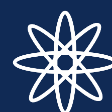

meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

It has been a solid, if unspectacular, quarter for international investors, building on previous positive returns. That is how we like to see it rather than very sharp rises which leave markets more vulnerable to a change in sentiment, especially if it is driven by speculative forces. Although a lot has been going on in the bond markets, the change in ten year government bond yields does not really tell the full story and this is discussed in our review. Currency movements have been smaller than in recent quarters whilst, in the commodity markets, oil and gold were little changed in price.

The tables below detail relevant movements in markets :

International Equities 27.02.15 - 29.05.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-1.8	-2.8	-4.0	-1.8
Finland	-1.8	-2.8	-4.0	-1.8
France	+3.8	+2.7	+1.5	+3.8
Germany	+0.3	-0.7	-2.0	+0.3
Hong Kong, China	+9.2	+10.7	+9.3	+11.8
Italy	+6.6	+5.5	+4.2	+6.6
Japan	+10.9	+8.2	+6.8	+9.3
Netherlands	+4.9	+3.8	+2.5	+4.9
Spain	+1.5	+0.5	-0.8	+1.5
Switzerland	+5.0	+6.9	+5.5	+7.9
UK	+2.1	+2.1	+0.8	+3.1
USA	+0.7	+2.0	+0.7	+3.1
Europe ex UK	+3.3	+2.8	+1.5	+3.8
Asia Pacific ex Japan	+1.4	+1.9	+0.7	+3.0
Asia Pacific	+6.2	+5.1	+3.8	+6.2
Latin America	+2.0	-3.8	-5.0	+2.0
All World All Emerging	+4.3	+3.6	+2.3	+4.6
The World	+2.1	+2.5	+1.2	+3.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : 0.3%

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

Currency	27.02.15	29.05.15
Sterling	1.80	1.92
US Dollar	2.01	2.11
Yen	0.34	0.40
Germany (Euro)	0.33	0.49

Sterling's performance during the quarter ending 29.05.15 (%)

Currency	Quarter Ending 29.05.15
US Dollar	-1.1
Canadian Dollar	-1.5
Yen	+2.5
Euro	+0.9
Swiss Franc	-2.2
Australian dollar	+0.9

Other currency movements during the quarter ending 29.05.15 (%)

Currency	Quarter Ending 29.05.15
US Dollar/Canadian Dollar	-0.4
US Dollar/Yen	+3.6
US Dollar/Euro	+2.0
Swiss Franc/Euro	+3.2
Euro/Yen	+1.6

Significant Commodities (US dollar terms) 27.02.15 - 29.05.15 (%)

Currency	Quarter Ending 29.05.15
Oil	+4.5
Gold	-1.9

MARKETS

International equity markets consolidated recent gains over the last quarter. In total return terms, the FTSE World Index returned 2.1% in local currency terms, 2.5% in sterling, 1.2% in US dollars and 3.5% in euros. Looking at local currency returns first, the stand out area was Japan with the FTSE Japan Index returning 10.9%. There was a slightly above average performance from the FTSE Europe ex UK Index which returned 3.3%, with Italy and Switzerland the two best performers with the respective FTSE indices returning 6.6% and 5.0% respectively. The FTSE UK Index performed exactly in line with the FTSE World Index but the USA underperformed with the FTSE USA Index returning 0.7%. Emerging Markets performed well with the FTSE All World All Emerging Markets Index returning 4.3%. The FTSE Australia Index underperformed world markets with the index showing a return of -1.8%. If we look at the indices in sterling terms, a slightly stronger US dollar reduced the underperformance against the FTSE World Index with the FTSE USA Index returning 2.0%, very slightly below the FTSE World Index. Although the yen weakened slightly, the FTSE Japan Index still put in a very good performance, returning 8.2%. The strength of the Swiss Franc raised the sterling return on the FTSE Switzerland Index to an excellent 6.9%. Hong Kong, China was an excellent market returning 10.7% in sterling terms but slight weakness in the Australian dollar meant a negative return of 2.8% in the FTSE Australia Index.

Government bonds experienced a very volatile quarter, as measured by ten year benchmark bonds, although this is not very apparent from the change in gross redemption yields over the quarter. The yield on the UK gilt rose by twelve basis points to 1.92%, on the US Treasury by 10 basis points to 2.11%, on the Japanese government Bond by 6 basis points to 0.40% and on the German Bund by 16 basis points to 0.49%.

Currency movements were relatively modest over the quarter. Against the US dollar, sterling weakened by 1.1%, against the Canadian dollar by 1.5% and against the Swiss Franc by 2.2%. On the other hand, it rose 2.5% against the yen, and by 0.9% against both the euro and Australian dollar.

