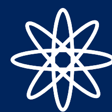

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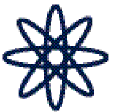
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

The first quarter provided satisfactory returns for international equity investors and negative returns for investors in high quality government bonds. Volatility was surprisingly low. In currency markets, the feature was the weakness of the yen following Bank of Japan action to make monetary policy more stimulative. In the commodity markets, the stand off with Iran over its nuclear intentions helped to cause a sharp increase in the oil price.

The tables below detail relevant movements in markets:

International Equities 30.12.11 - 30.03.12

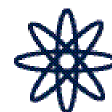
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+7.9	+6.1	+9.1	+6.3
Finland	+15.1	+14.8	+18.1	+15.1
France	+10.1	+9.8	+12.9	+10.1
Germany	+17.7	+17.5	+20.8	+17.7
Hong Kong, China	+14.2	+11.1	+14.2	+11.3
Italy	+6.3	+6.0	+9.0	+6.3
Japan	+18.6	+7.9	+10.9	+8.1
Netherlands	+6.7	+6.4	+9.4	+6.7
Spain	-6.1	-6.3	-3.6	-6.1
Switzerland	+6.9	+7.6	+10.6	+7.8
UK	+4.9	+4.9	+7.9	+5.2
USA	+12.8	+9.7	+12.8	+10.0
Europe ex UK	+9.7	+9.8	+12.9	+10.1
Asia Pacific ex Japan	+11.0	+9.7	+12.8	+9.9
Asia Pacific	+14.2	+8.9	+11.9	+9.1
Latin America	+10.4	+11.7	+14.8	+12.0
All World All Emerging	+10.6	+10.6	+13.8	+10.9
The World	+11.3	+9.0	+12.0	+9.2

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -1.7%

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

Currency	30.12.11	30.03.12
Sterling	1.98	2.21
US Dollar	1.88	2.21
Yen	0.98	0.99
Germany (Euro)	1.83	1.82



Sterling's performance during the quarter ending 30.03.12 (%)

Currency	Quarter Ending 30.03.12
US Dollar	+3.1
Canadian Dollar	+1.3
Yen	+10.7
Euro	+0.2
Swiss Franc	-0.8
Australian dollar	+1.9

Other currency movements during the quarter ending 30.03.12 (%)

Currency	Quarter Ending 30.03.12
US Dollar/Canadian Dollar	-1.8
US Dollar/Yen	+7.3
US Dollar/Euro	-2.8
Swiss Franc/Euro	+1.1
Euro/Yen	+10.4

Significant Commodities (US dollar terms) 30.12.11 - 30.03.12 (%)

Currency	Quarter Ending 30.03.12
Oil	+14.4
Gold	+7.5

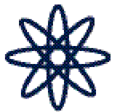
Markets

International equity markets opened the year with a positive quarter. In local currency terms, the total return on the FTSE World Index was 11.3%, in sterling terms 9.0%, in US dollar terms 12.0% and in euro terms 9.2%. Looking at local currency returns first, the highest return came from the FTSE Japan Index at 18.6%. The USA also showed an above average performance with the FTSE USA Index returning 12.8%, whilst the UK performance was below average with the FTSE UK Index returning 4.9%. Almost every market performed well but Spain was an exception with the FTSE Spain Index returning a negative 6.1%. Currency movements, however, changed the picture, particularly for Japan where the weakness of the yen reduced the sterling return on the FTSE Japan Index to a still satisfactory 7.9%, although this was a slightly below average return. Latin America, Asia Pacific ex Japan and the emerging markets all performed well with their respective FTSE indices returning, in sterling terms, 11.7%, 9.7% and 10.6%.

Looking at high quality government bonds, as measured by ten year government benchmark bonds, we note that there was some weakness in the UK and US government bond markets. The gross redemption yield on ten year UK gilts rose by 23 basis points to 2.21% and, on US Treasuries, by 33 basis points also to 2.21%. There was little change in Japanese or German government bond yields.

In the currency markets, the feature was the yen which, following the announcement of further quantitative easing, weakened sharply. Sterling rose by 10.7% against the yen during the quarter. There was some weakness in the US dollar against which sterling rose by 3.1%.

In commodity markets, continuing tension in relations with Iran pushed the price of Brent crude up by 14.4% whilst gold rose by 7.5%.

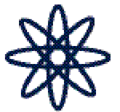


Economics

A satisfactory performance from international equity markets in the first quarter of 2012 should not instil any sense of complacency about the international economic position. The latter remains precarious and the times in which we are living are economically unique. Why do we say this? It is because of the combination of money printing, extraordinarily low interest rates and a dysfunctional monetary union which may partially, or totally, break up. Investors and investment managers therefore have to think on their feet as there is no exact precedent for the current combination of circumstances. It is helpful that international equity markets have performed well because it creates a much better feeling and might lead to what Lord Keynes called "animal spirits" driving a revival of economic activity. If asset values are rising, a positive wealth effect is created which might lead to an acceleration of economic activity, something which is badly needed in most industrialised nations in the west and in Japan also. As clients will know, the reason we regard equities as the asset class of choice is that the combination of quantitative easing (money printing) and very low interest rates in many countries will logically tend to raise asset prices as increasing quantities of money chase a finite amount of assets. In the most highly rated countries, the relative attractions of equity yields against bonds and cash are usually strong and seekers after yield have been attracted to good quality equities. Furthermore, short term administered interest rates are likely to remain very low for the foreseeable future, thus removing an element of uncertainty in investors' minds and strengthening the case for equity investments. So we can rationalise what has happened in international equity markets and confirm that there has been some fundamental underpinning to the rise in equity prices in the first quarter. By virtue of the reasons for the stock market's performance, we can conclude, though, that the rise has not been of the highest quality, but the returns have been welcome and, as we will confirm later in this review, equities, for us, remain the asset class of choice at present.

