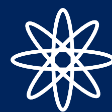

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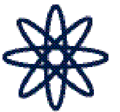
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

Following strength in the first quarter, equities have weakened as the eurozone's sovereign debt crisis has become more acute. Equities have fallen back moderately whilst high quality government bonds have strengthened. Currency movements have been quite pronounced with strength in the yen and US dollar. Commodities have come back including, importantly, oil which, if the price weakness persists, should be helpful for the world economy.

The tables below detail relevant movements in markets:

International Equities 29.02.12 - 31.05.12

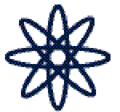
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-4.2	-10.7	-14.0	-6.9
Finland	-16.8	-20.2	-23.1	-16.8
France	-9.4	-13.1	-16.2	-9.4
Germany	-8.3	-12.0	-15.2	-8.3
Hong Kong, China	-11.2	-7.9	-11.3	-4.0
Italy	-18.5	-21.8	-24.6	-18.5
Japan	-13.4	-7.2	-10.6	-3.3
Netherlands	-8.4	-12.1	-15.3	-8.4
Spain	-25.7	-28.7	-31.3	-25.7
Switzerland	-2.0	-5.7	-9.2	-1.7
UK	-8.1	-8.1	-11.4	-4.2
USA	-3.6	+0.1	-3.6	+4.4
Europe ex UK	-9.2	-13.1	-16.2	-9.4
Asia Pacific ex Japan	-6.9	-8.5	-11.8	-4.0
Asia Pacific	-9.6	-7.9	-11.3	-4.6
Latin America	-7.1	-16.3	-19.3	-12.7
All World All Emerging Markets	-9.1	-12.7	-15.9	-9.0
The World	-6.4	-5.5	-8.9	-1.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +3.9%

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

Currency	29.02.12	31.05.12
Sterling	2.14	1.57
US Dollar	1.98	1.58
Yen	0.97	0.83
Germany (Euro)	1.82	1.21



Sterling's performance during the quarter ending 31.05.12 (%)

Currency	Quarter Ending 31.05.12
US Dollar	-3.3
Canadian Dollar	+1.3
Yen	-6.4
Euro	+4.5
Swiss Franc	+4.1
Australian dollar	+7.1

Other currency movements during the quarter ending 31.05.12 (%)

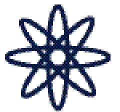
Currency	Quarter Ending 31.05.12
US Dollar/Canadian Dollar	+4.4
US Dollar/Yen	-3.2
US Dollar/Euro	+7.7
Swiss Franc/Euro	+0.4
Euro/Yen	-10.4

Significant Commodities (US dollar terms) 29.02.12 - 31.05.12 (%)

Currency	Quarter Ending 31.05.12
Oil	-16.9
Gold	-12.5

Markets

As in the third quarter of last year, although not as badly, the markets reflected increasing tension, at that time started by the stand off over the US debt ceiling and, now, by an increase in concern about developments in the eurozone. The result was a negative return of 6.4% in local currency terms in the FTSE World Index, one of 5.5% in sterling terms, 8.9% in US dollar terms and 1.5% in euro terms. If we look at local currency performances, the USA held up best of all with the negative return on the FTSE USA Index being just 3.6%. At the other end of the scale, the FTSE Japan Index showed a negative return of 13.4%, whilst the FTSE Europe ex UK Index, the FTSE UK Index and the FTSE All World All Emerging Markets Index fell by more than the FTSE World Index, with returns of -9.2%, -8.1% and -9.1% respectively. The FTSE Australia Index also held up quite well, with the FTSE Australia Index falling 4.2% in local currency terms. Within the Europe ex UK section, two of the most troubled non bailout countries, Spain and Italy, significantly underperformed the FTSE Europe ex UK Index, with returns of -25.7% and -18.5% respectively. On the other hand, the perceived safe haven of Switzerland, away from the eurozone, showed a negative return of only -2.0%. However, currency movements were significant over the quarter and sterling adjusted returns were markedly different as sterling lost ground against the US dollar and yen but rose against the Australian dollar, euro and Swiss Franc. In fact, the strength of the US dollar was enough to put the sterling adjusted FTSE USA Index into positive territory, albeit at 0.1%. Elsewhere, the negative return on the FTSE Europe ex UK Index widened to 13.1% and Australia to 10.7%. Sterling adjusted performances for Latin America, in particular, and emerging markets suffered from currency weakness with the FTSE Latin America Index returning -12.7%. Conversely, Japan, which underperformed significantly in local currency terms, clawed back a lot of ground, with the sterling return on the FTSE Japan Index being reduced to -7.2% reflecting the strength of the yen.



The table of high quality government bonds reflects an extraordinary situation with these governments' bond yields falling to levels which defy belief. The converse of this is the ballooning of yields in eurozone countries whose finances are suspect. Taking these ten year government bond yields as benchmarks, we see a fall of 57 basis points to 1.57% for UK government bonds, of 40 basis points for US Treasuries to 1.58%, of 14 basis points to 0.85% for Japanese government bonds and, most extraordinary of all, of 61 basis points in German government bond yields to 1.21%.

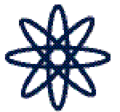
As we said, currency markets witnessed big movements. Sterling fell by 3.3% against the US dollar and by 6.4% against the yen but rose by 7.1% against the Australian dollar, by 4.5% against the euro, by 4.1% against the Swiss Franc and by 1.3% against the Canadian dollar.

