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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

For international equity markets, the first quarter was one of little change either way. Unlike recent quarters, performances, except for Japan, were quite closely bunched and, although the returns were slightly negative, the indices for Latin America and Emerging Markets lagged developed markets, except Japan, only slightly. In the case of Japan, a weak market, these markets' indices held up better. Jitters in emerging markets during the quarter pushed money into developed markets' bonds and the returns in this sector were usefully positive. Currency investments were less pronounced than in recent quarters but sterling edged higher, except against the yen and Australian dollar. In the commodity markets, gold staged a partial recovery.

The tables below detail relevant movements in markets :

International Equities 31.12.13 - 31.03.14

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+2.2	+5.2	+5.9	+5.8
Finland	-0.4	-1.0	-0.4	-0.4
France	+3.3	+2.6	+3.3	+3.3
Germany	-0.2	-0.8	-0.2	-0.2
Hong Kong, China	-1.7	-2.4	-1.8	-1.8
Italy	+14.3	+13.6	+14.4	+14.3
Japan	-7.3	-6.0	-5.4	-5.4
Netherlands	+0.3	+0.4	+0.3	+0.3
Spain	+4.8	+4.2	+4.9	+4.8
Switzerland	+4.4	+4.4	+5.1	+5.1
UK	-1.4	-1.4	-0.8	-0.8
USA	+1.9	+1.2	+1.9	+1.9
Europe ex UK	+3.6	+3.0	+3.7	+3.7
Asia Pacific ex Japan	+0.7	+0.9	+1.6	+1.6
Asia Pacific	-3.4	-2.6	-1.9	-1.9
Latin America	-2.2	-0.7	N/C	-0.1
All World All Emerging	-0.8	-0.8	-0.1	-0.1
The World	+1.1	+0.7	+1.3	+1.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +2.1%

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

Currency	31.12.13	31.03.14
Sterling	3.04	2.76
US Dollar	3.03	2.75
Yen	0.74	0.65
Germany (Euro)	1.94	1.58

Sterling's performance during the quarter ending 31.03.14 (%)

Currency	Quarter Ending 31.03.14
US Dollar	+0.7
Canadian Dollar	+4.6
Yen	-1.4
Euro	+0.8
Swiss Franc	+0.2
Australian dollar	-3.0

Other currency movements during the quarter ending 31.03.14 (%)

Currency	Quarter Ending 31.03.14
US Dollar/Canadian Dollar	+3.9
US Dollar/Yen	-2.1
US Dollar/Euro	+0.1
Swiss Franc/Euro	+0.6
Euro/Yen	-2.2

Significant Commodities (US dollar terms) 31.12.13 - 31.03.14 (%)

Currency	Quarter Ending 31.03.14
Oil	-2.8
Gold	+8.0

MARKETS

The end result of a volatile quarter was that international equity markets were little changed. In total return local currency terms, the FTSE World Index returned 1.1%, in sterling terms 0.7%, in US dollar terms 1.3% and in euro terms 1.3%. Looking at local currency returns first, the best performing area was Europe ex UK where the FTSE Europe ex UK Index returned 3.6%. Australia also had an above average performance with the FTSE Australia Index returning 2.2% as did the FTSE USA Index which returned 1.9%. Underperformers were the FTSE Japan Index, with a negative return of 7.3%, and the FTSE UK Index with a negative return of 1.4%. The FTSE Latin American Index and the FTSE All World All Emerging Markets Index showed negative returns of 2.2% and 0.8% respectively. Except against the Australian dollar, yen and Brazilian real, sterling tended to strengthen so the sterling adjusted total returns on the FTSE Europe ex UK Index and FTSE USA Index were slightly lower at 3.0% and 1.2% respectively. The strength of the Australian dollar meant that the return on the FTSE Australian Index rose to 5.2% whilst the negative returns from the FTSE Japan Index and FTSE Latin American Index reduced to 6.0% and 0.7% respectively.

High quality international government bond markets performed strongly. Taking 10 year government bond markets as a benchmark, the gross redemption yield on the UK government bond fell by 28 basis points to 2.76%, on US dollar bonds also by 28 basis points to 2.75%, on Japanese government bonds by 9 basis points to 0.65% and on German Bunds by 36 basis points to 1.58%.

