meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Overall, the quarter has seen a steady performance for international equities and a poor one for top quality bonds. Currency movements have been much narrower than in the previous quarter but food and energy prices continue to rise, giving cause for concern that inflation may rise further.

The tables below detail relevant movements in markets :

International Equities 29.02.08 - 30.05.08

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+3.2	+5.9	+5.2	+2.8
Finland	-9.0	-6.2	-6.8	-9.0
France	+7.7	+10.9	+10.2	+7.7
Germany	+5.6	+8.8	+8.0	+5.6
Hong Kong, China	+0.2	+0.6	-0.1	-2.4
Italy	+2.4	+5.5	+4.8	+5.5
Japan	+7.3	+6.5	+5.8	+3.3
Netherlands	+6.8	+10.1	+9.3	+6.8
Spain	+4.7	+7.9	+7.2	+4.7
Switzerland	+2.1	+2.7	+2.0	-0.4
UK	+4.4	+4.4	+3.7	+1.3
USA	+5.9	+6.6	+5.9	+3.4
Europe ex UK	+5.0	+7.8	+7.1	+4.6
Asia Pacific ex Japan	+4.1	+3.9	+3.2	+0.8
Asia Pacific	+5.6	+5.2	+4.5	+2.1
Latin America	+11.9	+16.0	+15.3	+12.6
All World All Emerging	+5.4	+5.5	+4.8	+2.4
The World	+5.8	+6.8	+6.1	+3.7

Source FTSE World Indices

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

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

Currency	29.02.08	30.05.08
Sterling	4.47	4.98
US Dollar	3.52	4.05
Yen	1.36	1.74
Germany (Euro)	3.87	4.45

Sterling's performance during the quarter ending 30.05.08 (%)

Currency	Quarter Ending 30.05.08
US Dollar	-0.7
Canadian Dollar	+0.8
Yen	+0.7
Euro	-2.9
Swiss Franc	-0.6

Other currency movements during the quarter ending 30.05.08 (%)

Other Currency	Quarter Ending 30.05.08
US Dollar/Canadian Dollar	+1.5
US Dollar/Yen	+1.4
US Dollar/Euro	-2.3
Swiss Franc/Euro	-2.4
Euro/Yen	+3.8

Significant Commodities (US dollar terms) 29.02.08 – 30.05.08(%)

Significant Commodities	29.02.08 – 30.05.08
Oil	+28.1
Gold	-8.5

Markets

It has been a satisfactory quarter for international equity markets. The total return on the FTSE World Index in local currency terms was 5.8%, in sterling terms 6.8%, in US dollar terms 6.1% and in euro terms 3.7%. Of the major markets, Japan performed particularly well in local currency terms, returning 7.3%. The USA, Europe ex UK and UK showed a close bunching of performance with returns of 5.9%, 5.0% and 4.4% respectively. Elsewhere, Latin America, once again, was the stand out market with a return of 11.9%. Emerging markets and Asia Pacific ex Japan returned 5.4% and 4.1% respectively. Over the quarter as a whole, currency markets moved less than they have done in recent quarters but, of the major currencies, the euro was the strongest and this meant that, of the major markets, Europe ex UK performed best in sterling terms, returning 7.8% for the quarter. The US returned 6.6% and Japan 6.5% in sterling terms. In sterling adjusted terms, Latin America's performance was even more outstanding with a return of 16.0%.

High quality bonds, on the other hand, endured a poor quarter as investors became slightly less risk averse and became more concerned about inflation. We have continually highlighted the fact that bond yields were too low to be attractive and an adjustment now appears to be taking place. As measured by the gross redemption yields on ten year government bonds, those on sterling bonds rose by 51 basis points to 4.98%, those on US dollar bonds by 53 basis points to 4.05%, those on Japanese government bonds by 38 basis points to 1.74% and those on euro denominated German government bonds by 58 basis points to 4.45%.

Compared with earlier quarters, there was little movement in currencies but the euro was the strongest of the major currencies and, against the euro, sterling fell by 2.9% over the quarter.

In commodity markets, oil, although off peak prices, rose by 28.1% over the quarter but gold fell by 8.5%.

Economics

- *A steady quarter for international equity markets* ...... this may be surprising given the background but markets look ahead.
- *A reduction in uncertainty has been unhelpful* ...... capital raising activities by certain financial institutions and aggressive central bank action to oil money market mechanisms have been helpful. The Federal Reserve induced takeover of Bear Stearns gave some confidence to investors that it would not allow a major financial institution to fail.
- *The world economy is not well synchronised at present* ...... differential growth rates can help to provide some safety valve for inflationary pressures which are demand induced.
- *However, there is an important element of cost push inflation at present* ...... food and energy prices are rising rapidly and will not easily respond to an economic slowdown.
- *Bond markets have been weak* ...... we have long felt that yields were too low because of inflation prospects. Also, in countries like the UK a large bond issuance will be necessary to cover increased government borrowing.
- *Property as an asset class, is losing favour* ...... the economic situation and credit crunch has caused some prices to fall both in commercial and residential property.
- *Commodities are more difficult to call* ...... market mechanisms are the best way to balance supply and demand in the long run. However, oil is more problematic because of the ability of OPEC, accounting for about 40% of production, to control output.
- *The dangers of populist politics have increased in the current environment* ...... in the USA, calls for windfall taxes on oil companies and attacks on free trade agreements are potentially dangerous. We have long felt that protectionism is the biggest danger to the world economy and stock markets. In Europe, anti business sentiment is being whipped up by attacks on executive pay and threats to control it.
- *Increased regulation of financial institutions and hedge funds is almost certain* ...... politicians, central banks and regulators will demand it as a quid pro quo for helping to bail them out.
- *One of the asset classes in which there has generally not been a bubble is equities* ...... although they have risen substantially in recent years from a low base, so have corporate earnings. We do not think they look dear.
- *Naturally, in the environment we have seen, growth forecasts have been pared* ...... the latest IMF forecasts show this.

USA

- *The first quarter growth estimate raised from 0.6% to 0.9% annualised* ...... net trade and an inventory build up were positive drivers to growth. Negative ones were investment and consumption.
- *The Federal Reserve cuts interest rates again on 30 April* ...... the target federal funds rate moves down a further 0.25% to 2.0%. The Federal Reserve leaves its options open about the next move.
- *The Federal Reserve releases its latest forecasts in May* ...... the central tendencies for economic growth are 0.3% - 1.2% this year, 2.0% - 2.8% in 2009 and 2.6% - 3.1% in 2010. Core personal consumption expenditure inflation, the Federal Reserve's favoured measure of inflation is forecast to be 2.2% - 2.4% this year, 1.9% - 2.1% next year and 1.7% - 1.9% in 2010.
- *The state of the US housing market is a key consideration for the Federal Reserve* ...... most, but not all, of the data has been negative and house prices are continuing to fall.
- *Inflationary pressures are apparent but they are not yet alarming* ...... the year on year rise in the core personal consumption expenditure index is 2.1%, only slightly above the Federal Reserve's target. The headline

consumer price index is up 3.9% year on year whilst the core rate is up 2.3%. The headline producer price index is up 6.5% year on year and 3.0% at the core level.