In a very significant development in the commodity markets, oil, as measured by Brent crude, fell 16.9%. Gold fell by 12.5%, in some ways surprising because one would have felt that confidence in paper currencies was low and low interest rates, meaning a low opportunity cost of holding gold, should also be helpful. It may be that inflationary concerns are abating, or simply a liquidation of positions to meet cash requirements.

Economics

Turbulence has returned to markets as a result of events taking a turn for the worse in the eurozone. As we have noted before, even with a poor and disturbed economic background such as we saw in the first quarter of 2012, stock markets can hold their own provided the news does not get unexpectedly worse, which is what has happened so far in the second quarter, primarily, but not only, because of the indecisive Greek government election result. In so far as one can interpret the Greek mood, it is that the electorate wants to remain in the euro but does not want to endure the austerity which membership of the euro has imposed on it by virtue of its loss of creditworthiness. It is the economic equivalent of having your cake and eating it.

Because no party, or group of parties, enjoyed a majority in the election and because no group of parties which could form a majority would coalesce around an austerity or anti-austerity policy, the Greek President had no alternative but to call for a further election in June. There is great value in becoming the largest party in Greek elections because it receives a further fifty seats. Even though this characteristic of Greek elections yielded a further fifty seats for the New Democracy party, it was unable to muster a pro bailout majority with Pasok, its rival but united by their support of the austerity measures. With the hard left anti-bailout party coming second, Greek politics is severely fractured and the outcome of the second general election is at this stage very unclear. A game of bluff is being played. The hard left anti-bailout party, Syriza, believes that Germany and the other countries are bluffing. Its argument is that Greece's weakness is its strength. If it reneges on its pledges to the troika (the European Commission, the European Central Bank and the IMF), it says that the damage to the eurozone's banks, if it is ejected from the euro, will be so serious that Germany and the others will blink at the last moment and will continue to support Greece. It is quite possible to see Syriza's argument. The state of denial amongst the eurozone's politicians, bureaucrats and central bankers has meant that this group of people has consistently been behind events. Firstly, Greece was not going to default, which everyone could see was untrue, then the first bailout was going to be sufficient and so on, but, all the while they were denying that Greece would leave the euro. Again, everyone knew that this would, at the very least, be a strong possibility. Now, even this group of people acknowledges that it is possible that Greece will leave the euro and, furthermore, is toughening its stance with a "take it or leave it" ultimatum to Greece. But Syriza may be right. Nobody should underestimate the embarrassment that the fragmentation of the euro would cause in EU circles. This is a political project, not an economic one, so they may be bluffing. But it is a game of very high stakes and the chances of an accident are high. Meanwhile, any meaningful action relating to Greece is likely to hinge on the election result so there is a hiatus before the Greek election on the 17th June.

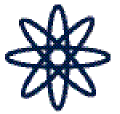


Elsewhere, the political furniture is moving in the eurozone, particularly as a result of Mr Hollande's presidential election victory in France. The change has started to leave Germany (and the UK outside the eurozone) looking rather isolated. The new mantra is to propose growth and austerity and, with many voters enduring such hard times, it is, not surprisingly, receiving a good reception. However, it is a contradiction in terms because what it is essentially saying is that countries should borrow more on specific projects to help to kick start growth at the same time as addressing the budgetary problems. But where is the money coming from? Given that some of the countries which might be the recipients of this extra spending are already shut out of the bond markets, it cannot be from them. Might it be the ECB? At present, it is not allowed to make direct loans to countries. Perhaps it could be raised by way of eurobonds guaranteed by the eurozone. This is really shorthand for asking Germany to shoulder the risk of default on the bonds just as it has money at stake in the bailout funds and at the ECB through the latter's bond buying programme and the Long Term Refinancing Operations of the ECB to provide liquidity for the banking sector. The logical ending of this process is money creation by the ECB to lend to banks, governments and on project finance. That the ECB would be operating well outside its mandate is besides the point. Borrowing yet more money would risk debasing the currency. And, of course, the more Germany provides guarantees, the weaker becomes its creditworthiness. It is for this reason that Germany continues to exclude the possibility of co-mingling eurozone debt. Its reasoning is that, apart from the unstated but obvious fact that it would weaken Germany's creditworthiness and thus raise its cost of borrowing, it would reduce the incentives for the structural reforms in the labour, product and services market which the debtor countries badly need but which vested interests ensure are strongly entrenched.

Connected with this is the concern about the eurozone's banks and, particularly, the southern eurozone ones. Part of the money provided by the ECB earlier this year under its Long Term Refinancing Operation, was invested by the local banks in Italian and Spanish government debt. Borrowing three year money at a very low rate of interest and picking up yield by investing in the relevant government bonds whose prices had been depressed by the eurozone's sovereign debt crisis, seems superficially attractive but, given the fall in some of the bonds, losses have already been incurred and, if the sovereign's debt has to be restructured, the banking system will be caught up in its woes. One of the ideas is for the ECB to recapitalise the eurozone's weakest banks. But the losses cannot be spirited away. The money has to be borrowed and the risks spread around strong and weak members of the eurozone, with the same argument about weakening the creditworthiness of the stronger eurozone countries, as mentioned earlier. If things become so desperate that it has to print money to provide the banks with capital, we are moving into the realms of currency debasement and serious inflation later on. Using the European Investment Bank for project finance to get a big infrastructure spending programme under way is another idea. The EIB is an AAA rated borrower but, to support all of this extra borrowing, its capital would have to be raised and some countries do not have the money to subscribe extra capital and, if the EIB was being used for political purposes, its rating and, therefore, the cost of money, would be adversely affected.