What has led us to this extraordinarily loose orthodox and unorthodox monetary policy is the financial crisis of 2008 and its aftermath and the existential crisis in the European Monetary Union. Although tied up with the banking crisis, the eurozone sovereign debt crisis has its origins in other causes, namely the fundamental flaws in the euro and lax budgetary discipline in a number of eurozone countries, together with an inability to control costs which left some of these countries uncompetitive. To us, the problem is intractable. Our view, which we have often expressed in the past, is that the only organisation which can provide some short term relief, but not a solution, to a problem which we believe to be insoluble, is the ECB, and this has proved to be the case. Although the final quarter of 2011 was a positive one for investors, it suffered a bad patch during that period when some investors were concerned about the solvency of some eurozone banks. We believed then, and we believe now, that the "too big to fail" argument was true and that, if necessary, the ECB would create as much money as necessary to secure the immediate position. In fact, the ECB has been far more effective than the politicians who have not acquitted themselves at all well at any time during the crisis. The ECB has undertaken its own version of quantitative easing, called the Long Term Refinancing Operation (LTRO), providing three year money to the banks against eurozone collateral whose quality has been lowered. Over €1 trillion has been provided in two operations and this has eased the eurozone banks' funding concerns. If we can pinpoint any factor which caused share prices to rise, it was the LTRO. Allied to this, the ECB cut its interest rate in two stages by 0.25% each time and has purchased almost €214 billion of eurozone bonds to try to keep down yields in the troubled eurozone countries. The ECB has, therefore, flooded the markets with money and, at least in the short term, this has had the desired effect. Furthermore, by lending to the banks at 1%, it enabled them to buy high yielding eurozone debt and make a turn to help to raise their capital base. We saw yields on, for example, Italian and Spanish bonds fall although the position has now reversed.

We noted last year that, in the absence of the news from the eurozone becoming even worse, equities had a tendency to rally. It was as if the trend was upwards and it would take something unexpected to stop the recovery. So far this year, the LTRO, in particular, has given investors the feeling that the background is becoming a little less bad and, as a result, shares have rallied.

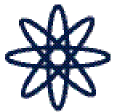


It all looks so easy. Print, or make available, vast quantities of cheap money. This will cause the fears about eurozone banks' funding to evaporate, eurozone bond yields will fall if some of this money is used to buy higher yielding government bonds along the maturity curve and share prices will go up. Of course, it is nothing like this simple. The ECB has successfully closed down one problem, for the time being, namely troubled eurozone banks, but it cannot close down the other, the eurozone's sovereign debt crisis. No amount of sticking plaster will hide the eurozone's existential problems.

It is for this reason that, pleasing though it is that markets have got off to a satisfactory start to the year, investors must be realistic about the future of the eurozone and the new problems which may appear at any time. One of the problems is that eurozone politicians lack credibility on the subject of the single currency, repeatedly giving over optimistic assessments of the outlook after one of their numerous crisis meetings. The one thing they do not do, which any independent observer would do, is to question whether the model of monetary union is the right one. After all, so many serious problems have arisen as a result of monetary union that the most obvious question to ask is whether a major mistake has been made by creating the union. Instead, the whole time is spent trying to treat the symptoms of the problem rather than to address the cause and, realistically, this is going to lead the project down a blind alley. The measures proposed to deal with the symptoms of the problem are inflicting untold misery on many eurozone citizens and this misery will only get worse. Can it be that those running the eurozone actually think that those countries in the eurozone represent a group of countries for which a currency union makes sense? It is difficult to believe that they do. However, having arrived at this situation, they may believe it to be too embarrassing and dangerous to retreat. They remain in denial about Greece which, almost certainly, will need a further bailout. They say it is a "one off", but what about Portugal, where government bond yields indicate serious doubts amongst investors about the country's ability to repay its debts?

If those in charge of the eurozone, in whatever capacity, are in denial, it is unlikely that the proposed remedies will be successful. Just to recap on the main problems for the struggling eurozone countries at present - it is the fixed exchange rate implied by monetary union which deprives those eurozone members, which have lost competitiveness relative to other members since the start of the euro, of their ability to restore their position. At present, what we might term the "creditor" nations of the eurozone are effectively imposing policies on the "debtor" countries. Those policies, which mean severe austerity, comprise tax increases, spending cuts and internal devaluations through pay and pension cuts in some cases. The best way to make a start on repairing a country's finances is for the country to resume economic growth, something which is almost impossible for the troubled southern eurozone members because of the measures forced upon them. Although these countries must take the responsibility for their loss of competitiveness because they did not follow the appropriate policies at the time, they are where they are, and the normal policy measure in these circumstances would be to devalue and grow through exports priced at more competitive levels and import substitution in the face of higher import costs. The economic thinking behind the austerity policies being imposed on the eurozone countries which are in difficulty is completely flawed and it is almost impossible to think of circumstances in which these countries can recover whilst they are in the euro's currency straitjacket. If the countries in question do not grow, or if they contract, then their finances will not improve, leading to further bailouts, if there is any money left, or, more likely, default. The proposed treaty enshrining in law targets for public finances, which is heralded as the answer to the eurozone's sovereign debt problem, is nothing of the sort. It is important to emphasise this point because, although stock markets have been in a sunnier mood in the first quarter, the next eurozone problem could suddenly emerge at any time. Although we favour equities as an asset class, we realise that, from time to time, when unexpectedly bad news emerges, as it will, they will have setbacks.