In the commodity markets, oil, as measured by Brent Crude rose by 4.5% but gold fell by 1.9%.

ECONOMICS

Although there are plenty of political and economic issues which could be expected to disturb the equilibrium of stock markets, most of them have been around for some time and one would expect them to be discounted by investors. An uneventful quarter for international equities, if not for bonds, supports this view. If any new serious political or economic news had emerged, which had not been factored into investors' thinking, then it may have been a different story. On the political front, therefore, the Middle Eastern and Russia / Ukraine crises persist and, on the economic front, the Greek economic crisis continues with the threat which this poses for the eurozone. It always appears that the end game is in sight for the Greek crisis but somehow it manages to take another twist and turn and so one is cautious about saying that an outcome one way or another is imminent. The problems of the eurozone are a continuing economic theme with Greece the main immediate issue in the short term but plenty of fundamental issues in the longer term. Even though the details of the

crisis are completely in the open, it would be an optimist who suggested that the stock market could shrug off the consequences of a Greek default and possible exit from the eurozone.

So, it is against this background that equities have held steady during the last quarter ending up, in many cases, at around their all time highest levels. For bonds, however, it has been a different story with large gyrations in prices which will have unsettled investors. We have long indicated in these reviews that we regard bond prices as dangerously extended and that they have become much higher risk investments than has been the received wisdom in the past. In our view, a blow out in the bond market, with its associated fall out, is one of the biggest risks for securities markets generally. The further along the yield curve one travels, the greater the risk. At the short end of the market, the risks are obviously very low. Unless bonds are bought on a negative gross redemption yield, there will be a very small return if held to redemption but there will be an opportunity cost risk. The further out along the yield curve, there will be a very significant chance of a capital loss on the bond, if it is sold, or a substantial opportunity cost if held to redemption, assuming, of course, that the bond was purchased on a positive gross redemption yield. Although it is an extreme example because it is a long dated issue coming off a very low yield, in a recent price cycle of 23 days the price in euro terms of the 30 year German Bund, at its most extreme movement, fell from €159.228 to €127.887 representing movement of 19.7%. This is a magnitude of movement more commonly attributed to equities. Even though bond yields have risen during the quarter, the yields shown in the table at the beginning of this review are still extraordinarily low by historical standards and, if the gross redemption yields shown were to be acceptable on a ten year view (those yields relating to ten year bonds), one would have to be an extremely pessimistic investor. The fact that we largely know why yields are so low does not make them any more valid. Low interest rates have been driven by central bank administered interest rates at the short end of the market and quantitative easing at longer maturities. But it is a dangerous game to play to buy or hold bonds on the basis that the central bank will always be there buying up government (or other) bonds. For example, since the ECB started its quantitative easing programme in the eurozone in March, eurozone bond yields have risen. This might seem counter intuitive but, on further reflection, one could argue that QE in the short term might be expected to stimulate economic activity and, in due course, inflation, as well as weaken the exchange rate, so higher interest rates and bond yields would be logical even if there was a big buyer of bonds in the market - the relevant central bank.

For investment models for a balanced portfolio, bonds are traditionally considered to be the low risk and low volatility component of a portfolio to offset the higher risk and higher volatility equity element. We do not consider this assumption is valid in the conditions which have prevailed since the 2008 financial crisis where extreme monetary policy has been implemented, driving down yields to levels which one scarcely believed to be possible. It would be one thing if it was felt that this was to be the new norm for interest rates but we do not think that this is a realistic assumption. If we are correct and interest rates do eventually move higher towards more normal historical levels then there are going to be some big losses made in the bond market. The recalibration of yields towards more normal levels would be painful enough if it occurred in an orderly fashion. However, the extent of the overvaluation of bonds is such that one can see a sudden realisation of this amongst certain investors leading to a sudden rush for the exit. Open ended funds facing a high level of redemptions would become forced sellers and, with liquidity lower in the market than it used to be because of tougher regulatory requirements on banks, price movements could be very sharp.

