long term the market distortions, which it causes, are highly undesirable. Here are a number of them. For business, very low interest rates perpetuate zombie companies. Businesses which are not in a healthy state can survive longer than they would normally do because of very low interest rates on their borrowings. The danger of this is that it "crowds out" healthy companies and restricts their growth, leading to an overall loss to the economy as these companies are held back from fulfilling their potential. For savers, of which there are far more than borrowers, the loss of income can cause real difficulty and hardship. In an attempt to restore their position, some investors have moved into other asset classes like equities and, perhaps, property to obtain yield. More disturbingly, they have bought bonds on what we consider to be unsustainable yields causing a bubble in the bond markets. The adjustment to a more realistic yield level will cause a sharp fall in prices particularly as we move along the yield curve. This will be a particular problem for more lowly rated and emerging market debt where the moves will be very sharp and what happened recently is a foretaste of this. For institutions like banks and insurance companies, not to mention central banks, stocked up with bonds which they have bought under their quantitative easing programme, the losses will be painful. The eventual benefit will be that the realistic pricing of bonds, equities and any other asset classes whose prices have been distorted by monetary policy will result in a proper allocation of capital across the economy where better investment decisions can be made.

It will be some comfort that equities, which may seem vulnerable to rising bond yields appear reasonably valued. Ideally, the further rise in interest rates out along the yield curve, which will almost certainly accompany the reversal of quantitative easing, will be gradual so the policy reversal is carried out carefully. An initial rise in interest rates can be for a good reason, namely that the economy is improving. But a central bank selling bonds back to the private sector can be expected to see interest rates rise at a time when the government in question is still having to raise money in the bond markets. For bond investors, there is little doubt that there is going to be an unhappy ending to the QE story but for equities there is much more doubt. This, in our view, is the biggest uncertainty hanging over the equity market and we have had an early taste, although it is unlikely to come into focus in the near future given that an easing of QE is likely to be some way in the future. Tapering is possible in the USA if the economic numbers justify an easing back. It is unlikely to happen in the near future in the UK and certainly will not happen in Japan given that it is only just being ramped up.

None of this has changed our view that equities remain the most attractive asset class at present and we do not wish to be unduly alarmist but it is right to point out what we believe to be the possible negative factor for this asset class at an undetermined time in the future. At this stage, this is just an issue to note arising from the warning shot given by the recent market turbulence.

How to fathom out what is happening in Japan is more difficult given how extreme the new economic policies (monetary, in particular) seem. The new Governor of the Bank of | Japan is more in tune with Mr Abe's thinking although supposed to be independent. The inflation target has been raised from 1% to 2% and the Bank of Japan plans to double the country's monetary base from the equivalent of US$1.43 trillion by March 2015. At the same time, the Bank of Japan plans to purchase longer dated bonds than hitherto so that the average maturity of the bonds held increases from three years to seven years. The further out along the maturity curve bonds are held, the greater the capital risk and this applies to central banks as well as private sector holders of government bonds. The Bank of Japan has calculated that a 1% rise in interest rates would lead to market losses equivalent to 10% of Tier 1 capital at big banks and 20% at weaker regional banks. For most investors outside Japan, it seems strange that a central bank would be targeting higher inflation but Japan is a special case with its history of deflation which itself can cause significant problems for economies although we tend to think that inflation is a greater threat because that is what the UK, as one example, has often experienced in the past. Deflation can have an insidious effect on an economy. For a start, it raises the real costs of servicing and repaying debt thereby threatening both individuals' and companies' solvency, not to mention that of the government although in the case of Japan money can be printed. If individuals or businesses know that the prices of goods and services which they buy are going to be cheaper in the future, they will hold off if they are rational unless it is expenditure which has to be incurred. This is self defeating for an economy because it builds in recurring weakness. In trying to aim for an inflation target of 2%, the Bank of Japan is hoping that it can reverse the mindset of deflation and get money moving around the economy. By increasing the monetary base so much, the Bank of Japan will be taking money printing to extremes and one of the side effects which we have already seen can be expected to be a weaker currency which should restore some of Japan's manufacturing competitiveness. The danger is that this can be seen as currency manipulation and protectionist and set off retaliatory action elsewhere. Japan has usually been seen as a strong currency country but by monetising its government debt in such a substantial way, it threatens currency debasement. It is, without doubt, a risky strategy. For this aggressive monetary policy to work as well as the fiscal stimulus, parallel supply side reforms have to be introduced, something which will prove very difficult in Japan where special interests are well entrenched. The labour market suffers from extreme rigidities which makes employers reluctant to take on younger people and for companies to control their cost base at a time when Japanese manufacturing companies face extreme competition from companies in countries like South Korea. The farming industry, a very powerful lobby group, enjoys significant protection and is ripe for opening up to more foreign competition. But tradition dies hard in Japan and vested interests must be faced down with supply side reforms to increase the country's potential growth rate. For it is only economic growth which will help to produce the revenue to start to address the country's fiscal problems. Whilst Japan has substantial foreign reserves, its current account position is deteriorating as a result of the trade account being adversely affected by the need for energy related imports following the closure of most of the country's nuclear power stations.