In the currency markets, movements were relatively modest. Sterling strengthened against the Canadian dollar by 4.6%, against the euro by 0.8%, against the US dollar by 0.7% and against the Swiss Franc by 0.2%. On the other hand, it fell by 3.0% against the Australian dollar and by 1.4% against the yen.

In the commodity markets, oil, as measured by Brent Crude, fell by 2.8% whilst gold recovered by 8.0%.

ECONOMICS

We head this section "Economics" but, of course, politics can be equally if not more important in the short term. So, at the moment, investors are having to come to terms with the latest international flashpoint, Ukraine. Where this will end, we do not know, but there will clearly be negative economic consequences apart from anything else. For Russia, capital flight, a weak currency and targeted economic sanctions will not help an economy which has not been performing well. In the long term, it might drive a move by countries which import energy from Russia to try to develop alternative suppliers or to hasten a move towards more energy security by moving to taking a more positive view towards fracking, for example. This is in the realms of speculation at the moment but countries cannot afford to be overdependent on uncertain sources of energy supply. For countries which export to Russia, their exports could be in danger, at least in the short term. So there are no economic winners from this confrontation. It is difficult for investors to know how to react to an event which has unexpectedly come to the fore quite suddenly. It is likely to have a negative effect on GDP growth in some countries and it may be mild or more serious according to the country involved. Concerning though the confrontation over Ukraine is, we consider it unwise to factor it into investment policy on the evidence we have before us. That may change if events take a turn for the worse but it is in no country's interest that the confrontation should escalate, least of all Russia's. As this is written, Russia's deputy economy minister has reported that capital outflows from Russia are expected to rise to US$70 billion in the first three months of this year. He said that Russian GDP was 0.3% higher in February than a year previously and 0.1% higher than in January. The steep depreciation in the rouble threatens to lead to an increase in inflation with the latest year on year inflation rate being 6.9% in March and this is an economy which is expected to show only minimal growth this year. This used to be called "stagflation" which is not a good situation in which a country should find itself.

There have been five issues over the past eighteen months or so which have hung over securities' markets although they have rotated in importance in investors' eyes. These have been the US budget deficit and borrowing ceiling stand off between Congress and the President, the eurozone crisis, emerging market worries, China and, back to the USA again, the pace of retrenchment on quantitative easing ("QE"). For the moment, we can put the first issue to the back of investors' concerns although it will almost certainly came back to the fore in the future given the trajectory of the USA's public finances. However, whilst discussing the USA, we should certainly discuss the last of the five issues, the gradual exit from QE.

Given the severity of the financial and economic crisis in 2008, most observers would agree that the extreme version of monetary policy undertaken in different ways by major countries saved the world economy from something worse than the recession which occurred. The recovery in stock markets, which started five years ago in March 2009, has been fuelled by cheap money. Rising asset prices, an objective of the policy, was meant to engender a positive wealth effect thereby encouraging individuals and businesses to spend. To a limited extent that has happened. House prices have recovered in the USA and UK and, at least in these two countries, there are signs of business investment picking up. However, there have been malign side effects. One of these is on savers who have relied on income from bank deposits or bonds and insofar as they represent one category of those who have suffered adversely from very low interest rates, they will not be able to support economic growth. Markets have been heavily distorted by monetary policy, forcing investors to make decisions which they never expected to have to do. An example would be to buy equities for yield when previously they might have considered fixed interest securities or cash. So far, such a decision will have served many of them well and it may change long term investment attitudes. Whilst we still favour equities, the distortion in the fixed interest markets has been very significant. Before the financial crisis broke, very few professionals would have believed it possible for interest rates or bond yields to fall as low as they did. However, although it may not feel like it now with inflation in most developed countries very low, it will become a problem in due course if QE and ultra low interest rates are not reversed. At the moment, most countries have an output gap which means that they are not producing as much as productive capacity would allow because demand is deficient. There is not therefore any pricing pressure. However, if the money which has been created starts to move around the economy more quickly, creating additional demand as it does so, those output gaps will disappear and pricing pressure will become stronger as imports become more expensive and demand stronger. So, if monetary policy is not tightened in time, we may expect to see inflation becoming a problem again. For that reason, what is happening in the USA is important.

