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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

After a positive first quarter, international equity markets have fallen back to leave them little changed from the end of last year. As the Greek crisis has appeared to be reaching a final outcome and as the Chinese stock market has fallen sharply after its strong earlier run, investors have become more cautious. Bond markets have also experienced a negative quarter, not surprising given their fundamental overvaluation. In the currency market, the strength of sterling was a feature whilst, in the commodity markets, oil continued to recover.

The tables below detail relevant movements in markets :

International Equities 31.03.15 - 30.06.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-6.8	-11.5	-6.3	-9.6
Finland	-7.9	-9.8	-4.4	-7.9
France	-2.5	-4.5	+1.2	-2.5
Germany	-8.3	-10.2	-4.8	-8.3
Hong Kong, China	-3.6	-2.2	+3.6	-0.1
Italy	-0.7	-2.8	+3.0	-0.7
Japan	+5.6	-2.3	+3.5	-0.3
Netherlands	-1.1	-3.1	+2.7	-1.1
Spain	-5.4	-7.4	-1.9	-5.4
Switzerland	-2.5	-4.3	+1.4	-2.3
UK	-2.5	-2.5	+3.4	-0.4
USA	+0.3	-5.4	+0.3	-3.4
Europe ex UK	-3.8	-5.8	-0.2	-3.8
Asia Pacific ex Japan	-2.7	-8.0	-2.5	-6.0
Asia Pacific	+1.5	-5.0	+0.6	-3.1
Latin America	+3.7	-1.9	+4.0	+0.2
All World All Emerging	+2.2	-3.7	+2.0	-1.7
The World	-0.4	-5.2	+0.5	-3.2

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : -3.4%

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

Currency	31.03.15	30.06.15
Sterling	1.70	2.14
US Dollar	1.94	2.33
Yen	0.41	0.45
Germany (Euro)	0.18	0.76

Sterling's performance during the quarter ending 30.06.15 (%)

Currency	Quarter Ending 30.06.15
US Dollar	+5.9
Canadian Dollar	+4.3
Yen	+7.9
Euro	+1.9
Swiss Franc	+1.8
Australian dollar	+4.7

Other currency movements during the quarter ending 30.06.15 (%)

Currency	Quarter Ending 30.06.15
US Dollar/Canadian Dollar	-1.5
US Dollar/Yen	+1.8
US Dollar/Euro	-3.8
Swiss Franc/Euro	+0.1
Euro/Yen	+5.8

Significant Commodities (US dollar terms) 31.03.15 - 30.06.15 (%)

Currency	Quarter Ending 30.06.15
Oil	+13.9
Gold	-0.9

MARKETS

As was to be expected after a run of mostly positive quarterly performances, there was a temporary break this quarter. In local currency total returns the FTSE World Index returned -0.4%, in sterling terms -5.2%, in US Dollar terms +0.5% and in euro terms -3.2%. Looking, firstly, at local currency returns, the best performer was Japan where the FTSE Japan Index returned +5.6%. The FTSE Latin American Index returned +3.7% and the FTSE All World All Emerging Markets returned +2.2%. The FTSE USA Index also showed a slightly positive return, +0.3%. Underperforming the FTSE World Index was the FTSE Australia Index, -6.8%, the FTSE Europe ex UK Index, -3.8%, and the FTSE UK Index, -2.5%. With sterling having performed strongly over the quarter, the relative performance of the UK market improved with its -2.5% return compared with the -5.2% return on the FTSE World Index. Although, in negative territory, the sterling adjusted returns on the FTSE Japanese Index, -2.3%, the FTSE Latin American Index, -1.9% and the FTSE All World All Emerging Market Index, -3.7%, outperformed the FTSE World Index. The worst sterling adjusted performance was from the FTSE Australian Index, -11.5%. Although the FTSE Europe ex UK Index, with a sterling adjusted performance of -5.8%, was only a little worse than the FTSE World Index, Germany had a particularly poor quarter with the FTSE Germany Index returning -10.2%.

Bonds, not unexpectedly, have experienced a difficult quarter and we will return to this in the review which follows. Taking ten year government bonds as a benchmark, the gross redemption yield on the UK government bond has risen by 44 basis points to 2.14%, on the US Treasury bond by 39 basis points to 2.33%, on the Japanese Government bond by only 4 basis points to 0.45% and on the German Bund by an enormous 58 basis points to 0.76%.