- *Short term indicators have been mixed* ...... because of the news headlines, people may have expected them to be universally negative. This was not the case. The fiscal stimulus, now coming through, should be helpful.

Japan

- *First quarter growth was strong* ...... the figures tend to be erratic but growth in the quarter was 0.8% to show an annualised rate of 3.3% but the year on year rate is 1.0%. Exports were a driver of growth but capital spending was a drag.
- *The Bank of Japan cuts its growth forecast to March 2009* ...... it reduces it from 2.1%, its forecast made six months ago, to 1.5%. It raises its core inflation forecast from 0.4% to 1.5%.
- *The bias of monetary policy moves towards neutral* ...... whilst the Bank of Japan would prefer to move towards a more normal monetary policy, current economic conditions preclude that.
- *The most recent economic data has been rather negative* ...... the purchasing managers index, unemployment figures and household spending data have been disappointing.
- *The Cabinet Office moves to encourage supply side reforms* ...... it would like to promote foreign takeovers and investment.

EUROPE EX UK

- *The ECB is in a hawkish state of mind* ...... although May's meeting kept interest rates at 4%, subsequent hints are that the rate may soon be increased because of elevated inflation. Inflation is its remit and the current rate of 3.6% is well over the upper ceiling of just below 2%.
- *The "one size fits all" interest rate policy embraced within monetary union is causing problems* ...... latest year on year inflation rates vary between 1.7% (Netherlands) and 6.2% (Slovenia). An interest rate which may suit Germany may not suit countries like Ireland and Spain where the housing market is weakening rapidly.
- *Although the eurozone is holding up relatively well, it is slowing down* ...... recent economic news such as the Purchasing Managers Index, industrial production, industrial orders and the EC's economic sentiment indicator point to the negative.
- *Politics give cause for concern on the economic front in Germany* ...... a move to the left by the SPD has dragged the centre of gravity of the whole political scene to the left. Backtracking on earlier reforms and an increase in anti-business sentiment are unhelpful.
- *There are signs of budgetary backtracking in Germany* ...... pressure for tax cuts threatens the commitment to a balanced budget by 2011. The more desirable combination of tax cuts and public spending cuts is unattainable in the present political climate.
- *The short term economic news from Germany is mixed* ...... on the negative front has been disappointing news on manufacturing orders, investor sentiment and the labour market. On the other hand, there was an improvement in the business climate index and first quarter economic growth was surprisingly high.
- *France's economic task remains difficult* ...... more public sector strikes, a slap on the wrist from the EC about the state of its finances, weak industrial production indices and declining consumer confidence are challenges of different kinds.
- *Strains in the eurozone reflect themselves in the bond market* ...... yields on ten year French government bonds are sixteen basis points higher than those on German bonds whilst Greek government bonds are fifty five

basis points above those on German government bonds. Convergence rather than divergence is what we are seeing.

- *The stock market, despite these problems, remains decent value* ...... the economic slowdown and the painful effect of a strong euro on manufacturing industry are not helpful but share ratings remain low enough not to be fazed by these problems.

UNITED KINGDOM

- *Economic conditions are becoming difficult* ...... some are caused by own goals, others by external circumstances.
- *Government finances are a serious concern* ...... the excessive growth of public expenditure in recent years has led to the entirely foreseeable problems now. There is no money to provide a counter cyclical boost to the economy unlike the situation in the USA.
- *It seems the public believes the limit of taxation has been reached* ...... yet cutting government expenditure will be difficult for the government in the present circumstances.
- *Without doubt, the housing market is weakening significantly* ...... this risks a negative wealth effect with unpleasant consequences for consumer spending.
- *The Bank of England gives a downbeat assessment in its latest Quarterly Inflation Report* ...... it expects inflation to remain above the government's target until 2010 and suggests the possibility of a quarter or two of negative growth.
- *Worryingly for the Bank of England, people's inflation expectations are rising* ...... The consumer price index carries little credibility with people but the higher Retail Price Index carries more. A YouGov survey for Citigroup suggests the average inflation expectation in twelve months' time is 4.1%. The Bank of England will take this into account in its deliberations.
- *The gap between the growth forecasts of the Treasury and outside forecasters remains wide* ...... a gap of around 1% for 2009 is large and has negative implications for government finances since the Treasury's government borrowing forecasts are predicated on its growth forecasts.

CHINA

- *The news has been dominated by the catastrophic earthquake* ...... the economic issues remain as before, namely inflation and the measures taken to deal with it such as higher interest rates and further rises in bank reserve requirements.

SUMMARY

- *Growth overall is slowing but is not expected to stop although individual countries might see some negative quarters* ...... the Far East is still likely to grow strongly and provide some offset to weakness in major industrialised countries.
- *Rising inflation will not be helpful to bonds* ...... yields generally appear too low in the current environment.
- *Property, too, looks to be in for a difficult time* ...... tighter credit conditions remain likely to affect the market.
- *Shares are obviously not immune from day to day items of bad news* ...... but, mostly, they are quite modestly rated and look the most reasonably valued of the major asset classes.

Investors can be excused for being perplexed by the apparent paradox of securities' markets. Newspaper headlines and articles seem to reflect nothing but gloom and doom but here we have equity markets showing a steady performance this quarter and top quality bonds weakening. What is happening?

It is important to note that stock markets reflect future expectations rather than current events. It is not unusual for equity markets to behave in what may seem a perverse way. At present, the world economy is slowing down, inflation is rising and many financial institutions have suffered severe losses or write downs on some of their assets. They have, or are in the process of, raising additional capital from sovereign wealth funds, wealthy investors and their shareholders to repair their capital ratios. Some are cutting dividends or paying them by way of stock. Food and energy prices are driving inflation so that core inflation rates are moving well apart from headline rates and seem increasingly irrelevant given how central food and energy prices are to many people's spending profiles. In the USA, eurozone countries like Spain and Ireland and, increasingly, the UK, falling house prices are a cause for concern for many people. The subprime mortgage problems in the USA are at the root cause of problems in many financial institutions. The wrapping up of some of these mortgages into various types of asset backed security has damaged their values and leverage has exacerbated the problem.