At every stage of the eurozone crisis, developments which political leaders, bureaucrats and central bankers said could not happen, have happened, and, therefore, although some are now willing to accept that Greece's departure from the eurozone is possible, none are willing to accept that the eurozone could fragment totally, or partly, except, as mentioned above, for the possibility of Greece's departure. We should not believe this either, as events have spun out of control and beyond their ability to fix the problem.

For some in the euro area, the weakness in the project was the absence of a fiscal union to complement a monetary union and so this idea is being promoted, the reasoning being that, as, say, in the USA, fiscal transfers can be made as necessary. It is unlikely that the eurozone's electorates, assuming they were asked, would favour this idea. This is one idea on from a jointly guaranteed eurobond. A single currency rules out a devaluation possibility for individual countries which are suffering from a loss of competitiveness. What is being tried by the troika, as part of the bailout package, is internal devaluation through, amongst other things, public sector pay cuts, the idea being to restore these countries' competitiveness. But the pain is enormous, as we are witnessing

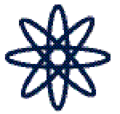


most starkly in Greece, and, as recent eurozone election results show, the electorates are becoming increasingly disenchanted by these policy prescriptions. The latest idea to gather ground, even within the German political class, is that competitiveness should gradually be restored through encouraging higher German inflation, so that the loss of competitiveness by the weaker eurozone members since the start of the euro should gradually be whittled away, thus easing the position for those countries within the eurozone which have lost competitiveness against Germany. A by-product of this is that higher wages would encourage higher German consumption which would help to reduce Germany's current account surplus and improve the balance in debtor countries. This is a strange argument and it is unusual for politicians to endorse higher inflation. One could understand the argument if the country was experiencing deflation like Japan has done, because, in a deflationary environment, people and businesses will defer unnecessary expenditure, hoping to buy goods and services more cheaply. Such an outcome would lead to economic contraction. But this is not the case in Germany and the encouragement of higher inflation has malign effects. For lenders and savers in cash and bonds, inflation erodes the real value of their assets. If the eurozone were to break up, and this is not a hypothetical situation, the German currency, perhaps a new Deutschemark, would almost certainly be a strong currency and higher inflation would be bad for its exports. For an export orientated economy, like Germany, this would be a negative development, so this new train of thought emerging, which one can only put down to desperation, is a case of being careful what you wish for because you may not get the result you expected.

All the evidence suggests what one commentator describes as "an economic weapon of mass destruction", that is the euro, has left policymakers with little idea of how the position can be resolved. All their efforts are concentrated on the symptoms of the problem rather than the causes and, until they do the latter, the monetary union will be in a permanent state of crisis. That is why the eurozone should be concentrating on how it can sensibly go back to each country having its own currency, with the safety valve that freely floating exchange rates and the ability to issue a country's own currency provides. Whether by trying to keep the existing system going, or allowing the currency union to break up, the scenario is going to be nightmarish, but, at least, if early action is taken, the benefits will appear after a time, whereas the current position holds out no promise at all. Many, in countries outside the eurozone, look on in bewilderment at what is going on in the eurozone, not least because of the economic damage the eurozone's woes are doing to them, the UK being a good example.

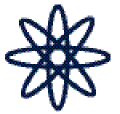
So, it is no wonder that stock markets have seen bouts of renewed nervousness in the quarter which has just ended. It is a surreal situation, with a sense of crisis distorting markets. The best example is the government bond markets. The yields shown at the beginning of this review can only make sense if the countries are facing a sustained period of deflation so that, in the case of the UK, and if we take ten year bond yields as the benchmark, the current negative real yield of about 1.4% would need inflation of about 0.2% to show an equivalent positive return (actual current inflation rate is 3.0%). In the case of the USA, the current negative real yield is about 0.5% and to get an equivalent real positive yield inflation would have to be about 1.3% (actual current inflation rate is 2.3%). In the case of Germany, the current real negative yield is about 0.6% and, to get the equivalent real positive yield, inflation would have to be about 0.6%. We know why these yields are so low - a flight to perceived quality and a very loose monetary policy, typified by non standard measures like quantitative easing, but these do not make them good investments. The returns bear no relation to the risks involved and, when some semblance of normality returns, the restoration of realistic bond yields will involve some very large negative returns for investors. At the moment, with confidence low, this money has not circulated round the system sufficiently to cause increased inflation, but, once confidence picks up, the inflationary consequences are likely to be significant. Therefore, the quantitative easing programmes will have to be reversed in due course and one would expect this to put upward pressure on interest rates.