In the currency markets, the feature of the quarter was the strength of sterling. Against the yen, it rose by 7.9%, against the US dollar by 5.9%, against the Australian dollar by 4.7%, against the Canadian dollar by 4.3%, against the euro by 1.9% and against the Swiss Franc by 1.8%.

In the commodity markets, oil, as measured by Brent crude rose by 13.9% but gold fell by 0.9%.

ECONOMICS

We have delayed this part of the economic review for as long as possible, given the Greek crisis. Whenever the end game has appeared to be in sight, it has taken yet another unexpected turn, so one has become diffident about calling the outcome of the crisis. As this is written, the referendum has been held and the result has been a decisive “No”. Whilst it is uncertain as to what it was “No” to, since there were no longer bail out terms on the table, one can assume it was “No” to any terms the creditors might put to Greece which did not meet with the approval of the Greek government. That this stage has been reached is testament to a whole litany of mistakes and bad decisions taken on both sides. It is easy to blame Greece for the whole problem but that would not be fair. The origin of the problem was the creation of the euro. It has never had any proper economic underpinnings and would effectively work only if the eurozone was one country with transfers between its different parts being made to where they were needed, in some ways like the USA. It was purely a political project driven by those who should have known their economics better. Entry criteria became flexible if colliding with political imperatives, i.e. the single currency. Greece did not meet these criteria and the problem was compounded when it was later discovered that Greece's financial position was not as it was set out at the time of its joining the euro. The eurozone was nowhere near being an optimal currency area, with the different members having so many different economic characteristics that economic convergence was impossible. Greece is as different economically to, say, Germany as it is possible to be within a European context. The problems with the Greek economy are well known but, if it had stayed out of the euro and had a flexible exchange rate, its economic problems would have been reflected in a weak currency which, although it would have brought many problems, including inflation, would have been the necessary adjustment mechanism to reflect its lack of competitiveness. As a weak currency, the drachma would have attracted high interest rates and placed some discipline on the politicians in terms of the economic policy they were following. For a time, being able to borrow cheap euros took away all the disciplines leading to the position in which the country now finds itself. One of the original theoretical attractions of the euro was that the discipline of the single currency would have forced on its members economic convergence and discipline to remain competitive. This is patently not the case, with misery being forced on Greece through, amongst other things, an internal devaluation, i.e. lower wages and pensions. As this is written, it is uncertain whether Greece will stay in the euro. In the short term, leaving it will cause immense pain but, in the longer term, the benefits of a flexible exchange rate, if the country reforms itself, should be much stronger. Whatever happens, the eurozone as a concept has suffered a significant setback.

It was inevitable that international equity markets would draw breath after so many mainly positive quarters, something which we have always been keen to emphasise in our economic reviews. It was even more inevitable that bond markets would suffer a poor quarter given how far from reality bond yields were and still are standing. Whilst the economic and political background remains, in places, as troubled as ever, the Greek situation is currently at an elevated state of crisis as the stand off between the creditors and debtors intensifies. The Greek Finance Minister, Mr Yanis Varoufakis, who has just resigned, has an academic background in game theory and this is certainly being tested to destruction with neither side blinking so far. Either the creditors or debtors have got it badly wrong in believing that the other side will blink first. We will come back to this shortly, as it obviously has a bearing on the turbulence in the bond markets, but we should consider other issues which have affected bonds this quarter. Other than Greece, two issues come to mind, firstly fears about deflation and, secondly, the start of quantitative easing by the ECB in March.