On the face of it, therefore, this does not seem to be a very promising situation. However, perceptions are important. At the beginning of the year (January was a poor month for equity investors), fear of the unknown was driving sentiment. The unknown was the ability of some affected financial institutions to survive. Not only was this reflected in a weak stock market but money markets were seizing up as financial institutions lost confidence in other financial institutions. Gradually, through evidence of capital raising exercises by the affected financial institutions and the Federal Reserve brokered deal for JP Morgan Chase to take over Bear Stearns, it became clear that the financial system was going to survive, with central banks acting aggressively to ensure a supply of funds to the money markets, albeit at elevated interest rates compared with what banks would have expected to pay. So two hurdles were on the way to being cleared, albeit at a cost. Central banks seemed unwilling to let a major commercial or investment bank fail and money was available to fund balance sheet assets, albeit at a cost. The central banks seemed to be on top of the situation and acting effectively in their lender of the last resort role. Without wishing to tempt fate, it seems that the first staging post on the road to normality has been reached. With that uncertainty reduced, investors were in a position to look to the future for signs of guidance on the investment policy they should follow.

The picture they can see is complex but, nevertheless, they can draw some conclusions. The world economy is not well synchronised but this can, in certain circumstances, be an economic advantage. Very broadly, we can say that the USA was first into a downturn as a result of the subprime mortgage problems. Europe is now slowing down, as is Japan, but the rest of Asia, and we think here of China and India in particular, is still growing very rapidly as are some other economies. If growth is unsynchronised, this can provide a safety valve to release inflationary pressures as demand weakness in some areas acts as a brake on inflationary pressures caused by excessive demand elsewhere. However, this may not be totally the case at present as there are elements of cost push as well as demand led inflation. The two high profile drivers of inflation at present, food and energy, may not react to an economic slowdown. In the case of food, changing tastes in the face of increasing affluence in Asia are changing the profile of demand and competing with western countries. There is also an issue created by land previously used to produce food crops now being converted to production for biofuels. One can now see official alarm being shown at this development with moves to reverse this trend because of the effect on food prices. The issues for oil resolve around increasing demand from countries like China and India where, for example, the room for increased car ownership amongst the population is so large that increased oil demand is a given. On the supply side, OPEC, accounting for a growing percentage of output, about 40% at present, is becoming more effective in determining the oil price. Supply interruptions from countries like Nigeria, because of political strife, often affect the day to day price whilst some other OPEC members have radical political agendas which do not involve helping the west. It is quite likely that OPEC, which appears to be increasingly content with the high prices, would react quickly to protect the oil price if there were a reduction in demand. So, in the cases of food and energy, we cannot assume that weaker economic growth or, in the worst case, recession, will ease inflationary pressures because of the cost push element which is present. Investors must, therefore, factor into their thinking that inflation may not be as benign as it has been in recent times.

For a long time, we have expressed a cautious view of bonds. With an economic slowdown, the prospect of a falling inflation rate might make bonds seem an attractive investment but the cost push drivers of inflation, detailed above, which call into question this inflation assumption, combined with current low bond yields, reinforce our view that high quality bonds are expensive. The sharp increase in bond yields this quarter, as evidenced by the table of ten year government issues at the beginning of this review, reflects the move towards more realistic pricing but there is still quite a way to go before the yields become interesting. Inflation is not the only issue here. The deterioration in public finances in countries like the UK means an increasing supply of bonds which could drive up yields as investors' appetites become satiated.

Property, commercial and residential, has until recently, been a popular asset but is now moving into reverse in a number of countries in the west. Weakness in the US subprime market was the start of current economic problems and the difficulties of the financial system and macro economic sphere followed on from that. Besides significant weakness in US house prices, we now see the same phenomenon in the UK and, in the eurozone, in Spain and Ireland. Weakness in the commercial property market has become very apparent in the UK and quarters of negative returns are now building up. As a sector, it is difficult to be optimistic about returns but we must distinguish between the immediate outlook for the commercial property market and the valuation of shares which cover this sector. If we look at the UK, we see a number of high quality real estate investment trusts standing at a significant discount to already reduced net asset values.

Commodities are more difficult to call. In the long run, there is probably little doubt that the pricing trajectory is upwards. Economic growth, particularly in the east, will keep demand rising and supply will find it difficult to keep up. The same is true for food. In the short term, it is not so easy to see what is happening. If we take oil for example, OPEC says that the market is well supplied and there is no need to raise production. It blames speculators for pushing up the price so rapidly. Others say the very sharp rise is because the supply of oil is very tight. In the short term, it is difficult to know how commodity prices will perform but, again, we must distinguish between commodities and the shares which represent the sector. Rapid consolidation puts a scarcity value on meaningfully sized companies and share prices can be expected to reflect that situation.

In the current circumstances, when voters are feeling the squeeze of rising food and energy prices, some politicians are following the populist route and, for us, this is a concern because of the possibilities for any resulting action or threats to cause economic damage. In difficult times, hostility to business resonates with many voters and it becomes an easy target for populist politicians seeking votes. A number of examples make the point.

The primaries in the USA are a good example. A concern of ours, articulated over many previous reviews, is the danger of increasing protectionism. Free trade produces many winners and a smaller number of losers but those who lose out are, naturally, more vociferous. The two candidates for the Democratic nomination, now settled, have been responding to protectionist calls amongst their constituents, attacking free trade agreements and China which, they say, has been responsible for unemployment in traditional manufacturing industries. The benefits of lower inflation, caused by cheap Chinese imports (but this could also apply to other countries), and increased consumer purchasing power are not mentioned as should be the case in any objective analysis. A second example is their threat to impose windfall profits taxes on oil companies. This may help to garner more votes but, as an example of a sensible economic or energy policy, it is crass. It is hardly going to encourage badly needed exploration for further oil. The US Administration wants to open up further areas for drilling for oil but this has been rejected by the Senate. We are not going to make any comments on the pros and cons of the environmental argument which is the one used to defeat the request but, whichever side of the argument is taken in this respect, the idea of blocking exploration in certain areas and then imposing windfall taxes on the oil companies is eccentric. This is part of a larger problem which is an increase in anti-business sentiment.

