meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Despite the unsettled financial background, international equity markets have generally held their ground over the quarter whilst high quality bond yields have fallen. It may seem strange that shares have performed as well as they have but investment policy requires one to look to the future and investors' expectations about offsetting interest rate moves by central banks explain, in part, the performance of equities. We also rate the influence of sovereign wealth funds, which we discuss later, a positive factor for sentiment and markets.

The tables below detail relevant movements in markets:

International Equities 31.08.07 - 30.11.07

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.6	+12.6	+14.8	+6.6
Finland	+5.8	+11.8	+14.0	+5.8
France	+0.1	+5.8	+7.8	+0.1
Germany	+3.4	+9.2	+11.3	+3.4
Hong Kong, China	+22.9	+20.8	+23.1	+14.3
Italy	-1.6	+4.0	+6.0	-1.6
Japan	-3.9	-1.5	+0.4	-6.7
Netherlands	-3.1	+2.4	+4.4	-3.1
Spain	+9.2	+15.3	+17.5	+9.2
Switzerland	-1.0	+3.9	+5.9	-1.6
UK	+2.4	+2.4	+4.4	-3.0
USA	+1.2	-0.7	+1.2	-6.0
Europe ex UK	+0.3	+5.8	+7.9	+0.2
Asia Pacific ex Japan	+6.9	+9.2	+11.4	+3.4
Asia Pacific	+1.3	+3.6	+5.6	-1.9
Latin America	+10.8	+16.2	+18.5	+10.0
All World All Emerging	+10.2	+12.0	+14.2	+6.1
The World	+1.5	+2.5	+4.4	-3.0

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +2.6%

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

Currency	31.08.07	30.11.07
Sterling	5.04	4.69
US Dollar	4.53	3.97
Yen	1.61	1.48
Germany (Euro)	4.25	4.16

Sterling's performance during the quarter ending 30.11.07 (%)

Currency	Quarter Ending 30.11.07
US Dollar	+1.9
Canadian Dollar	-3.7
Yen	-2.4
Euro	-5.3
Swiss Franc	-4.8

Other currency movements during the quarter ending 30.11.07 (%)

Other Currency	Quarter Ending 30.11.07
US Dollar/Canadian Dollar	-5.9
US Dollar/Yen	-4.3
US Dollar/Euro	-7.1
Swiss Franc/Euro	-0.6
Euro/Yen	+3.0

Significant Commodities (US dollar terms) 31.08.07 – 30.11.07 (%)

Significant Commodities	31.08.07 – 30.11.07
Oil	+21.7
Gold	+16.4

Markets

Against continued problems in credit markets, the current quarter's performance for equities must be considered satisfactory as they have broadly maintained their position. In local currency terms, the FTSE World Index returned 1.5% over the quarter, in sterling terms 2.5%, in US dollar terms 4.4% and only in euro terms was there a negative performance of -3.0%.

In local currency terms, the FTSE USA Index returned 1.2%, Europe ex UK 0.3%, Japan -3.9%, the UK 2.4%, Asia Pacific ex Japan 6.9%, Latin America 10.8%, emerging markets 10.2% and Australia 5.6%. So, there was a significant divergence of performance and, once again, as so often in recent times, it was Asia Pacific ex Japan, Latin America and emerging markets which led the way. As implied by the widely varying performance of the FTSE World Index in different currency terms, currency movements have had a significant effect on returns when translated into the relevant currency bases. In sterling terms, the total return on the FTSE USA Index was -0.7%, on the FTSE Europe ex UK Index 5.8%, on the FTSE Japanese Index -1.5%, on the FTSE Asia Pacific ex Japan Index 9.2%, on the FTSE Latin American Index 16.2%, on the FTSE All World All Emerging Markets Index 12.0% and on the FTSE Australian Index 12.6%.