Last May, when the then President of the Federal Reserve, Ben Bernanke, mentioned the possibility of tapering, markets were temporarily spooked, as they were again later in the year when it came closer to reality. From an outside observer's point of view, the market's reaction should have been a surprise because one would have expected tapering to have been discontinued. It was obvious that the first steps towards unwinding everything that had been done since 2008 had to be taken and therefore the negative market reaction was surprising. It seems that the sugar rush created by cheap and newly created money had dulled investors' senses. The USA is further into the process of recovery than other major countries so it is not surprising that it is leading the way. There is, however, a long way to go before the policy reversal is completed and this will be the challenge for markets. There are likely to be three stages in the policy reversal process. The first is taking place now. This is not the end of QE but a reduction in its pace. With the Federal Reserve's latest tapering announcement made in March, three batches of US$10 billion reductions in QE have been announced and these represent a reduction in the monthly amount of money which is being created to buy fixed interest securities and even with the latest reduction to US$55 billion a month, it still represents a significant amount of money creation. Assuming the US economy stays roughly on its present course, we may expect this process to continue until QE actually stops which, at the present rate of progress of tapering, would be the autumn. At the same time, however, short term interest rates will almost certainly, as guided, remain very low so monetary policy will still be very easy by historical standards, just not as easy as it has been. The next stage will be to start to reverse QE, probably through the Federal Reserve selling back to the private sector the securities which it has purchased thus sucking back from the economy the money which has been created. Such a policy will have to be handled very carefully in order to avoid destabilising markets. Fifteen months ago, the USA was a big issue for markets because of the stand off between Congress and the President; now it is for a different reason which is the first steps to unwinding QE.

Given that the USA is the world's largest economy and that the US dollar is by far the world's largest reserve currency, a significant change in policy is going to have repercussions elsewhere and the turbulence which has been witnessed in some emerging markets reflects this. In recent years when monetary policy has been very loose, money moved to many emerging markets in search of higher yields. It was an indiscriminate move and a number of emerging market countries complained about the rise in their currencies and the effect which it had on their competitiveness. That is now rather a distant thought as the prospect of the Federal Reserve's tapering programme and the effect which it might be expected to have in time on US interest rates caused a reversal of currency flows and sparked weakness in emerging markets' securities and some of their currencies. Those which proved especially vulnerable were those with weak current account positions where capital inflows are necessary to bridge the deficit. When there is optimism and an indiscriminate rush to emerging markets (or any others, for that matter), this issue can be overlooked but not when the position is reversed. If we plot the movement of various currencies against the US dollar since the beginning of 2013, we note falls of approximately 38% in the Argentine Peso (political troubles as well as a serious economic position), 32% in the Venezuelan Bolivar (the same), 15% in the Russian Rouble (political issues i.e. the Ukraine), 22% in the South African Rand, 21% in the Turkish Lira, 15% in the Indonesian Rupiah, 15% in the Chilean Peso, 12% in the Brazilian Real, 11% in the Colombian Peso and 10% in the Indian Rupee. Although there are political uncertainties in some of these countries, all are vulnerable because of weak current account positions. It is quite possible that, as investors become more resigned to the fact that the Federal Reserve will continue its tapering programme, they will feel more relaxed about emerging markets because, notwithstanding what has happened recently, there is no reason to believe that their economies' growth rates will not continue to outstrip those of developed markets. That in itself does not guarantee outperformance of those markets but it puts some of the more negative views into perspective. However, notwithstanding the jitters in stock markets arising from the implementation of the Federal Reserve's tapering programme, investors should take comfort from the knowledge that the start of the tapering programme implies that economic conditions are starting their long journey towards normality and, secondly, that, whilst it may have given markets a "sugar rush" in recent years, this is not a good basis for rising securities' prices. Added to this, the potential inflation implications arising from QE which we discussed earlier and it becomes evident that "short term pain for long term gain" is as relevant a saying as ever in this context. If ultra loose monetary policy, where practised, can be safely exited before its malign consequences become apparent, then investors will benefit. It is just that it might not seem like it along the way. One of the reasons why we have suggested that, against the background of our view that equity markets will rise this year, albeit unsteadily with setbacks along the way, there will be these periods of weakness is because the progression along the path of tapering, initially, and then perhaps when followed by the start of the unwinding of QE, will cause nervousness. This is apart from any political factors such as the current confrontation over Ukraine. So, this part of the review has captured two of the issues which have been influencing markets, the USA and turbulence in emerging markets, with the two factors connected, and, within the USA, the emphasis of concern has moved away from the stand off between the executive and the legislature to the path and consequences of tapering.

