meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

This has been a relatively quiet quarter for equities which have broadly consolidated last year's modest advance. Economic conditions have been generally benign and the period of increased volatility at the end of February was not due to economic factors. Bonds, as measured by ten year government bond yields, have been mixed, drifting higher in the USA but lower in sterling and the euro. The oil price has firmed over the quarter on geopolitical concerns.

The tables below detail relevant movements in markets :

International Equities 29.12.06 - 31.03.07

Total Return Performances (%)

Country	Local Currency	£	US$	€
Australia	+6.9	+9.4	+9.6	+8.6
Finland	+8.9	+9.7	+9.9	+8.9
France	+2.4	+3.1	+3.1	+2.4
Germany	+5.5	+6.3	+6.5	+5.5
Hong Kong, China	+2.7	+2.0	+2.2	+1.2
Italy	+0.6	+1.3	+1.5	+0.6
Japan	+2.0	+2.7	+3.0	+2.0
Netherlands	+6.4	+7.2	+7.4	+6.4
Spain	+3.7	+4.5	+4.7	+3.7
Switzerland	+2.7	+2.5	+2.7	+1.7
UK	+2.6	+2.6	+2.9	+1.9
USA	+0.9	+0.7	+0.9	N/C
Europe ex UK	+3.7	+4.2	+4.4	+3.4
Asia Pacific ex Japan	+4.2	+4.4	+4.6	+3.6
Asia Pacific	+2.9	+3.4	+3.7	+2.7
Latin America	+4.9	+6.4	+6.6	+5.6
All World All Emerging	+2.6	+2.4	+2.6	+1.7
The World	+2.2	+2.3	+2.5	+1.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -0.5%

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

Currency	29.12.06	30.03.07
Sterling	4.74	4.94
US Dollar	4.71	4.65
Yen	1.69	1.66
Germany (Euro)	3.96	4.06

Sterling's performance during the quarter ending 31.03.07 (%)

Currency	Quarter Ending 31.03.07
US Dollar	+0.2
Canadian Dollar	-0.7
Yen	-0.7
Euro	-0.7
Swiss Franc	+0.2

Other currency movements during the quarter ending 31.03.07 (%)

Other Currency	Quarter Ending 31.03.07
US Dollar/Canadian Dollar	-0.8
US Dollar/Yen	-0.9
US Dollar/Euro	-0.9
Swiss Franc/Euro	-1.0
Euro/Yen	N/C

Significant Commodities (US dollar terms) 29.12.06 – 31.03.07 (%)

Significant Commodities	29.12.06 – 31.03.07
Oil	+12.5
Gold	+4.6

Markets

The slight upward bias to international equity markets during the quarter was evidenced by the FTSE World Index showing a total return of 2.2% in local currency terms, 2.3% in sterling terms, 2.5% in US dollar terms and 1.6% in euro terms. Looking at local currency returns in various countries and regions, we note the US section returning a very modest 0.9%, Europe ex UK a good 3.7%, the UK a satisfactory 2.6%, Japan a satisfactory 2.0%, Asia Pacific ex Japan a very good 4.2%, Latin America an impressive 4.9% and emerging markets a good 2.6%. Australia continues to show exceptionally good returns with the FTSE Australia Index returning 6.9%. Within the Europe ex UK section, Finland (because of Nokia) stands out with a total return of 8.9% and, likewise, the Netherlands with a return of 6.4%. Because currency movements have been unusually small this quarter, returns have not been greatly different in sterling, US dollars or euros. For sterling investors, returns in eurozone markets have been modestly enhanced by sterling's small decline against the euro. The strongest enhancement in the table is seen in the sterling return on the Australian Index where the 6.9% local currency return is enhanced to 9.4% at the sterling level because of the strength of the Australian dollar.

If we turn to the international bond market and look at the movement in ten year government bond yields, we note quite a sharp rise in UK yields, up by 20 basis points to 4.94%. Yields also rose in euro denominated bonds where German government bond yields rose by 10 basis points to 4.06%. On the other hand, US government bond yields declined by 6 basis points to 4.65% although the longest dated bond yields rose to give a more conventional upward sloping yield curve, unlike at the end of December when it was flat. The German and Japanese yield curves are also upward sloping (particularly the Japanese one) but the UK yield curve remains steeply inverted.