International bond markets, as measured by ten year government bond yields, saw a significant drop in yields as some investors plumped for the security of government bonds. The gross redemption yields on sterling government bonds fell by 35 basis points to 4.69%, on US government bonds by 56 basis points to 3.97% on Japanese government bonds by 13 basis points to 1.48% and, on German government euro denominated bonds, by 9 basis points to 4.16%.

Over the quarter, there were notable currency movements with the US dollar, in particular, but also sterling weakening against other major currencies. Whilst sterling rose by 1.9% against the US dollar, it fell by 5.3% against the euro, 4.8% against the Swiss franc and 2.4% against the yen.

In the commodity markets, oil rose by 21.7% (although well off its highest level) and gold rose by 16.4%.

Economics

- *Credit market problems dominate the news* ...... the fall out from the US sub-prime mortgage losses is widespread.
- *Sovereign wealth funds become more important* ...... not only is there vast wealth available for investment in assets likely to earn a higher return than cash or near cash in normal times but recent events have enabled them to invest substantial funds without protectionist noises being made - i.e. the welcome for Abu Dhabi's investment in Citigroup.
- *Central banks provide technical help to the money markets* ...... there is real stress in the interbank markets as shown by the margin of one and three month interbank rates over base rates or the equivalent. Central banks act to provide liquidity.
- *Central banks react in different ways to the economic fallout* ...... the Federal Reserve cuts interest rates quite aggressively, the Bank of England more reluctantly whilst the ECB holds off from raising interest rates.
- *However, there is a policy dilemma for central banks* ...... although the case for lower interest rates rests on reduced growth prospects, inflation presents a problem with food and energy prices the driver. At its very worst, but unlikely, is the prospect of "stagflation". International growth, driven mainly by the east, should still be satisfactory next year.
- *Not every central bank is holding back on raising interest rates to combat inflationary pressures* ...... those in Switzerland, Sweden and Australia, for example, have raised them recently.

USA

- *Third quarter GDP growth was 4.9% annualised according to the latest Commerce Department estimate* ...... this was an upward revision from the previous estimate of 3.9%. It is encouraging that one of the drivers of growth was net exports.
- *The GDP figure quoted above is, of course, a backward looking figure* ...... it would not reflect what has happened in credit markets in recent months.
- *Two economic forecasts downgrade next year's growth expectations* ...... the FOMC's October minutes show the range of expectation reduced from last June's 2.5% - 2.75% to 1.8% - 2.5%. The White House's forecast has been reduced to 2.7% from its previous estimate of 3.1%.
- *The FOMC minutes of October's meeting show that the decision to cut interest rates was not easy* ...... in the background was the spectre of inflation. As measured by the personal consumption expenditures price index, the Federal Reserve has a target of 1.5% - 2% and it currently expects inflation to stabilise at between 1.5% and 2.1% on the assumption that energy prices flatten out. The rationale for the FOMC's concern is therefore clear.
- *Some encouraging productivity figures* ...... the Labour Department reports that, at an annual rate of 4.9%, third quarter productivity growth showed its highest rate of increase for four years. Labour costs fell 0.2% over the quarter, a positive pointer for the FOMC in its interest rate deliberations.
- *Good news on the export front* ...... the very competitive level of the US dollar is having its expected positive effect on exports. The USA's September trade deficit is the lowest since May 2005.
- *The housing sector remains very depressed* ...... nearly all the pointers are negative although, earlier in the year, we had hoped that, by now, there would be signs of stability. Prices and volumes are generally weak.

- *Inflation is manageable* …… this is the Federal Reserve's main concern. On its preferred measure, inflation is near the top of its range.
- *Even though the US economy is slowing, many companies with exposure to faster growing economies are doing well* …… many US companies represent a good low risk way of gaining exposure to emerging markets.