At one stage, a large swathe of the European bond markets saw gross redemption yields on government bonds in negative territory, even those of up to 10 years' maturity in the case of Swiss bonds which are regarded as the ultimate safe haven. Even after the shake out in the bond market, 10 year Swiss government bond yields (0.16% at the time of writing) are only fractionally in positive territory. At one stage, there were a number of eurozone government bonds trading in negative yield territory at the 5 year maturity range, for example, Germany, France, the Netherlands, Austria and Finland, whilst, outside the eurozone, as well as Switzerland, government bonds issued by Denmark and Sweden were also showing negative gross redemption yields. Even after the shake out, at the 2 year maturity range, all these countries' government bonds are in negative yield territory. So, an investor in these securities is paying the relevant government to invest in their debt. This is an extraordinary state of affairs, with some interesting implications. In looking for a fundamental reason why this may not be as nonsensical as it sounds, there are two possibilities. The first is that these countries are in for a prolonged period of deflation and, therefore, that buying a bond in these areas on a negative nominal yield might actually offer a positive real return if inflation was even more negative. An investor would have to feel a high degree of confidence that a dip into deflationary territory was not going to be temporary. A second reason could theoretically be that there was so much economic fear about, that making an investment into an asset with a negative yield but which appears safe in a qualitative sense (i.e. it is unlikely to default) was the least bad option. Whilst there is plenty to be concerned about in the current political and economic situation, one would have to be unrealistically pessimistic to believe that this was a sustainable argument for making such investments. There was also a technical argument used by some optimists which was that with the ECB's quantitative easing programme running at €60 billion a month from March and with purchases of assets intended to be continued until at least September 2016, meaning that at least €1 trillion will be involved, it would not necessarily be counter intuitive to buy bonds with negative yields. Given what has happened in the bond market recently, that has quickly proved to be a triumph of hope over experience and, even though there is a very large buyer in the market, there could be an economic reason for higher yields. One of the reasons for implementing quantitative easing in the eurozone is to try to help to kick start the eurozone's economies, economic growth being the best way to address debt problems. By signalling even more strongly that interest rates will remain at exceptionally low levels for the foreseeable future and depressing the euro's exchange rate (for that was a likely consequence of quantitative easing) it is a plausible argument that, at least in the short term, it will raise the eurozone's economic growth rate and then actually raise interest rate expectations which will find their reflection in bond yields. So there is a valid reason why quantitative easing and rising bond yields are compatible. Furthermore, it is unlikely that the eurozone is going to embark upon a prolonged period of deflation. Whilst the headline rate of inflation is the one which captures the headlines, it is usually instructive to look at the core rate of inflation which excludes volatile items like food and energy. The latest core eurozone inflation rate for May stands at 0.8% year on year and the lowest level at which it has stood is 0.6% this year as it did in January, March and April. To us, it shows that inflation is not dead and buying bonds on negative yields in the belief that one may still earn a real return is fanciful. Furthermore, we do not believe that investors in the eurozone bond market have taken sufficient account of the credit risk involved and that there has been indiscriminate chasing of yield. It has been noticeable that weaker eurozone sovereign credits have been particularly hard hit in the recent bond rout and, if the Greek crisis is not resolved and it leaves the eurozone, it is not hard to see bond investors probing the weaker credits. The problem arises from the belief held by some that the advent of the euro meant that credit risk was reduced. As we have seen from the Greek crisis, it has not been and the mispricing of risk is a significant current concern. Whilst the risks with the credits in a monetary union are more difficult to discern than in a single country, the absence of an economic union means that they are still there as the Greek situation shows at present. In discussing trends in the bond market this quarter we have inevitably concentrated on the eurozone but the fall in bond markets elsewhere shows that the overpricing of bonds is not just a eurozone phenomenon.

Because bonds are so overpriced we have to be concerned about what happens if and when confidence, already fragile, cracks. At the short end of the bond market, provided the issuer is creditworthy, there should not be an issue albeit that the return will be minuscule. But further along the yield curve there have already been some ugly price falls. If we look at the ten year government bond market in selected markets and the movements between the highest and lowest prices so far this year, we note the following percentage falls in prices - the UK 7.7%, Germany 8.2%, Italy 10.8% and the USA 4.8%. As is to be expected, the damage in the thirty year bond market was far greater. For the UK the fall in price was 14.7%, for Germany 25.4%, for Italy 24.5% and for the USA 18.2%. Some serious realised or unrealised losses have therefore been sustained. Because of the extent of the overvaluation of bonds, there is a concern that there will be a rush for the exit which will accentuate price movements. Open ended funds will be forced sellers to meet redemptions and with banks holding lower inventories of bonds because of the regulatory cost of doing so, some further sharp downward movements could occur. For this last quarter, we think that the movement in bond markets has been a more significant event than the relatively modest correction in international equity markets.