As we mentioned above, currency markets have shown very little movement over the quarter. Sterling declined by just 0.7% against the yen and the euro and rose by just 0.2% against the US dollar and Swiss franc.

In the commodity markets, oil and gold both rose, by 12.5% and 4.6% respectively.

Economics

- *After a long period of very low volatility, there was a relatively mild bout at the end of February* ...... as with May/June last year, there was no fundamental change in the background and it soon passed.
- *Investors should not be intimidated by short term volatility* ...... provided the background has not changed, policy changes can be costly. The media will always dramatise downward movements in markets but usually ignore upward ones.
- *But there are bubbles in certain areas of financial markets* ...... the yen "carry trade", certain areas of the property market and low grade bonds spring to mind and have the ability to cause damage to some investors.
- *We do not think this applies to shares* ...... despite a four year rising equity market, corporate earnings have risen so rapidly that shares have been downrated in some markets.
- *Companies have increased their attention to increasing shareholder value* ...... fascinating research from Citigroup quoted in the Financial Times shows that, since 2003, share buy backs and special dividends in the UK represented 63% of total dividends paid during the period, and the figure for Europe was 56%.
- *Dividend pay out ratios are low* ...... there is still room to raise regular dividends.
- *Because shares are cheap relative to bonds, the boom in M &A activity is likely to continue* ...... relatively low interest rates and ample liquidity makes the mathematics of conventional and private equity acquisitions compelling.
- *Takeover deals by private equity investors are getting larger* ...... in the USA, KKR and Texas Pacific Group are bidding US$44.5 billion for the utility, TXU. In the UK, private equity investors are interested in Alliance Boots and Sainsbury.
- *Economic conditions have been benign in the first quarter* ...... there have been no real economic surprises.

USA

- *Fourth quarter of 2006 growth estimate raised to 2.5%* ...... the previous estimate had been 2.2% and the first one had been 3.5%.
- *The latest Beige Book survey gives no cause for alarm* ...... economic activity shows a slight slowing down, labour shortages had only a minor effect on wage pressures, no increase in price pressures and even a sign of hope in the housing market.
- *Some ambivalence from the Federal Reserve* ...... the market enthuses over the wording of the Fed's March policy making meeting, but in his testimony to the joint Economic Committee of Congress, Ben Bernanke insists the Fed has not shifted away from its inflation bias.
- *Problems in the sub-prime mortgage market surface* ...... but the Fed seems confident, at present, that this problem can be contained.
- *Inflation remains higher than the Fed's target* ...... not dramatically so but enough to leave open the possibility that interest rates will rise further.
- *The relationship between share ratings and interest rates suggests more takeover activity and share repurchases* ...... the deals are likely to get larger. This will be helpful to market sentiment.

Japan

- *Stronger than expected economic growth in the fourth quarter of 2006* ...... an annualised rate of 5.5% is above expectations and is led by exports and capital spending.

- *Deflation, embarrassingly for the Bank of Japan, has reappeared* ...... in February, core consumer prices fell 0.1% year on year and core consumer prices in Tokyo fell by 0.1% in the year to March. This puts into question the second Bank of Japan interest rate rise to 0.5%.
- *Although rising slightly against the US dollar and sterling over the last quarter, the long term weakness of the yen has benefited Japanese exporters* ...... with no inflation and a weak currency, Japanese companies are very competitive.
- *The yen "carry trade" remains a dangerous strategy* ...... it is not a riskless policy in a currency which should derive some support from its very large current account surplus.

China

- *Growth remains very strong* ...... for example, factory output in January and February was 18.5% higher than a year earlier.
- *The authorities are trying to restrain excessive investment in property and fixed assets* ...... banks' reserve requirements have been raised.