China

- *The economy continues to grow strongly* …… the People's Bank of China forecasts growth of 11% this year with inflation at 4.5%.
- *But the year on year rate paints a less rosy picture* …… it was 6.5% in October. Food price inflation is driving the rate upwards as well as excess liquidity deriving from the vast trade surplus.
- *The authorities try to do their best to control inflation* …… bank reserve requirements are raised, interest rates are increased and state administered prices temporarily capped.
- *The trade surplus gets ever larger* …… at the ten month stage this year, it is 59% higher than in the previous year at US$212.4 billion.

Japan

- *Third quarter growth has been revised down from initial estimates* …… it is now estimated at an annualised rate of 1.5% against the original estimate of 2.6%.
- *Some disappointment from the leading economic indicators* …… they register zero in September.
- *In principle, the Bank of Japan would like to operate a more normal monetary policy* …… but the lack of inflation precludes this.
- *At the corporate level, there is frustration about measures to protect companies against unwelcome takeovers* …… many companies are putting in place "poison pill" measures. This will tend to depress share values against those in more shareholder friendly markets. On the other hand, dividend growth and share buy backs point the other way.

Europe Ex UK

- *Third quarter economic growth was robust* …… quarter on quarter growth was 0.7%, up from 0.3% the previous quarter, and the year on year rate was 2.6%.
- *The European Commission expects growth to "hold up reasonably well"* …… it expects EU growth to be 2.9% this year and 2.4% in 2008 and 2009. The respective eurozone forecasts are 2.6%, 2.2% and 2.1% respectively. However, it points out the danger caused by the possibility of a sharp housing downturn.
- *Monetary growth is still strong and this will be watched by the ECB* …… M3 is accelerating at its fastest ever pace and loans to non financial institutions remain buoyant, hardly the background for the ECB to consider a cut in interest rates.
- *The ECB will also be concerned about inflation* …… the preliminary figure of 3.0% for November is at least 1% over its target and real interest rates are too low for this level of inflation. On this evidence, the ECB will be anxious to raise interest rates as soon as it safely can.
- *France is facing a pivotal moment* …… November was a turbulent month as public sector trade unions tried

to face down President Sarkozy's reforms. This is the President's best opportunity to make the necessary reforms as there have to be changes in France if it is to compete successfully.

- *There are worrying developments in Germany* …… moves to roll back some of the previous government's hard won reforms and protectionist measures in the postal industry, which is blatantly populist yet with potentially damaging economic consequences, are depressing, especially as the Chancellor seems to be supporting them.

United Kingdom

- *The Northern Rock affair* …… the UK's image has taken a beating and confidence has been affected.
- *Government finances are a concern* …… the structural deficit is inappropriate and, after a long period growth, finances should be in much better shape. Borrowing forecasts have consistently been too optimistic and there is no flexibility in government finances to take offsetting fiscal action to stimulate the economy in less favourable times.
- *Tax changes to raise additional revenue pose a risk to the UK economy* …… tax increases on small business and non-domiciled individuals threaten to be counter productive.
- *The signs for the housing market are unambiguously bad* …… the statistics now all point one way whereas, in previous months, one could still argue that there was some ambiguity.
- *The Bank of England cuts rates but, one feels, reluctantly* …… the MPC is still worried about inflation but the negative wealth effect deriving from falling house prices would have particularly serious effects on the UK economy.

Summary

- *The negative factors for equity markets are quite clear* …… problems in the credit markets and some housing markets.
- *But there are important positive factors as well* …… interest rate trends, sovereign wealth funds, the impact on world growth of China and India and modest share ratings.
- *We rate shares as a more attractive asset class than bond*s …… we still think yields are too low on the latter class.

It has been an interesting quarter for financial markets and painful for many. The main story is, of course, the problems of the sub-prime mortgage market in the USA which has spread worldwide but particularly to Europe whilst causing large problems for some financial institutions in the country of origin of these problems, the USA. Whilst, in the old days, loans would stay on the books of the originators, that is no longer the case as they are packaged with other loans and receivables into various types of asset backed securities. This is how they have turned up on the books of financial institutions in other countries and, with their value becoming uncertain, this has contributed to a seizing up of the market. As well as losses being reported by some financial institutions, liquidity has become very tight as banks have hoarded cash and, as this is being written and with the end of the year approaching, inter-bank rates have once again moved very sharply above base rate, indicating stress in the inter-bank market. Central banks have indicated their willingness to ease the pressure over the year end by providing liquidity.