Although eurozone leaders continue to emphasise that Greece is a "one off ", these same people said that Greece would not default. They have continually been behind events. One of the dangerous consequences of the recent Greek bond swap implying a "haircut" of roughly three quarters of the present and future value of their holdings for

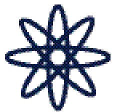


private holders of Greek debt, is that official holdings of Greek debt have been spared a haircut, at least for now. If the private sector is seen to have suffered discrimination, then the bonds of other weaker credits will be shunned.

The project, because the economics does not stack up, is essentially political and there are threats to the recently agreed treaty stemming from within. Ireland has judged that it needs to hold a referendum for constitutional reasons. Although the opinion polls currently show the "yes" camp in the lead, the outcome is uncertain. Spain has shown a streak of independence by announcing that it has taken a "sovereign" decision not to press ahead with a recently agreed target for its budget deficit this year because of the effect which it will have on its economy. Eventually, it agreed a compromise with the European Commission. Perhaps most worrying of all for the architects of the new treaty, the Socialist candidate for the French Presidency, Mr Hollande, has said that he would want to renegotiate it, if elected. The response to this of Angela Merkel is not hard to imagine. Given the pressure which she is under domestically because of the bailouts of what many German electors regards as feckless eurozone countries, the idea of France wanting a softening of the treaty, which is effectively what it would be asking for, is likely to be an anathema to Germany. So, there must be doubts about the resolution of the eurozone to keep to the agreement which has just been made on public finances and the associated disciplines necessary to ensure an improvement.

The austerity programmes have already led to public protests, particularly in Greece, but also in Spain, Portugal and Italy, and it is highly likely that they will increase, putting pressure on governments and finding their reflection in the ballot boxes. Already, we see in Greece, polarisation between left and right, leaving the previous government party, Pasok, with a much reduced share of the vote, according to the opinion polls, whilst the favourite to gain more votes than any other party, New Democracy, does not look likely to gain an overall majority at the forthcoming election. This is likely to lead to a very messy situation. We cannot see how Greece can stay in the euro. With citizens suffering severe hardship, the economy contracting sharply and more austerity on the way, it is a country without any hope. Whilst it would be extremely messy for it or any other country to leave the euro, the weakness of the new currency would at least give it some hope of growing out of its troubles. The alternative is almost indefinite economic and social hardship.

Whilst the problems of Greece, Portugal, Ireland, Spain and Italy are well known, in some ways the most interesting country is France, shortly facing a presidential election. France has been steadily losing competitiveness to Germany and its public finances are in a poor condition, having failed to balance its budget since the 1970s. Like Germany, it ignored the Stability and Growth Pact at an early stage when it became inconvenient to observe the Pact's budget deficit restrictions. It has a very large public sector which is "crowding out" the private sector and it needs to act to achieve a better balance in its economy. Historically, France has had an antipathy towards wealth and, in the current campaign, the rhetoric against business, the finance sector, as well as the wealthy, has reached new extremes. This puts France at some distance from its competitors and these policies are unlikely to arouse Lord Keynes' "animal spirits", to which we referred earlier. Protectionist noises have become much louder, as they always do in difficult times, even if the measures aired are illegal within the single market. In this febrile environment, and this is not just talking about France, accidents can happen. For example, in France, the 35 hour week, which has done the country so much harm, developed by accident. Nobody thought that it would become enshrined in law and France is still living with the consequences of a law which reduces its competitiveness. None of the politicians is really putting forward positive ideas for growth, rather the emphasis is on the negative. France has already lost its AAA rating from Standard & Poors and its bond yields stand at a considerable premium to those of Germany, about 110 basis points as measured by ten year bond yields. The forthcoming presidential election in France is therefore likely to be very important for the eurozone, initially at the macro level, namely Mr Hollande's attempts, if he wins, to renegotiate the treaty terms recently agreed, and, at the micro level, tax and spending measures which may be inimical to growth. As it is, and ahead of any other countries which might do it, France proposes to introduce a Financial Transactions Tax later this year. It does not send out a positive signal to the rest of the world and is a clear diversionary tactic to blame the banks alone for the eurozone sovereign debt crisis, rather than include profligate governments, which have failed to control their

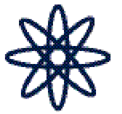


spending, and the fundamental flaw in the European Monetary Union which is visiting so much misery on so many people. With globalisation, business and capital is much more mobile and signals such as those emanating from France are counterproductive, given that it is vital to restart growth in the eurozone. The headline on the cover of The Economist for the week beginning 31 March reads "France in Denial" which is very apt. Tax and spend policies and no measures to stimulate growth could easily cause a further crisis for the eurozone.