As the world's third largest economy, it is in the world's interests that the Japanese economy becomes successful again but it has to be recognised that the country is following a very high risk policy.

The waves caused by Mr Bernanke's remarks on the possible tapering of QE in the USA have slightly pushed the eurozone into the background but we think it should be at the front of investors' minds. Some eurozone politicians have tried to suggest that the worst is over but that is ridiculous and speaks poorly of their judgement or understanding of the deep flaws in the euro project. In the last few days, the issues have flared up again as the Portuguese government has lost two of its ministers, including the Finance Minister, and Portuguese government bond yields have soared as investors realise that it will almost certainly require another bailout. Economic contraction is the order of the day in the troubled southern eurozone countries, whilst France faces an enormous cultural challenge in reducing the size of its public sector and welfare benefits in order to provide room for growth and tackling its severe budgetary issues. Because it is the second largest eurozone economy, its problems could easily lead to social unrest as the growth versus austerity argument on which last year's elections were based is shown to have been a bogus choice. France could well be the Achilles heel of the eurozone and the issues are likely to come to a head soon. Nearly all of the forecasts suggest a eurozone contraction this year, with the European Commission, for example, forecasting that the eurozone will contract by 0.4% this year. To improve public finances, economic growth is essential because economic contraction is self defeating tying, as it does, these countries into a vicious circle of economic contraction and increasing debt levels to where they are unable to be financed by the markets.

Moving on to China, this is a country, because of its status as the second largest economy, which increasingly influences markets and concerns about an economic slowdown have been a contributor to market turbulence and weakness in the international mining sector, for example. A squeeze on the shadow banking sector at the end of the quarter temporarily raised interest rates sharply causing worries about a credit crunch and a further reduction in the rate of economic growth. Because of its strong financial position, China has the ability to be more flexible abut the management of its economy and to be able to move more quickly. But when investors view the glass as "half empty" these fears can affect share prices as we have seen. China is trying a transition to a country with less wasteful fixed asset investment, more consumption and less emphasis on exports.

All these issues have been with us this year but, in the first quarter, were considered benign and also some way into the second quarter before investors looked at them in a different light and temporarily took fright at what they had seen even though these should have been not unexpected. The optimistic interpretation on the market reaction to the possible tapering of QE in the USA is that it will give investors time to adjust their investment response to a winding down of QE. Everyone should have been aware of what was eventually going to happen but it seemed to come as a shock to some investors, hence the level of volatility and a rush for the door in some markets. As we have often said, the rise in share prices since March 2009 has been largely due to the extraordinarily loose monetary policy being followed, one of the purposes of which was to raise asset values, but it is not the best quality reason for this to have happened and markets should not be dependent for their performance on an artificial stimulus like this. It will be a very tricky balancing act but, ideally, the exit from QE, whenever it takes place, will be orchestrated with an improvement in economic growth so that the markets can accept the accompanying rise in interest rates to more natural levels. We are here talking about a long drawn out process given the current fragility of the world economy so a reining back of QE, where applied, is likely to be a protracted process which, from an investor point, of view is a good thing.

Although the problems of the world economy are fundamental, investors should recognise that there are some mildly positive developments in terms of economic growth which is what is badly needed.

So, we will now turn to look at various parts of the world economy, starting with the USA. We have already discussed the remarks made by Ben Bernanke which spooked the markets. It is noticeable that, since he spoke, there has been an attempt by those connected with the Federal Reserve to reassure markets that the Federal Reserve was not going to pull back on its support for the US economy. This has, so far, provided some assurance to the stock market.