The broad picture will be known to clients so the most value can be gained by looking at the implications of what has happened for markets rather than how we got there in the first place. Investment is like a game of chess.

It is more important to think ahead rather than just to concentrate on the present situation. We think there are two important players here, central banks and sovereign wealth funds. It will be noted that we do not mention governments. We do not think that there is much that they can do. Central bankers can do more and move quickly. In terms of their money market activities, they can do something to alleviate tightness in the money markets through open market operations or in their "lender of the last resort" role. Those, if you like, are the technical aspects. In terms of monetary policy, what has happened in the USA and is likely to happen again is that interest rates will be cut or that they will remain at levels lower than they would otherwise have been. This could manifest itself in interest rates being held rather than raised or simply delayed before raising them again. It is clear that the ECB would already have moved to raise interest rates above 4% had not the credit market problems emerged. That might also possibly have been the case in the UK. The Federal Reserve was the first to move with two reductions, in total amounting to 0.75%. The Federal Reserve has a wider mandate than most other central banks and can look at the bigger picture. We have seen this before this decade when it moved aggressively to reduce the target rate for federal funds to 1%. Thus, when the sub-prime problems blew up, the Federal Reserve wasted no time in moving from a neutral and very cautious position to one where action to offset some of the damage to financial markets and the US economy was of the paramount importance. However, the situation is not an easy one for central banks. Indeed, in countries like Australia, Sweden and Switzerland, interest rates have recently been raised by the central banks because of the perceived need to act to stem inflationary pressures. In the eurozone and the UK, notwithstanding the threats to economic growth posed by what has happened, they have to worry about inflation as well. Banks will be much more careful about lending after what has happened. Not only will they become more cautious about extending credit, what they do extend will, quite often, become more expensive. Although, quite rightly in our view, the stock market has held up well, other assets, like housing, look vulnerable. This has already happened in the USA where house prices are weakening but it could also happen in the UK and in parts of the eurozone (Spain comes to mind). The negative wealth effect would then influence economic growth as people, then businesses, felt less confident. Normally, this would call for a cut in interest rates especially as central banks could normally feel more sanguine about inflation than at present. The shift in the balance of economic power to the east means that China and India, for example, because of their rapid economic growth, have a voracious appetite for oil. At the same time, the OPEC cartel seems increasingly effective at controlling the price of oil so an economic slowdown, if it occurred on a worldwide basis, would most likely be met by a reduction in the supply of OPEC oil. As the price of oil has risen so has, apparently, OPEC's reference price. For various reasons, food price inflation is rising and this does not seem likely to be a short lived phenomenon. So central banks, and this is a particular issue for the Bank of England and the ECB given their restrictive terms of reference on inflation, face a dilemma. Inflation is rising whilst growth is slowing. The spectre of "stagflation" seems unduly alarming but even the outside possibility quite clearly makes interest rate decisions difficult. It is easier to call further interest rate reductions in the USA than it is in the UK or eurozone.

In recent reviews, we have drawn our clients' attention to the increasing impact of sovereign wealth funds on the investment scene and we think this is a positive long term driver for international equity markets providing protectionism does not take hold, which is a possibility, though, on balance, we think not a major threat at this stage. In the past, we have talked about China, in particular. As the country with the world's largest foreign exchange reserves, it has set aside a portion, US$200 billion to start with, for investment in assets which are capable of producing enhanced returns. Obvious asset classes are equities, private equity and property as well as possible outright purchases of foreign companies, although the latter could be very sensitive for foreign governments and perhaps not all that likely at present. Energy producers, looking forward to the day when their supplies are exhausted, are particularly large potential investors as well.