We have noted before that extreme monetary policy in the largest economies and regions is being implemented to try to produce circumstances that will be conducive at least to only very modest growth. We have to be concerned that economies can only show even modest growth when interest rates are close to zero for it means that monetary policy, which used to be a powerful tool of economic management, has lost nearly all of its power to be effective. For example, if the world economy, or any sub-set of it, needed a stimulus to accelerate economic growth, then monetary policy would not be there to help and would be of very little use. This lack of economic firepower, if economic circumstances became more difficult, must be a concern and a reason to try to normalise monetary policy as soon as possible, albeit that that time seems quite far distant at present. Apart from the theoretical concerns about relying on exceptionally low or negative interest rates to stimulate only modest economic growth, there are some very practical ones. Misallocation of resources is one danger. If interest rates are very low, debt servicing costs will be lower than in more normal times. This enables less successful or "zombie" companies to keep going and thereby "crowd out" or damage the growth prospects of more dynamic and successful companies. This affects the overall performance of an economy and reduces growth prospects. The natural selection of successful companies which occurs in a more normal economic policy background is muted in circumstances like those which exist at present and this is not healthy. The distortion also affects macro economic policy. The disciplines imposed by a high level of public debt on an economy are reduced if the servicing cost of that debt is low. It reduces the pressure on a government to address its public finances and, whilst this may feel a short term benefit, it is building up trouble for the future. Because of the maturity profile of the official debt, it would take time for the impact of an increase in interest rates to be reflected in debt servicing costs but, over time, increased debt servicing costs would adversely affect the budget deficit and cause harder than necessary economic decisions to be made which would impact on growth. Artificially low interest rates can enable governments to avoid decisions necessary to ensure better long term growth prospects. Originally, the Stability and Growth Pact, drawn up as the financial criteria for those countries planning to join the euro, had, as one of its rules, a 3% limit as a country's budget deficit and, as a second rule, a national debt ceiling at 60% of GDP. 60% is now a dream for most eurozone countries but, had it been adhered to, the concern about the normalisation of interest rates on budget deficits in the future would not now exist. It is fair to say that there is very little current comment about the effect of rising eurozone interest rates on budget deficits but it is a problem which is being stored up for the future. However, it is not just a eurozone problem. The USA, UK and Japan fell into the same category. In fact, Japan, with an outstanding public debt to GDP ratio of about 230% and the largest budget deficit as a percentage of GDP of the major economies, faces a particularly acute threat if interest rates rise. A high level of public and private debt is a threat to economic growth. If we take the UK, for example, we see debt interest costs forecast for 2015/16 at £35 billion which equates to about 4.7% of the public sector spending forecast. Were that figure to grow, either because the government was not successful in its attempt to balance the books or interest rates rose, the remedies to address the problem, either higher taxation or lower public spending, would bear down on the economy and this would apply to any relevant economy. Similarly, in the private sector, if individuals or businesses are overindebted and rein back on spending, this also affects economic growth. Apart from the economic distortions and mispricing of risk which result from very loose standard and non standard policy, another risk, which is not on most people's radar at present, is inflation. It is always tempting to concentrate on the present rather than on what may happen in the future, but the idea that we do not need to worry about inflation is, we think, wrong and something which bond yields should take into account. Current low levels of inflation are a function most recently of falling commodity prices and subdued or weak economic growth in the aftermath of 2008's financial crisis. This is particularly relevant to the eurozone. As a result of this, business investment in many countries has been weak. But, even in the eurozone, there is now some economic growth. With unemployment high in the eurozone, the current level being 11.1%, wage inflation is unlikely to raise the general level of inflation but capacity shortages are likely to at some stage. In the latest OECD Economic Outlook, there is a table of estimated output gaps in 2015, the difference between actual and potential GDP. For the UK, it is relatively small, -0.5%, which means the Bank of England will be watching closely in determining the time of the first interest rate increase in the UK. In the USA, the estimate is larger, at -2.4%. In Japan, the figure is actually positive, 0.3, but circumstances there are rather different as we shall come on to later. In the eurozone, the overall estimate of the output gap is -2.7% but that covers a wide range amongst its members. Not surprisingly, with the collapse in its economy since 2011, Greece's output gap is estimated by the OECD at -12.7% for 2015. Other troubled economies have large estimated output gaps. Italy, the third largest eurozone economy has one estimated at -5.6%, Portugal at -5.0% and Spain at -4.1%. On the other hand, Germany is estimated to have an output gap of just -0.4%. Next year, the output gap of all of these economies is expected to diminish and, in the case of Germany, to disappear to a positive 0.8%. It must be emphasised that measurements of output gaps are subjective. Also, it cannot be a given that erratic items like energy and food will continue to have such a favourable effect on the headline inflation numbers. In detailing these issues, we are bringing together pointers as to why it is not possible to be complacent about current inflation rates and bond yields and the risks which holders of bonds, particularly those at the longer end of the maturity spectrum, are running. In our view, notwithstanding the magnitude of the falls in bond prices, which we detailed earlier, bond prices at the medium and longer end of the market remain vulnerable with holders risking significant losses. Much further out, it will be necessary to reverse quantitative easing because eventually a flood of newly created electronic money chasing a finite amount of goods and services will create inflation through the mechanisms described above. Central banks selling bank bonds to the private sector as one manifestation of the reversal could be expected to raise interest rates.