In Europe, the targets are different, but still a cause for concern. Protectionism is generally more endemic than in the USA and UK, and especially France and Germany, particularly the former, reflect this mood. It comes in different forms. In France, it may be the promotion of "national champions" protected from unwanted foreign takeovers. In Germany, it may be hostility towards sovereign wealth funds. The latest evidence of the hostility towards business comes from Germany, from the President, Herr Kohler, no less, a former IMF head, with an attack on global financial markets which he said had become "a monster" that "must be put back into place". In his polemic against global financial markets, he attacked executive pay as a factor in the subprime crisis and accused bankers of acting irresponsibly. Boardroom pay is also on the EU's agenda with interest shown in ideas to limit it indirectly.

There is no doubt that the rewards for failure in the financial industry have been excessive and have caused understandable anger amongst many people. Action by shareholders would seem the obvious answer for, whilst action by governments or the EU may seem a good idea seen through politicians' eyes, it would be highly dangerous for the finance industry and potentially very damaging for the UK economy given the importance of the financial sector, representing about 10% of the economy. In this increasingly nimble world, business, as far as it is able, will move towards more inviting jurisdictions. It is a very dangerous game to run an incomes policy for a group of people who have options. Although the financial sector has brought this upon itself and there is an understandable wish to do something about it in some quarters, those advocating such a policy have to be careful what they wish for. They may end up damaging their economies.

A sharp move to the left in Germany as a result of coalition politics and problems within the SPD has led to attacks on boardroom pay and a call for action. This does not just relate to the financial sector and, given the importance of manufacturing to the German economy, it is a dangerous game for Germany. The attitudes displayed in Europe and in certain sections in the USA are out of date in this very mobile environment.

We do not know how all of this will end up. In the USA, the result of the Presidential election will be important. The Republican contender is a free trader, his opponent has protectionist tendencies although, having won the election, campaign pledges are sometimes diluted in the reality of office. It is quite possible that Congress will be of a different political hue to the President.

But, of one thing we can be certain and that is an increase in regulation. It will certainly affect the banking sector in terms of increased capital adequacy, reporting procedures and, perhaps, the type of business which can be transacted. There will be increased transparency. If one had to sum up the consequences, it will be that there will be a return to more traditional banking and less risk taken. Of course, future generations easily forget the lessons of the past, not having experienced them but it may just be, on this occasion, that increased regulation will thwart them. Whilst increased regulation in many areas is not to be welcomed, there would be no strong argument against it given what has happened in financial markets. Hedge funds, private equity, short selling and futures trading in commodities for those not actually in the physical market are all likely to come under closer scrutiny for their involvement in the current financial problems.

Via this convoluted path of economics and politics, we come back to shares. Although share prices have risen strongly in recent years, so have corporate earnings. The result is that we have an asset class which is not highly rated and cannot be said to be in bubble territory. Bears of equities say that, cyclically adjusted, shares do not look so cheap but, although international economic growth forecasts have been reduced, the consequences for companies overall in terms of earnings should be manageable in that very moderate share ratings leave no hostage to fortunes, in our view. Even though we remain negative on bonds, earnings yields on equities well exceed bond yields. Whilst holding significant cash might seem a safe option, returns, when measured against inflation, are either minimal or negative in the major currencies. That might not be an insuperable obstacle to holding cash if the outlook for equities was very poor but we do not think it is and we are well aware of the opportunity cost of holding significant cash. Investors need to bear in mind that the USA has applied a very significant stimulus to its economy through monetary and, now, fiscal measures. Should there be some response from the US economy later this year, as we would expect, markets should begin to anticipate this.

The IMF published its latest economic forecasts in its April "World Economic Outlook" and we detail below excerpts from it.

Real GDP Growth (%)

Country	2007 (actual)	2008 (estimate)	2009 (estimate)
USA	2.2	0.5	0.6
Eurozone	2.6	1.4	1.2
Germany	2.5	1.4	1.0
France	1.9	1.4	1.2
Japan	2.1	1.4	1.5
UK	3.1	1.6	1.6
Major advanced economies	2.2	0.9	0.9
Newly industrialised Asian economies	5.6	4.0	4.4
China	11.4	9.3	9.5
India	9.2	7.9	8.0

Consumer Prices (%)

Country	2007 (actual)	2008 (estimate)	2009 (estimate)
USA	2.9	3.0	2.0
Eurozone	2.1	2.8	1.9
Germany	2.3	2.5	1.6
France	1.6	2.5	1.7
Japan	—	0.6	1.3
UK	2.3	2.5	2.1
Major advanced economies	2.2	2.4	1.8
Newly industrialised Asian economies	2.2	3.0	2.7
China	4.8	5.9	3.6
India	6.4	5.2	4.0

Source IMF World Economic Outlook

It forecasts a considerable slowdown in the US economy compared with 2007 and only a slight improvement in 2009. The eurozone is forecast to fare rather better with less of a drop in growth than the USA. It is a broadly similar story for Japan and the UK. However, although lower than in 2007, the newly industrialised Asian economies are still expected to perform relatively well and, although growing at a slower rate than in 2007, the rate is still forecast to be high in China and India, helping to offset lower growth in the USA, eurozone and Japan. Growth in the UK is expected to slow sharply and the forecasts are at odds with those of the UK Treasury.

Not surprisingly, given what has happened to food and energy prices, inflation is expected to rise this year. Even though the IMF's forecasts are very recent, it is possible that further recent price rises will push the figures higher. Some respite is seen as occurring in 2009 but this will depend upon what happens to the "cost push" element of inflation which we discussed earlier. However, we should put these forecasts into perspective. By historical standards, inflation is not high. Given the extent of the rise in food and energy prices, it has been held down remarkably well as the benefits of globalisation have helped to restrain prices. But what central bankers will be concerned about is that "core" inflation, which is usually lower than headline inflation, becomes to be seen by wage negotiators and consumers as increasingly irrelevant thus helping to embed food and energy prices in inflation and risk further increases. It is becoming increasingly difficult to justify basing monetary policy on core inflation rather than headline inflation. Core inflation seems increasingly irrelevant to many people as it does not match their experience. If these forecasts are close to reflecting what actually happens in 2008 and 2009 and are as bad as it gets in this cycle, then we can be cautiously optimistic. A lot can happen between now and the end of 2009.

We turn now to discuss each major area or country, starting with the USA where annualised first quarter growth was 0.9% higher than the earlier estimate of 0.6%. Drags on growth were investment and consumption but drivers were a build up of inventories and exports (up 5.5% over the quarter), and a fall in imports helped by the very competitive level of the US dollar. Real personal consumption expenditure increased at a 1% rate, the slowest rate of increase since the second quarter of 2001.

In response to economic conditions, the Federal Reserve made a further cut of 0.25% in interest rates on 30 April to take the target federal funds rate down to 2%. The comments accompanying the cut were rather delphic and left the Federal Reserve's options open either way. There were rather negative comments on economic activity, household and business spending and the labour market. The statement referred again to difficult conditions in the financial markets and commented negatively on the state of the housing market. It did not hint about worsening inflation conditions.