In looking at the justifications for the level of bond yields, besides central bank buying under quantitative easing programmes, the prospect of deflation was another one. If price levels are falling, then a nil yield will mean a real return. So, the question is whether deflation or very low

inflation is to become a permanent feature of the landscape or whether it is a transitory phenomenon. Although other areas or countries, like the UK, have experienced or are experiencing deflation, the main area of concern is the eurozone, although, as we will touch upon later in this review, the picture is looking a little more promising in that respect. That may seem a very odd thing to say when most people have spent more time worrying about inflation. A fall in prices might seem an unmitigated blessing. But it is not and it depends on what has caused deflation in the first place. There is "good" deflation and "bad" deflation. "Good" deflation occurs when, as at present, prices fall because, for example, commodity prices decline or productivity increases as firms become more efficient and can reduce prices in a competitive market. With wages, at least static, this can raise real incomes and increase demand in an economy. This will make one of the disadvantages of deflation, a real increase in the burden of liabilities, less dangerous. This is "good" deflation but there is also "bad" deflation. This is what, for example, we have seen in Greece. The weak state of Greek finances and the need for a bail out necessitated cutbacks in government spending which included pay cuts. Austerity measures, therefore, drove down domestic demand and the need to make an internal devaluation to combat the loss of competitiveness, which had built up over many years, drove down costs. The normal safety valve, a currency devaluation, is not available to countries in a currency union. This is "bad" deflation since it threatens a downwards economic spiral. There is no boost to demand coming from rising real incomes as in the first example of deflation. In this case, the dangers of bad debts increase as individuals and businesses are less able to service their debts and are more likely to default. At the government level, tax revenue suffers and the burden of public debt increases which may, in extreme circumstances, lead to a sovereign default. This is the denominator effect whereby, in a deflationary environment, nominal GDP can decline whilst nominal debt stays unchanged or rises leading to an increase in public debt as a percentage of GDP.

However, this "bad" deflation scenario is not generally applicable. Whilst the headline inflation rate is the one which catches most people's attention, the core inflation rate series is the more important one since it excludes volatile items like food and energy. At the moment, these volatile items have been dragging down the headline inflation rate but it is unlikely that these items are going to be permanently depressed in price. Indeed, the oil price has staged quite a smart recovery from its low point which will in time boost the year on year headline figures as the comparisons become less favourable. Core inflation in the UK is 0.8%, in the USA 1.8% and, in the eurozone, 0.9%. If it is correct to say that deflation is unlikely to be a problem and that modest headline inflation numbers will be the norm, then this removes a prop from the argument supporting current levels of bond yields. The problem of very low or negative bond yields is most pronounced in Europe. However, one effect of quantitative easing has been to weaken the euro and this action will result in an increase in inflationary pressures. The recent volatility in bond prices, especially within the eurozone, is a warning of events to come in the bond markets, probably particularly the eurozone bond markets. It also shows that quantitative easing does not automatically mean that bond yields will fall when it is being undertaken. Whilst the changes in the bond markets' yields as shown in the tables at the beginning of this review might not seem too remarkable, the base off which the yield movements have occurred have been so low that the changes in yield have proportionately been significant and meant sharp price movements particularly in German Bunds.

We have pointed out in recent reviews that the phenomenon of bond and equity prices rising at the same time is unusual and both markets cannot be right. If bond yields are falling, one would expect this to presage deteriorating economic growth prospects, perhaps even a recession or worse, in extreme circumstances, a depression. On the other hand, rising share prices would suggest that investors are optimistic about economic growth. Although, as we have just said, bond yields can rise when quantitative easing takes place, as has just been happening in the eurozone and Japan, the

prospect of it happening can also drive yields down. So, when it was announced in January that the ECB would undertake quantitative easing, starting in March, investors scrambled to buy eurozone government bonds in anticipation of the start of the programme. With deflation looking less likely as a continuing problem and slightly better economic data emanating from the eurozone, bond yields have started to rise and so we have seen the start of a diverging performance between equities and bonds. Because we have been expecting modest international economic growth and not a recession, we have sided with equities as giving the correct signal and we still maintain that view.

In assessing the economic outlook for the world economy, the fall in commodity prices, particularly oil, has been an unexpected bonus and, as discussed earlier, has contributed to "good" deflation where that exists or to very low inflation elsewhere. Of course, it is a mixed picture and has been bad news for oil producers but for oil importers it has been excellent news. This gives credence to various organisations' economic forecasts of moderate economic growth this year and next. In April's World Economic Forecast from the International Monetary Fund, it projected world economic growth of 3.5% this year, a slight increase on last year's rate of 3.4%. It expected a moderate acceleration in 2016 to 3.8%. Leading the way, it expects, will be the USA where growth is expected to accelerate from 2.4% in 2014 to 3.1% in 2015 and for it to hold that rate in 2016. This projection was made before the very disappointing first quarter growth figures which have now been revised to show a negative figure (annualised at -0.7%). Some recovery is expected in the eurozone to 1.5% in 2015 from 0.9% in 2014 and to 1.6% in 2016 but this growth, if it occurs, will not be strong enough to make a dent in the debt problems of the eurozone. For Japan, the forecast is rather disappointing given all the money thrown at the economy by "Abenomics". The IMF forecasts growth of just 1.0% this year and 1.2% next year. The country needs far faster growth than this to make a dent in its debt profile. The UK, having performed best of all the G7 economies in 2014 with growth of 2.6%, is forecast to grow at 2.7% this year and 2.3% next year which will put it in second place behind the USA for both years. A higher growth rate would be preferable but, if accurate, the projections are just about satisfactory for the USA and UK although this cannot be said for the eurozone and Japan.

