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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Equities and bonds have advanced this quarter to provide satisfactory returns in most areas, with Japan and Europe ex UK being the best equity markets. Quantitative easing, which started in the eurozone during the quarter, has propelled eurozone equities higher. There has been a remarkable drop in eurozone bond yields, many now in negative territory. There have been significant currency movements as the US dollar and yen have strengthened whilst the Swiss Franc's unchaining from the euro caused a sharp rise in that currency. Quantitative easing weakened the euro. There were modest falls in oil and gold.

The tables below detail relevant movements in markets :

International Equities 31.12.14 - 31.03.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+10.4	+8.3	+3.1	+16.1
Finland	+16.4	+8.5	+3.3	+16.4
France	+18.2	+10.2	+4.9	+18.2
Germany	+22.1	+13.8	+8.4	+22.1
Hong Kong, China	+5.6	+10.9	+5.6	+19.0
Italy	+20.3	+12.2	+6.8	+20.3
Japan	+10.8	+16.4	+10.8	+24.8
Netherlands	+18.1	+10.1	+4.9	+18.1
Spain	+11.8	+4.2	-0.8	+11.8
Switzerland	+2.9	+10.5	+5.2	+18.6
UK	+4.4	+4.4	-0.6	+12.0
USA	+1.3	+6.4	+1.3	+14.1
Europe ex UK	+14.9	+10.6	+5.3	+18.6
Asia Pacific ex Japan	+6.0	+8.4	+3.2	+16.2
Asia Pacific	+8.4	+12.4	+7.0	+20.5
Latin America	+1.1	-5.5	-10.1	+1.3
All World All Emerging	+5.0	+7.1	+1.9	+14.8
The World	+4.9	+7.5	+2.3	+15.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +2.2%

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

Currency	31.12.14	31.03.15
Sterling	1.76	1.70
US Dollar	2.17	1.94
Yen	0.33	0.41
Germany (Euro)	0.54	0.18

Sterling's performance during the quarter ending 31.03.15 (%)

Currency	Quarter Ending 31.03.15
US Dollar	-4.7
Canadian Dollar	+4.0
Yen	-4.6
Euro	+7.4
Swiss Franc	-6.8
Australian dollar	+2.1

Other currency movements during the quarter ending 31.03.15 (%)

Currency	Quarter Ending 31.03.15
US Dollar/Canadian Dollar	+8.5
US Dollar/Yen	+0.1
US Dollar/Euro	+12.8
Swiss Franc/Euro	+15.2
Euro/Yen	-11.3

Significant Commodities (US dollar terms) 31.12.14 - 31.03.15 (%)

Currency	Quarter Ending 31.03.15
Oil	-3.5
Gold	-1.6

MARKETS

It has been another positive quarter for most international bond and equity markets. In local currency terms, the FTSE World Index has shown a total return of 4.9%, in sterling terms 7.5%, in US dollar terms 2.3% and in euro terms 15.3%. Looking at local currency returns first, the stand out area has been Europe ex UK where the FTSE Europe ex UK Index has returned 14.9% with the FTSE German Index the best performer of the major eurozone markets, returning 22.1%. Elsewhere, Japan was a notable performer, with the FTSE Japan Index returning 10.8% in local currency terms, whilst the Australian Index returned 10.4%. The weakest performer of the major markets was the USA where the FTSE USA Index returned 1.3%. Latin America also underperformed, with the FTSE Latin America Index returning 1.1%. There were some significant currency moves during the quarter which changed sterling adjusted returns. The recovery in the yen meant that in sterling terms the FTSE Japan Index returned 16.4%. The return on the FTSE Europe ex UK Index fell from 14.9% to a still excellent 10.6%. Within that figure, the most notable change from local currency to sterling adjusted return came from Switzerland where the unpegging of the Swiss Franc raised the local currency return on the FTSE Switzerland Index from 2.9% to 10.5% in sterling terms. The strength of the US dollar meant a more than satisfactory sterling adjusted return in the FTSE USA Index of 6.4%. The only negative showing in the sterling adjusted indices was from Latin America where the FTSE Latin America Index returned -5.5%.

Turning to the international bond markets and taking benchmark ten year government bonds as the marker, there was a fall of 6 basis points in the yield on the UK government bond to 1.70%, of 23 basis points in the yield on the US Treasury to 1.94%, of an astonishing 36 basis points in the German Bund to 0.18%, whilst the Japanese Government bond went against the trend with an 8 basis point rise in the gross redemption yield to 0.41%.

There was a quieter time in the commodity markets where oil, as measured by Brent Crude fell by 3.5% and gold by 1.6%.