Europe Ex UK

- *Short term economic performance has been surprisingly good* ...... this is expected to continue through this year and the ECB forecasts eurozone growth this year of 2.5% and 2.4% next year.
- *The ECB raised interest rates again in March to 3.75%* ...... at least one further increase is likely. The ECB remains concerned about inflation and will be watching German pay negotiations in the engineering and metals sector.
- *Short term economic news is good* ...... for example, the EC's eurozone economic sentiment index rose to 111.2 in March compared with 109.7 in February. Eurozone employment fell to 7.3% in February from 7.4% in January.
- *Germany seems to have weathered January's 3% VAT rise well* ...... most short term indicators are positive but the progress of wage negotiations will be important.
- *The main point of interest in France is the forthcoming Presidential election* ...... some very 1970's policies are being put forward which, if implemented, would accentuate France's loss of competitiveness.

UK

- *The Budget highlights the UK's economic problems* ...... despite relatively fast economic growth for a long time, public finances are in poor shape and are badly placed to cope with any unexpected economic slowdown. Headline tax cuts for companies and individuals are broadly offset by compensating revenue raising measures.
- *A rising current account deficit points to possible weakness in sterling in the future* ...... in the final quarter of 2006, the current account deficit amounted to 3.8% of GDP, up from 3.2% the previous quarter.
- *The IMF describes the UK's economic performance as impressive* ...... but it warns on the state of public finances and urges restraint on public spending.
- *Inflation remains above target* ...... the MPC will be concerned with this and a further interest rate increase is likely. The formerly used Retail Price Index shows year on year inflation of 4.6%.
- *There are tentative signs of cooling in the housing market* ...... but the indicators are not conclusive and further evidence will be needed to be seen. The MPC will be watching the housing market closely.
- *M & A activity continues to support the market* ...... inexpensive ratings and cheap money mean that these conditions should support more takeover activity.

Summary

- *Background economic conditions continue to favour equities* ...... moderate economic growth, inexpensive share ratings and relatively cheap and plentiful money are supportive factors.
- *Bonds continue to look unattractive* ...... yields continue to look unrealistically low, sometimes supported by artificial demand.
- *In the absence of unexpected geopolitical events we think equities should experience a satisfactory year* ...... conditions are very much like a year ago.

As we see from the tables, equities have generally provided superior returns to bonds over the quarter. This chimes in with our thinking that equities offer better value than bonds. There was a modest setback at the end of February, sparked off by a fall in the Chinese market, but it was a milder affair than the setback of last May and, hopefully, investors are becoming less unsettled by these movements as they concentrate their attention on market fundamentals. As we have noted before, the profile of investors in the stock market is changing with many more short term operators. With very short term investment horizons, the herd instinct mentality is prevalent and this can result in periods of short term volatility unrelated to changes in market or economic fundamentals. One of the most damaging effects on portfolio performance is when investors react to short term movements in markets, sell out at depressed prices and either do not have the confidence to return until prices have risen, and investors generally feel more confident, or do not return at all. 2006 is a good example. Although it was not a spectacular year for investors, it was a satisfactory year, yet if one had sold after the 10% setback in May and early June, the performance could have been poor. Nothing happened at that time to justify a fall of that size (even though it was not enormous compared to where the market had come from). So it was at the end of February with a much smaller fall. As ever, the media focussed on this modest decline blowing it up out of proportion yet when the market moved higher again in March, the move did not attract the opposite headlines. This is a way of saying that one should not be swayed by short term factors.

Whilst we do not think that shares are dear, we do believe that there are bubbles in some areas of the financial markets. Prior to the relatively minor weakness at the end of February, markets had been notable for the very low level of volatility they had displayed. This had increased some investors' appetite for risk and certain danger areas were apparent. One was in the foreign exchange markets where the "carry trade" had attracted investors' interest. Borrowing in low interest rate currencies, notably the yen but, to a lesser extent, the Swiss franc, to invest in higher yielding currencies or assets, denominated in other currencies, is fraught with risk, if either interest rates rise in the low yielding currency or the currency itself rises relative to the currency into which it has been switched. One often cited example is the Hungarian property market where homebuyers take out loans in Swiss francs to invest in forint valued property. But it is the yen carry trade which attracts most attention given the minimal cost of borrowing yen. It is not a given that the yen is on a permanent downward path and, as we see, it has risen very slightly against sterling and the US dollar over the last quarter. Relatively low interest rates and large capital flows overseas may depress the yen but, on the other side of the equation, it runs a very large current account surplus which is an argument for a stronger currency.