Although Emerging Market and Developing Economies will show a much higher growth rate than that of Advanced Economies, with the IMF projecting growth of 4.3% this year and 4.7% next year against 2.4% for Advanced Economies for both years, it is a mixed picture. If we look at the BRIC countries, Brazil and Russia are experiencing very difficult times. Both are affected by weak commodity prices. Brazil has to start addressing the problems created by poor economic decisions taken in the past with a high degree of political meddling and policy decisions which were quite clearly wrong for the economy. It has to address very large current account and budget deficits and high inflation. Russia's economy is unbalanced with it being over dependent on the energy industry and it has been badly affected by the fall in price of oil. This is before the sanctions imposed on the country as a result of its actions in the Ukraine, so the IMF forecasts an economic contraction of 1.0% for Brazil this year and growth of 1.0% next year, a far cry from a growth rate of 6.0% in 2007, 5.0% in 2008 and, after a contraction of 0.2% in 2009, growth of 7.6% in 2010. Economic forecasts for Russia are even more problematical because of economic sanctions. After growth of 0.6% in 2014, the latest IMF projections suggest a contraction of 3.8% this year and 1.1% next year but there has to be a huge element of guesswork in this given so many political and economic variables.

In economic numbers, China and India look so much better than Russia and Brazil, as we would expect for oil importers as well as many others. Both countries benefit from the fall in the oil price, the opposite of the position in Russia and Brazil. They have different issues. Whilst the IMF's

projections of 6.8% growth in China this year and 6.3% next year are way above those of any advanced economy, they represent quite a fall from the double figure growth rates seen previously, the last being 10.4% achieved in 2010. There are reasons for this as the country moves away from fixed asset investment and downplays exports towards consumption, thereby raising the quality of its growth. A new government in India, with much more of a pro business attitude and a positive attitude to supply side reforms, has given investors more confidence although concern about retrospective tax demands on foreign companies has weighed heavily on foreign investment attitudes to India. The IMF sees economic growth of 7.5% this year and next in India against 7.2% in 2014.

We also have the 2015 spring forecast from the European Commission to give an additional view on the world economy. Its forecasts for the USA are much the same as those from the IMF. It sees growth of 3.1% this year and 3.0% next year. For the eurozone, it sees growth of 1.1% this year and 1.4% next year, rather less than the IMF's projections of 1.5% and 1.6%. For the UK, it sees growth of 2.6% this year and 2.4% next year, close to the IMF's projections of 2.7% and 2.3% respectively. For Japan, it sees growth this year of 1.1% and 1.4% next year, close for this year to the IMF but more optimistic next year (1.4% against the IMF's 1.2%). The last forecast from the ECB in March was for eurozone growth this year to be 1.5%, for 2016 to be 1.9% and, looking further out, to be 2.1% in 2017, the projections for this year and next being in line with those of the EC.

Whilst these forecasts are nothing to be excited about, if they are accurate, they are just about acceptable as a background which is supportive to equity prices. What is, or, at least, should be, a fundamental concern for economists, politicians and central bankers is that this very modest projection for world economic growth is only made possible by levels of interest rates which, in previous years, would have been considered inconceivable. Monetary policy must almost have reached the limit of its power to stimulate economic growth, given very low, non existent and, in some countries or areas, negative interest rates. When interest rates are at a meaningful level, movements can have a noticeable effect on an economy, one way or another. That power to influence an economy is almost non existent at present. Quantitative easing may have some effect as money supply increases or it depresses an exchange rate, making the country or area more competitive, and one can see some early but tentative signs that this is happening in the eurozone, but it is an extreme measure with plenty of risks. For example, it distorts the balance between monetary and fiscal policy. If monetary policy loses its ability to be effective, as described above, and economies remain weak, then it puts the onus on fiscal policy. However, doing that, which would mean running a loose fiscal policy to try to stimulate an economy would risk a loss of confidence in an economy with consequences for medium and longer term interest rates and the currency. Whilst borrowers benefit from lower interest rates, it makes for difficult decisions for savers and, perhaps, unwise ones, too, in the search for investments which might provide the desired return. There is plenty of evidence that risk is being mispriced at the moment, the eurozone sovereign bond market being a good example. When risk is mispriced, dangerous consequences can ensue. The current level of interest rates can also affect companies and distort their behaviour. For example, the quantum of pension fund liabilities rises as the rate of interest used to discount them falls. A diversion of companies' funds from investment to the plugging of their pension deficits has a negative economic effect. In a perverse way, cheap money has encouraged companies to hold back on investment in favour of the short term benefits of repurchasing shares. This has been helpful to share prices and it may be that company directors feel that they cannot justify increasing capital investment at present because economic prospects do not justify it. However, such decisions, whilst they may be perfectly justifiable, do nothing for the long term potential growth