It may seem counter intuitive, but companies are more likely to be better prepared than governments for a partial, or complete, break up of the euro. We must assume that, behind the scenes in the eurozone, work is being done on contingency plans to deal with one or more departures from the single currency but, because the subject is



taboo in the eurozone, not enough is being done, at least as far as one can tell. However, in the private sector, extensive newspaper reports have detailed some of the precautionary measures that are being taken by multinational companies to deal with a Greek exit initially, though this may be extended elsewhere. Bank deposits are being swept out of Greece each night and, as far as possible, assets and liabilities are being matched in Greece to minimise the consequences of a return to the drachma. These moves highlight how the crisis could escalate to other countries within the eurozone as funds are withdrawn from banks to move to, say, Germany. In the troubled countries, banks could find themselves short of collateral to post with the ECB if they need to tap it for cash. If the ECB lent the money without proper collateral and the bank in question failed, the losses would be shared by all of the eurozone's members. One would expect large multinational companies to be better prepared than small companies or governments in the event of a break up of the eurozone. Our view remains that, notwithstanding the problems of the eurozone and balancing the view with acknowledgement that economies in other parts of the world are doing much better than western Europe, shares are best placed as an asset class. They are reasonably rated and the dividend yields are often appealing. Although the first quarter demonstrated unusually low levels of volatility, we must not be fooled by this. Shares from time to time will have bad periods, as we have seen during the last quarter, but we see value in this asset class, certainly much better than in bonds which look dangerously overpriced.

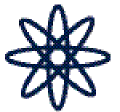
So, at this stage, with the certainty that the eurozone crisis is going to rumble on, we should try to expand on the reasons why equities are our preferred asset class at this turbulent time. If we exclude physical commodities as non income producing and direct property, though both asset classes can, of course, be accessed through good quality equities, and look at equities, bonds and cash, we can identify the pros and cons of each asset class, making the point that, in the bond markets, we would exclude what we would define as risky assets in quality terms and, in equities, we would mainly confine ourselves to high quality reasonably large capitalisation companies. For cash, the argument in favour is that, provided the bank where the deposit is placed is safe, the capital is intact in nominal terms. Secondly, if every other investment option looks unattractive, cash might hold an attraction in relative terms. The disadvantage in the current economic policy climate is clear. Ultra loose monetary policy is likely to continue so that interest rates for some time will be very low and not sufficient to keep up with inflation. In normal circumstances, making an investment which is almost certain to depreciate in value in real terms each year would be ruled out of consideration. We are talking here of cash being held as a mainstream asset rather than being held in a portfolio with a view to investing at a particular level of the market. It is, of course, possible to speculate in currencies in the hope of making money, but it is just that, speculation. In talking about bonds, we are omitting the speculative low grade variety, where it is possible to make and lose a lot of money, and concentrating on high quality bonds such as those in the table at the beginning of this review. On the plus side is, if the bond is held to maturity, the certainty of income and capital flows. Although yields are very low, the further out along the maturity curve one goes the better the yield advantage over deposits. In the current environment, German government bonds, in the context of the eurozone, are regarded as safe and investors are prepared to accept extraordinarily low yields because they are not prepared to take risks elsewhere. As with cash, the disadvantage is that gross redemption yields, well out along the yield curve, are below the level of inflation implying a loss in real terms. But the disadvantage is that bonds in these countries are fundamentally mispriced and that, the further along the yield curve one goes, the greater the danger of significant negative returns. Of course, if the bonds are held to redemption, there will be a positive nominal return, but the opportunity cost could be substantial if alternative uses of the money invested in bonds would have produced a greater return. Now, as mentioned earlier, we understand the reasons why yields have been pushed so low (quantitative easing, low administered short term interest rates and safe haven status) but, at some stage, they will return to normality and that will imply a very serious fall in bond prices. Bonds are often considered to be low volatility assets but a steep rise in yields to more normal levels would mean that they would become very volatile. Finally, we consider the pros and cons of equities. Let us turn this round and look at the cons first. As we have seen in recent weeks, they can be volatile, perhaps rising or falling 2% or 3% a day. Equities are purchased for their future income streams so, if the world faces economic depression, as opposed to recession, these income streams would



have to be re-evaluated, thus threatening share price valuations. For many investors volatility is disconcerting and, with the economic news so troubling, especially with regard to the eurozone, they cannot see how equities might be a suitable investment. But our view is that the pros outweigh the cons and we are talking about the considerations for long term investors here because no investor or investment manager can judge short term share price movements with any confidence. Firstly, a general observation is that stock market and economic cycles do not have to move in tandem. It is a common mistake to believe that a gloomy economic background must mean a poor equity market performance and vice versa. Stock markets are supposed to look ahead. At present, the extremely loose standard and non standard monetary policy being pursued means that equity dividend yields compare favourably with top quality government bond yields. If we use ten year government bond yields as the comparator then, in the UK, we see the FTSE 100 Index showing a dividend yield of 3.95% and the government bond showing a gross redemption yield of 1.57% (31 May). In the USA, we see the S & P 500 Index showing a dividend yield of 2.7% and the US Treasury bond showing a gross redemption yield of 1.58%. In Germany, the DAX 30 index shows a dividend yield of 4.2%, whilst the Bund shows a gross redemption yield of 1.21%. In Japan, the Topix shows a dividend yield of 2.6% and the Japanese government bond shows a gross redemption yield of 0.83%. These relationships are the opposite of what investors have come to expect and they represent, in the case of bonds, the size of the distortion in the markets caused by the present economic background. So, something is wrong. Either companies are going to face a catastrophic decline in their fortunes, rendering the current dividend yields academic, or bonds are severely over valued and, as we have suggested above, we think it is the latter. If we look at price/earnings ratios for the different markets, we see modest multiples. If earnings were about to fall off a cliff, then the attractive dividend yields and modest price/earnings ratios would be meaningless, but we do not think that this is going to happen. An advantage of equities is that by investing, for example, in multinational companies, the geographical and economic risk can be spread. Whilst all the attention is focused here on the eurozone's woes, elsewhere the world economy is performing reasonably well even though there are fears about an economic slowdown in China. So, in our view, these positive arguments for equities as an asset class outweigh the negative ones. Volatility is inevitable, as we have warned before in our reviews, but, for long term investors, this is the class of asset which, to us, offers value.