In late May, the Federal Reserve released its latest economic projections, given in the form of central tendencies. It forecasts growth of 0.3% - 1.2% this year, rising to 2.0% - 2.8% in 2009 and 2.6% - 3.1% in 2010, a far higher figure than the IMF is looking for. The headline personal consumption expenditure measure of inflation is expected to be in the range of 3.1% - 3.4% this year, 1.9% - 2.3% next year and 1.8% - 2.0% in 2010. Core personal consumption expenditure inflation, the Federal Reserve's favoured measure is forecast to be 2.2% - 2.4% this year (above its 2.0% target ceiling), 1.9% - 2.1% next year and 1.7% - 1.9% in 2010. It is relatively sanguine about unemployment prospects, too. The Federal Reserve's central tendency this year is 5.5% - 5.7%, next year 5.2% - 5.7% and the following year 4.9% - 5.5%. Seen against the worries presently apparent in markets, these projections, if they are anywhere near accurate, are quite comforting.

From the minutes of the 30 April Federal Reserve meeting, it appears that the decision to cut the target for the federal funds rate to 2% was not necessarily an easy one. The minutes suggest Board members felt the balance of risks between higher inflation and lower growth were fairly evenly matched suggesting that we may be in for a period of stalemate as far as interest rates are concerned. Board members seemed slightly less concerned about the effects of problems in the financial markets on the economic outlook but more concerned about the threat posed by a greater than expected decline in house prices. So, it is a difficult call for the Federal Reserve but at least it has greater latitude in the factors it can take into account in making its decisions than the ECB or the Bank of England which are limited by their inflation remit.

As we have just mentioned, the state of the housing market and the effect of a larger than expected further fall in prices on the US economy is exercising the mind of the Federal Reserve. Most of the data published in May suggests the weakness is continuing. Pending home sales for house purchases awaiting completion fell to a new low in March according to the latest index from the National Association of Realtors. The index was 20.1% lower than a year ago. It was also reported that new construction of single family homes fell to the lowest level for seventeen years. The Office of Federal Housing Enterprise Oversight house price index fell by 3.1% in the first quarter against last year, the sharpest decline in its seventeen year history. The S&P/Case-Shiller national house price index fell by 14.1% in the first quarter of 2008 compared with the same period a year earlier, the sharpest drop in the index's twenty year history. It was not all gloom, however. Housing starts rose by 8.2% in April compared with March and applications for building permits rose by 4.9% in April compared with March.

As well as the housing market, inflation will be one of the main focuses of the Federal Reserve's attention. If the figures are bad, it could well trip a closely balanced decision towards a more hawkish policy. The Federal Reserve's preferred measure of inflation to which we referred earlier, the core personal consumption expenditure index, rose by 0.2% in April, reflecting a year on year increase of 2.1%, slightly over the top of its target of 2.0% maximum. The latest consumer price index for April showed a month on month rise of 0.2% to give a year on year rate of 3.9%. The core rate rose by 0.1% on the month whilst the year on year increase was 2.3%. This discrepancy in the year on year rate highlights the effect which rising food and energy prices have had on inflation. The producer price index rose by 0.2% month on month whilst the year on year increase was 6.5%. The core figures were 0.4% and 3.0% respectively. The core figure needs watching carefully being significantly higher for the month than the headline figure.

Although the federal funds rate does not reflect the rate at which businesses and consumers borrow, the 2% level reflects a negative real rate of interest. This is an unusual position but reflects the very aggressive action taken by the Federal Reserve to prevent the economy falling into recession. In normal circumstances, such a level of interest rates would be considered as a risk to inflation but stresses in financial markets, the difficulty of borrowing for some and elevated margins are reducing real world risks. Nevertheless, the Federal Reserve will want to move towards a more normal level of interest rates as soon as it feels it can safely do so because of the risk of present interest rate levels to future inflation.

Economic indicators from the USA have been mixed over the past month. On the negative side, the latest ISM index for the manufacturing sector was unchanged on the month at 48.6 with the employment component of the report falling to 45.4 compared with 49.2 the previous month. This is its lowest level since May 2003. Consumers, according to two surveys, have become less confident. The Reuters / University of Michigan consumer confidence survey fell to 59.8 in May compared with 62.6 in April. This is the lowest reading since June 1980. The Conference Board's consumer confidence index fell to 57.2 in May from 62.8 in April. For this survey, the index reading was the lowest since October 1992.

There has been some good news also from recent indicators which can easily be overlooked when the bad news always seems to be catching the headlines. But, of course, economies do turn and the better trend will be characterised by an increasing flow of good or, at least, better news so people should not be surprised. The latest set of unemployment numbers have been better than expected if only in the sense that April's rise in unemployment was less than expected. Factory orders in March were better than expected, rising by 1.4% over the previous month. News from the services sector was better. The ISM's non manufacturing index rose from 49.6 in March to 52.0 in April with the employment index rising from 46.9 to 50.8. The competitive level of the US dollar is benefiting exports. March's trade deficit was a better than expected US$58.2 billion down from US$61.7 billion in February. The Conference Board's index of leading indicators painted a more optimistic picture. As in March, the index crept up by another 0.1% in April. Although factory orders fell by 0.5% in April, they rose by 2.5% if transportation orders are excluded. After very substantial civil aircraft orders in 2007, orders have tailed off in recent weeks, so the underlying picture is healthy. Electrical equipment orders rose by 27.8%.

There is a good chance that the fiscal stimulus, now coming into play, and the aggressive action on interest rates will have its desired effect later this year. As we have seen above from some of the recent economic data, there are some encouraging aspects. The news is not all one way. US shares do not look dear as a whole.

Turning now to Japan, we see a growth rate in the first three months of the year at 0.8% to show an annualised growth rate of 3.3% and a year on year rate of 1.0%. The main driver of growth was exports which contributed 1.4% to growth from a year ago. Exports were strong to China and other emerging economies, highlighting an attractive feature of the Japanese economy for investors. Japan is also doing well in the Middle East, the vast wealth of which should continue to provide attractive export markets and investment opportunities for Japan. On the other side of the coin, capital spending was a drag on growth contributing -0.4% compared with a year ago.