prospects of an economy. If they look at the modest longer term economic growth forecasts, they may wonder where are the economic policies which can drive higher economic growth given that monetary policy can offer very little more and fiscal policy initiatives to take up the slack from monetary policy are fraught with danger as described above. If we look at the latest IMF longer term projections out to 2020, we see the growth projection for that year to be 4.0% compared with 3.5% this year. If we look at the forecast for advanced economies in 2020, it is actually lower at 1.9% compared with 2.4% for this year. Within that definition, the USA is at 2.0% compared with 3.1% this year, the eurozone remains at its 2015 projected level of 1.5% whilst Japan slips to just 0.7% against 1.0% this year. None of the seven largest eurozone countries is projected to grow by even 2.0% in 2020. The UK fares better but even its 2.1% forecast growth for 2020 is less than the IMF's expectations of 2.7% this year. Of the advanced economies, Taiwan at 4.2% and South Korea at 3.7%, are forecast to be the leading economies for economic growth in 2020. It is to Emerging Market and Developing economies that the IMF, not surprisingly, continues to see the fastest rates of economic growth. Overall, the projection in 2020 for this group of countries is 5.3% against 4.3% this year with China at 6.3% (6.8% this year) and India 7.8% (7.5% this year) continuing to lead the way. So, the issue for investors to consider is what will be the catalysts for growth when monetary policy is being pushed to its extremity and has lost its power to stimulate economies?

Another reason for only modest growth projections is the debt overhang, public and private. As individuals and governments attempt to get on top of their excessive borrowing levels, aggregate demand suffers. Although it is too early to be sure, there is some evidence that the surprising negative growth in the US economy in the first quarter (-0.7% annualised) is because the effective tax cut which arose from the fall in the oil price has been used by consumers to pay down debt rather than to increase spending. That is a rational decision in the face of the shock occasioned by the financial crisis in 2008 and its after effects on the world economy. However, as the UK, one of the most indebted economies, has shown, it is possible to achieve reasonable economic growth against such a background. Although there is a long way to go on eliminating the budget deficit, the UK has shown that it is possible to increase employment levels, reduce the budget deficit and produce reasonable economic growth against such an unpromising background. So, it is not impossible and therefore are there any clues from the UK's experience as to why this might be true? One important reason is the UK's flexible labour market. Although it is not as flexible as it was, it is still relatively so. There is less risk associated with increasing the number of employees in a company than there is, say, in Europe. That makes it easier to grow. Countries like France and Italy have highly regulated labour markets and this perpetuates unemployment and crimps demand as it keeps unemployment high. The introduction of more flexibility in the previously rigid Spanish employment market has helped a very bad employment market to improve, albeit still in a very bad state, and for the economy to start to grow again. The IMF forecasts economic growth in Spain this year of 2.5% against 1.4% last year and, if achieved, it will be by far and away the best performance amongst the largest eurozone economies. As economic growth is the best way to tackle excessive government borrowing, it follows that any policies governments follow to achieve this will be a positive factor. Emphasis on the supply side of an economy, whether it be Japan or the eurozone, will help to improve the long term growth potential of an economy. The UK has been relatively well placed in that respect. An enormous benefit for the UK has been that it has remained outside the euro and therefore has had flexibility on economic policy denied to those countries within the eurozone. Because the eurozone is such an important trading partner of the UK, the former's economic woes have dampened the demand for UK exports to the currency area and it is very difficult to see the eurozone carrying out significant supply side reforms over the next few years which would improve its potential growth rate.

Relating all of this to the stock market, the outlook for raising the world economy's potential growth rate is mixed and it is growth and its effects on profits and dividends which investors have to concentrate upon. Share prices from a low base have risen way in excess of economic growth since the 2009 recession and this phenomenon cannot go on happening indefinitely. Share prices reached their trough in March 2009. To be more confident, we have to see supply side reforms, deficit and debt reduction and increasing business investment. If we see these features of the world economy, we can be more optimistic that the international equity market is well underpinned. This is a medium/long term issue for owners of shares.