Before we turn to look at issues in the major countries and regions, it is instructive to look at the latest OECD Economic Outlook No 91, just published. In the current unsettled economic environment, projections are more than usually prone to uncertainty but are, nevertheless, useful in pinpointing strong and weak areas of the world economy. Its forecast for world trade growth this year is 4.1% against 6.0% in 2011, with a recovery to growth of 7.0% in 2013. It sees economic growth of 2.4% in the USA this year, up from 1.7% in 2011, and forecasts a modest acceleration to 2.6% next year. The euro area is projected to contract by 0.1% this year after 1.5% growth in 2011 and to grow by 0.9% in 2013. UK growth is projected to be just 0.5% this year after 0.7% in 2011 and is projected to rise to 1.9% in 2013. Japan is expected to make some recovery after the terrible natural disasters in 2011, which caused the economy to contract by 0.7%. The OECD projects growth of 2.0% this year and 1.5% next year. As so often in recent times, it is the BRIC countries and other Asian economies which are expected to lead the way. Whilst the Brazilian economy has slowed down considerably since the 7.6% growth rate of 2010 and is projected to grow by 3.2% in 2012 and 4.2% in 2013, China is forecast to grow by 8.2% this year, a slowdown on the 9.2% rate of 2011 and it is then projected to accelerate to 9.3% in 2013. India, which has seen some disappointing news recently in terms of growth and erratic decision making which threatens foreign direct investment in the country, is projected to grow by 7.1% this year and 7.7% next year. Russia's growth rate is not projected to vary very much from recent figures, 4.5% this year and 4.1% next year against 4.3% in 2010. Indonesia, an increasingly important economy, with its vast population, is projected to grow by 5.8% this year and 6.0% next year.

It is instructive to look at the breakdown of the eurozone's projections. Of the countries in the most trouble, Greece is projected to contract by 5.3% this year and 1.3% next year. Greece is obviously a very fluid situation and is a country widely expected to leave the eurozone shortly, but a contracting economy is not one that can be expected to get its house in order and service and pay off debts as they are due. Judging by government



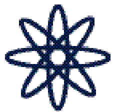
bond yields, the country next in the order of trouble is Portugal. Here, again, the projections spell trouble. The economy is projected to contract by 3.2% this year and 0.9% next year. The expectations for Ireland are slightly more optimistic with very modest growth of 0.6% projected for this year and 2.1% next year. The other two eurozone members about which there is heightened concern at present, Spain and Italy, are projected to contract by 1.6% and 1.7% respectively this year and by 0.8% and 0.4% next year. If these projections are broadly accurate, contractions in economic activity are going to make the task of restoring public finances and attracting confidence in these countries' debt markets difficult. Austerity measures, if there is no flexibility in the exchange rate, exacerbate the downward economic spiral. The Netherlands, an AAA rated credit, is projected to show an economic contraction of 0.6% this year and growth of 0.7% next year. Of the big two, Germany and France, Germany is projected to grow by 1.2% this year and 2.0% next year, whilst France is projected to grow by 0.6% this year and 1.2% next year, So, not unexpectedly, in view of all that has gone on in the eurozone, the outlook for growth this year and next is poor.

As the OECD's latest projections show, however, the news is not totally bad with some areas of the world continuing to perform well, and these areas are economically very important. As always, it is important for investors to look at the worldwide picture and, difficult though it is to avoid considering the eurozone's woes as representative of the world picture, it is not. Many companies are performing far better than the countries in which they are domiciled.

We now move to individual countries and regions and examine some of the recent news and relevant issues, starting with the USA.

In normal circumstances, much of the economic attention would be focused on the USA, this being election year, with particular reference to its debt problems. However, this seems to be secondary to the crisis which is engulfing the eurozone. The USA's debt problems are bad now but threaten to cause major problems later on as entitlement benefits rise. Decision making is currently paralysed in the USA in front of November's elections. A major part of the problem is that, with the different parties controlling the executive and legislature, and with a poisonous atmosphere pervading US politics, relevant action is next to impossible. The ugly debt ceiling standoff last year is indicative of this. At present, investors' eyes are not focused on the USA's debt problems, and the USA, as our bond table at the beginning of this review shows, is able to borrow at extremely low interest rates. The budget balance in the USA, according to The Economist's table of forecasts, is -7.6% of GDP this year, an uncomfortably large figure. Like the UK and Japan, the USA has the inestimable advantage of issuing its own currency and being able to control its own interest rates as well as indulge in quantitative easing. As we see from the OECD's projections, it is expecting modest growth this year and next, 2.4% and 2.6% respectively, which, together with Canada, puts it at the top of the G7 countries' growth prospects.