In Europe, Norway has a vast fund for just this purpose with widespread international equity investments. In aggregate, they are very large but in percentage terms very low in most companies. Middle East oil producers, building up vast surpluses, are another case in point, with some of them, like Abu Dhabi, having long established equity funds. Financial stocks often have appeal to these type of funds and the recent proposed investment by Abu

Dhabi in Citigroup is a case in point. Singapore has a long established fund and, together with China, has been a recent investor in Barclays. It is interesting to note that, after Dubai was rebuffed by the USA when it acquired P&O, the Abu Dhabi investment appears to have been welcomed in the USA. Given the write offs which some financial institutions have had to make, these types of fund are likely to be given a greater welcome and, at the same time, enable them to make meaningful investments with their vast available funds.

The problem for the world economy at present is not so much the present growth rate but the seizing up of credit markets with all the implications which this has for future growth. Apart from everything else, deals will be more difficult to do with the commercial property market being a case in point. It is in this situation that sovereign wealth funds (we use the term loosely because companies may also be involved) with plenty of available cash may not only be able to complete advantageous deals for themselves but also provide some liquidity to the market.

Our view is that sovereign wealth funds will be a positive feature both in the short term and the long term for international equity markets, although the diversion of cash flow from bonds is likely to be less helpful to the latter. In the short term, their actions might help sentiment in regards to providing additional capital to financial companies and as a provider of liquidity for transactions. In the long term, they should provide a driver to markets. All this comes with the important caveat that protectionism is kept at bay. The guess is that it will probably be with liberal countries like the UK welcoming foreign investment but that some areas will put some barriers in place.

We turn now to look at different areas of the world economy, starting with the USA where the US economy grew at an annualised rate of 4.9% in the third quarter, according to the latest Commerce Department estimate. This is a much higher figure than the initial estimate of 3.9%. Consumer spending and exports were drivers of growth. Some may say that backward looking data is only of limited use now given what has happened in credit markets. The problem blew up in the third quarter, too late to affect the outcome. Some encouragement, however, can be gained from the extent of the momentum going into the fourth quarter and, certainly, one of the catalysts to growth, buoyant exports, should be present in the fourth quarter.

In November, two forecasts of economic growth for the USA were reduced. Minutes from the FOMC's October meeting showed that the Federal Reserve's forecast for 2008 growth was reduced from a range of 2.5% - 2.75%, made last June, to 1.8% - 2.5%. The White House's forecast for economic growth for 2008 was revised down to 2.7% from its previous estimate of 3.1%. Housing and credit market conditions caused a reduction in its forecast.

We can see from the minutes of October's meeting, that the decision to make a further reduction in interest rates was not an easy decision. One member did not want a rate cut at all. The feeling of the meeting was that a rate cut would provide some offset to deteriorating economic conditions, but the concern about inflation was clear with reference being made to the effect of rising energy prices. It was interesting to learn that the Federal Reserve had reduced its forecast for the rate at which the US economy could grow which was consistent with stable inflation. It does not now think that this rate is much more than 2.5%. The minutes also reveal that the Federal Reserve's unofficial inflation target, as measured by the personal consumption expenditures price index is 1.5% - 2.0%. Next year, the Federal Reserve is expecting inflation to stabilise at between 1.8% and 2.1% on the assumption that energy prices flatten out. The core inflation rate is currently 1.8%. Further forecasts were that unemployment would rise slightly in 2008, stabilise in 2009 and fall back slightly in 2010. Its forecast for GDP growth over the next three years was that it would average between 1.6% and 2.6%. In its forecast, the White House was also expecting unemployment to rise.