Now, to the ever present concern, the eurozone. It is correct to say that, at present, the eurozone has fallen down the list of worries for investors but it has certainly not gone away. The fundamental flaw in the currency union remains and the damage wrought on the troubled southern eurozone economies is as serious as ever with the consequences reaching far into the future. The European elections in May are likely to show the level of disaffection with what has happened not only in countries which have had bailouts and austerity heaped upon them but also in France where there is a great deal of dissatisfaction with the extent of the tax increases imposed on the country. The substantial fall in the bond yields of the troubled eurozone countries suggests that the crisis has passed but the still high levels of budget deficits, missed deficit targets, high overall levels of debt in relation to GDP and very high unemployment levels is a potentially explosive cocktail of problems which could ignite at any moment. We regard the eurozone problem as dormant but it could spring to life at any time.

Aside from the political events in the Ukraine, on the economic front China is right at the top of investor attention at the moment as it moves to reorient its economy away from fixed asset investment and exports and towards consumption. In trying to do so, it needs to keep the economy growing quickly by western and Japanese standards. 7.5% is its target for this year. As well as the state banks, the shadow banking sector has become very large. Because of the substantial overinvestment in fixed assets, which have not proved their economic worth, there are concerns about the banking sector and the authorities have shown in recent times that they are prepared to inflict pain on the shadow banking sector by allowing a sharp spike in short term interest rates to occur. With bank loans having ballooned in size with some of them going into unprofitable investment, it is a major job to rein in excesses but China is one economy which, because of its financial strength and capital controls, may be able to handle this. On the encouraging side for the future is the emphasis placed by the new leadership on the market to work along state owned businesses and, for the long term, this is very positive. In the short term, investors are concerned about the threats of defaults. In order not to sap confidence, the Chinese authorities have to manage defaults carefully. Too aggressive an attitude could cause confidence to collapse yet the need to tolerate some defaults reflects a warning shot across the bows of imprudent lenders and investors. Growth in China has been slowing down in recent years and the target of 7.5% this year is roughly in line with recent years having fallen from double figure growth levels. Everyone realises that the transition in the economy involving a much better allocation of resources, which is where the increased emphasis on the market helps, is a major task which is why short term market movements are currently sensitive to news from China. As the world's second largest economy, what happens in China is very important, especially as many developed countries' economies are relatively sluggish.

These, then, are the five specific issues which have been influencing markets at various times in the recent past with their order of importance changing. However, the day to day release of economic news provides the bread and butter of market influences and we now turn to look at these .