One important backward looking indicator, the first quarter U.S. GDP figure, was revised downwards quite sharply in June. The annualised growth rate was revised to 1.8% against the previous estimate of 2.4%. It is important to emphasise that this relates to the past and that current economic data from the USA presents a more optimistic picture. The housing market is one example of this. It was central to the USA's financial and economic problems, so any improvement in the housing market touches many elements of the economy including creating a positive wealth effect which benefits consumers and businesses. Examples of a continuing improving trend in the housing market include the highest level of sales of previously owned houses for 3 ½ years. The median price of an existing house was 15.4% higher than a year earlier and reached the highest level since July 2008. The monthly gain of 4.2% was the largest gain since October 2005. According to the widely followed S & P Case-Shiller house price index, the level of house prices was 12.1% higher than in April 2012. Although fast house price inflation is not something one would normally like to see, the recovery from very depressed levels is positive news on this occasion. The Commerce Department reported a 0.4% rise in construction spending in April following a 0.8% decline in March. It also reported that new home sales rose by 2.1% in May, the most since July 2008. Elsewhere, the Conference Board's consumer confidence index rose to 81.4 in May compared with a reading of 74.3 in April. Durable goods orders rose by 3.6% in May. In the credit markets, S & P raised the USA's long term rating outlook to "stable" from "negative" as it cited reduced fiscal risks. The IMF was, however, more critical, suggesting that fiscal policy will reduce growth by up to 1.75% this year. It forecasts that US economic growth will be 1.9% this year and 2.7% next year, down from its earlier forecast of 3.0%.

The U.S.A. still has to face enormous fiscal problems arising from rising entitlement expenditure in the future but, at present, its economic position is relatively good and it is an equity market that we continue to favour. The recent rise in the ten year US Treasury bond yield has put its yield roughly on a par with that of the S & P 500 Index whereas the former would normally be higher. The relation between bond yields and equities still favours the latter and we think a return to the more normal relationship whereby bond yields will be higher than those on equities does not pose a significant threat to US equities provided the rise is not very sharp. Whilst yields are significantly lower than we would consider realistic, the continuation of very loose monetary policy is likely to keep them lower than they should be. As we have said earlier, and this applied to other markets, winding down QE will be a very delicate task and all asset classes will be very sensitive to any mishaps.

For the eurozone, there is little more than can usefully be added because it is the major fundamental flaw in the project which will dictate the economic news. It is almost certain that the eurozone will contract this year and the European Commissions's latest forecast suggests economic contraction of 0.4% making it very difficult for the necessary outcome for public finances to be achieved. If we look at the likely outcomes for some of the eurozone countries this year, we are likely, or certain, to see economic contraction in France, Greece, Italy, the Netherlands, Spain and Portugal. Whilst European shares look cheap, there is obviously a risk discount applied to the various eurozone markets. However, notwithstanding our highly negative view on the eurozone and the euro project, investors should take advantage of the opportunity to invest in world class companies based in the area. It remains important to distinguish between the sovereign and the companies domiciled in the area. The latter have the opportunity to invest and trade away from the eurozone with its myriad of problems.

Japan is going for broke, particularly in the area of monetary policy, as it tries to kick start its economy. Its economic problems are horrific. Its gross level of public debt in relation to GDP is likely to be around 240% of GDP this year with the net level still at about an eye watering 150%. It is an economy regularly prone to deflation which makes stimulating demand for goods and services difficult, an issue we discussed earlier. It has a major demographic problem looming which will exacerbate budgetary pressures and it has at least a short term economic problem following the closure of most of its nuclear reactors which is causing its current account surplus to deteriorate. It also has major structural regidities in the economy which hold back its growth potential. If throwing money at the problem is to be the answer, and it is a very high risk strategy, then serious supply side reforms, targeted to increase the potential growth rate of the economy need to be enacted. This includes tackling the protectionist tendencies in Japan. The Prime Minister's supply side reforms, which also crucially need to tackle labour market rigidities, need to be significant to give the economy the chance to grow. The list of reforms Mr Abe has targeted is wide and possibly as far as he feels he can go at present but much more will need to be done and there will be powerful vested interests facing him down. The areas he mentioned would liberalise the sales of non prescription drugs and create areas of deregulation and tax experiments in selected cities. Other areas include promoting trade and investment, liberalising the electricity sector, strengthening agriculture (which is heavily protected) and trying to provide career opportunities for women. Other areas for boosting are Foreign Direct Investment, tourism, farm incomes and targeted export industries and corporate investment.