Looking forward, the Bank of Japan, at the end of April, cut its growth forecast for the year to next March to 1.5% from its previous forecast of 2.1% made six months ago. At the same time, it raised its core inflation forecast from 0.4% to 1.5%. The current core year on year inflation rate for April is 0.9%. For the first six months of the current fiscal year to the end of September, the Bank of Japan said "deceleration in the economy seems likely to continue, due mainly to the slowdown in overseas economies especially the US, and the effects of high energy and materials prices". It said that the outlook for growth and prices was "highly uncertain". From a bias towards raising interest rates, currently 0.5%, the Bank of Japan has moved to a neutral position where "it is not appropriate to predetermine the duration of future monetary policy". So its neutral position gives it flexibility to deal with whatever situation arises. Later on in May, the Governor of the Bank of Japan warned of continuing "downside risk" to the Japanese economy. Although with interest rates at 0.5%, monetary policy does not have a lot of scope to influence the economy, the implications of the Governor's remark are that what help monetary policy can give, i.e. cutting interest rates will be applied. Although monthly figures are notoriously volatile, his caution will not have been lessened by a 3.1% fall in industrial output in March and one of 0.3% in April, nor by the NTC Research / Nomura / JMMA purchasing managers' index for May which fell to a seasonally adjusted 47.7 in May from 48.6 in April. Unemployment also rose by 0.2% to 4.0% in April. Household spending was down by 2.7%.

As in the USA, official Japanese interest rates are below the headline rate of inflation and, in normal circumstances, would be leading the Bank of Japan to raise interest rates. After a long deflationary spell, rising energy and food prices are making their presence felt. In March, inflation rose by 0.5% with the year on year figure rising to 1.2%. This contrasts with core inflation, i.e. excluding food and energy, where the year on year increase in inflation was just 0.1%. It is not an easy situation for the Bank of Japan to call and the "do nothing" policy would seem to be correct at present.

A negative factor for investors in Japan has been lack of structural reform. Although some important steps have been taken, protectionist attitudes have manifested themselves in different forms. Barriers to takeovers have put Japan at a disadvantage to many other markets because if companies cannot easily be taken over, shares will not be rated as highly as in markets where barriers to takeovers are not erected. Encouragingly, the Cabinet Office is calling for reforms to promote foreign takeovers. This would include a reduction in corporate taxes and a review of investment restrictions to encourage foreign investment. We will see what happens but, at least, it is an encouraging move.

The real inflation hawks are to be found in the ECB which resolutely refuses to follow the very aggressive Federal Reserve action or the much more limited one by the Bank of England on interest rates. Its remit is inflation which is so much above the target that something very dramatic would have to happen for it to relent, one feels. Furthermore, unlike the Federal Reserve and the Bank of England's Monetary Policy Committee, which have been split to some extent, there is a much more uniform feeling within members of the ECB. The decision, for example, at the May meeting to keep interest rates unchanged at 4% was unanimous. Its resolve to take a fairly bullish position on interest rates will have been stiffened by the still rapid rate of business lending. April's figures showed an annual rate of increase of 14.9%. In this context, the ECB said that "there has been little evidence that the financial market turmoil has strongly influenced the overall dynamics of money and credit expansion". The ECB also saw signs that people expected eurozone inflation to rise. Central banks' interest rate policy will normally be influenced by people's inflation expectations. They like to have these well anchored and any upward drift will normally find its reflection in higher interest rates. Some possible offset to this position comes from an ECB survey of banks' loan officers which point to falling demand for loans. The figures quoted above were for April and the rate of growth was hardly different from that in March. So it will be interesting and perhaps relevant for interest rates to see what rate of increase the next few months' figures show.

As we mentioned earlier, inflation in the eurozone is running well above the ECB's target level of just below 2.0%. In April, the monthly rise in the headline rate was 0.3% to give a year on year rate of 3.3% and the inflation rate, just out for May, was back at a record 3.6%. There were several countries where the year on year rate exceeded 4.0% in April. These were Belgium (4.1%), Greece (4.4%), Spain (4.2%), Luxembourg (4.3%) and, a recent addition to the eurozone, Slovenia (6.2%). The lowest rate, and the only one below 2.0%, was the Netherlands (1.7%). The core inflation rate for the eurozone, which excludes food and energy, showed a 0.2% rise for April and a year on year increase of 1.6%, again a big discrepancy with the headline rate, reflecting the severe effects of food and energy price increases. These are not the level of figures to make the ECB comfortable, hence its "hair shirt" approach to interest rates. Producer prices in the eurozone, in March, rose by 0.7% to give a year on year increase of 5.7%, again a figure to worry the ECB.

Most eurozone news has tended towards the negative during the past month which is consistent with the slowing rate of growth being seen in the eurozone. The final Purchasing Managers Index for April showed a fall to 50.7 from 52.0 in March, the lowest level since August 2005. In March, industrial production fell by 0.2% to give an annual increase of 2.0% compared with 3.2% in February. Industrial orders also showed weakness falling in March by 1% compared with February and down 2.5% from a year earlier. The European Commission's economic sentiment indicator for the eurozone was unchanged in May at 97.1. Consumer confidence was generally weak across the eurozone and confidence generally had fallen sharply in France. Slightly more positively, the eurozone purchasing managers index for the services sector rose to 52.0 in April from 51.6 in March although input price inflation rose to its highest level since October 2000. By European standards, eurozone unemployment, although higher than in the USA, UK and Japan, remains low. From April, it remained at 7.1% for the fourth month in succession.

In Germany, we have the paradoxical situation where recent relative economic success has resulted in a sharp leftward movement in the political consensus threatening to undo the reforms which Germany urgently needed. The effective stalemate in the last federal elections led to the current CDU-SPD coalition. Because of the compromises which have to be reached, further reforms are difficult to achieve. The low ratings of the SPD and power struggle within it have pushed the party to the left pulling the whole coalition's centre of gravity to the left. In a further blow to the coalition government, the SPD has put forward a candidate for the Presidency. The unpicking of welfare reforms and the hostility towards directors' pay, to which we referred earlier, do not sit with a country that has a world class manufacturing industry. Whilst hostility to lavish rewards for failure is understandable, the unhealthy atmosphere which this creates and the policy decisions to which this can lead can threaten damage to the economy through its effect on successful companies. This is a problem in countries like France, Germany and the Netherlands and investors need to be aware of the dangers which these attitudes can cause. In a difficult economic climate, it is always tempting for politicians to grandstand and indulge in populist politics but such stances risk economic damage. The oil industry is a classic example. When oil prices are high, one can guarantee that some politicians will call for windfall taxes on oil companies, conveniently forgetting that in many areas like Western Europe, the majority of the price is represented by tax. Furthermore, there is no explanation of how capricious taxation is going to further oil exploration.