These forecasts accord with common sense expectations. Housing and credit market problems are bound to impact on economic growth. This will almost certainly be countered on the policy side by the Federal Reserve through further cuts in interest rates and we would expect monetary policy to work at some stage. But there is a catharsis in the banking world after what has happened. The immediate reaction is to tighten credit standards and, in some cases, to raise lending margins. Then one says "never again" but, gradually, over the years, the lessons are forgotten and some other excess occurs. For the world economy, whilst it may be painful in the short term, tighter lending standards and a reduction in the level of risk taken should ensure a better quality of economic growth which is more sustainable. We do not see much action which can be taken on the fiscal front in the USA or, for that matter, most other major industrialised economies which are constrained by their budget deficits from taking offsetting reflationary action as and when growth falls to unacceptably low levels. In any case, we are not there yet and it may not happen, given the extent of expansionary forces still prevalent in the world economy, i.e. China, as one example.

Whilst the news from the USA has generally been discouraging recently, one positive item which the Federal Reserve will certainly continue to take into account in future deliberations, if the trend continues, is the encouraging US productivity figures, recently reported. Rapid productivity growth reduces inflationary risks and, given that the Federal Reserve's main constraint on cutting interest rates is the inflation concern, this is good news. The Department of Labour reported that the third quarter witnessed the highest rate of increase in four years. Business productivity rose at an annual rate of 4.9% following an increase of 2.2% in the second quarter. As a result of this rise in productivity, labour costs fell by 0.2% in the quarter, reducing the upward pressure on prices.

One of the positive drivers of third quarter growth was exports. The weakness of the US dollar is a positive feature for many US companies which have substantial overseas business or are meaningful exporters. When a currency weakens, either through a devaluation or through a gradual decline against its main trading partners, as has been the case with the US dollar, the immediate impact on the trade balance is negative as imports become more costly. Over a period of time, the increasing competitiveness of exports raises their value though a contribution of higher volumes, business gained through import substitution or raising the dollar price of exports which, because of the lower currency value, may mean an unchanged price in the harder trading partners' currencies. It is the "J curve" effect. This is now coming through in the figures. The US trade deficit for September of US$56.5 billion, whilst still very large, is at its lowest level since May 2005. The current account deficit, the main component of which is the trade deficit, has been reducing steadily, although it is not something which has been unduly highlighted. It is also a reason why it is a lazy assumption that the US dollar will keep falling. Extrapolating trends, without looking at the fundamental issues, is unwise. An example of the effect of sharp and prolonged currency movements is provided by the Boeing /Airbus situation. The two major civil aircraft manufacturers have enjoyed an enormous inflow of orders as a result of the boom in civil aviation and have record order books stretching many years ahead. But their respective profitability positions could not be more different. As the US dollar hedges of Airbus run out, it is suffering extreme pain as it strives to remain competitive. Airbus has a particular difficulty caused by the clashes of interests within European politics which makes cost cutting a more difficult task. But, even so, it is having to look at very radical measures to make its vast order book profitable for its shareholders and this includes possibly having a plant in the USA to provide a better match between costs (currently largely in euros) and revenues in US dollars, the currency in which aircraft are priced. Followed to their ultimate conclusion, originally sourced business in the current weak currency, the US dollar, would increase at the expense of the dear currency, the euro, and this would reflect a self-correcting mechanism. This is a very simplistic example but, nevertheless, a very good one because the companies are direct competitors, with one, Boeing, being very profitable and the other, Airbus, through its parent EADS, having to take drastic action because of the euro's overvaluation against the US dollar.

Clearly, one of the key variables for the US economy is the housing market, the state of which will influence the economy and decisions by the Federal Reserve on interest rates. By now, one had hoped that it might be stabilising but that is not the case as repossessions put more pressure on prices. Mostly, news has been negative. Housing starts did show a 3% rise in October but this was after an 11% fall in September. Building permits were at a fourteen year low. The S&P/Case-Shiller Index recorded a fall of 1.7% in the average value of a US home in the third quarter to start 4.5% lower than a year earlier. On another measure of house prices from the Office of Federal Housing Enterprise Oversight, US houses fell in price by 0.4% in the third quarter which would be the first quarterly decline since 1994. The median price of a new house in October fell by 8.6% from September and the year on year price fall was 13%, the largest year on year fall since September 1970. In October, sales of existing homes fell by 1.2% compared with September. These figures make grim reading and the sub-prime loan crisis with its ramifications for the housing market make it likely that the recovery, when it comes, will be slow.