Although short term interest rates have risen, they are still relatively low in most areas and bond yields further out the maturity spectrum are very low (the UK is a particular case in point with 30 year government bond yields at 4.42% as this is written and 50 year government bond yields at 4.20%). This has led some investors to chase yield by bidding up prices on low grade bonds to a stage where the risk/reward ratio is unfavourable. In February, the Financial Times reported that Moody's Investors Services said that only 1.57% of all junk rated debt defaulted in 2006 compared with 1.8% in 2005. However, it warns that default rates would almost double to 3.07% by the end of this year. It also warns that the historical average of 4.9% could be breached over the next two years as the quality of junk issues in the sector declines.

In the USA, problems have emerged in the sub-prime lending market as borrowers have defaulted or fallen behind with their repayments. Overconfidence can lower lending standards below what is prudent.

Yet in the equity market, we do not see this "bubble" phenomenon. Since the international equity market bottomed around four years ago, corporate earnings have risen very strongly and, in many cases, ahead of share prices so that share ratings have declined. Nearly everywhere, we see earnings yields well in excess of bond yields. This provides some intellectual underpinning for share prices but, in practical terms, it accounts for one of the positive factors driving markets at present, the very high level of M & A activity. With money quite cheap, earnings yields well in excess of bond yields and ample liquidity, private equity deals look appealing. They are getting larger as the US$44.5 billion bid by KKR and Texas Pacific Group for the US utility, TXU, shows. Companies continue to produce shareholder friendly measures whether in the form of rising regular dividends, special dividends, returns of capital or share buybacks. In February, the Financial Times quoted research by Citigroup which said that, since 2003, £118 billion had been returned to shareholders through buybacks and special dividends in the UK. Citigroup said this represented 63% of total dividends paid during the period. In Europe, the return represented 56% of total dividends paid and the amount returned was 292 billion. Interestingly, payout ratios have fallen. Whilst it is estimated that there has been a doubling of corporate earnings in Europe since 2003, dividends have only risen 45%. The respective figures for the UK are given as 55% for earnings growth and 30% for dividend growth. It is said that payout ratios are at a fifteen year low in Europe and an all time low in the UK. All of this provides a reasonably healthy platform for equities to build on their advance.

The increasingly large takeover bids by private equity investors are attracting political and trade union criticism, particularly in the UK, and Europe. Probably, nothing significant will happen but, if private equity bids were made to be less attractive, perhaps by changes in the tax system, markets could be affected. Two large prospective bids in the UK, for Alliance Boots and Sainsbury, will, if they succeed, put a lot of money back into the market.

It will be noted from the table that oil rose strongly over the quarter by 12.5%. This is as a result of the political crisis which arose as a result of the capture of the fifteen British sailors. Now that the hostages have been released, the oil price has eased.

Broadly speaking, the international economic picture in the first quarter has been benign. Whilst the USA has slowed down, the eurozone has performed well, as has Japan, and Asia continues to grow strongly. Inflation has been a slight, but not yet serious, worry. As always, there are concerns, the US housing market and the oil price being two examples, but, overall, positive features, in our opinion, outweigh negative features.

We turn now to look at different areas of the world economy, starting with the USA where the official estimate of fourth quarter growth was raised upwards to 2.5% from the 2.2% second estimate of growth (well below the first one of 3.5%). The latest Beige Book, published in early March, indicated, if anything, a slight slowing down of economic activity, but nothing serious. There was still a shortage of skilled employees which had some minor reflection in wage pressures. There appeared to be no increase in price pressures in most Federal Reserve districts. There was some very modest optimism that there were signs of stabilisation appearing in the housing market even though it remained weak in nearly every district. The commercial real estate market remained firm or solid.