ECONOMICS

To look at international bond markets over the last quarter and assuming that one had read or heard no news since the end of December, one would conclude that the world economy was in or heading for recession. It is possible that the idea of deflation might have occurred to the observer although, unless that person had been following the Japanese economy closely for many years, it would not have been the first reason that came into his or her mind. On the other hand, if the same person had been looking at the performance of the international equity markets over the quarter, he or she would have assumed that the world economy was performing well. Looking at both markets together, the observer would have been totally confused. This is the surreal economic world in which we now live.

Both markets cannot be right so the question is, which one is correct? Before trying to answer that question, we need to explain why both bond and equity markets have continued to perform well turning the usual economic verities on their head. The answer is that, as for the past six years when international stock markets started their ascent from their nadir, monetary policy has been the key. With interest rates being cut by central banks to rock bottom levels and, now in some cases, to negative levels and money having been printed in the USA and UK, and still being printed in Japan and, just recently, the eurozone, bond yields responded accordingly and the dividend yield on equities appeared even more attractive relative to bonds and cash. In many markets, the usual situation of high quality bonds yielding more than equities has been turned on its head. The effect of quantitative easing has spread internationally, driving up asset prices, not only financial ones but real estate as well. Put very simply, cheap and printed money has driven up asset prices, there being a finite amount of those. One of the reasons for the policy makers choosing to follow very loose standard and non standard monetary policies in 2009 was to raise asset values to create a positive wealth effect and to raise Keynesian "animal spirits" to kick start depressed economies. We can certainly say that policy makers have been successful in raising asset prices but the jury is out on whether business and consumer confidence has been raised sufficiently to provide a solid foundation for economic growth which can justify the rise in international equity markets.

One of the reasons why the jury is out on whether it is the equity or bond market that has read the situation correctly is the perennial problem area, the eurozone. It is hard to overstate the negative effect which its problems have had on the international economic situation and it is difficult to see a happy ending in sight. Whilst Greece is gaining all the headlines, the area's woeful economic performance has much to do with the single currency. With the eurozone's members' exchange rates unable to reflect economic fundamentals relative to each other, those countries which have become uncompetitive have had to attempt internal devaluations at great social and economic cost to their countries, reflected in shocking unemployment levels. So, whilst the eurozone as a whole is in significant current account surplus, it reflects vastly different experiences. Germany is expected to have a current account surplus of around 7% of GDP this year whilst France is expected to be in deficit, perhaps to the tune of about 1% of GDP this year. France has steadily been losing competitiveness against Germany for a number of years and, pre the euro, the French Franc would have devalued against the Deutschmark and differences in relative exchange rate movements would have reflected the relative rise in costs in France against Germany. This is just one example and Italy would be another. On the other hand, Germany has become super competitive because the euro is cheaper than the Deutschmark would have been and, as a result, it has been piling up current account surpluses. This has cut aggregate demand in the eurozone. The lack of decent growth in a number of eurozone countries has affected countries' budgetary positions with the Stability and Growth Pact's requirements on budget deficits and overall levels of public borrowing relative to GDP having a contractionary effect on economies. Given the importance of the eurozone in the world economy (about 20.6%), the area's problems have limited growth elsewhere. One could have a greater degree of confidence that the international equity markets, rather than the bond markets, were correct if the eurozone was performing better and not giving rise to what have become chronic economic concerns.

Although the ECB has been indulging in different ways of monetary easing, it is only in March that it has started what would be recognised as formal quantitative easing and its actions have been circumscribed by disagreements between the various countries and board members. The ECB will buy more than €1 trillion in assets (government and private sector bonds) by September 2016. 80% of the risk will be taken by member countries' central banks and the biggest purchaser will be Germany, by virtue of its size, but the irony is that Germany, which does not have a budget deficit and is not therefore a big government bond issuer, has to be the biggest purchaser of bonds. Because of the scarcity of German government bonds in these circumstances of low issuance, holders will be reluctant to sell them. So, we now have this extraordinary situation where a large area of European (not just eurozone) government bonds has negative yields meaning that buyers are prepared to pay borrowers for the privilege of lending to them. The situation defies belief although is explicable in terms of substantial central bank purchases, in some cases limited supply and very low inflation or deflation. So, as this is written, if we look at five year European government bond yields, we see negative gross redemption yields from Switzerland, Denmark, Germany, Slovakia and Austria, whilst, out at ten years, Swiss government bonds have a negative yield.