One important side effect of the austerity measures being imposed on the southern eurozone members by the troika, the IMF, European Commission and the ECB, is the attempt to insist on supply side reforms in these countries and others like Italy and Spain which have not been in receipt of bail out funds but where bond markets have indicated concerns. With governments having no spare cash, supply side reforms in labour and product markets, whilst they will have no effect in the short term, should have beneficial medium and long term effects in raising these economies' long term growth rates or, at least, their potential. Vested interests are strongly opposing these reforms but the tragically high levels of youth unemployment in the southern eurozone countries make it vital that employers can hire employees without running unacceptable risks to their businesses. When backed into a corner of necessity, it is often easier to make the necessary changes because there is no option and supply side reforms are vital. In the latest OECD Economic Survey covering the euro area, just published, the OECD estimates the potential gains from a broad reform package in the eurozone. To quote the review, it says that a package of structural reforms, however, could transform the outlook and generate large gains in productivity and boost growth significantly. It then lists areas of action for named countries in the areas of product market regulation, labour market regulations, taxation, human capital, financial regulation and some other areas.

How does this leave eurozone investors? As we can see from the performance tables at the front of this review, most eurozone markets have joined in the rise in stock markets, notwithstanding the severe problems in the currency area. It has been our often stated view that it is important to distinguish between eurozone countries and companies domiciled there. Companies, particularly those with an international flavour to their business, are often performing well. Since the financial crisis of 2008, companies worldwide have battened down the hatches and many of them enjoy strong balance sheets. Operating internationally, they have valuable experience of managing currency exposure and we know from what several large companies have said that they are paying enhanced attention to this as well as to where they place their cash. One way to provide some protection against a break up of the euro, for example, is to try and match assets and liabilities within a particular country, whilst another is to sweep euro cash from banks in the weaker eurozone countries into banks in stronger countries which might stay in the euro for the time being if the fragmentation of the single currency is gradual. There are many world class companies based in the eurozone, as there are, for example, in the USA and UK, which are benefiting from exposure to fast growing economies in Asia. The relative weakness of the euro has been of benefit to these companies. The greater risk to these companies would come from domestic measures and, in this respect, France needs watching. We should also note that, in countries like France and Spain, the withholding tax on dividends has been increased as their respective governments search for more tax revenue.

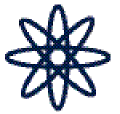
We have discussed why we believe that the ECB's LTRO has been an important driver of equity markets in the first quarter, but we want to develop further the theme of why we believe that monetary policy, notwithstanding the modest setback in equity markets last year, has been behind the strong recovery in equity prices since March 2009, almost exactly three years ago. The quantitative easing programmes, in their various guises, introduced in the USA, UK, Japan and the eurozone, have helped to drive up asset prices. Vast quantities of cheap money, as we said earlier, chasing a finite amount of securities will drive up asset prices, as they were meant to do as a by-product of trying to stimulate economic activity, the prime purpose of quantitative easing. We talked about the positive "wealth effect" this was hoped to create and the positive economic multiplier which could result as increased spending found its way around the economy in question. But one can have too much of a good thing. If it was that easy, central banks would be printing money the whole time. Particularly when stock market



movements have been quite benign, the pitfalls of quantitative easing on the ECB's equivalent, the LTRO, need to be emphasised. The policy was introduced at a time of extreme emergency to stabilise the economic position of the countries affected. But if some central banks' balance sheets balloon, as they have done, the risk of inflation becomes acute at some time in the future as the newly created money starts to circulate round the economy or seep into other markets such as commodities. Hence, it is desirable, at an appropriate stage, to return to a more conventional monetary policy regime where normal interest rates imply a real interest rate and quantitative easing has been reversed. Given the extreme conventional and unconventional monetary policy which has been followed, this is not going to be easy. At present, given the fragile nature of the economies of the countries in question, the inflationary consequences of money printing have not been widely felt. It has, however, had some secondary effects. One of these is on some commodity prices including, perhaps, oil. The other is to drive capital flows into developing and emerging markets and these flows are proving extremely unwelcome to some countries. Brazil, for example, has introduced measures to discourage the inflow of capital to try to prevent the strength of the Brazilian real causing damage to its industry. It has also introduced protectionist measures on imported Chinese cars to help domestic car production. Unwelcome as protectionism is, it is partly a function of cheap and plentiful money finding its way to markets where investors hope to enjoy higher returns and, in the process, causing market distortions. For those countries in which quantitative easing has been practised, the potential for an inflationary threat is very real once the newly created money starts to circulate around the various economies. At present, the lack of confidence has meant a low demand for loans but, once activity increases and the velocity of money circulation increases, the inflationary pressures will rise and could easily spin out of control. Central bank buying of bonds has depressed yields and the theory is that cheap money will encourage borrowing and, hence, spending and investment and thereby stimulate the economy. Most economies have labour market and capacity slack but, once those are used up, bottlenecks could start to occur which drive inflationary pressures.