However, one issue in the USA is beginning to come to the fore in economists' thinking and this is the so called "fiscal cliff", which could take effect next year. This "fiscal cliff" comprises tax rises through the expiry of the Bush era tax cuts, payroll tax and employment benefit rises through the ending of concessions and mandatory spending cuts which formed part of the settlement after the debt ceiling standoff in 2011. The estimated effect on the economy varies, but ranges of 3.5% to 5.0% of GDP have been quoted. This represents an enormous fiscal adjustment which threatens the USA's growth prospects. There is no question that the USA must address its fiscal problem. It is just that such a dramatic drag on GDP would be counterproductive. Ideally, the adjustment would be achieved more slowly, consistent with a credible medium and long term plan for controlling public spending and, hence, addressing the deficit issue. The chasm between the Democrats and Republicans on the economy is enormous, with very little middle ground left. So partisan have become the politics, that rational thinking seems to be at a premium. That US politicians should be prepared to put the USA's creditworthiness at risk is hard to understand but that is what happened last year and, as a result, Standard & Poor's reduced its AAA credit rating. As it happens, because of what has happened elsewhere, the USA has been able to borrow at even lower rates, but

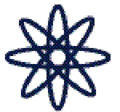


having a budget deficit of the current size is no cause for complacency. Although the US elections are five months away, it looks quite likely that the executive and legislature will be divided between the parties. The checks and balances in the US political system do not make for decisive economic action, such as the Westminster system of government makes possible. It must be hoped that there is not another debt ceiling standoff, which did so much harm to the USA and the stock markets for a time last year. At the moment, it is an issue to note.

Individual items of news from the USA have, generally, been modestly encouraging, although this was against the background of revised downwards annualised growth of 1.9% in the first quarter, a slowdown compared with the 3.0% annualised growth figure for the fourth quarter of 2011. The modest growth of the U.S. economy can be gauged from a number of indicators. The market was disappointed by the downward adjustment to first quarter GDP growth, from 2.2% to 1.9% and this coincided with some rather weaker individual items of data. The latest May payrolls figure came in below expectations with only 69,000 jobs created, many less than expected although some of the explanation may lie in the unusually good winter which benefited earlier readings. Consumers appeared to feel less confident. The Conference Board's consumer attitudes index fell to 64.9 in May from 68.7 in April. The purchasing managers' Index for manufacturing for May came in at 53.5 against 54.8 in April whilst that for the non manufacturing sector was 53.7 against 53.5 in April. Industrial production for April was 0.8% higher than the March level whilst new orders were unchanged over the same period. There was some slightly better news from the housing sector. The National Association of Home Builders reported that its sentiment index rose from 24 in April to 29 in May, whilst housing starts rose by 2.6% in April, following an upward revision to March's figures. There was also some modestly favourable news on inflation and on drivers of inflation. The latest unit labour cost figures showed unit labour costs to be rising at an annualised rate of 2.0%, whilst the latest Consumer Price Index showed a decline in the annual rate of inflation from 2.7% in March to 2.3% in April. These series of data indicators fit in with the IMF's projections of economic growth in the U.S.A., but we must bear in mind the outcome of the "fiscal cliff" problem we mentioned earlier.

Against such a troubled background for the eurozone, it is difficult to find any good news. Germany, of course, stands out as being in relatively good shape, although slowing down, but, elsewhere, the news is grim with, as we saw earlier, several countries facing economic contraction this year and next, at the very least. Eurozone growth was flat in the first quarter. Unemployment is a very serious problem in parts of the eurozone, especially for the young who are victims of highly regulated labour markets. Loosening these regulations is one of the major supply side reforms being urged on the troubled countries. In March, eurozone unemployment reached 10.9%, up from 10.8% in February. In Spain, unemployment is at the scarcely believable level of 24.1% with over half of young people out of work. Another weak feature is industrial production which fell by 0.3% in March. The European Commission's consumer confidence indicator was very weak in May, at -19.3, although it was very slightly better than April's level of -19.9. Markit's eurozone composite Purchasing Managers' Index fell to 45.9 in May from 46.7 in April, well into negative territory and the fastest pace of decline since June 2009.

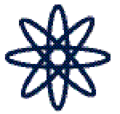
The strongest economy, Germany, is, to some extent, insulated from the worst of the eurozone troubles by virtue of its economic profile and successful export markets. Its economic growth rate in 2011, 3.1%, was far higher than any of its major eurozone competitors and its first quarter of 2012, 0.5%, is also relatively good but, as the OECD forecast for 2012, 1.2%, indicates, the economy is slowing down quite rapidly. On the relatively positive side, German retail sales rose by 0.8% in March. This was a little lower than expected but, in the eurozone context, a good result. Factory orders rose by 2.2% in March, an acceleration on February's figure of 0.6%. As one might expect, this was not due to any strength in orders from other eurozone countries but, rather, from outside, an advantage which Germany has over its eurozone counterparts. Germany's exports rose by 0.9% in March and imports rose by even more, 1.2%. Industrial production rose by 2.8% in March, compared to a fall of 0.3% in February. On the negative side, Germany's composite purchasing managers' index fell from 50.5 to 49.6 in May, whilst Ifo's business sentiment index fell to 106.9 in May from 109.9 in April. Germany's relative economic strength is apparent but effectively underwriting other eurozone's country's debts, as some others would have it, is a different matter.