It is instructive to consider, as a template for what might happen in the world economy this year, the IMF's World Economic Outlook published last January. Obviously, the Ukraine crisis had not blown up then and we do not yet know what the economic consequences arising from Russia's annexation of the Crimea will be but, assuming they are containable, the forecasts can provide a useful guide at this stage although, of course, as with any economic forecast, events can overtake them. Its projection for world output is that it will increase by 3.7% in 2014 with a slight acceleration to 3.9% in 2015. This compares with 3.0% in 2013. Advanced economies are projected to grow by 2.2% this year and 2.3% next year compared with 1.3% in 2013. With advanced economies, the IMF forecasts growth of 2.8% this year in the USA and 3.0% in 2015, up from 1.9% in 2013. The recession in the eurozone in 2013, when the area's economy contracted by 0.4%, is expected to give way to modest growth of 1.0% this year and 1.4% next year. It projects that all four of the eurozone's largest economies will show some growth this year even though it is very modest in most cases - Germany (1.6%), France (0.9%), Italy (0.6%) and Spain (0.6%). Italy (-1.8%) and Spain (-1.2%) were in recession last year whilst Germany (0.5%) and France (0.2%) hardly grew at all. For countries with significant budget deficits and /or excessive outstanding public debt as a percentage of GDP, these growth rates, if they are achieved, are not sufficient to make inroads into the problem. Japan, which grew by 1.7% in 2013 is projected to grow at the same rate this year and 1.0% next year, quite a fall off when advanced economies are expected to grow marginally faster next year. The star performer in terms of expectations is the UK. This time last year, the IMF was bearish on the UK economy but it has had to revisit its forecasts in the light of encouraging developments in the UK economy. So, last year's growth rate of 1.7% is projected to expand to 2.4% this year and to slow down to 2.2% next year. These forecasts are lower than those of some other forecasters. For example, the Office for Budget Responsibility, in its forecasts accompanying the Budget, projects growth of 2.7% this year and 2.3% next year (its forecasts for later years are 2.6% in 2016 and 2017 and 2.5% in 2018). Turning to Emerging Markets and Developing Economies, the IMF projects growth of 5.1% in 2014 and 5.4% in 2015 against 4.7% in 2013. Within that, its forecast for Chinese growth this year is 7.5% slowing to 7.3% next year against 7.7% in 2013. For India, where growth by its standards was a sluggish 4.4% in 2013, the IMF expects growth of 5.4% this year and 6.4% next year. Brazil, where growth has slowed significantly in recent years, is expected to grow at 2.3% this year, the same as in 2013 and 2.8% in 2015. Mexico, a rising star amongst investors in the light of its radical supply side reforms, is projected to show a sharp acceleration in growth this year to 3.0% from 1.2% last year and to 3.5% in 2015.

Overall, these are not spectacular numbers, indeed they are sub-par especially in the eurozone, but they do suggest some modest progress at a low level. This is important for the stock market because last year's rise in share prices well exceeded the growth in corporate earnings, leading to expanded share valuations. This year, it will be important for corporate earnings to do some catching up and, if world economic growth does accelerate this year, it should inspire companies' revenue growth rate because, up to now, cost cutting and share buy backs have been instrumental in raising the level of corporate earnings. There is only so far that companies can go in cutting costs if they are not to prejudice future growth and we are at or near that stage. So analysts and investors will be watching closely the progress of corporate earnings growth this year to validate last year's rise in share prices and to justify a modest further advance this year. The economic growth numbers, always important, will perhaps assume added significance this year given the extent of the rise in share prices in 2013.

Turning now to look at various areas of the world and starting with the USA, Wall Street initially reacted adversely to comments by Janet Yellen, the new Chairman of the Federal Reserve, in which she appeared to harden guidance on monetary policy and the timing of the first interest rate increase. The Federal Reserve's task has been complicated by the extent and timing of the fall in the US unemployment rate which now stands at 6.7%. This is close to the 6.5% level which was the earlier indicated level at which an increase in interest rates would be considered. Instead she said that the Federal Reserve would "assess progress towards its objectives of maximum employment and 2% inflation". As mentioned earlier, the latest FOMC meeting decided to reduce its monthly bond buying programme to US$55 billion, the third monthly reduction of US$10 billion. As far as one can see, this regular monthly reduction is likely to continue. The Chairman indicated that, once the bond buying stopped, interest rates were likely to remain at current levels for some time assuming no nasty surprises on inflation or long term inflation expectations. Most people have considered that, in the absence of unexpected developments, interest rates in the USA will start to rise next year. As we have said before, it is desirable that early moves are made to normalise monetary policy because of the distortions it causes for the economies in question and financial markets. Bond and equity markets must not be dependent for their strength on artificial supports.