Although Germany's relative economic position within the eurozone remains strong, the day to day news has been getting less good. The political weakness of the coalition government has made economic management more difficult. Slippage on budgetary targets is a case in point. The latest estimates for government revenue this year show a reduction of €5 billion against the previous forecast. At the same time, the Economics Minister suggested tax cuts for the middle classes should take priority over fiscal rectitude. This would put into doubt the commitment to balance the budget by 2011. Whilst tax cuts are generally to be favoured, financing them though cuts in public expenditure is more difficult given the nature of the coalition. An economic slowdown and coalition politics are an ideal mixture of circumstances for slippage on the fiscal front.

Most individual items of news in Germany have been negative. March saw the fourth successive monthly decline in manufacturing orders. They were down by 0.6% in March. Industrial production was down by 0.5% during

March. The ZEW survey of German investor sentiment fell to -41.4 in May from -40.7 in April. There was some possible evidence of a deterioration in the labour market even though one month's figures do not provide hard evidence. There was a rise of 4,000 in the seasonally adjusted level of unemployment according to the latest figures. Retail sales have been weak. April saw a 1.7% drop which followed on from a 2.2% fall in March. But, on a more encouraging note, the latest Ifo business climate index rose in May to 103.5 from 102.4 in April. Companies which responded were more confident about current trading and, to a lesser extent, for the next six months. This chimes in with a surprisingly strong first quarter for the German economy which showed growth of 1.5%. This rate of growth is most unlikely to be repeated in the second quarter. Other findings of the survey were a less optimistic view of export prospects but expectations of increasing staff numbers. Overall, the picture of the German economy is one which is slowing down but in a relatively good position compared with its peers.

France's struggles with its public finances are worse than those of Germany. President Sarkozy is attempting much needed reform in France but, as recent public sector strikes and demonstrations show, it is not an easy task. France has been receiving warning messages from the European Commission about the state of its finances and encouragement about its reform plan. The EC acknowledged that France had started its reform programme but said that it had stopped budget consolidation. The French Prime Minister has confirmed that it is the target to eliminate the budget deficit by 2012. Of the 50 billion deficit last year, he said that 40 billion would be gradually eliminated by holding the rate of growth of government expenditure and the other 10 billion would come from faster economic growth. This will not be an easy task in the face of many vocal special interest groups in France. Meanwhile, things are becoming more difficult in France. Industrial production fell by 0.8% in March with the car industry particularly weak. Consumers are not feeling confident either. May saw the eleventh consecutive monthly fall to -41 compared with -38 in April in the consumer confidence index.

Politicians and eurozone central banks should be concerned about the disparities in performance between member countries of the eurozone because it will ultimately put monetary policy under strain and perhaps lead to more serious political difficulties than there are at present over the level of interest rates. The eurozone is not an optimal currency area and, ultimately, the strains could put the project in danger. A particular area of difficulty at present is Spain which has enjoyed a long period of growth and where, for a long time, interest rates were inappropriately low. The first quarter of 2008 saw the Spanish economy growing at its slowest quarterly rate for thirteen years. Growth was just 0.3% compared with 0.8% in the previous quarter and 0.9% in the first quarter of 2007. The housing and construction market is in difficulty. Compared with a year ago, March's completed house sales were 36% lower than a year earlier. Interest rates set at too low a level in the past caused inflation to rise and Spain to lose competitiveness, resulting in a very large current account deficit. Although there cannot be a run on the currency now because of monetary union, there can still be countries experiencing economic crises which eurozone governments cannot fight with an independent monetary policy appropriate to the particular economy's needs. Devaluation is also no longer a possibility. In due course, political difficulties could arise which could cause strains on monetary union.

There is some evidence of a problem emerging within the eurozone, if we look at relative gross redemption yields within the eurozone bond market. If we take Germany as the best eurozone credit within the eurozone bond market, we note, as we have done in previous reviews, that there is a wide yield spread against bonds of other eurozone countries. If we take another good eurozone credit, France, we see that its ten year government bond yields 16 basis points more than that of Germany. If we look at Greek government ten year bonds, they yield 55 basis points more than those of Germany. As one example of the difficulties of economic divergence, this is striking. Effectively, there are different interest rates within the monetary union zone. This will have economic consequences, for example, on potential growth rates, Although the euro as a currency has been very strong, it does not mean that the euro will survive. We can see countries clamouring to leave in due course because of the political difficulties of remaining in. Already we see countries like France attempting to influence decision making on interest rates because of the pain of the high value of the euro is causing to some counties.

Notwithstanding the difficulties of the high euro, the European stock markets as a whole have performed well over the quarter. Financial institutions have suffered less than those in the USA and UK though they have not been immune. There are many world class companies in Europe with a good international spread of business to give them exposure to faster growing economies. The ratings on European markets are low and we feel should accommodate a worsening profits outlook. We remain committed to an important exposure to this region.

The UK market, although putting up a decent performance over the quarter, slightly underperformed the FTSE World Index. There were some notable areas of weakness in the financial sector which held back the market but there are also, in our view, some particular concerns about the UK economy which make international exposure so important as a way of diversifying risk.

We consider the UK economy to have more problems than most in the present environment. Hindsight is a wonderful thing, but some of the problems facing the UK economy were foreseeable a long time ago. We have often written in previous reviews, going back a long time, of the threat to government finances from the rapid growth of public expenditure at a rate in excess of economic growth. The present poor state of government finances was easily predictable and an inevitable consequence of this spending. The Treasury has consistently underestimated the scale of government borrowing and now risks uncomfortably large borrowing levels. This gives the government no room for fiscal action, such as that taken in the USA, to offset the current economic difficulties. Furthermore, the present weakness of the government's position and the fact that this parliament is beyond the halfway stage, means that it will find it difficult to take decisions which start to rectify the position. The electorate has made it pretty clear that the limits of taxation have been reached and the obvious answer would be to cut public expenditure. That would be likely to upset some of the government's natural supporters and would be a difficult political decision. But whilst the furore over the abolition of the 10p income tax rate was met in the short term by the costly device of raising personal allowances and borrowing the money to do so, such measures do not look good from the outside and could well trigger further weakness in sterling. Although the currency has not moved much over the past quarter, it had been very weak before then and the weakness will exacerbate inflationary problems because of the open nature of the UK economy.