There were two other items of positive news for Japan, one backward looking and therefore not as significant and one forward looking. The backward indicator was an upward revision to the first quarter growth estimate. It was raised to 1% for an annualised growth rate of 4.1% and the forward looking indicator was an upward revision to the Bank of Japan's assessment of the Japanese economy. It was the sixth month in a row that it had raised its assessment. It noted a "pick up in exports and industrial production and continued resilience in private consumption". The violent change in monetary policy, in particular, has caused enormous gyrations in the Japanese stock market and currency. Many Japanese companies in the manufacturing sector are highly geared to the currency, hence the very sharp rise in the prices of some of the Japanese manufacturing companies. During the time of yen strength, many Japanese companies established further manufacturing facilities abroad, particularly in Asia, and it is unlikely that they will change course because of a short term trend in the yen which may or may not be maintained. Nevertheless, a weaker yen will help their profitability with consequent benefits for the Japanese economy. The danger of the extreme monetary policy being followed is that the currency will be debased to a dangerous level. Whilst that might help to achieve and probably exceed the 2% inflation target, an excessive depreciation risks destabilising the economy. There remains a case for holding Japanese equities on the basis of enhanced earnings prospects and Japanese shares still offer a dividend yield well in excess of JCB ten year bond yields at approximately twice the level.

In China, the new Chinese leadership is treading a path between orthodoxy and trying to maintain a sustainable rate of growth without setting off inflation. It also wants to limit the bad debt problems of banks caused by over investment in fixed assets. This is why it put pressure on the shadow banking sector by inducing a cash squeeze which pushed up short term interest rates sharply. However, having fired this warning shot, China was at pains towards the end of the month to say that there was ample liquidity in the financial system. China remains a major influence on markets especially as there is little growth elsewhere and, for this reason, investors are very sensitive to any signs of a slowdown which could further impact the world economy. Of all the major economies, China, probably because of its political system, can move most quickly on economic policy and it is certainly not in its interests for the economy to decelerate too much. Where the west has to be careful is in provoking a trade war with China which it is not in a position to win. China has retaliated against the EU after its imposition of a high tariff on solar panel imports as well as its carbon emissions scheme for the EU for airlines flying into EU aerospace. China has held off signing important orders for A330 aeroplanes which it had planned to purchase. In a difficult economic environment, protectionist tendencies tend to rise and that is not good for the world economy. China will remain a crucial influence on the world stock markets.

In the UK, the economic news is indicating better times although it is very early days. The latest Purchasing Managers Indices for all three categories are pointing in the right direction. That for the dominant services sector of the economy, accounting for about three quarters of activity, showed quite a sharp rise in June with a reading of 56.9 against 54.9 in May. The manufacturing PMI rose slightly to 525 against 51.5 whilst the construction PMI rose slightly to 51.0 from 50.8. Therefore, all three indices were in positive territory, signalling growth. The news from the housing market is improving as well, an area the government wants to stimulate as it provides a quicker boost to the economy than many other measurers. Although, as we said when discussing the USA, rising house prices are not an unmixed blessing, in the current environment they are generally a positive influence by encouraging a "feel good" factor. So, for example, in England and Wales, house prices reached a record in May. They rose by 0.4% in the month in May to take the annual growth to 2.7% although it is very much a two tier market with London almost a country in itself with its buoyant property market. The Council of Mortgage Lenders reported that gross mortgage lending rose to £14.7 billion in May. This was 21% higher than the April figure and 3.1% higher than a year previously. However, there is a two way pull in the market as many homeowners seek to deleverage. As an example, although banks approved 25% more mortgages in May than in May 2012, repayments were greater. This does not matter too much as it is the trend in housing activity and prices which is important for the economy.

The news is certainly better than in the eurozone but it is a huge struggle for the UK to restore its public finances with the Public Sector Net Borrowing Requirement hardly moving over the past two fiscal years and not much change expected by the OBR this financial year. Having its own currency and an independent monetary policy gives the UK an enormous advantage over eurozone countries but years of austerity lie ahead. The best antidote to the debt problem is economic growth but the UK's efforts in this area have been hampered by the eurozone's problems. Rebuilding the UK economy towards the private sector at a time of substantial job cuts in the public sector is vital and there is some evidence that this is happening. Against this difficult background, it is still possible to be positive for UK equities with their wide reach of international businesses. They look reasonably valued.

After a strong start to the year, we warned that there were bound to be some negative quarters, given the very difficult economic outlook and, in the March review, talked about a "bumpy ride". With international equity markets not having risen for the best quality reasons, given the uplift in asset values caused by an extremely stimulative monetary policy, prices will from time to time be vulnerable to unexpected developments. But given the unappealing prospects for bonds and a certain negative real return from cash, reasonably valued equities should remain the asset class of choice for long term investors. Overall, there is some growth in the world economy, albeit patchy and quite modest, but this should support company earnings and dividend prospects. Notwithstanding the rise in bond yields over the quarter, this market continues to look dangerously expensive. We expect more fluctuations in equity prices and some negative quarters against the background of a medium term uptrend in equity prices.