The US stock market received a boost after the Federal Reserve's policy meeting statement in March which appeared to suggest a slight change in emphasis in the Federal Reserve's thinking. Whilst the Federal Reserve appeared to firm up its concern about inflation, at the same time it seemed to lighten its approach to a further interest rate rise by replacing the words "additional firming" with "policy adjustments". On these nuances can short term market movements depend. Its broad view of the US economy remained unchanged and it expects the economy to expand at a moderate rate over the coming quarters. In his testimony to the joint Economic Committee of Congress at the end of March, Mr. Bernanke appeared keen to correct any impression that the

Federal Reserve's earlier statement had implied a softening of its attitude. He emphasised that the Federal Reserve had not shifted away from its inflation bias, merely that it was looking for a little more flexibility. He went on to discuss one of the key issues which those who are negative about the USA focus on, the effect of the weakness of the housing market and problems in the sub prime loan market. Mr. Bernanke was relatively sanguine about this situation. To quote him, "the impact on the broader economy and financial markets of the problems in the sub prime market seem likely to be contained". He did, however, recognise that the correction in the housing market "could turn out to be more severe than we currently expect, perhaps exacerbated by problems in the sub prime sector". A few days earlier, the President of the New York Fed had indicated that, although it was too early to be sure, it did not appear that problems in the sub prime mortgage sector had spilled over into other areas of the credit market.

This leads on to recent information which has appeared about the mortgage market and the housing sector. The Mortgage Bankers Association reported that delinquency rates in the sub prime adjustable rate mortgage sector reached 14.44% in the fourth quarter of 2006, rising 1.22% in three months. The overall mortgage delinquency rate was 4.95% in the fourth quarter compared with 4.67% the previous quarter and 4.70% in the fourth quarter of 2005. The housing market continues to show mixed signs. Housing starts in February were stronger than expected, up 9.0%, but building permits fell by 2.5%. February's new house sales fell by 3.9% and were 18% lower than a year earlier. The inventory of unsold houses was at a sixteen year high and it is this which must be drawn down before the sector can feel more confident. On a brighter note, the National Association of Realtors said that sales of existing homes fell by 3.9% in February.

Obviously, inflation is crucial to the Federal Reserve's policymaking decision on interest rates. The latest month on month change in the CPI of 0.4% gives a year on year rate of 2.4%, whilst the core CPI rate rose 0.2% month on month to give a 2.7% year on year rate. The Federal Reserve's preferred measure, the Personal Consumption Expenditure deflator, rose by 0.3% in February to give a year on year rate of 2.4%. The Producer Price Index rose by 1.3% in February. These figures are on the high side of what the Federal Reserve would like to see, hence its caution. They are not, however, spectacularly bad figures.

As one would expect with the level of growth being seen, the short term economic statistics are mixed. The ISM Purchasing Managers' Index for manufacturing fell in March to 50.9 compared with 52.3 in February although it was still just in positive territory. The equivalent index for the service sector fell quite sharply from 59.0 in January to 54.3 in February, still, however, comfortably in positive territory. Durable goods orders rose by 2.5% in February following a sharp fall of 9.3% the previous month. Industrial production in February rose by 1.0% compared with January and was 3.4% higher year on year. Productivity growth slowed down last year. Non-farm productivity was 1.6% higher for the last quarter of 2006 and 1.4% higher for the year. As a result of lower productivity growth, unit labour costs accelerated, being 1.6% higher in the last quarter. Personal incomes grew strongly in February, rising by 1%. Positively, the employment market remains strong. The unemployment rate in February was 4.5% with 97,000 employees being added to the payrolls in February and there was an upward revision of 55,000 to the December and January payrolls with relative strength in the service sector. Possibly because of cold weather in February, retail sales rose a below expected 0.1%. Consumer confidence is weaker according to two surveys but not dramatically so. The Conference Board's consumer confidence index for March fell to 107.2 from 111.2 in February, still a good reading and the Board reported, importantly, that consumers' view of the state of the economy was slightly improved over the month and confidence over the availability of jobs was at a five and a half year high. The University of Michigan's index of consumer confidence fell from 91.3 in February to 88.4 in March.

So, whilst the economy has entered a slower period, it is still performing satisfactorily. Corporate earnings growth, for long time in double digits quarter by quarter compared with the previous year, is likely to slow down to single digits, but this is not a disaster. Earnings growth in 2006 is estimated to have been 14.5% compared with 2005 and the estimate for 2007 is 9.4% according to Thomson Financial's estimate of analysts' predictions. Bloomberg estimates the current year's earnings yield on the S & P 500 Index at about 6.5%, 179 basis points above the ten year US government bond yield at the end of March. This is an attractive relationship between equities and bonds as far as the former is concerned and represents fertile ground for further M & A activity. On the information currently available, we believe Wall Street to be attractive with moderate economic growth (the Federal Reserve's forecasters suggesting a central tendency of 2.5% to 3.0%) supportive of share prices.