Simplistically, we can see what needs to be done to reverse the quantitative easing. If, for example, quantitative easing was used to buy back government bonds and create money electronically for the seller so the reversal should manifest itself in the sale of government bonds by the central bank back to the original sellers to take back the liquidity created. That is going to be easier said than done, so substantial has been the level of quantitative easing. For example, when the latest round of quantitative easing in the UK has been completed, taking the amount up to £325 billion, the Bank of England will own around 30% of the UK government bond market. Notwithstanding the UK government's deficit reduction target, the UK is still going to have to borrow very large amounts of money, and the combination of net new gilt edged issuance and the sale into the market by the Bank of England of vast amounts of gilts could lead to a significant rise in interest rates. In practice, the Bank of England is likely to finesse the situation, acting pragmatically, but it will be aware of the potential for high levels of inflation which quantitative easing has built up. Once inflation takes off, it is very difficult to tame. This, therefore, is an issue for the future and no one should allow the present period of low volatility and upward drift in stock markets to lull them to a false sense of complacency. The measures put in place to deal with the aftermath of the financial crisis in 2008 were extraordinary in the true meaning of the world. The same broad principles apply to countries like the USA and Japan, as well as the eurozone with its own variation of quantitative easing.

We have talked about the ECB's LTRO as the eurozone's equivalent of quantitative easing, as we have mentioned above. It has undoubtedly been very successful in meeting its objective of restoring confidence to the eurozone banking system by ensuring that its foreseeable funding needs are met. The longer term issue will be weaning the relevant banks off cheap ECB money so that they can fund themselves independently as they used to do. A prerequisite is for banks' balance sheets to have credibility and that will, importantly, partly depend upon how the eurozone sovereign debt crisis develops. Even though banks are required to bolster their capital, an escalation beyond Greece of the eurozone's sovereign debt crisis, which we believe to be highly likely, would weaken the collateral which the banks will be able to place with the ECB in return for funding. Although the ECB has had to do things it would never have dreamed of but for the crisis, providing funds against very doubtful collateral would



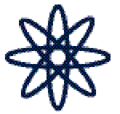
risk massive losses if the banks failed. Providing the funds without proper collateral risks debasing the currency. The ideal outcome of this emergency funding will be that banks became sufficiently strong to be seen as credible with their normal funding sources so that they can attract deposits. For those banks which have been playing the yield curve in the government bond markets where yields have been elevated because of concerns about the relevant countries' solvency, the boost to profits from borrowing short from the ECB and lending longer has to be considered against the background of another Greek situation developing. If that happened, it would be catastrophic for the banks and the ECB. We have to recall that in the face of denials by the politicians about the state of Greece's finances and its ability to honour its obligations, independent observers knew that Greece was not in a position to repay its debts in full. With the inevitable having happened in Greece, there is now a denial about a similar fate awaiting other troubled eurozone countries, with the emphasis being on Greece being a one off. But with countries like Portugal, Spain, Italy and, perhaps, Ireland facing economic contraction as a result of the austerity measures being taken, there is no certainty that losses can be contained to Greece and, naturally, investors have become wary.

Countries and regions which have undertaken quantitative easing, or variations thereof, have to consider when it will be withdrawn and the consequences, for example, for interest rates of this action. Whilst it will be very tempting to do nothing, money printing potentially has a very serious future cost in terms of inflation. Investors will need to see how policy develops on this front but they will need to be aware of it especially in the relatively benign conditions which now prevail as a result of the ECB's LTRO.

The printing of vast quantities of money leads to major distortions in the financial system. Its principal purpose was to calm nerves during the crisis and hope that cheap money would stabilise economic activity. It was also hoped that it would raise asset prices, as we mentioned earlier, thereby activating a positive wealth effect. The most severe distortion has appeared in the bond markets, especially government bonds issued by those countries which are highly rated by investors. In the most nervous times after the financial crisis, US Treasuries, UK gilts and German Bunds benefited from a perceived flight to quality and some investors were prepared to buy these bonds and short term bills at almost any price. Even though these bond yields are off their lowest levels, the bonds' gross redemption yields are far removed from reality. The risks to the bond market generally are so great, ranging from sovereign defaults to a sharp increase in inflation arising from quantitative easing, not to mention the still vast amounts which governments are having to borrow, that we feel it is only a matter of time before there is a very sharp correction in bond markets which will leave investors nursing very severe losses which may never be recovered. In the search for yield, investors have been piling into lowly rated high risk bonds this year, a very dangerous strategy. As an aside from this, we believe that high yielding equities with some dividend growth prospects are a much better proposition. Some of those being tempted by the yields on these low grade bonds are investors for whom income is very important. There are many more savers than borrowers for whom the present interest rate levels are a disaster. For those retiring and buying annuities, with bond yields as low as they are, the situation is shocking. For pension funds where gilt yields are used to discount future liabilities, the situation is serious and a threat to some companies' finances.

So, whilst some of the side effects of all this newly created money are superficially very pleasing, such as the rise in the stock markets, it is highly desirable that the world reverts to a more normal monetary policy so that undesirable distortions in the markets can be wound down.

We now look briefly at individual areas of the world economy. In the aftermath of the 2008 financial crisis, we downplayed this area of our review because events were moving so quickly that individual items of economic data had little relevance for the stock markets. Data which was historic was virtually meaningless and current data was likely to be overtaken by events in the financial sector. Although monetary conditions are extraordinary as a result of the measures taken to stabilise the world economy, the recovery in international equity markets since their nadir in March 2009 shows some degree of confidence and so it is therefore relevant to give greater weight to current economic news.