The US equity market hovers around its all time high, relatively unperturbed by the first quarter's poor GDP figures (-0.7% annualised). First quarter US growth estimates are treated with some suspicion because they have not always reflected the trend of the whole year with seasonal adjustments sometimes cited as the issue and, for the last two years, the weather has disrupted the US economy. To reach the IMF's 3.1% projected growth rate this year, the US economy will have to pick up some speed over the next three quarters. Currency movements have been unhelpful with a strong US dollar adversely affecting the competitiveness of manufacturers. The latest purchasing managers indices from the USA were slightly higher than those of the previous month. The index for manufacturing stood at 52.8 (51.5), whilst that for non-manufacturing strengthened to 57.8 from 56.5. Overall, these high value indicators suggest a better picture of the US economy than those numbers for first quarter GDP. Industrial production has been disappointing, having declined slightly in March and April. Unemployment has fallen 0.1% to 5.4% in the latest figures for April continuing a steady draft downwards albeit with the usual caveat that the labour participation rate is low thereby making the headline unemployment rate less impressive than it is. Retail sales have also been disappointing, the latest month on month figures showing no change. The Conference Board's index of leading indicators crept up by 0.2% in its latest reading against an increase of 0.1% the previous month. There is better news from the housing market which has recently been subdued. In April, purchases of new homes rose by 6.8% on an annualised rate, a higher figure than expected. There was a slight increase in the pace of house price rises in March. The S & P/Case-Shiller index of property values in 20 cities showed a year on year increase of 5.0%, slightly higher than the 4.5% reported the previous month. Housing starts are also accelerating. Housing starts in April were running at an annualised rate of 1.14 million, the most since November 2007. Consumer confidence also seems to be increasing. The latest Conference Board consumer confidence index stood at 95.4 in May compared with 94.3 in April. We discussed the importance of business investment earlier and, in this context, there are some tentative signs of improvement. Capital goods orders (non military and excluding aircraft) rose by 1.5% in March and a further 1.0% in April. What these figures show is that, notwithstanding the disappointing first quarter growth figures, there are a number of indicators which belie that figure and suggest that the US economy is moving forward at a moderate rate.

Notwithstanding all of the issues bedevilling the eurozone, growth prospects look a little brighter this year and this hope has been manifested in a strong eurozone stock market performance so far this year. For those eurozone based companies with substantial export business which is price sensitive and those with large overseas operations, the weakness of the euro will be a great help and can be expected to stimulate some additional economic growth. The latest purchasing managers indices for April, although slightly down on the levels of March, still point to a modestly better outlook. The composite PMI in May stood at 53.4 compared with 53.9 in April. Within that figure, the index for services stood at 53.3 (54.1) and that for manufacturing at 57.2 (52.0). Although the eurozone's year on year consumer price index was flat and negative in countries like Spain and

Italy, the core level is positive and with the oil price having recovered from its lowest levels and the euro being a weak currency, it seems unlikely that the eurozone will sink into a deflationary state with all the problems this brings. There are other modest signs of improvement; for example, industrial production which, although down month on month in the latest figure, stands 1.8% higher than a year ago with Italy and Spain particularly strong performers, 4.3% and 4.8% respectively. However, no one should mistake this for the start of a turnround in the eurozone's problems. The single currency is at the root of much of the malaise and the lack of an adjustment mechanism, the exchange rate, for those countries in difficulty means that they are in a worse situation than if they had a flexible exchange rate. An unemployment rate of 11.3%, roughly double that of the UK and the USA tells its own story. Year on year real GDP growth in the eurozone is 1.0% and at least none of the four largest eurozone economies is registering a negative figure, although Italy is flat. Immediate issues surround Greece and how the country deals with its servicing of debt repayments which are due over the coming months. It is clear that the country does not have the money to repay its debts and the sooner all parties involved in the debt crisis take a realistic stance, the better. Because the euro is a flawed concept, there should be a recognition that countries can leave the monetary union in certain circumstances and Greece is the obvious candidate. Even though this would cause big problems in the short term, the flexibility of a country's own exchange rate offers a better long term solution if combined with sensible economic policies to match the situation. As we have seen from the recent Spanish local and regional elections, there is a lot of dissatisfaction with the austerity policies being pursued and the unemployment levels and the Greek election outcome gives an indicator that the catalyst for change may come from the electorates. On a completely different point, the volatility of the eurozone bond markets, to which we referred earlier, could also become an issue. Even after the rise in bond yields in the eurozone sovereign bond market, they look well away from fair value. Nevertheless, as we have said before when discussing eurozone equities, the companies must be separated from their sovereign when assessing eurozone shares' attractions. Just now, they have certain factors, like the currency, in their favour.