So, we can understand that very loose monetary policy and quantitative easing have caused this extraordinary position but are there any fundamental economic reasons why these bonds can possibly be considered good investments? One is the deflationary one, and the eurozone as a whole is in deflation as measured by year on year price changes, -0.1%. Deflation can, under certain circumstances, have malign economic effects such as causing an economic downturn as businesses and consumers hold off unnecessary purchases in the hope of buying more cheaply or raising bad debts as the real value of liabilities rises and thereby poses a problem to the banking system. It was this threat of deflation that probably forced the ECB's hand. Why has this deflation come about? It is, firstly, important to differentiate between headline inflation and core inflation which excludes volatile items like food and energy costs. In the eurozone, it is only the former which is in negative territory as energy and food prices have weakened but they can bounce back. Excluding energy and unprocessed food, the year on year inflation rate is 0.6%. If we take oil, which has collapsed in price, market forces are likely to push up the price in due course as exploration is pared back or high cost fracking sites are closed. Supply will react to price signals and, in due course, supply constraints are likely to raise the oil price again. A particular issue which will feed through to inflation is the weakness of the euro. This is a function of very low or negative interest rates and, now, quantitative easing which is driving the currency down, another aim of policy making. In passing, it may be noted that competitive devaluations are a form of protectionism and can invite retaliation. The USA will not be happy about the weakness of the euro as it will make life difficult for US exporters and there is a strong protectionist lobby in the USA which will make its opinions felt.

The ultimate aim of monetary policy in the eurozone is to restart economic growth which is the best way of tackling budget deficits and excessive amounts of public debt. By making the cost of borrowing even cheaper for reasonably creditworthy borrowers and placing more cash in banks' balance sheets, they hope that the flow of credit will increase and kick start the relevant economies. However, with interest rates having been low for a long time, further slight reductions are unlikely to represent a tipping point in consumers' or businesses' attitudes towards spending and borrowing more, thereby helping to raise economic growth in the eurozone. To achieve this, there has to be confidence in the eurozone's economic prospects, with the interest rate being secondary, for, as a company, there has to be a good commercial case for borrowing and investing. On the positive side, quantitative easing has the effect of pushing money into shares and the strong rise this year in eurozone equities reflects a lot of money chasing a limited number of shares which have attractive dividend yields. Although the equity culture is generally not strong in the eurozone, rising share prices are, nevertheless, bound to have some positive wealth effect and perhaps raise a few "animal spirits".

Another reason for the rise in eurozone share prices this year has been the beneficial effect on eurozone based companies' profits which the weakened euro is likely to provide. Exports will become more competitive, imports more expensive, perhaps leading at the margin to import substitution, and the translation effect of overseas profits earned in stronger currency countries will be positive. There is, however, a downside to this in that quantitative easing's effect on the euro could be construed as protectionism in some countries, notably the USA, as we have noted above.

Then, there is the Greek situation, the outcome of which remains uncertain at the time of writing. Two points are very obvious. Greece should never have joined the eurozone and it cannot repay its debts in full but, this being the eurozone, there is a sense of denial. Apart from the distress evidenced in Greek bond yields, markets appear to be relaxed about the problem. We think that this attitude is complacent. There remains a significant chance that Greece will leave the euro. Both sides have entrenched positions. One would think that Greece, which will shortly run out of money to pay its bills, would do its best to reach an agreement which would be acceptable to its creditors if only because there was nowhere else to turn but that is to underestimate the political pressure under which the Greek government is working given its election pledges and the various elements of the coalition which form the Greek government. Eurozone governments and officials have tried to play down the chances of a "Grexit" and the effects which an exit would have on the eurozone. Whilst various protections might have been put in place since the height of the eurozone crisis, it is wishful thinking that the effects could be contained. Once a crack appears in a monetary union, from which no country is supposed to be able to leave, markets will probe the country which they believe to be the next most vulnerable. Greece has debts to repay every month for the rest of the year and without support will not be able to meet its obligations. As it is, Greece has lost a lot of time since the election. Tax collection has been poor and substantial sums of money have been withdrawn from Greek bank accounts.

So, going back to our original questions as to whether it is the equity market or bond market which is correct, what can we conclude about the eurozone's influences on the answer? On the plus side for the bond argument is the fact that the eurozone is in deflation and, therefore, negative or very low bond yields are explicable even if they are not justified. With large amounts of quantitative easing guaranteed for the future, negative yields or very low bond yields may persist simply because there is an aggressive buyer in the market, the central banks. Absent quantitative easing, these yields would have led an observer, who had been completely out of touch with the news but who knew something about economics, to conclude that the world was in an economic depression or, at the very least, a serious economic recession. As we have known ever since these extraordinary monetary policies were introduced to combat the financial crisis in 2008, markets have been severely distorted and the signals which they give out can be misleading. Dealing with the deflation argument first, as we have said above, it is valid to distinguish between the headline rate which is negative (0.1% year on year) and the core rate, which is positive at 0.6%. There is a reasonable chance that energy prices will pick up at some stage as market forces restrain supply and that food prices, too, will recover. Furthermore, the marked fall in the euro will feed through to inflation. Deflation is, of course, a serious problem for an economy if it persists, threatening borrowers' defaults and a serious downward spiral in the economy and the aggressive quantitative easing which the ECB has put in place is directed at trying to ensure this state of affairs does not happen. We think it unlikely that the eurozone will face a period of chronic deflation. So, we think that the signal given by the bond market is incorrect in this respect but quantitative easing and monetary policy in general are causing this. If we think it incorrect to be signalling deflation, are these yields, which would normally be consistent with a very poor economic outlook, either depression or recession, correct in this respect? This looks unlikely if we consider the international context. Whilst it is true that a majority of eurozone trade is intra eurozone trade, its woes are unlikely, of themselves, to cause the type of outcome that eurozone bond yields are suggesting. The US, Chinese, Japanese (to a small extent), other Asian and UK economies, amongst others outside the eurozone, are all growing and it is very unlikely that there will be a recession, let alone, depression, caused by the eurozone's problems. To the extent that current inflation/deflation figures are heavily influenced by the fall in the oil price, this is, on balance, very positive for the world economy. It acts as a tax cut and should stimulate economic growth. For an oil importing area, like the eurozone, it is very good news.