Moving on to Japan, the economy finished 2006 on a very strong note with annualised growth at 5.5% in the final quarter. This was the best performance for three years. Growth was led by exports and capital spending rather than consumption which rose 1% compared with the previous quarter. For exporters, the current situation represents a perfect background. With no inflation and a weak currency (although not this quarter), their competitive position is strong. In February, core consumer prices fell by 0.1% year on year. The government also reported that core consumer price figures for Tokyo fell 0.1% year on year in March. This is a slightly embarrassing position for the Bank of Japan which has raised interest rates in two stages to 0.5% as it seemed the country had moved out of deflation. It makes it unlikely that we will see another rise in Japanese interest rates in the near future and this has implications for the continuation of the risky carry trade strategy which we mentioned earlier. For many, it has seemed a riskless strategy to borrow in low interest rate yen and invest in higher yielding currencies, say the New Zealand dollar, Australian dollar, US dollar and sterling without any danger of being caught in a sharp yen recovery which could wipe out the interest rate differential. Currency movement drivers are complex these days with such large capital flows between countries but all four of the above currencies represent countries with large current account deficits, traditionally one of the factors which could weaken a currency. Japan, on the other hand, has a large current account surplus and it would be no surprise if, at some stage, the speculators were caught out by a sharp bounce back in the yen which looks a cheap currency. Japan looks in quite good economic shape and its four year economic recovery looks set to continue. To complement the good export performance and business investment intentions, it would be desirable that domestic consumption strengthened. There is certainly more optimism about the jobs picture with January's jobless rate falling to 4.0%. Tightness in the labour market could exert inflationary pressures on the Japanese economy. Rather strangely, in view of the anecdotal evidence, wages, including overtime pay, fell in January by 1.4% from a year earlier. This does not alter the overall view of the Japanese economy but a continuation of this trend on wages would be likely to detract from prospects. On balance, though, the outlook still remains encouraging for the Japanese economy and stock market although the very restrictive attitude to takeovers means that the M & A stimulus, evident in other markets, does not apply to Japan.

Europe has proved to be a pleasant surprise in terms of the growth which it has achieved and the forecast this year remains good for an area where the long term potential growth rate, consistent with stable inflation, is lower than that of the USA. The ECB is forecasting growth in the eurozone this year of 2.5% and next year of 2.4%. However, eurozone interest rates are on the increase and the ECB remains concerned about inflation. In March, the ECB raised its interest rate to 3.75% from 3.5% and signalled a further increase to 4% shortly, although a change in terminology suggested the peak may be near. The 3.75% rate was described as "moderate" as opposed to "low". The ECB's staff inflation rate forecast for this year now shows a range with a mid point of 1.8%, 0.2% lower than December's forecast. The latest eurozone inflation level for March is 1.9% compared with 1.8% in February. The ECB is concerned about the prospect of inflationary pay increases, particularly in Germany, where I G Metall, supported by some politicians, is pushing for a large pay increase in the engineering and metals industry, following a period of low pay deals, which has improved the competitiveness of the German engineering and metals industry. The ECB President was also concerned about excessive pay increases for top business executives. But he also said that higher than expected wage settlements posed "significant upward risks to price stability". Amongst central banks, the ECB pays most attention to money supply growth and it will be concerned about the latest figures which showed M3, in February, growing at an annual rate of 10.0%, the highest level since the start of the euro.

The short term news from the eurozone is generally positive. The EC's eurozone economic sentiment index rose to 111.2 in March from 109.7 in February and it reports "very good economic momentum". Although it is still relatively early in the year, the eurozone appears, so far at least, to have weathered some of the potentially negative factors such as currency strength, the rise in German VAT, rising interest rates and a slowdown in the US economy. A more positive view towards the employment market is helping sentiment. Eurozone unemployment fell to 7.3% in February from 7.4% in January, the lowest level since Eurostat started the series in 1993.