The last estimate of fourth quarter GDP in the USA was revised downwards from 3.2% to 2.4% but it contained some encouraging news on business investment. This is very important because it drives good quality growth. At some point, companies have to draw the line under cost cuts and holding off new investment because it will prejudice their future growth potential. It looks as if we may be getting to that stage. The Purchasing Managers Indices are one of the most closely watched items of data which are published in any country which produces them. The latest ISM PMI for manufacturing in March stood at 53.7 compared with 53.2 in February whilst that for services rose to 53.1 from 51.6. Both are on the right side of 50 and suggest modest growth. It is possible that the bad weather in the USA early this year has distorted some data readings and the latest unemployment data suggests that this is the case. In her statement, Janet Yellen said that the Federal Reserve was possibly too optimistic about the US economy in January. Whilst the steady downtrend in the unemployment rate to 6.7% is good news, this is still a high rate and has been flattered by the low participation rate in the USA with many people having dropped out of the labour market or not looking for work, although the latest figures are more encouraging in this respect. That is one reason for being less prescriptive about the level of unemployment at which the FOMC might think about raising interest rates. On a positive note, factory output rose sharply in February, possibly a weather related rebound. Inflation remains low which, in the context of reducing market fears of an unexpected early interest rate increase, is important. The year on year increase in the Consumer Prices Index to February was just 1.1% and the PCE deflator's last quarterly annualised increase was 1.3%. This is an indicator which the Federal Reserve watches closely. But investment is about the long term and, in this context, the dramatic change in the USA's energy profile is important. The shale revolution in the USA has transformed its position relative to other countries which have either decided not to develop their resources or are moving slowly. What this means is that the USA's current account deficit is shrinking dramatically as it replaces imported energy, reducing the reliance on foreign capital and, secondly, that falling energy costs will make US companies more competitive so we can confidently expect more "reshoring" as US companies repatriate production or non US companies decide that the USA is a more attractive country for capital investment. In this respect, Europe, with its generally high energy costs, is at a disadvantage. There are very few countries around the world which do not have significant economic or financial issues and the USA is not one of them with its worrying long term trajectory of public finances but, in relative terms, it is well placed and the development of cheap energy sources is very positive for the country so, for long term investors like ourselves, the USA remains a very important area of asset allocation.

Moving on to the eurozone, we have discussed it earlier in the context of one of the five issues which have overhung the market and there is nothing to add to the list of fundamental problems of the eurozone which we have articulated in previous reviews. As we said earlier, all is quiet (relatively speaking) but the problems could spring to life at any moment. However, we would also reiterate the point that we must separate the fortunes of companies based in the eurozone from those of the sovereign. They have the opportunity to do well in areas away from their home market. Even though the eurozone was in recession last year, the areas' stock markets performed well. We referred earlier on in this review to the IMF's forecast of 1.0% growth in the area this year and 1.4% next year. For interest, the latest European Commission forecast is for the area's growth to be 1.2% this year and 1.8% next year, slightly more optimistic than the IMF's projections. These more optimistic (but this is a relative state) forecasts chime in with some better economic data. The closely watched Purchasing Managers Indices show in March a reading of 53.2 at the composite level with the readings for manufacturing and services at 53.0 and 52.2 respectively. Germany's readings were fairly strong at 54.3 at the composite level, 53.7 at the manufacturing level and 53.0 at the services level. Encouragingly, although the economic outlook remains very bleak, France's readings have moved above 50. They have been stuck in negative territory previously but, in March, the composite figure rose to 51.8, manufacturing to 52.1 and services to 51.5. Italy, another concern because of its high outstanding level of public debt as a percentage of GDP (about 133%), was also in positive territory overall in March with a composite index reading of 51.1, a manufacturing index reading of 52.4 and a services index reading of 49.5. These items of positive news should be put into context, however. The eurozone unemployment rate is 11.9% and for the under 25s at 23.5%. The constraint of a single currency with the inability to regain competitiveness through devaluation means that the internal devaluations (i.e. policies such as wage cuts) reinforce the vicious downwards economic spiral as demand is crushed in these countries. What was positive for the USA in terms of cheaper energy as a result of the shale revolution is negative for Europe where energy costs in important countries like Germany are very high. No supply side revolution is likely in Europe and this is likely to put some manufacturing industry at a competitive disadvantage which it will seek to offset by relocating investment. The chemical industry is one which comes to mind. It is difficult to be optimistic about prospects for the eurozone but we have confidence that many eurozone based companies will be able to navigate their way around some of the difficulties in the area. There are, after all, many world class companies based in the area. It is unlikely that the year can pass without one or more crises developing within the eurozone as its flawed structure brings to the fore its fault lines. This area, for the reasons mentioned above, remains an important one for our portfolios as we believe that companies are better able than the sovereign to deal with the contradictions of the currency union.