What about the signals coming from international equity markets and, in this context, particularly, the eurozone markets which are rising strongly at present? We know why that is. Quantitative easing and the resultant weak euro have improved many eurozone companies' profits outlook. The point which we have often made is that it is important to distinguish between the sovereign and the individual companies based in the eurozone. The latter still have the ability to flourish even if their own country of incorporation is in difficulty. It does not mean that they necessarily will but they may if they have good products, exports and overseas operations. We conclude that the outlook for many eurozone companies has improved and that the rise in share prices in eurozone stock markets this year is justified.

So, if we believe that equities in the most troubled developed economic area of the world, the eurozone, are justified in performing well so far this year and that deflation is unlikely to persist even in the eurozone, then we conclude that it is the equity market which is giving the correct signals and the bond market the wrong ones.

If not the eurozone, could it be anywhere else which is giving the signals which suggest that it is the bond market which has got it right and not the equity market? Although the Japanese and UK stock markets are the second and third largest, in isolation they are unlikely to have sufficient economic influence to tip the balance to the question of whether bonds or equities are sending the correct signals. The Japanese economy is, of course, an enormous one but, in many ways, it operates independently of the rest of the world. There is, however, one caveat to this which is helpful to equities. As part of the supply side changes to the Japanese economy, the government is pressing official bodies and pension funds, traditionally very heavily invested in bonds, to make a partial switch to equities in the domestic and foreign markets. Such is the size of the funds we are talking about, that Japanese purchases, at least at the margin, support the positive view of equities. During the last two years, the Bank of Japan has purchased JPY2.8 trillion (US$23 billion) of exchange traded funds tracking the Japanese equity market. Last year, it was announced that the Japanese Government Pension Investment Fund would set a 25% target each for the allocation to Japanese and overseas equities, up from 12% in both cases. At the end of March, it was announced that three Japanese public pensions controlling JPY30 trillion (US$249 billion) would follow suit.

The two countries which could influence the equity/bond question conclusively are the USA and China. The argument that the performance and outlook for the US economy suggest that the equity markets are giving the correct signal is relatively straightforward. The US economy is moving forward steadily, if not spectacularly, the political risks are low since the party deadlock between the executive and legislature ensures that there should not be too many nasty shocks or unpalatable measures and interest rates are likely to start rising this year which is likely to affect the US bond market. However, the rise in interest rates is not likely to be to a level which threatens equities since it is expected to be fairly modest given the inflation outlook with inflation running below the Federal Reserve's target range. At the moment, it appears that the US has less risk than most markets.

There is more anxiety about China. This may seem a strange thing to say when the economy grew by 7.3% last year, a rate of increase of which the major developed countries can only dream. In fact, it would be impracticable for the latter to grow at this rate because their output gap would be closed and inflationary pressures result, but that is beside the point in this context. The challenge facing China is to transition its economy as seamlessly as possible into one led by consumption with fixed asset investment being reined back. The proportion of Chinese GDP accounted for by fixed asset investment at nearly 50% of GDP is extraordinarily high and a lot of it has been unproductive and, as a result, is causing problems for the banks. By moving the emphasis towards consumption, the Chinese government is aiming for better quality growth than previously, albeit at a slower rate than the double digit growth rates of a few years ago. Following a boom in property prices, they are now falling sharply in many cities, posing problems for the banks. It is a very delicate balance which the Chinese authorities are trying to achieve for, if the economy slows too much, social problems could arise due to increased unemployment. China will also be worried about deflation. It is not in this position at the moment with year on year inflation in February at 1.4% but, as elsewhere, deflation brings its own nasty problems just like inflation does. So, there are many difficult issues in China and the size of the economy, the second largest after that of the USA, means they could spill over elsewhere. The world economy cannot afford Chinese growth to slow down too much. The central bank has shown itself willing to move interest rates and reserve requirements very quickly. China is a hugely indebted country and the authorities will try to manage the risks which come with this. With the tools it has at its hands to act quickly, we would give China the benefit of the doubt and say that its economic issues are not bad enough to threaten the world economy and therefore make bonds a better investment than equities.