But, whilst it is encouraging to see the eurozone economy performing well and it is helpful to stock markets, structural and budgetary problems still have to be addressed. The EC issued a timely warning in this report. Whilst warning about the risks of higher oil prices and global imbalances, it advised eurozone governments to take advantage of the upswing to "consolidate public finances, carry out structural reforms and address the challenge of ageing".

The news from the eurozone's largest economy, Germany, has been encouraging. In the run up to the 3% VAT increase on January 1, there had been concern about the effect this would have on the economy in terms of inflation and short term economic activity. In the event, so far at least, the economy appears to have coped well. Most of the economic news coming out of Germany in March was favourable. The Institute for the World Economy, based in Germany, forecast slightly higher growth in 2007 than 2006, 2.7% compared with 2.6%. The Ifo's March business climate index rose from 107.0 in February to 107.7 in March. In March, the Federal Labour Agency reported that unemployment had fallen by a seasonally adjusted 65,000 in March to 9.2%. German machinery and plant orders were 27% higher in February than a year earlier and domestic orders rose by 22%. Inflation rose to 2.1% in March but was not sufficient to push eurozone inflation as a whole to 2.0%. We mentioned the importance of German wage negotiations to the ECB in setting interest rate policy. In the chemical sector, a 3.6% increase was agreed for a period of fourteen months. This is probably at the outer limit of the ECB's comfort level and the chemical industry's trade union is not a notably militant one. The settlement with IG Metall in the engineering and metals industry will be crucial and is likely to have a bearing on eurozone interest rates.

In France, the main short term issue is next month's election. France has maintained its distinctive economic policy in the face of global trends and finds itself increasingly uncompetitive. Whilst there appears to be some realisation of this, the situation is not bad enough for most people to give recognition of the need for action. There are some very 1970's protectionist and interventionist policies being proposed which, if implemented, would be likely to be highly damaging to France. Whilst the introduction of the euro and single market has made the country issue less important, if policies are so unhelpful to the economy or the stock market, they could still have a country effect independent of influences on the eurozone stock market generally. Even the centre right wing candidate for the Presidency, Mr. Sarkozy, is putting forward protectionist policies. The EC managed to unlock Spain's protectionist policy over Endesa but it will find France a much tougher proposition.

Overall, the outlook for European stock markets continues to look positive. Shares are modestly rated, growth should be strong by the eurozone's standards this year and corporate earnings should continue to increase satisfactorily. We expect more shareholder friendly measures and also more M & A activity.

In the UK, the main economic event has been the Budget. It serves to highlight the problem of the British economy - quite fast growth and weak public finances. Given the extended period of growth which the UK economy has witnessed, the public finances should at least be in balance, if not in surplus, to provide flexibility to deal with an economic downturn which could strain public finances. The Treasury's forecasts for public borrowing have been consistently over optimistic with the outcome significantly worse than the forecast at the beginning of the financial year. It is the same for the future, with forecast borrowing levels having to be raised against first and second estimates. Whilst the headlines emphasised the cut in Corporation Tax and the standard rate of Income Tax, much of this was clawed back in other ways, so little room is there for manoeuvre in public finances.

Although, on the surface, the UK economy appears to be moving forward well, it is unbalanced growth and not of the best quality. The huge increase in public expenditure has contributed to growth but at a cost in terms of weak public finances which could cause the British economy problems later on if remedial measures have to be taken. Now that the rate of growth of public expenditure is set to slow dramatically, it could increase the government's political problems at a difficult stage in the electoral cycle. Another sign of the imbalances in the UK economy is evident in the increasing size of the current account deficit which, in the fourth quarter of 2006, amounted to 3.8% of GDP compared with 3.2% in the previous quarter. As we mentioned earlier, whilst the state of a country's current account could be a pointer for the currency, capital flows can swamp these deficits or surpluses, rendering the current account as a short term pointer not particularly helpful. In the case of the UK, there is evidence that foreign central banks have been increasing their holdings in sterling, and 2005 and 2006 saw large cash bids from abroad for British companies. But, at some stage, the weakness of the UK's trading position will come to be reflected in the economy. It is the timing which is uncertain.

In its review of the British economy, the IMF described its performance as "impressive" but warns on the state of public finances and urged restraint on public spending rather than tax rises which could affect incentives to work and invest. It was less sanguine than the Treasury about the housing market. It welcomed the rise in interest rates but felt that more might need to be done in certain circumstances.