For Japan, the jury is out on "Abenomics" and April sees a rise in consumption tax from 5% to 8% which will provide a challenge for economic policy. Extreme monetary policy, represented by quantitative easing on an enormous scale, and a large public spending programme have and will provide the stimulus and there was a major debate about whether the consumption tax increase should go ahead. However, with an enormous burden of outstanding public debt, at 240% of GDP, and a very large budget deficit, Japan is vulnerable to a loss of confidence and a rise in interest rates. Servicing the deficit at very low rates of interest is one thing but, at a higher level the debt, dynamics worsen considerably. We showed earlier the extent of the decline in the currencies of some emerging markets which had been caught up in the aftermath of, first, the prospect and then the reality of the Federal Reserve's tapering programme. In a different context, because it was a deliberate act of policy to weaken the yen, the currency is approximately 15% lower against the US dollar since the end of 2012. With an inflation target of 2%, the aim is to change the psychology of businesses and consumers towards a preference to spend money before prices rise rather than, hitherto, in the deflationary environment, which has prevailed in Japan, to hold off discretionary purchases because prices are expected to fall. A 3% rise in consumption tax might be expected to bring forward some purchases at the expense of a period of temporary reduced demand after the tax increase. One feels that the authorities made the right decision to proceed with the tax increase because otherwise, given existing monetary and fiscal policy, their already bold policy might have been considered reckless. In terms of inflation, Japan has not yet reached its target. The year on year rate of increase in consumer prices in February was 1.5% and the March figure for the Tokyo region was 1.3%. The tax increase will cause a one off rise in prices which should leave the system after a year unless the original plan to increase consumption tax in two stages is implemented. With negative real interest rates along most of the yield curve, the threat to nominal Japanese interest rates is clear. The positive side, the effects of which it is hoped will stimulate the Japanese economy through increased investment, is that the weaker yen has boosted the profits of many Japanese companies with overseas business, either through exports or overseas subsidiaries or both. Overall, the latest Purchasing Managers Index is in positive territory at 52.0, with quite a strong manufacturing reading at 55.5, but a services reading of 49.3 which signals a contraction in that sector of the economy. After a strong performance in 2013, even after the significant fall in the value of the yen which impacted on foreign investors' returns, this year has seen Japanese equities produce the worst returns from the major markets. This volatile performance reflects the conflicting strands to the Japanese economic experiment, both positive and negative. As the world's third largest economy and with a stock market roughly equal in size to the UK, one would expect to have some modest involvement since, if things go well with "Abenomics", company profits and dividends should benefit. Foreign investors have long been wary of Japan because of its history of disappointments. If the gamble succeeds, it could be a very profitable market once again but the weighting in the market has to be tempered by the high risk nature of the economic policy being followed.

We have discussed China in some detail earlier on as one of the five factors either influencing or having the potential to influence markets and we have indicated that the desired transition in the economy away from fixed asset investment and exports to consumption is a difficult task. Too strong a push could reduce the growth rate of the economy and China needs to grow rapidly by western standards to maintain employment levels. As we have said earlier, the forecasts for growth in 2014 tend to be lower than last year's growth rate of 7.7% with the official target for this year being 7.5% so any deviations from this expected level could have marked consequences. In the past, the authorities have moved to rein in the economy when inflation, particularly food inflation, threatened to rise to unacceptable levels partly because of the dangers of social unrest. At present, inflation is not a problem in China. The year on year increase to February is 2.0%, down from 2.5% in January, whilst food inflation is running at 2.7% year on year in February, down from 3.7% year on year in January. This suggests that, apart from occasionally firing a shot across the bows of the shadow banking sector, interest rates are not likely to move much in China. The Purchasing Managers Indices in China are overall modestly in positive territory at 50.3 in manufacturing and 54.5 in non-manufacturing, not much different from February's figures. China is running a delicate balancing act in trying to alter the balance of its economy but the encouraging prospect is that of the market taking a more important position in the Chinese economy. That will ultimately lead, if it is successfully implemented, to a more efficient allocation of economic resources.