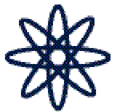


Of course, it is election year in the USA and we cannot therefore expect any major policy decisions before November and we may not get much after that if different parties control the White House and one or both houses of Congress. We have commented before on the poisonous atmosphere which pervades American politics with the centre ground all but vacated. The American political system militates against decisive economic action, for example, unless the circumstances are favourable when the White House and Congress is controlled by the same party and then not always. Were it not that all eyes are on the eurozone, the USA's serious imbalances might be capturing investors' attention. The USA has a serious budget deficit and an alarming outlook for public finances because of the prospect of ballooning entitlement outlays which have to be addressed. Especially not in front of elections, and perhaps not afterwards, do politicians want to address the issue. The worldwide problem is that the outlook and needs of politicians is short term, i.e. election or re-election whilst the required economic perspective is long term and they are not likely to be in office when the consequences of their action or inaction become clear. So, vital decisions are either not taken or are postponed, exacerbating longer term problems and perhaps only a crisis will force action. In the USA, the one serious attempt to address the looming crisis in the USA's public finances was the Simpson Bowles report named after the two Co-chairmen (one Democrat the other Republican) of the President's Deficit Commission. It produced a broad plan to reduce the federal deficit by cutting spending and raising taxes. The report was knocked into the long grass and nothing more has been heard about it. Meanwhile, the Republicans and Democrats support entrenched positions regarding tax increases and public spending levels and the Simpson Bowles middle ground is vacated.

At the moment, the state of US public finances is not a market issue because events in the eurozone look so much worse. In fact, there have been flickers of good news from the US economy which have encouraged investors, as we can see from Wall Street's good performance in the first quarter. Back in January, the IMF, in its World Economic Outlook Update, forecast US economic growth for 2012 at 1.8%. Now, some optimistic forecasters do not think that 3% growth is out of the question. That does look optimistic at present, especially if oil prices misbehave, but 1.8% may be too cautious. Going into 2012, the Bureau of Economic Analysis raised its estimate of fourth quarter 2011 growth from an annualised rate of 2.8% to 3.0%. In its latest statement, released in mid March, the Federal Open Market Committee (FOMC) raised its assessment of growth in the coming quarters to "moderate" from its previous description of "modest". One tentative sign of an improvement in US economic conditions has been seen in the labour market and the FOMC anticipates that the unemployment rate will decline "gradually". It thinks that the rise in the oil price will have a temporary effect on inflation but, beyond that, "inflation will run at or below the rate that it judges most consistent with its dual mandates". The importance of this statement relates to the short term interest rate outlook and enabled it to confirm that it still expects interest rates to remain exceptionally low until late 2014 at least.

Despite the fact that monetary policy, both orthodox and unorthodox, is exceptionally loose because of the very stressed world economic conditions, very low short term interest rates and the likelihood that they will continue that way are supportive to US equities in our view. In an important boost to the financial sector, fifteen of the top nineteen US banks passed the Federal Reserve's stress tests enabling dividend increases and share buy backs to occur. In the troubled housing sector, there are signs of stabilisation at very low levels and in the important services sector the latest ISM index for non-manufacturing moved up from 56.8 in January to 57.3 in February, a reasonably robust reading.

The USA is in a paradoxical situation in that, in 2013, unless anything changes, the Bush era tax cuts will expire, the budget sequester will kick in and the payroll tax holiday will end, thus representing a significant tightening of economic policy. Whilst it is vital that the gaping hole in the US public finances is addressed, it is awkward that fiscally contractionary measures are taken after what is likely to have been a year of modest growth. It would have been an easier issue to address if monetary policy was still able to give some traction but, with interest rates at practically zero, conventional monetary policy has lost the power to be effective. Intuitively, one would feel that

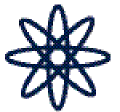


the further rounds of quantitative easing are likely to be less effective. This, of course, is a problem shared with many other indebted countries such as the UK, parts of the eurozone and Japan. But those countries, and this especially applies to the USA, which have their own currency, have the advantage of being able to print their own money and, although, as we have said above, further rounds of quantitative easing are likely to be less effective, that is not to say that they will have no effect.

In this globalised economy, many companies based in slow growing or advanced economies which are contractionary which have an international reach to their business can still perform well because of their exposure to faster growing markets. US companies are expected to face some earnings headwinds in the first quarter of 2012 when compared with a year earlier but, in the absence of unforeseen events, should be able to register modest progress for the year. In terms of valuations, American shares are not dear. The prospective dividend yield on the S & P 500 Index is about 2.09% which, as is the tradition, is lower than for most other markets. However, compared with ten year government bonds and short term interest rates, which we know for the foreseeable future are going to be ultra low, the yield comparison is favourable. At the time of writing, the yield on the ten year Treasury is 2.266% so, given that US dividends will almost certainly continue to grow, the valuations look reasonable.