The second largest eurozone economy, France, has, of course, had its presidential election and its parliamentary elections will be held in June. The election of a President with quite different views to Mr Sarkozy has made for a difficult start in the relationship between France and Germany. Whilst there were often problems with the "Merkozy" relationship, France does normally try to speak with one voice as far as Germany is concerned. Now the "growth" angle which Mr Hollande is promoting, along with other southern eurozone countries, has put France at odds with Germany. All the evidence points to France losing economic ground against Germany. For nearly 40 years it has failed to balance its budget because of lack of control over spending. Its estimated budget balance, according to The Economist, this year is -4.7% of GDP compared with -1.3% for Germany. The estimated current account deficit for this year, according to the same source, is 2.0% of GDP, whereas Germany is forecast to have a surplus of 4.8%. Its economic growth rate has been lagging that of Germany. Embarrassingly, earlier on Standard & Poor's downgraded its sovereign credit from AAA. Whilst Mr Hollande has committed to last December's treaty deficit reduction plans, albeit one year later, he has indicated that France will not ratify the treaty without a growth element added to it. Compared to Germany, it is very hard to be optimistic about France. At about 55% of GDP, the public sector swamps the private sector. There is an antipathy to business. There are plans to raise taxes on large companies, with a surcharge for the banks, a plan to take on more civil servants and also a plan for more taxes on those deemed to be wealthy, with a proposed marginal rate of tax of 75% on those with incomes of over □1,000,000 and an increase in the wealth tax. The tax and spend policies offer no prospect of getting growth going again, whilst the complete absence of supply side reforms, such as those successfully introduced by Germany when Gerhard Schroeder was Prime Minister, is another constraint on growth. One would expect the exodus of wealth creating entrepreneurs from France to accelerate. Whilst it is difficult to feel optimistic about France's economic prospects compared to those of Germany, France remains the home to world class companies whose fortunes do not depend unduly on what happens in France.

As we have indicated before, it is important to distinguish between the fortunes of individual countries in the eurozone and the companies domiciled in them. The latter can still prosper even whilst the former still struggle and remains a reason why we still invest in companies based in the eurozone.

At some stage in the future, investors will turn their attention to Japan's public debt problems. Japan relies relatively very little on foreign purchasers of its debt so it has some insulation from the problems affecting weaker eurozone sovereign credits. In the short term, Japan is performing better than a number of major industrialised countries. In the first quarter, the Japanese economy grew by 1.0%, after it had been flat in the fourth quarter of 2011. The natural disasters of March 2011 have distorted Japan's economic statistics. One of the drivers of this growth was private consumption, which increased by 1.1%. Public investment rose by 5.4%, partly because of reconstruction work after the earthquake and tsunami. The 2.0% growth rate for this year projected by the IMF stands up relatively well, given the international economic background, but the country faces enormous problems with its public finances. Only about half of government expenditure is financed by taxes and its gross level of public debt as a percentage of GDP is over 230%. Because most of the deficit is financed by domestic investors, about 93%, it has not, up to now, been a problem and, having its own currency, has given it flexibility, which eurozone members lack. Traditionally, Japan has run a current account surplus but, partly as a result of having to import more fossil fuels, it is not impossible that it could move into deficit. Its large foreign exchange reserves are, of course, a big buffer for Japan, but problems are looming. The Economist's estimate of its budget balance this year is -8.1% of GDP. Like the USA, although for different reasons, political decision making is paralysed. Japan needs major supply side reforms, but there is no will to carry these out. A rise in Japan's low rate of consumption tax, 5%, has been put forward as a way to start to address the serious budgetary situation but the move is not gathering traction. With businesses and consumers showing caution, notwithstanding some modestly encouraging first quarter economic numbers, and no inflation, further quantitative easing measures are not likely to be effective, especially with interest rates as low as they are. Against a background of politicians unwilling to make radical supply side reforms, which Japan so badly needs, it is difficult to be optimistic about

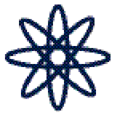


Japan's medium and long term economic outlook but, as with the eurozone, it contains world class companies that should attract investment.

As the west, and Europe, in particular, wrestle with poor economic conditions, hope increasingly rests with China as a country which can stop the world economy moving into recession. As the second largest economy, and with a growth rate of which the major industrialised countries can only dream, all eyes are focused on China. As the OECD projections show, there is an expectation of an economic slowdown this year compared with 2011, 8.2% against 9.2%, but with a recovery to 9.3% next year. China has shown itself adept at managing its economy to deal with particular issues as they arise. In the field of monetary policy, frequent changes in interest rates and bank reserve requirements, as well as administrative measures, have been favoured. Whilst the Chinese authorities have indicated a new target growth rate of 7.5% for the Chinese economy, they will hope to exceed this. For the moment, the data has been on the disappointing side. For example, first quarter GDP year on year growth slowed from 8.9% the previous quarter to 8.1% and the rate of increase in industrial production slowed quite significantly in April, with the year on year increase down to 9.3% compared with 11.9% in March. Fixed asset investment slowed slightly for a year on year increase in April of 20.2% compared with 20.9% in March. Retail sales growth slowed to 14.1% in April compared with 15.2% in March. Bank lending also fell quite sharply. Import and export growth has also slowed down. Imports in April were just 0.3% higher year on year, whilst exports were 4.9% higher. For March, the figures had been 5.3% and 8.9% respectively. Other indicators of slowing growth are the level of electricity consumption, crude steel production and lower levels of real estate investment. The Chinese Premier has indicated that measures will be taken to stimulate the economy. Infrastructure approvals are being speeded up to bring forward the start of construction from the previously planned start dates. Investors should be able to draw encouragement from the action being taken by the Chinese authorities and, just as this review was being completed, it was announced that China had cut its one year benchmark lending rate by 0.25% to 6.31%.