Whilst keeping interest rates at 5.25% at its March meeting, the MPC will be keeping a very close watch on inflation which currently stands well above its target. Manufacturers' output prices rose by 0.3% between January and February and the year on year increase was 2.2%. Core producer prices showed a larger level of increase, 2.7%. At the retail level, the consumer price index rose to a year on year inflation rate of 2.8% in February, up from 2.7% in January. The previously used measure, and one which will be more meaningful to many people, the Retail Price Index, rose by 4.6% which is the fastest rate for fifteen years. We feel that these inflation figures point to a further rise in UK interest rates. The MPC will also be watching the housing market. A number of indicators come out each month, sometimes giving conflicting information. On the house price front, the latest FT House Price index shows the annual rate of house price inflation at 7.6% in February. The Halifax said house prices rose by 1.8% between January and February to give a year on year increase of 9.9%. The property website, Rightmove, said the asking price for a property between the middle of February and the middle of March was up 1.5%, to leave the year on year rate at 12.2% against 11.5% in February. The latest Nationwide index showed the average price of a home rising 0.4% in March compared with February, with a year on year increase of 9.3%. These are still quite strong figures but there is some evidence of a moderation in house prices. The Governor of the Bank of England told MP's that the housing market is at last slowing. The Bank of England reported that the number of mortgage approvals rose from 114,000 in December to 120,000 in January. The RICS says that rising interest rates are starting to cool the housing market. Building societies said that mortgage approvals rose from £4.2 billion in January to £4.92 billion in February. Over the same period, gross mortgage lending rose from £4.06 billion to £4.21 billion. Some signs of moderation came from British Bankers Association figures. The BBA accounts for about 70% of gross lending so gives a representative picture of what is happening in the market. It reported that loan approvals fell by 5% in February compared with a year earlier. So some sign here of a cooling of the market but it is too soon to be sure and, certainly, the Bank of England will be keeping a close watch. But the probability is that we shall see at least one further rise in UK interest rates soon.

Back in the stock market, M & A activity continues to be buoyant with the targets being large, Alliance Boots and Sainsbury. With artificially low interest rates, as demonstrated by the downward sloping yield curve, and low ratings on many large UK companies, it appears to be only a matter of time before private equity tries to buy very large UK companies. This, together with the highly liberal attitude to foreign takeovers, will provide some support for the UK equity market even though we have some concern about the economic fundamentals.

China still continues to grow very strongly although the Chinese authorities have tried to dampen down growth by raising banking reserve requirements. They did this a second time in February by raising the requirements another 0.5% to 10.0%. Their aim is to restrain inflation and to avoid overinvestment in fixed assets which could cause problems in the banking sector. That the economy is still growing very rapidly is shown by the fact that factory output in January and February combined grew 18.5% against a year earlier. China remains under pressure to revalue its currency significantly rather than allowing it to creep up but it will act in its own time and, with the world's largest foreign exchange reserves, it is in a position to determine its own policy. Countries like China and India will continue to be a force propelling the world economy forward.

The Australian economy continues to perform well as does the stock market, as we saw earlier. The Reserve Bank of Australia has been tightening monetary policy as capacity constraints have threatened to lift inflation. As in a number of other markets, takeover activity is at a high level with large private equity bids in evidence in companies like Qantas and Coles Group. The one area of weakness is the current account where the deficit represents nearly 6% of GDP. Such is the confidence in the Australian economy that it has no problem attracting capital and it is a beneficiary of the carry trades but this not the best quality support for the currency. Nevertheless, we consider the positive factors continue to be in the ascendancy in Australia.

So our best estimate, a quarter of the way into 2007, is that the combination of the benign economic outlook, moderate share ratings and further corporate earnings growth should lead to a satisfactory performance for international equities this year in the absence of unexpected geopolitical shocks. There will, no doubt, be periods of volatility, such as we saw at the end of February but it is important not to be unduly influenced by them unless there is some fundamental issue which was not contemplated and to stay with those fundamentals. Bond yields generally look too low, particularly in the UK, and we think they look unattractive in relative and absolute terms compared with equities.