The substantial falls in bond prices in the medium and, particularly, long dated bond market was a highly significant event during the quarter. Against this background, equities held up reasonably well although they have fallen further post quarter end. As our clients know, the latter is our preferred asset class, but we have to ask ourselves if that view is consistent with what has happened in the bond markets recently. This comes back to a question which we have asked in recent reviews. At the time, bond prices were rising and, therefore, yields falling and equities, too, were rising. We said that both could not be right and the question was, which one was right and which one was wrong? We know that quantitative easing has raised asset prices and some investors have bought bonds in search of some yield and this has often meant travelling down the quality spectrum, whilst others have bought shares where, relatively speaking against high quality bonds, some attractive yields have been on offer. In most cases, dividend yields in major markets have been in excess of those on the relevant ten year government benchmark bonds. It is also a reasonable expectation that dividends will grow as the world economy grows even if not at a fast rate.

In its latest Economic Outlook, the OECD forecasts that the world economy will grow by 3.1% in 2015, down from 3.3% in 2014, and by 3.8% in 2016. Within that forecast, 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%) 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. Whilst forecasts are necessarily imprecise, current political and economic events make the task even more difficult than normal. But the point is that when the generally superior yields of equities over high quality bonds is combined with the prospect of some dividend growth as a result of probable modest economic growth, the relative attractions of equities become apparent especially as bonds appear to us to be seriously overvalued.

Whilst we have a high degree of confidence in our judgement that bonds are seriously overvalued, and that seems to be the general consensus, there are divided opinions on equities. Those who are negative on this asset class argue that, on a cyclically adjusted basis, i.e. allowing for the economic cycle, say ten years, shares are expensive. On the other hand, those who look at the current and prospective position and do not expect a sharp economic downturn, feel more sanguine about the prospects for equities. We fall into this latter camp. Even if shares are not as cheap as they were given the run up in share prices, their relative attraction appeals to us, albeit we expect shares to go through difficult periods such as the present.

We turn now to look at specific areas of the world economy starting with the USA where the latest estimate of first quarter GDP, the third, is not as bad as the second estimate and has now reverted to being in line with the first forecast of a contraction in the economy of 0.2%. This seems to follow a pattern of recent first quarter US data being very poor, only to be followed by a decent recovery. The figures have been weather related as the US has suffered very bad winters in the last two years but there are also questions over the seasonal adjustments. Although individual items of data coming out of the US economy have not been sparkling, intuition tells one that the US economy has not been performing as badly as the figures show and recent data suggests a stronger position. Besides the bad weather in the first quarter, the economy was held back by an industrial dispute in the west coast ports, reduced activity in oil drilling, caused by the weak oil price, and net trade with the stronger US dollar being a problem for many companies. One of the reasons for the positive revision in the third estimate was an increase in inventories which may have a negative impact in the next quarters as these are drawn down to meet demand. One of the puzzles about the US economy has been the lack of impact on activity of the fall in the oil price which has the effect equivalent to that of a tax cut. However, the latest retail sales figures suggest that the expected increase in consumer demand may be happening. These show strong growth with a rise of 1.2% over the previous month. Consumer spending generally was strong. In May, it grew at its fastest rate in nearly six years, 0.9% month on month. There are signs of a strengthening housing market with activity and prices rising. Leading indicators are stronger. In the latest month, the reading has risen by 0.7, the same as in the previous month. The purchasing managers indices are consistent with an economy experiencing moderate growth. The latest ISM reading for the manufacturing sector was 53.5 (52.8) and that for the non manufacturing sector was 56.0 (55.7). Whilst inflation is below the Federal Reserve's target rate of 2% (currently nil), there is evidence of a tightening labour market with a number of large companies like Wal-Mart raising wage rates. With profit margins and profits as a percentage of GDP at high levels, investors will be looking at the effect of increasing pay rates on operating margins.