The second dangerous issue for the UK economy is growing evidence of weakness in the housing market. House prices have, of course, risen very strongly over a long period of time. The IMF has recently stated that it believes that UK house prices, following the property boom, are about 30% above what can be justified by fundamental factors. Recent data points to gathering weakness. Halifax's index of house prices fell by 1.3% in April to be 0.9% lower than a year earlier. The RICS reported that the balance of surveyors reporting that house prices had fallen rather than risen in April rose to 95.1% compared with 79.4% in March. It also reported a sharply lower level of property transactions. The Department of Communities and Local Government reported a fall in the annual rate of house price inflation in March to 5.2% compared with 6.3% in February. The Nationwide's index of house prices in May showed a drop of 2.5% in prices over the month. The Nationwide said that this was the largest monthly fall in its index over the seventeen year history of the survey. The Land Registry reported the lowest annual rate of growth in house prices since November 2005 at 2.7%, the eighth consecutive month that the annual rate fell. Prices in April were down 0.2% over March. The FT/Acadametrics house price index showed a fall of 0.2% in April. In other signs of distress and weakness in the UK housing market, the ONS reported that the volume of private housing orders fell by 27% quarter on quarter in the first quarter of 2008. Repossessions granted by the courts in England and Wales in the first quarter were up 17% from a year earlier and up 9% on the previous quarter. The Council of Mortgage Lenders reported that the number of loans for house purchase in the first quarter fell to the lowest levels since 1975. The CML also said that it expects house prices to fall by 7% this year and transactions to be 35% lower than in 2007. The British Bankers Association reported that mortgage deals fell by 39.4% in April compared with a year previously.

Falling house prices will have a negative wealth effect, making people feel less confident about spending on non essentials. This will have a knock on effect on the economy and can be expected to affect employment levels. There is tentative evidence of this beginning to happen and the trend is likely to accelerate. The claimant count rose by 7.200 in March to 806,300, the third consecutive month that this measure rose. The ILO unemployment level rose by 14,000 to 1.612 million in the three months to March.

There was not a hint of comfort in the Bank of England's latest quarterly inflation report, which was more negative than the previous one. It said that inflation would remain above the government's target level (2%) until early 2010. The Governor said that there would be a squeeze on take-home pay and that there could be a quarter or two of negative growth. He said that a recession was not the Bank of England's central forecast. The Governor said that inflation was likely to rise above 3% over the next few months and remain more than 1% above its 2% target. Disturbingly, for the Bank of England, people's inflation expectations are rising. Central bankers take notice of these surveys and they are one factor influencing interest rates. Changing the standard measure of inflation to the consumer price index on the basis of bringing the measurement into line with Europe might have seemed a good idea at the time but, with hindsight, using that measure as a target might have meant the Bank of England keeping interest rates too low and helping to contribute to the present problems, including the house price inflation which has occurred in recent years. There is little confidence in the consumer price index as a realistic measure on inflation for most people. The Retail Price Index, the former measure, has more credibility but, even there, with what is happening to food and energy prices, people will suspend belief. According to the latest YouGov Survey, conducted for Citigroup, and quoted in the Financial Times, the average inflation expectation in twelve months' time is 4.1%. 34% of people questioned thought inflation will be above 5% in twelve months' time. This explains why the Bank of England has indicated that it is reluctant to cut interest rates. Inflation is very much its focus. The latest consumer price index for April showed it to be 0.8% up on March and 3.0% up, year on year. The core figure shows a rise of 0.5% on the month and 1.4% year on year. As we have noted elsewhere, the difference between core and headline rates is now substantial because of the effects of rising food and energy prices. The Retail Price Index, widely regarded as far more relevant to most people, rose by 0.9% on the month and 4.2% year on year. Producer prices have been rising very sharply. In April alone, they were up by 1.4% to give a year on year rise of 7.5%. Manufacturers' input prices rose by 2.6% in April and, year on year, were 23.3% higher. These are very significant cost pressures. With the economy weakening, competitive pressures may stop the full effect being passed on but some will be.

Most of the individual items of economic news for the UK over the past month have been negative and there is little doubt that the economy is facing a difficult time. There is a wide disparity between the economic forecasts of the Treasury and other forecasters including the Bank of England. For example, whereas the Treasury is forecasting economic growth of between 2.25% and 2.75% for 2009, the IMF is forecasting growth of 1.6% and the Bank of England 1.5%. Whilst 1% may not seem a big difference, in fact it is very significant especially for the state of public finances. These have been deteriorating even when headline growth has been healthy. When economic growth takes a downturn, the geared effect on public finances will be large and the UK is threatened with a serious deterioration in public finances. This leaves the government with a very difficult dilemma. Cuts in public expenditure, as we have indicated earlier, will be politically difficult, raising taxes will be very unpopular and increasing borrowing will not raise the economic perception of the UK and may well be accompanied by further weakness in sterling. With a floating exchange rate, the government would not be faced with the same pressures as being forced to defend a fixed exchange rate (we remember the sterling crises of the past) but, nevertheless, the government would probably be forced to take some remedial action, embarrassing in front of a General Election.

What we have discussed above gives some idea of why it is difficult to be optimistic about the immediate prospects for the UK economy. The unwinding of the public and private spending binge is resulting, and will continue to result, in a serious economic headache for the country. The situation is made worse by the problems of the international financial sector because this sector accounts for about 10% of the UK's GDP. But, whilst we believe, as a generality, that overseas equities have better prospects, it does not mean that one should abandon the UK. Whilst the financials, currently out of favour, offer scope for recovery, many of the large UK companies have important exposure overseas and to faster growing markets. If we are correct in expecting sterling to weaken further, these companies should benefit.

The news from China has been dominated by the dreadful earthquake. Our comments on the economy are really the same as in previous reviews. The economy, whilst it may not grow as fast as in 2007, will still grow at a very substantial pace as suggested by the IMF in its forecasts. The problem for the Chinese authorities is inflation, currently running at 8.5% year on year. Interest rates and bank reserve requirements continue to be raised in an attempt to slow down bank lending and inflation. But, as elsewhere, food prices are rising sharply and contributing strongly to the inflation level. The China story remains a compelling one for investors not only for its own growth and the effect on economies and industries which benefit from it but also for its growing investment influence. We have written before about its sovereign wealth fund which, along with others, we expect to become increasingly influential in international financial markets.

The feature of the quarter for investors has been the resilience of equities in the face of some disappointing economic news. It is easy to be overwhelmed by the negative financial and economic news but it is more important still to look ahead. In the shorter term, we await the economic effects of the US economic stimulus, currently being administered. In the longer term, the shake out in the financial sector is likely to lead to a much more sober assessment of risks and better quality economic growth as a result. There will continue to be bad days and market volatility, although lower this quarter, is still likely to be in evidence. But shares do not look expensive compared with bonds and many companies retain strong finances which give them interesting opportunities in the current environment. Although it may be tempting to hold high levels of liquidity, long term investors should be aware of the opportunity cost if markets respond to better economic prospects later this year in the USA.

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