To try to pull together the argument as to whether it is bonds or equities which are giving the correct signal when both cannot be right, we would sum up as follows. It is understood why bond yields are so low or negative in certain countries. Central banks' monetary policies, including aggressive quantitative easing, whereby newly created money has been used to purchase bonds, has depressed yields and, against current inflation or deflation levels, these do not look as out of line as at first appears. The flight to quality is evident in the yields on German and Swiss bonds (negative at some maturities) but elsewhere, apart perhaps in Greece, monetary policy has smothered credit quality considerations so that large swathes of risk are mispriced in the market. There is good deflation and bad deflation and, on balance, we believe the drivers of deflation and disinflation (where inflation still exists) are of the good variety. Good deflation occurs when costs are falling for supply side reasons whether it be a fall in the cost of raw materials such as oil, or efficiency reasons. That can have the equivalent effect of a tax cut for individuals or an input cost cut for businesses. Either way, that is likely to be beneficial for economic growth. Even if that improvement in prospects is from a position of negative economic growth or low economic growth, the current level of bond yields, particularly in the eurozone, is not consistent with this scenario and it would normally be signalling a pick up in economic growth and, perhaps, inflation. In this scenario, absent quantitative easing and very easy monetary policy, current bond yields would be anomalous and sending out the wrong signals. The story would be different if it was bad deflation and the eurozone is nearer to this position than most. Bad deflation occurs when costs are driven down, not by cheaper imports of raw materials and efficiency gains but by weak economic conditions forcing down wage levels, thereby weakening demand and exacerbating deflation. This is particularly relevant in the eurozone where, because exchange rate flexibility cannot be used to counter a loss of competitiveness, internal devaluations have had to occur whereby pay and the benefits are cut.

Greece is the most obvious example. Demand collapses and price levels fall (Greece's current inflation rate year on year to the end of February is -2.2%). In these circumstances, the signals being given out by the bond markets would be correct.

Internationally, we think the good deflation argument outweighs the bad deflation argument and that the resulting benefits of weak commodity prices will spur economic growth so that the outlook signalled by the international bond market is wrong. The price signalling of the international bond market has been smothered by monetary policy and quantitative easing. In our view, this indicates that, whilst we can understand why the bond market is where it is, it is the international equity markets which are putting out the correct signals. Whilst saying that, we must recognise that share prices have been boosted by the case for yield which is no longer available on high quality bonds and cash. A plentiful supply of funds at very low rates of interest chasing a finite amount of assets, shares, will push up prices. Furthermore, one of the catalysts of the rise in international equity markets has been share buy backs which become very attractive to many companies if they can borrow money very cheaply. In the fourth quarter of 2014, companies in the S & P 500 spent US$125.8 billion on share repurchases.

The fact that the international bond and equity markets are sending out contradictory signals demonstrates the significant distortions to securities markets caused by current monetary policy and, whilst holders of bonds and equities may be pleased with the financial results, these market rises, particularly for bonds, have not been of the highest quality. For that to be the case for equities, one would want to see satisfactory economic growth being reflected in rising corporate earnings and dividends. The concern has to be that economic growth will fizzle out if interest rates start to return to more normal levels. For growth to depend on rock bottom interest rates is not a sustainable position. The reason why the current level of interest rates is not sustainable indefinitely is that, at some stage, inflationary pressures will be unleashed. This may seem a strange thing to say when current concerns surround deflation but one of the greatest mistakes investors can make is to say that it will be different this time. When we come to discuss the USA in more detail, it will be seen that the question is not will the Federal Reserve raise interest rates but when? The reason for the Federal Reserve's view that it will almost certainly have to raise interest rates this year is that the USA's output gap is closing. It is a subjective opinion as to what is the size of the output gap but, once it is reached, inflationary pressures rise. If interest rates are behind the curve, i.e. not at an appropriate level for the state of the economy, inflation can become a big problem requiring more drastic action on interest rates to stop it getting out of control. There is a similar, if less pressing, issue in the UK which, like the USA, has been performing relatively well. The UK does not have a good record on inflation and the present situation where year on year inflation is nil is anomalous. In these two countries, interest rates will have to rise fairly soon. Although it may seem light years away from being a potential problem in the eurozone, it will be at some stage for some of the better performing economies like Germany which have benefited from an undervalued currency. Although some have argued that Germany should let inflation rise to restore competitiveness elsewhere in the eurozone, it is unlikely that Germany would willingly countenance such a situation. There are other malign effects from interest rates being artificially depressed. It is unfair on savers who might typically hold some bonds and cash in their portfolios to provide income. With these avenues shut off by current monetary policy, some might take inappropriate risks to achieve a higher level of income. In the business world, and this would damage a country's economic prospects, zombie companies might be kept alive because of very low interest rates, crowding out potentially more successful ones and affecting a country's economic growth prospects.