Japan has now worked its way through the effects of 1st April 2014 3% consumption tax increase to 8% which will drop out from the second quarter in year on year inflation figures although the effects on GDP will be much less precise. The year on year consumer price index to the end of March showed an increase of 2.3%. Once the consumption tax increase took place, its effect on the economy, as was to be expected, was immediate and is still showing up in the figures. First quarter GDP was 1.4% lower than a year previously. First quarter of 2015 GDP was 0.6% higher than the level of the final quarter of 2014 to give annualised quarterly growth of 2.4%. Industrial production was 1.7% lower than a year previously at the end of March and was down 0.8% month on month although this followed two quite strong positive months. The purchasing managers indices do not show a particularly strong story. The latest composite purchasing managers index stands at 50.7 implying hardly any growth. Within that figure, the index for manufacturing stood at 49.7 and that for services at 51.3. There is not much new to say about Japan. Its problems are well known, namely a vast level of public debt in relation to GDP (about 240%), a very large budget deficit (expected to be around 7.0% of GDP this year), terrible demographics and a history of deflation with all the negative implications for an economy which that brings with it. It has a rigid labour market and protectionist tendencies in some areas such as agriculture. A high risk/high reward economic experiment is being carried out under the guise of "Abenomics" with an extremely aggressive monetary policy being undertaken, including quantitative easing on a massive scale, together with an expansionary fiscal policy to get the economy moving before tax raising measures (the consumption tax) kicked in. The second phase of the increase, a rise of 2% to 10%, has been put back to 2017 from the planned date of this year in view of the greater than expected economic weakness last year. With the fall in the oil price (Japan is a big beneficiary of this because it is

a large energy importer), the 2% inflation target has become more difficult to achieve. This is important for Japan because a deflationary mindset discourages consumers from spending unnecessarily and businesses from investing. The aim of the inflation target is to reverse this mindset and get spending moving. Paradoxically, although the lower oil price should be helpful to Japan because it is a big oil importer, it makes the inflation target more difficult to meet. The third arrow of "Abenomics", supply side reforms, is vital. If an economy's growth prospects are limited by structural rigidities in labour and/or product markets, no amount of monetary or fiscal activism will have more than a short term effect. Structural reforms are often difficult to achieve because they come up against vested interests. In Japan, for example, the inflexible labour market makes it difficult for young people and women to enter the jobs ladder. In agriculture, the farm lobby is very powerful in the Liberal Democratic Party so reducing very high tariffs on imported rice, for example, is very difficult. But, if "Abenomics" is to work, the long term potential growth rate of the economy must be raised through supply side reforms. With such dreadful debt dynamics, economic growth is vital to start making inroads into the problem. That should provide more tax revenues and save some government expenditure. For many Japanese companies, the fall in the value of the yen has been helpful and they are gradually becoming more shareholder friendly, an example being dividend increases which can be afforded given many Japanese companies' very strong finances. With Japanese bond yields so low, Japanese dividend yields look compelling. There is, however, an important technical factor which could help the equity market tied to "Abenomics". The Japanese authorities have given instructions to public sector funds to switch allocations from bonds to equities. During the last two years, the Bank of Japan has purchased JPY2.8 trillion (US$23 billion) of exchange traded funds tracking the Japanese equity market. Last year, it was announced that the Japanese Government Pension Investment Fund would set a 25% target each for the allocation to Japanese and overseas equities, up from 12% in both cases. At the end of March, it was announced that three Japanese public pension funds controlling JPY30 trillion (US$240 billion) would follow suit. These moves should be supportive to the Japanese and overseas equities markets which are affected by this policy switch.