An important support for the US equity market has been the volume of share buy backs. In 2014 US$677.5 billion value of shares was bought back in the USA and this year will also see very large repurchases. With such low levels of interest rates, it has often made sense for companies to borrow money and repurchase their shares to enhance their company's earnings per share. This has been a support for US equity markets. We also now see, as confidence gradually returns to markets, an upturn in merger and acquisition activity which tends to buoy equity markets.

As the latest economic data is received, analysts will be examining it to see if it gives stronger clues than hitherto about the timing of the Federal Reserve's first interest rate increase. Members of the FOMC will be looking for signs of inflationary pressures. We have mentioned increased pay levels and members of the FOMC will want to know if these are starting to be reflected in prices. They will be looking at the unemployment rate and the participation rate to see if any pressures are building. They will make their judgement on the output gap to see how much spare capacity they think that there is in the US economy. The OECD estimates it at -2.4% for this year and -1.6% for next year. If that is correct, there is some leeway. With the world economy in a fragile condition, members of the FOMC will have to weigh up the dangers of acting too early and setting off a reaction in markets which could damage confidence, or leaving it too late and finding that they have let the inflationary genie out of the bottle. Given what the world economy has been through, one might expect central bankers to err on the side of risking inflation rather than an economic relapse by acting prematurely. In the past, this would have been a strange conversation to have because of the fear of inflation but now it is fear of doing anything to damage growth given the importance attached to monetary policy to resurrect it. For investors, the question is about how markets will react to a move upwards in interest rates after having remained unchanged for such a long time. One would expect that investors would have built the prospect into their expectations and that, because a rise in interest rates would reflect a stronger economy, investors would not react badly. What we can say is that interest rates are unlikely to rise to a level which would threaten equities and that they will still remain low historically. Furthermore, as and when interest rates return to more normal levels, it will mean that monetary policy will become a more powerful tool of monetary policy once again and able to be called into service if it is necessary to stimulate the economy in future.

In relative terms, the USA is a low risk country. With the Presidency and Congress controlled by different parties, little is likely to happen on the political front until the elections next year. That is not a bad thing because the economy seems to be making moderate progress, notwithstanding the disappointing first quarter which had a number of negative headwinds to face. As we say, all things are relative and the USA represents an oasis of calm compared with the eurozone.

The Greek crisis dominates everything else in the eurozone and normally important economic statistics and other data pale into insignificance compared with the implications of the crisis. From a very low level, there have been some more encouraging developments but these could be wiped out by the damage to confidence arising from the crisis. The first quarter of 2015 showed growth in

GDP over the previous quarter of 0.4% and year on year growth of 1.0%. Unemployment, whilst very high at 11.1%, has been drifting down but still represents a blight on the eurozone. Industrial production is slightly higher than a year previously by 0.8%. In terms of the important purchasing managers indices, the readings are satisfactory given the economic problems, although for meaningful growth they should be higher. The latest composite index stands at 54.2 (53.6), reasonably well ahead of the dividing line between growth and recession. Within that composite index, the reading for manufacturing stands at 52.5 (52.2), for services at 54.4 (53.8), but for construction at only 46.0 (47.1). Of the four largest eurozone countries only Spain is now showing a lower consumer price index reading than a year ago, helping to dispel the fear of deflation which we discussed earlier. Lower oil prices and a weaker currency should, one would expect, give something of a boost to the economy.