So, at some stage, sooner in the USA and UK than the eurozone and Japan, interest rates will have to rise both in the short term and along the maturity curve and therein lies the dangers for holders of bonds. To buy bonds on negative or minuscule yields is a very high risk strategy. It is possible to make a profit by buying a bond on a negative yield and selling it on to someone else at an even more negative yield but at this level, where prices are out of touch with reality and artificially elevated by monetary policy, it represents an enormous risk. Many commentators are warning about the dangers for bond markets when sentiment changes and there is a rush for the door. So we would say that not only are bond markets seriously overpriced but the economic signals they are giving are wrong. International equity markets could probably take in their stride a steady rise in bond yields in the initial stages if it represented an early move towards normality and a better economic outlook. A sudden crash in bond markets would be a different matter. Given how monetary policy is driving economic policy at present, one might expect central banks to take some further action if markets became disorderly. The difference in the outlook for equities and bonds in a disorderly market is that a reversion to mean would be a much bigger issue for bonds than equities given how far out of line the former are. Bond losses from such a move would be very large and, if bonds bought at current levels were held to maturity, there would be a guaranteed loss on those issues with negative gross redemption yields and almost certainly a huge opportunity cost on those with slightly positive gross redemption yields compared with what could be earned elsewhere. For equities, which do not look overvalued in our eyes, a collapse in the bond market would cause collateral damage but on past performance they would be likely to recover and then move on up. This is an important difference for the prospects for these two asset classes. Extreme monetary policy is only being used because of the depths of the economic crisis following the financial crisis of 2008 requiring something extraordinary. It appears to have been successful so far in that the world economy has resumed growth but it has left very dangerous side effects and bond investors, in particular, need to be aware of this. A further point of concern to many is that a rush for the door in the bond market could cause extreme price movements. It has become more expensive for banks to hold inventories of bonds and, because the market is so overvalued, a change in sentiment could cause serious market dislocation.

We have said that we believe it is the international equity markets which are sending the current signals, namely that economic growth is more likely than recession or depression which bond yields (absent quantitative easing and very loose monetary policy) would suggest. In this context, it is interesting to note a number of recent economic forecasts. For example, in March, in its Interim Economic Assessment, the OECD slightly increased its growth forecast. In its aggregate forecast, which covers economies representing over 70% of global GDP, it now forecasts growth of 4.0% in 2015 and 4.3% in 2016, increases over its November forecasts of 0.1% and 0.2% respectively. Within that total, the USA is expected to show growth of 3.1% this year and 3.0% next year, in both cases unchanged forecasts from last November. The eurozone has received an uplift of 0.3% for this year and the same again for next year. The OECD now expects it to grow by 1.4% this year and 2.0% next year. Included in this is a significant uplift for Germany this year of 0.6% to 1.7% and of 0.4% next year to 2.2%. After the USA came the UK in terms of the fastest expected economic growth with a rate of 2.6% this year (0.1% lower than November's forecast) and 2.5% in 2016. The outlook for Japan has been raised in both years, by 0.2% this year to 1.0% and by 0.4% next year to 1.4%. Its growth forecast for China is little changed this year at 7.0% (down 0.1% on its November forecast) and unchanged for next year at 6.9%. Its forecasts for India, however, are much more optimistic than in November. It now expects growth of 7.7% this year, up 1.3% on November's forecast and 8.0% next year, up a very substantial 1.4%. On the other hand, Brazil has suffered a significant downgrade of 2.0% for this year to -0.5% and of 0.8% next year to 1.2%.

Back in January, the IMF had projected world economic growth of 3.5% this year and 3.7% next year. Within that aggregate, it had forecast growth in the USA of 3.6% this year and 3.3% next year. For the eurozone, the figure for this year was 1.2% and for 2016 1.4%. It saw UK growth of 2.7% this year and 2.4% next year. For Japan, growth was projected at 0.6% for this year and 0.8%

next year. Its forecast for China was 6.5% this year and 6.3% next year with respective figures for India being 6.3% and 6.5%. Brazil was forecast to grow by 0.3% this year and 1.5% next year. With two months' differences in the timing of the forecasts, one can rationalise the OECD's rather lower forecast for the USA to the headwinds caused by the stronger US dollar, and, conversely, the much higher forecast for eurozone growth to the weak euro consequential upon quantitative easing. Elsewhere, India will be helped substantially by the falls in oil prices and confidence in the new government's economic policies. Conversely, Brazil's woes have deepened with the corruption scandal impacting badly on the economy.