We have discussed the eurozone at length, the main problem being that, in a monetary union, there is no hiding from a loss of competitiveness through the normal medium of devaluation. Whether the monetary union holds together in whole, or in part, or disintegrates, economic growth is essential because it provides extra revenue for the government and should reduce some costs, such as those for unemployment benefit as job numbers increase. Whatever happens, supply side reforms, being insisted upon by the troika, are essential to improve medium and long term economic growth prospects. The rigidities in labour and product markets, particularly in the southern eurozone countries, but also in larger countries like France, raise costs by introducing inefficiencies, reduce economic welfare because prices are higher than they need to be and condemn many young people to a prolonged, if not indefinite, period of unemployment, a terrible waste and injustice. Supply side reforms cannot work overnight and before their benefits kick in, that is assuming they do, the weaker members of the eurozone have to hope that one or more other influences may help them. It could be Germany, as the largest and strongest eurozone member, deciding to reflate and thereby reduce its current account surplus and increase its relative inflation rate to help the others to improve the competitive gap which has developed since the eurozone started or since the country in question joined. We regard this factor as one which is unlikely to come into play because we cannot see Germany agreeing to it. It could be a reacceleration of growth in developing and emerging markets but not all the troubled eurozone countries have the economic profile to benefit from such a development. This is veering towards wishful thinking, in our view, because the austerity measures being imposed upon these countries threaten a self perpetuating economic contraction. The latest EU forecasts for 2012, published in February, indicate negative growth of 4.4% for Greece, 3.3% for Portugal, 1.3% for Italy and 1.0% for Spain. Ireland is forecast to grow by 0.5% but recent GDP data for the fourth quarter of 2011 suggests that the economy is weaker than expected. The two largest eurozone countries, Germany and France, are forecast to grow by only 0.6% and 0.4% respectively. The fastest growing countries in the eurozone are forecast to be Estonia and Slovakia at 1.2%. The German economy, which has been a powerhouse, growing by 3.0% in 2011, suffered a 2.7% fall in industrial orders in January compared with December. Industrial production did, however, rise by 1.6% after falling 2.9% in December.

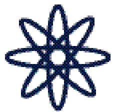
Turning to Japan where the latest IMF forecast is suggesting growth of 1.7% this year, the Bank of Japan recently announced a further round of quantitative easing. Cynics said that this was due to political pressure but the Governor of the Bank of Japan has denied this. The Bank of Japan is increasing its asset purchasing programme to JPY65 trillion (US$829 billion) from JPY 55 trillion. The emphasis is to be on purchasing short dated bonds with maturities up to two years. The reasoning behind this is the need to keep down short term interest rates in order to discourage inflows of speculative capital which serve to drive up the yen which hampers Japanese



manufacturing industry. It has also strengthened its policy on inflation, aiming, for the time being, to hit a goal of a 1% change in the consumer price index. Despite being an enormously wealthy country, with the world's second largest foreign exchange reserves, its current account surplus is deteriorating. The shutdown of many of its nuclear power stations has raised its import bill as alternative sources of energy have to be generated. Japan, with its weak public finances, would not want to be a capital importer. The recent weakness of the yen will be welcomed by Japanese manufacturing companies as its strength has caused them to be placed at a competitive disadvantage. As with the USA, the dire state of Japanese public finances will have to be addressed sooner rather than later but, with all eyes focused on the eurozone, it is not a current issue of concern for investors. With an estimated budget deficit for this year of over 8% of GDP and the gross level of public debt at over 200% of GDP, Japan is experiencing unsustainable trends in its public finances. It does have the advantage of being able to finance its deficit at very low levels of interest rates but this state of affairs cannot be counted upon to last indefinitely.

One of the reasons why we believe that the world economy will avoid a recession, notwithstanding the eurozone's difficulties, is that growth in developing and emerging markets should be sufficiently strong to offset areas of weak or negative growth. We will talk about China shortly, but we do have to recognise that, overall, the BRICs (Brazil, Russia, India and China) are slowing down. Brazil, now the world's sixth largest economy, showed growth of 2.7% in 2011, a third of the rate in 2010 and the largest rate of growth since 2003. We have mentioned earlier in this review that Brazil has embarked on certain protectionist measures aimed at undoing the damage to Brazilian industry caused by the high value of the real. Brazil suffers from relatively high inflation, the latest figure to February being 5.8%, whilst the central bank keeps short term interest rates high. India, too, has problems with a political paralysis at the top leading to a lack of decision making. In the fiscal year to March, growth is forecast to be 6.9% against an earlier government projection of 9.0%. India is sending out mixed signals to foreign investors, with the latest plan to seek retrospective taxation on deals involving Indian assets but through companies based overseas, the tax department having been unsuccessful in its attempt to extract capital gains tax from Vodafone Group. This is about as bad a signal as a country can give if it wishes to attract foreign investment. A stable and predictable environment is essential. Higher oil prices should help Russia but, even so, growth is forecast to moderate to 3.5% this year. The malaise in some of their overseas markets will obviously negatively affect the BRIC's growth prospects.

The giddying pace of expansion, which in three decades has seen China grow at an average of 10% per year, has shown signs of slowing in recent months, caused principally by its export markets demanding less from its factories. The challenges that China is facing go beyond this as the phenomenon of 're-shoring' emerges where production is moved back to its home market or to even cheaper countries as costs rise in China. The government also needs to take the next steps on its one way transition from command to free market economy and, somewhere between the two, its politicians need to create economic conditions that nurture internal demand to replace capital expenditure and foreign demand as the driver of growth. A clue to the political direction of the country comes as Bo Xilai, seen by many as the personification of the Communist Party's conservative faction, has seen his sphere of influence greatly reduced in Beijing. His Chongqing model is named after the south-west region that he is from, and it calls for a top-down push for social equality, with a stronger role for government. Only last month, the Party's People's Daily newspaper strongly supported more reform of government in an editorial, and a research arm of China's cabinet joined a call from the World Bank for a smaller state role in finance and industry. The existential big government versus small government dilemma is not just being played out in Washington. The Chinese government's engineering of a soft landing is underway, this being particularly important in a year when the Party wants a stable leadership transition. Higher interest rates and tighter credit to the private sector has slowed investment in housing and foreign trade has weakened. Export growth in 2012 is currently held to be about 7% (OECD November 2011) due to weaker demand and a decline in competitiveness, but the impact on activity may be partially offset by increased public spending and a cut in income taxes. The foreign exchange policy throws more light on the dynamics of the situation, with the yuan currently fixed at around 6.29 to the