The jury is still out on Japan as it waits to see how "Abenomics" will turn out. To complement the economic measures taken to raise economic growth and banish the spectre of deflation, structural reforms will be vital and these are the most difficult. Freeing up labour, product and agricultural markets will meet significant opposition, in the case of agriculture from LDP supporting farmers, but they are all necessary to improve the productive potential of the Japanese economy. In financial markets, improving corporate governance and encouraging companies to raise their dividends are all part of the plan, and the Japanese stock market has been a relatively successful one in which to invest recently. The government is trying to encourage official investment in equities as opposed to bonds. Large sums have been channelled into equities. During the last two years, the Bank of Japan has purchased JPY2.8 trillion (US$23 billion) of exchange traded funds tracking the Japanese equity market. Last year, it was announced that the Japanese Government Pension Investment Fund would set a 25% target each for the allocation to Japanese and overseas equities, up from 12% in both cases. At the end of March, it was announced that three Japanese public pension funds controlling JPY30 trillion (US$240 billion) would follow suit. The Japanese economy is still working through the effects of 1st April 2014's consumption tax increase from 5% to 8%. It was always expected to have an effect on spending patterns immediately before and after the increase but it was larger than expected. The latest year on year GDP increase, first quarter 2015 against first quarter 2014, showed an increase of 0.9% with quarter on quarter growth at 1.0% and the quarter on quarter annualised rate at 3.9%. It will be interesting to see if this pace can be maintained. The latest monthly industrial production figures were disappointing with a fall of 2.2% month on month with a year on year decline of 4.0%. The latest purchasing managers indices were only just over the 50 level, representing expansion or contraction. The composite reading was 51.5 (51.6) and, within that figure, the manufacturing index stood at 50.1 (50.9), and that for services at 51.8 (51.5). As a major energy importer, Japan can be expected to benefit from lower energy prices, not only in terms of its trade account, but also to act as a boost to consumption. Added to this, the official policy is to encourage funds under its influence to become larger equity investors and one can construct a positive case for Japan, notwithstanding its significant economic issues. The demographics are very poor in Japan and the country's debt burden as a percentage of GDP is by far the largest of the G7 economies, with outstanding public debt at around 230% of GDP. As we mentioned earlier, were interest rates to rise, the servicing costs of the country's large debts would become more problematical. Given that only a small percentage of Japanese official debt is held by foreign investors, the problem is reduced but still serious. We maintain our view that the Japanese equity market is a high risk/high reward one where our exposure would be modest. The high risk part comes from the dangers of the large public debt ratio bearing down on the economy if interest rates rise and there is a loss of foreign confidence in Japan arising from this its poor public finances. This is not as serious an issue as it is for other countries because of the high level of debt held internally, as mentioned above, but it is not without concern. The very poor demographic outlook for Japan builds on this concern about debt. A more immediate risk is that the third arrow of "Abenomics", supply side reforms, become stalled because of opposition. Fiscal and monetary policy can only be effective if barriers to improving the country's long term growth potential are removed, notably in the labour and product markets. The rewards will be if the government can enact its supply side reforms and generate greater growth, if the 2% inflation target is met which would help to banish the deflationary mindset of Japanese consumers and businesses and thereby encourage spending and that the resulting increase in the country's rate of economic growth would start to make some impression on the debt problem. Encouraging the equity mindset in individuals and companies, the latter as far as corporate governance and taking shareholder friendly actions like raising dividends are concerned, would also be part of the positive story for the Japanese equity market.

Were is not for the Greek crisis, the big story of the quarter would have undoubtedly been China with the big equity swings which have taken place, particularly in the "A" share market, the one mainly available to domestic investors but increasingly being opened up to foreign investors. Firstly, there was the big rise in share prices and now the big fall with very significant volatility in share prices. This market pattern has occurred at a time of a slowdown in the country's rate of economic growth as the government tries to transition the economy towards a more consumption orientated one, away from fixed asset investment and exports. These substantial market movements suddenly occur from nowhere and are not correlated to the country's economic performance. A lot of speculation has occurred as individuals have borrowed money to buy shares which is fine when they are moving upwards but, when they are falling and there are margin calls, those same buyers become forced sellers, hence the violent downwards swings in the "A" share market. The Chinese authorities have tried to alleviate the problem through interest rate cuts and reducing the bank reserve requirements but, such has been the speculative frenzy, a lot of unwinding of positions has had to occur. The balance for the Chinese authorities is a difficult one, namely achieving higher quality growth at the expense of a lower overall growth rate. No one now expects to see the Chinese economy grow at the double figure rate of a few years ago. As we noted earlier in this review, the latest OECD growth forecast is 6.8% this year and 6.7% next year. Individual items of date support these lower growth forecasts. The closely watched Purchasing Managers Indices are only modestly over the 50 reading. The latest one for manufacturing stands at 50.2 (50.2) and that for non-manufacturing at 53.8 (53.2). The latest figures for industrial production show a year on year increase of 6.1% and a month on month increase of 0.53%. These figures are excellent by developed countries' standards but represent a slowdown by Chinese standards. The index of leading indicators has hardly moved so far this year. China has high levels of debt, an obvious cause of concern for the government and it needs the country to show a significant rate of growth to be able to deal with the issue, economic growth being the best way to deal with a debt problem. As elsewhere, the government will want to ensure that the country does not experience a prolonged period of deflation which would be damaging to economic growth and endanger the banks as the real value of liabilities rises and the ability of borrowers to discharge them weakens. The latest year on year consumer price index is 1.2% higher than a year earlier but the last three month on month readings have been negative. There are big problems for the Chinese government to deal with and the gyrations of the stock market represent one example. Opening up the "A" share market more widely to foreign investors should help to reduce some of the wild swings in the market but it will be a slow process. With the world economy experiencing only modest growth, it is important that China, the second largest economy, is able to support international growth so all eyes will remain on it. Its advantage is that it is usually able to pull the economic levers quickly but, just at the moment, this is not working in terms of the stock market.