We have also had updated economic forecasts from the European Commission and the European Central Bank. The EC is forecasting economic growth in the eurozone this year of 1.3% and in 2016 1.9% whilst the ECB is forecasting growth of 1.5% this year and 1.9% next year, the same as the EC's 2016 forecast. Obviously, forecasts change in the light of subsequent developments but, if they are anywhere near being correct, these projections support the view that it is the equity market which is more correctly reading the outlook.

Looking briefly at each of the main areas of the world economy and starting in the USA, we see an economy performing moderately well but where some companies with overseas businesses are facing headwinds in terms of the stronger US dollar. The latest revision to the Q4 GDP figure was downwards to 2.2% from 5.0% in the third quarter although the expectation is that growth will accelerate as the year progresses. The year on year growth rate was therefore revised down to 2.4%. The latest Purchasing Managers Indices are consistent with the moderate growth state of the US economy as evidenced by the GDP figure. The manufacturing PMI was lower than the previous month's figure at 51.5 against 52.9, whilst that for non-manufacturing was at 56.5 (56.9) The employment figures have been very strong with the unemployment rate down at 5.7% and this will be one of the most important pieces of data which the Federal Reserve will watch in determining the time of the upward move in interest rates. There are some areas of weakness in the US economy. Retail sales, for example, have been quite weak with a series of disappointing figures. The latest data show a decline of 0.6% in February, month on month. House prices, although rising, have been subdued. The latest FMFA price index is up just 0.3% month on month, consistent with previous modest monthly price rises whilst the S&P/Case Shiller Composite Index is up 4.5% year on year at the end of January. As we look ahead towards the rest of the year, the economy should gain some strength as the benefits of the lower oil price filter through. With petrol prices lower in the USA than many other countries because of lower taxation, the proportionate fall in price is greater than in, say, the UK where duty and taxes form the majority of the price and, therefore, the percentage reduction in price, caused by the fall in the oil price, is less. It is the equivalent of a fairly meaningful tax cut which, if spent, will further boost the US economy. As well as the employment data and making estimates of the output gap in the US economy, the Federal Reserve will wait to see signs that it should act to avoid future problems with the level of inflation. Because inflation is well below the 2% level, it has been able to be relaxed about the strong growth in employment levels. The latest figures for consumer price inflation in the USA are a month on month increase in February of 0.2% and a flat year on year figure. The big challenge for the US stock market and, by extension, elsewhere, because of the importance of the USA, is how investors will react when the first tightening takes place. It should not come as a shock because it has been well trailed (although not the timing) but, as we saw with the "taper tantrums" in 2013, the execution of an event, however well flagged, can upset the market, if only temporarily as was the case then.

Moving to the eurozone, which we have discussed at some length earlier, notwithstanding the major issue of Greece, some of the indicators have been more positive, perhaps as a result of the anticipation of quantitative easing and the competitive advantage arising from a weaker euro. The latest Purchasing Managers indices were certainly looking better and these indices are widely followed. The latest composite index stands at 54.1 compared with 52.6 the previous month, with the manufacturing reading at 51.9 and the services reading at 54.3 against 52.7. The contrast between Germany and France remains a concern, however. The latest composite index for France stands at 51.7 compared with 55.3 for Germany, that for manufacturing at 48.2 compared with 52.4 and that for services at 52.8 compared with 55.3. France and Italy remain a major concern for the eurozone with France's budget deficit being a problem and Italy's overall level of debt being dangerously high. France has effectively been given a further extension on its budget deficit objectives having said that it will not meet its targets but it does not enhance the credibility of the deficit reduction requirements to give waivers to the second largest eurozone country again.

At the moment, of course, the biggest issue is Greece. The more entrenched are the positions of Greece and the rest of the eurozone and IMF, the greater the chance of an accident occurring leading Greece to leave the eurozone. Although that would be immensely damaging in the short term, it may give Greece a better long term chance of recovery to have its own currency which would enable it to act as an economic shock absorber which, being in the euro, cannot happen. Whilst the rest of the eurozone might be less worried than in the past about a Greek exit, it would be a big blow to the project, and investors would start probing the weak spots. If the unthinkable happens and Greece leaves, further departures will no longer be unthinkable. In the short term, at least, stock markets would suffer a bad shock even though everyone knows that a Greek exit is possible.