The measures being proposed by China are in stark contrast to the messages for the foreign investors coming out of the other giant economy in Asia, India. Political paralysis appears to have gripped the country and this has deterred foreign investors. For example, having lost in the Supreme Court a case to try to extract some capital gains tax from Vodafone on a transaction carried out outside India, the Finance Minister has made new proposals to levy taxes on such transactions retrospectively to 1962. The messages coming out of India for foreign investors are very discouraging and, ultimately, will affect the economy's growth potential and its ability to influence the international economy.

In the UK, as was always going to be the case, the coalition government has run into heavy political weather and the concern is whether, in an effort to recover popularity, it will try to spend its way out of trouble. We think this unlikely as the government would lose all credibility if it did so. Any government, particularly one which is unpopular, is an easy target for criticism. In the case of the UK, where public finances are in a very serious state, unpopular measures have to be taken and criticism will always gain traction. Whilst not in the eurozone, events there will continue to cast a big shadow over the UK economy. With measures having to be taken to tackle the UK's unacceptably high level of borrowing, the government needs economic growth, but events in the eurozone look like derailing its hopes. The idea that slowing down the pace of retrenchment is a magic bullet for the UK economy is fanciful. Borrowing more now, to borrow less in the future, to stimulate economic activity, is a dangerously seductive argument which the markets are unlikely to wear. In the current economic gloom, the UK has two advantages. Although public expenditure continues to rise, the automatic stabilisers come into play and the Chancellor is not trying to offset these. Automatic stabilisers refer to the effects on government revenues and expenditures arising from economic strength and weakness. So, at the moment, with the economy depressed, government revenues suffer and expenditure on items like unemployment benefit rise. But, in good times, and this is what the UK did not do, the benefits should be banked and, ideally, the government should run a surplus. The UK disengaged the automatic stabilisers at that time. Foreign investors understand this and they are willing to buy UK government debt at extraordinarily low interest rates. That is helpful in terms of debt servicing charges. If we look at the yields on troubled eurozone government bonds, it can be seen that these economies cannot



possibly grow at rates which will enable them to service these debts. The second major advantage relates to it not being a member of the single currency and thereby retaining the ability to manage its own monetary policy. This does give it the flexibility to do things which eurozone governments cannot, since monetary policy is under the control of the ECB. Whilst the UK does not have the USA's important advantage of having the US dollar as the world's largest reserve currency and, therefore, a vital component of other countries' foreign exchange reserves, it is still a major benefit in terms of flexibility.

There is no doubt that the UK is bumping along the bottom and that the problems in the eurozone are very unhelpful. First quarter GDP has been revised down to -0.3% from -0.2%. The Bank of England has cut its growth forecast for the UK economy for 2012 to 0.8% from 1.2%. Against this background, it is no surprise that much of the data coming out of the UK economy is soft. The latest readings of the purchasing managers' index for manufacturing fell to 45.9 in May from 50.2 in April. The British Retail Consortium reported that sales were down by 3.3% in the year to April. Manufacturing stagnated in the first quarter whilst construction activity was 4.8% down in the first quarter of the year. Although house prices are strong in London, there are further overall signs of weakness. For example, Halifax says that the average price of a house dropped by 2.4% in April to be 0.5% lower year on year, whilst the Nationwide reported a 0.2% fall in April to be 0.9% lower year on year. One slight glimmer of hope came from the fall in inflation which, on the Consumer Price Index measure, fell to 3.0% in April, down from 3.5% in March. This trend, if continued, should release some of the pressure on disposable incomes and give some help to consumption which has been weak.

But, before we become too depressed about the UK's prospects, at least for the equity market, we should remember that an estimated 70% of the FTSE 100's companies' business comes from outside the UK in areas which are performing better than the UK and Europe, such as the USA, Asia, Latin America, Middle East and some emerging markets. That is why the profits of UK companies have been holding up well, with positive implications for dividends.

Because of all the twists and turns in the eurozone saga, we must expect to see continued volatility in markets. Whilst countries and their central banks have expended a lot of their financial ammunition, some countries still have some firepower. China has started to use some by cutting bank reserve requirements and now interest rates. Where interest rates are already very low such as in the USA, UK and eurozone, there is little more which can be done by conventional methods, i.e. interest rates but non standard measures like more quantitative easing are still possible although their effectiveness is likely to diminish. This is desperate stuff but as we have said before, going back to 2009, cheap money and newly created money should be helpful to asset prices. If we are looking at securities markets, that is what has happened. It has made high quality bonds very expensive but equities still offer value particularly large multinational companies. We have to expect continued volatility and periods of market weakness but shares are the assets which, to us, offer value for those who are patient.

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