All eyes remain on China as it attempts its transition to a more consumption based and less investment orientated economy. As we see from the IMF economic projections earlier in this review, growth is expected to slow down, albeit to a level of which advanced economies can only dream. The aim is to increase the quality of economic growth. One of the major problems for the Chinese economy is the high level of indebtedness and associated concerns about the banking sector. With fixed asset investment accounting for approximately 50% of GDP, a lot of it cannot provide returns consistent with discharging debt obligations because it is not profitable. Marked weakness in Chinese property prices is an associated concern and so would be the prospect of deflation for all the usual dangers with which it is associated. At the moment, the year on year rate of consumer price inflation in China is 1.5% and the latest month on month figure showed a fall in prices of 0.2%. The authorities have been relaxing economic policy modestly by cutting back reserve requirements and the position of the economy is delicately poised in this transition period. The latest GDP figure shows first quarter growth 7.0% higher than a year ago with the quarter on quarter figure 1.3% higher than the final quarter of 2014 to give an annualised rate of increase of 5.3% and therefore showing that the Chinese economy's growth rate is slowing. The latest Chinese purchasing managers indices are consistent with this impression. The PMI index for manufacturing stood at 50.1 and that for non-manufacturing at 53.4. Year on year industrial production figures were 5.9% higher and the latest month on month figure is up 0.57%. The figures for the Chinese economy are consistent with a slowing down in the rate of increase in GDP. As the second largest economy, China continues to be in the forefront of investors' minds as they look at the background for their target asset allocations. But there seems to be little correlation between the state of the

Chinese economy and the stock market which has recently taken off with the Shanghai Composite Index up by 52% so far this year. The "A" share market, dominated by domestic investors, is starting to open up for foreign investors as China opens its doors at the same time as it is investing heavily overseas. Economically, it is very important that China manages to maintain a satisfactory (by its standards but excellent by almost any other country) growth rate.

For the UK, by far the most important event over the last quarter has been the General Election. On the evidence of the opinion polls, right up to 7th May, it appeared that there would be an indecisive result and a messy coalition afterwards. Additionally, there was such a wide gulf between the major parties on economics and attitudes to business and markets, that the result would almost certainly be an influence on the UK stock market. Furthermore, based on what the opinion polls were saying, any coalition was likely to be much less stable than the one in the 2010-2015 parliament because the two main parties appeared to be close in terms of the number of seats which the opinion polls were predicting. In the event, something happened to make the opinion polls wrong and the markets got the result they wanted but hardly expected. With a small overall majority, the new government will be vulnerable to the usual attrition which occurs over five year parliaments but, for the moment, the political concerns have gone away and we do not believe the EU referendum is one of the main issues for markets in the near future, although some will feel otherwise. Although the UK economy has been performing relatively well, as we see from the figures earlier in this review, there is still much work to do on reducing and then eliminating the budget deficit, so tough decisions will continue to have to be made. But, as we noted earlier, it has proved possible to control public expenditure with the cuts in the public sector which have occurred and more than offset that by increases in employment in the private sector. Being able to run an independent monetary and fiscal policy outside the constraints of the euro is a huge advantage to the UK and it might reasonably be expected that, following the General Election outcome, confidence amongst consumers and businesses will increase. Anecdotal evidence suggests, for example, more activity in the housing market. The unexpectedly poor fourth quarter GDP figure (0.3% quarter on quarter and 1.2% annualised) is likely to be an aberration. The purchasing managers indices point to a very satisfactory position. The composite index stood at 58.4, a high level implying quite strong growth. Within that figure, the index for manufacturing was the lowest at 51.9, that for services, by far the largest sector of the economy, a very strong 59.5 and that for construction at 54.2. Unemployment has continued on its improving trend at 5.5%. Although the Bank of England has slightly reduced its growth forecasts for the UK economy, investors must expect interest rates to start increasing before long. Although year on year consumer price inflation is negative at -0.1%, this move into deflation will almost certainly be very short lived and the core rate is positive. With wages starting to rise and productivity weak, the ingredients are there for the Bank of England's Monetary Policy Committee to prepare the ground for an interest rate increase which, astonishingly, did not change for the whole of the last parliament. As ever, a headwind remains the eurozone, not only because of its poor growth position but also because of the strength of sterling. There remain some very tough economic decisions to be made because the UK's budget deficit is still the highest of the G7 countries other than Japan. As we said in recent economic reviews prior to the UK General Election, the new government could not afford to put a foot wrong economically because of the twin deficits, budget and current account (which is also alarmingly high), and, even though there has been a decisive result, that remains the case.

At these high levels, international equity markets are finding it difficult to advance further but neither do they appear to want to overreact to bad news. This is consistent with our view, expressed in recent economic reviews, that international equity markets would grind higher, with quarters of weakness interspersed with the general upward trend. Although the international economic outlook

is not strong, it is not so weak as to preclude modest profits and dividend growth nor is the stock market so highly rated that it is vulnerable to a major setback on unexpectedly bad political or economic developments. That cannot be said about the bond markets which, although there is large natural demand for bonds from some investors, remains significantly overvalued and vulnerable to a reaction which could come at any time. We see just modest returns from equities this year but the greater risk for longer term investors of being under exposed remains in terms of potential opportunity cost.

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