Japan continues its huge quantitative easing programme as it tries to induce inflation and confidence into the economy to get consumers to spend and businesses to invest and pay higher wages. But its efforts to move towards 2% inflation (excluding the effect of last April's rise in consumption tax which will soon drop out of the comparisons) have been hampered by the fall in oil prices. However, as a large oil importer, this works both ways for it should give consumers and businesses more confidence as it has the same effect as a tax cut. Whilst the latest year on year consumer price index stands at 2.2% reflecting April 2014's consumption tax increase, the month on month movement was -0.2%. The hope must be that consumers and businesses recognise the month on month deflation as "good" deflation rather than "bad" deflation as in the past. As we have said in recent reviews, Japan's vast monetary expansion carries a high degree of risk as well as potential reward. It is a hugely indebted economy with a large budget deficit and a high level of outstanding public debt as a percentage of GDP and, even though a very high percentage of public debt is held domestically, it is not a given that there will not be a crisis arising from the huge level of debt. There is, as we touched upon earlier, an important support for the Japanese and, to some extent, foreign equity markets as the government orders official bodies to purchase more equities as a way of instilling confidence into the Japanese economy. At the moment, the jury is out as summed up by the latest purchasing managers indices which give a neutral reading with the composite index at 50.0. So, in our view, it is a high risk/high reward market with no clear indication as to whether "Abenomics" will succeed.

China has indicated that it wants to keep growth at around 7% and it does have tools at its disposal to act quickly mainly through monetary policy although reduced interest rates and bank reserve levels are no guarantee of success. We have discussed earlier how China is trying to transition to a more consumption led economy away from one led by fixed asset investment. That it is having a difficult time is shown by its latest purchasing managers indices which stand at 49.9 for manufacturing and 53.9 for non manufacturing. These figures do not imply strong growth by Chinese standards. It will also be concerned by the strength of the US dollar. On a year on year basis the renminbi is stable against the US dollar thereby reducing its competitiveness. Market movements globally are much influenced by the news coming out of China and economic developments in China will be one of the influential on international stock market movements this year.

Market movements in the UK are hard to equate with the fact that it faces a very important and uncertain General Election on the 7th May. It is hard to overstate the importance of this event yet the UK stock market appears to be taking very little notice of it. The main reason why it is so important is the gulf in policies and philosophies between the two main political parties, one which generally believes in markets and one which thinks they are flawed and need government intervention to correct them. Tied in with this is a ramping up of anti business rhetoric. For about the last twenty years the two main political parties have not been that far apart economically but it is no longer correct to say this. Furthermore, if the opinion polls are correct, neither of the major parties appears likely to win an outright majority which could lead to horse trading with some of the smaller parties which would give them influence out of proportion to the number of seats which they will hold. The UK has been performing relatively well economically. Last year, the UK showed the fastest growth rate of the G7 countries, growing at 2.6% ahead of Canada at 2.5% and the USA at 2.4%. This year, if the IMF and OECD predictions are correct, it will be second to the USA. A number of the economic data items have been very positive such as the employment data, for example, and now that year on year inflation has fallen to nil, real wages are rising. It is fair to say that overseas confidence in the UK is high. However, beneath the surface, things look less good and the twin deficits are a major concern. For the first fiscal year just ending, the Office for Budget Responsibility expects public borrowing to be £90.2 billion and £75.3 billion in 2015/16. However, it is not fanciful to suggest that in coalition or case by case issues, if no party obtains a majority, there will be pressure to spend more, thereby threatening deficit targets which, on current plans, are forecast to be in surplus by 2018/9. Slippage or modification of the targets could cause a loss of confidence which leads on to the second deficit, the current account one. The UK is in danger territory here with the current account deficit presently running at a level of about 6% of GDP. This needs to be financed and, if confidence in the UK is reduced as a result of economic policy decisions, sterling could be badly affected. The UK has to be an attractive place in which to invest but two examples, out of a number, suggest that the UK is taking risks. One is the banking sector where the bank levy was raised yet again in the Budget and, in the property market, the UK is becoming a less attractive place. Banks do not have to operate in the UK and foreigners do not have to live in the UK. By following crowd pleasing policies, the UK is in danger of an own goal. At present, we regard the UK as a high risk area which seems to be ignoring the General Election, one which is particularly important.

Whilst it is always pleasing to report a positive quarter, we should be under no illusions that this magnitude of rise is sustainable. Stock markets have moved well ahead of the pace of economic recovery and have been supported by very active monetary policy, meaning that the quality of the rise has not been high. This monetary policy activity has meant that bond yields bear no relation to reality and one of the dangers for markets will come when sentiment towards bonds changes and there is a stampede for the exit. Quantitative easing has to be reversed at some stage, otherwise inflation will become a danger even if it does not seem that way at present. Given the extent of money creation, this will be one of the biggest challenges to the stock market. Middle Eastern conflicts, Greece, Russia, the wider eurozone problems and the forthcoming UK General Election are all issues which could disturb the stock market. That said, shares do not look significantly overpriced and represent the most attractive asset class, in our view. However, it is bound to be an uneven move upwards for them and it is realistic to anticipate some negative quarters. For long term investors, we continue to keep an important equity position and will use cash which has accumulated to add to positions on a meaningful setback.