Finally, we come to the UK where, undoubtedly, the most important event of the quarter was the UK General Election. Sometimes, General Election results matter and, in other cases, they are of only minor importance. This one definitely did matter for the stock market because of the large gulf in economic views and philosophies between the two major parties. The gulf has not been as wide since the 1980s, with one party believing in the market and the other believing that perceived market imperfections needed official intervention. Without going into the rights and wrongs of the arguments, it would have been difficult for the market and, in particular, sectors affected, to deal with an environment where there was heavy government intervention and, hence, uncertainty. The energy sector was a relevant example. In the event, the unexpectedly clear cut outcome and the outright election of a pro business government gives a degree of certainty about government policy which should be helpful for UK equities. With the opinion polls suggesting an indecisive result and, in some cases, leading up to the election, a change of government, spending decisions were undoubtedly held up in some cases, the housing market being a good example, so, intuitively, one would expect some pick up afterwards and this now seems to be happening. The latest revision to first quarter GDP has been slightly upwards, 0.4% instead of 0.3%, to give year on year growth of 2.4%. The purchasing managers indices have generally been strong although the difference between the services sector and the smaller manufacturing sector is wide. Whereas the manufacturing sector is only just in positive territory at 51.4 (52.0), the important services sector has given a very strong reading at 58.5 (56.5). The smallest sector of all, construction, is also showing a strong reading at 58.1 (55.9). There has also been a better than expected level of business investment, with the latest revision to the first quarter figure showing a quarter on quarter increase of 1.97% and a year on year increase of 5.68%. The squeeze on real incomes is beginning to abate, with pay rising by 2.7% in April, the highest level for nearly five years, and driven by the private sector. With the headline rate of inflation now at 0.1% year on year, this bodes well for household finances and spending. One of the disappointing facets of what has been an otherwise relatively good economic performance, has been poor productivity. This can partly be explained by the increase in the numbers in employment and weak business investment but, for confidence in a country's long term economic performance prospects, it is important that its productivity rises. The latest figures show that output per hour grew by 0.3% in the first quarter of 2015, lifting the annual rate to 1.3%. It is still 1% lower than in the first quarter of 2008. With a faster rate of pay increases, rising productivity will be important to prevent inflation becoming a problem, with its implications for interest rates. If the OECD is correct in its forecasts, the UK will be the fastest growing of the G7 countries this year, just as it was last year. Whilst the UK's economy certainly looks in relatively good shape, it still faces major problems of which its outstanding debt level, budget deficit and current account deficit are the most serious. The strength of sterling this quarter shows a degree of international confidence in the UK but the economy is still unbalanced. The current account deficit, at around 6% of GDP, is at danger level and the internal deficit, the budget deficit, whilst coming down, is still far too high. The tough stance on tackling the deficit will have to be continued and, with such a vast current account deficit, confidence in the UK has to be maintained, otherwise sterling could be vulnerable to attack. The headwinds which businesses are facing from the stronger pound and the travails of the eurozone are unhelpful. With the political risk to the UK market now much smaller and the economy performing reasonably well, the UK is in a relatively good position, albeit with the caveats just mentioned.

In the last quarter, markets have experienced the sort of setback to be expected given the current political and economic environment albeit against our expectation of a modest upward trend in equities, the view we outlined in our March review as well as earlier ones. The current quarter has also started off negatively. However, nothing has changed our view that equities remain the most attractive class of asset in which to be invested and bonds the least attractive. We do, however, emphasise that we continue to expect there to be an uneven path upwards for equities. There are enough positive factors favouring equities for it to be dangerous to introduce significant liquidity into portfolios as we are always aware of the opportunity costs of doing so should markets rise and not return to the levels at which liquidity was raised. Equally, where cash has built up in portfolios, we will be looking for an opportunity to invest should the setback be significant.