Finally, we move to the prospects for the UK and we note how much things have changed in a year. This time last year the talk was of a triple dip recession and a flatlining economy. Now, it is one of the fastest growing G7 economies and, as the IMF's projections show, assuming they are roughly correct, only slightly behind the USA. But, as we have seen, other forecasts, notably the OBR's and the Bank of England's, are for higher growth than the IMF has forecast at 2.7% and 3.4% respectively. A year ago, the IMF was critical of the UK's economic policy but now it has had to revise its forecasts in the light of the economic data since that time. Most of the short term news is good. If we look at the important Purchasing Managers Indices, these are quite solidly in positive territory. The composite figure for March stands at 57.6, comprising a reading of 55.3 for manufacturing, 57.6 for services and 62.5 for construction. These are all strong figures and provide an encouraging pointer for the near term. Unemployment, whilst still far too high, remains at 7.2%, a significant fall from its peak of 8.4% at the end of 2011. Importantly, inflation has now fallen to 1.7% opening up the prospect of increases in real earnings which have been depressed by inflation standing at above the target level. If there is a recovery in real incomes one might expect this to filter through to the economy. The prospect is that the UK economy will have recovered all the output lost in the recession by September if the OBR forecasts are correct. Whilst it is excellent news that the UK economy is in recovery, it is also important to be realistic. That the UK may be back to where it was pre recession and, given how long ago that was, is a sobering thought. The quality of UK growth is not ideal. There is too much dependence on consumer spending and housing as drivers of growth whereas, ideally, the emphasis should switch to exports and business investment. Again, this is easier said than done when such a large export market as the eurozone is depressed by the currency area's economic woes. There are some early encouraging signs that business investment is picking up and, as we said earlier, this is necessary anywhere to provide the means to assure long term economic growth. Whilst confidence in the UK economy, as measured by the strength of sterling appears high, the weak current account position renders the currency vulnerable to fickle capital flows if confidence in the UK subsides. In the last two quarters of 2013, the current account deficit was well above 5% of GDP. Government borrowing, whilst on a falling trajectory, is far too high. Productivity is also weak. If real earnings are to rise, as is desirable, they have to be driven by increased productivity to keep firms competitive. This is not happening. This is not to carp. A year ago, the progress which the UK has made economically seemed very unlikely, proving that it is possible to address the dire state of public finances, even if the programme is well behind schedule, and still grow. At present, our main concern about the UK is the whipping up by politicians and others of an unpleasant and dangerous anti business culture which appears to be resonating. Whereas long term thinking and planning is required for an economy, free from the vagaries of politicians' passing whims, this seems to be impossible in an environment where the UK is just over a year away from a General Election. The anger felt against bankers and others in the financial sector has provided a background for a toxic anti business campaign. Whilst it might seem good politics, it is shocking economics. The energy sector, together with the banking sector, have been picked out for particular vitriol and now there is to be another enquiry into the energy sector. The upshot of this is that no sensible board of directors could consider investment in a sector which has become so unpredictable from a regulatory and political point of view. This is doubly dangerous when the UK's energy margin of error is so slight. The cost of capital in the industry has already been raised by the political threats and blackouts cannot be ruled out in the years ahead because of the fine margins of supply and demand and this is an industry which was widely considered internationally to have one of the most stable regulatory regimes. Some shocking things have happened in the banking sector, and they continue, but the sector is of vital importance to the UK. The continued criticism and increasing interference in the sector risks pushing important parts of it to move abroad with the consequent loss of revenues to the UK. These would be unlikely to return. This anti business rhetoric threatens to spill over into damaging policies being implemented and this is, in our view, the biggest threat to the UK stock market. We mentioned above the UK's frighteningly large current account deficit. This has to be financed by capital inflows. If confidence evaporates, then sterling will be very vulnerable. The risks to the UK stock market are increasing.

The performance of international equity markets in the first quarter is consistent with our view that markets will grind their way unevenly upwards this year with quarters of negative performance, interspersed with more positive ones, reflecting economic and political uncertainties. Whilst our review inevitably concentrates on what could go wrong, we think that the positive drivers of the market, which we have outlined, will end up in the ascendancy. We do not, however, expect the double digit returns of 2013. Notwithstanding their good performance in the first quarter, we consider that bonds remain poor value.

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