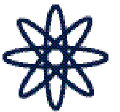


dollar having been allowed to strengthen since June 2010 when the rate had been held around 6.80 for around two years, to the frustration of trading partners and which has played a bit part in the American Presidential elections. An artificial exchange rate certainly suggests evidence of protectionism and China promised a great deal in order to join the World Trade Organisation ten years ago, but many promises remain unfulfilled, such as on piracy. China replies saying that its economy is more open than Japan's or South Korea's were at the same stage, that import tariffs are capped at 10% on average which compares with Brazil's at over 30% and in China, unlike India, you can shop at Wal-Mart, most of the time. The Party's target for GDP growth has been set at 8% since 2005 and, when it was announced on 5th March that this year's target was 7.5%, markets slid, and not just in China. Premier, Wen Jiabao, has prolonged the crackdown on real estate speculation to reduce the risk of asset price bubbles and make housing affordable, adding to the risk of a slowdown, but moderating inflation gives Chinese officials more room to add stimulus after two reductions in bank reserve requirements in the past four months. Prices of new apartments fell in 45 of 70 cities in February, according to the IMF. Despite these political developments and shifts of emphasis in policy, China, as the world's second largest economy, remains a very important influence on world economic outcomes and is still a positive force in the battle to avoid a world economic recession.

The UK has been dominated by the recent Budget. Whilst the details are obviously important, the key issue, we believe, is the structural deficit elimination programme. Although the UK, unlike the USA and France, retains its top credit rating from all three leading credit rating agencies, two of them have put the UK on negative watch, which could lead to a downgrade. In our view, it is absolutely essential that the UK does everything it can to preserve its top credit rating. This is one reason, quantitative easing is another, why the UK can borrow so cheaply. Were this not the case and, given the horrific level of the deficit, the UK would have even more problems because of higher debt servicing costs. As it is, the forecast level of public net borrowing as a percentage of GDP is forecast to fall from 9.3% of GDP in 2010/11, to 8.3% in 2011/12 and steadily down to 1.1% in 2016/17. All the while, of course, the UK will be adding to its level of outstanding debt. This is why we believe that siren voices calling for the Chancellor to move more slowly on his deficit reduction plans are so wrong. The UK's level of borrowing, forecast to peak at 76.3% of GDP in 2014/15, remains dangerously high and, for investors, we think the single most important issue to concentrate upon is the trajectory of the deficit reduction plan. The stock market can live with austere conditions but putting the economy at risk by moving away from the plan would be serious. Fortunately, there is no sign of this happening at present.

One of the problems of a coalition government, especially when formed from parties which hold quite different views on many topics, is that compromises have to be reached. Sometimes that can be good, at other times bad. One of the unfortunate by-products of the financial crisis, and the recession which followed, is the development of an anti business, anti wealth creation culture. Ever political, those in the Coalition sent out mixed messages about business. This is dangerous as it is only the private sector which can generate sustainable growth. So the Budget's moves on Corporation Tax are to be welcomed and, within the constraints of the Coalition, the message seems to have got through. Taxes should be levied at the level at which they raise the maximum amount of money. Personal taxes are too high in the UK and the attention on the high end property market could be damaging, especially in London, as the residents create a significant economic multiplier effect. Politics being what it is, gestures are everything. It is to be hoped that the UK has not gone too far in this respect. Within the constraints of the deficit, the Budget has not worsened the outlook for the UK and the UK, with its large number of multinationals, remains an attractive equity market.

Although the international equity markets have moved higher in the first quarter, investors should not underestimate the gravity of the economic situation as the post quarter end market weakness on renewed nervousness about Spain shows. Given that there is no obvious end to the eurozone's troubles, we must expect bouts of volatility in markets. The French Presidential election will provide an early test should Mr Hollande win. The markets may



well turn their attention to France where the virtual absence of any policies to provide economic growth and seriously address the spending problem will not go unnoticed by markets. If attempts are made to unpick the recently agreed treaty proposals, the markets could take fright. But other areas of the world provide more hope as developing and emerging economies continue to grow and provide opportunities for the economies of advanced countries and for the companies based in them. Another possible problem is an escalation in the tension with Iran. The effect on the oil price has already been felt and further rises will provide economic headwinds for the world economy as it struggles to recover from the debt crisis. We would continue to avoid bonds where yields in highly rated countries reflect a flight to safety, quantitative easing and other regulatory pressures to buy government debt. None of these factors, however, make the gross redemption yields on the sovereign bonds detailed in the table at the beginning of this review remotely attractive. The danger of significant losses remain. For the reasons given, equities look a more attractive proposition but the serious economic position and concerns about the debt levels make periods of volatility inevitable and, in this respect, the first quarter was atypical for its low volatility.

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