The Federal Reserve's main reason to maintain interest rates at current levels against the background of the problems in the credit and housing markets, is inflation. October's producer price index was benign, rising by just 0.1%. The US consumer price index rose by 0.3% in October and the core rate rose by 0.2% to give year on year increases of 3.5% and 2.2% respectively. The Federal Reserve's preferred measure of inflation, the core personal consumption expenditure deflator, rose by 0.2% in October, compared with September, to give a year on year increase of 1.9%, close to the upper level of its comfort zone. Measured on the core basis, the figures look manageable but without any room for complacency. But, increasingly, the question is asked about why food and energy should be excluded, given their importance in people's spending patterns. They will certainly feed through to wage negotiations and then, depending upon the outcome of wage negotiations, to the general level of inflation. Probably, we can say at present that, if other factors determine a further cut in US interest rates, inflation is not a significant enough issue to prevent that happening. But it is a fairly fine balance. Apart from interest rate reductions to try to offset the damage to the economy caused by the credit market problems, the Federal Reserve has promised that it will take aggressive action to keep borrowing rates at the year end around its target rate, since soaring inter bank rates mean an interest rate increase for borrowers whose loans are tied to inter bank rate.

Although it is easy to be negative about the USA, it is a resilient economy which, in the past, has shown significant powers of recovery. Parts of the financial sector are weakened at present but, as Citigroup has shown, high quality investors can be attracted to a company with a well recognised franchise. The recovery potential of the sector is strong when confidence returns. Many other sectors have held up well. Many US consumer goods companies, for example, are benefiting from their international exposure. In the short term, at least, currency movements are favourable to their business, but, perhaps more importantly, and a better quality reason for liking them, is that it gives them exposure to faster growing economies including emerging markets, which are growing rapidly, and high quality branded goods are generally performing well. So, many US companies also provide a relatively low risk way of taking exposure to rapidly growing economies.

Some investors are wary of US equities because of the decline in the US dollar in recent years. In terms of determining equity asset allocation, currency exposure is not a significant issue for us, rather it is the underlying attraction of the economies, markets and companies in which we invest. To avoid the US equity market, which accounts for over 40% of the world's stock market and is the largest economy, would, in our view, be raising significantly the risk in any international portfolio. For reasons we have mentioned earlier, it is not a given that the US dollar will continue to fall because, for example, the current account deficit is on an improving trend. That there are problems with the US economy, there is no doubt, but there are also opportunities for companies in the most dynamic of the largest developed economies in which we think it important for long term investors to have significant exposure.

Moving on to Japan, the latest figures show that the Japanese economy grew at an annualised rate of 1.5% in the third quarter, lower than the original estimate of 2.6%. GDP grew at 0.1% in the first half of the fiscal year to next March and at an annualised rate of 0.3%. Drivers of growth were exports and consumer spending, whilst housing was a negative contributor. We are seeing a volatile quarterly series which makes it difficult to establish trends. In these circumstances, there is little reason for the Bank of Japan to move interest rates, much as it would like to establish them at a more normal level. Because exports have been an important driver of growth, the Japanese economy is vulnerable to a downturn in its export markets so it will be watching the situation in the USA.

There was some disappointing news from the latest index of economic indicators which, in September, registered zero for the first time in a decade. Compared with the previous reading, three months earlier, all the constituent components declined. More encouragingly, the coincident indicators, which reflect the present situation in the economy, were well into positive territory at 66.7, although this was a lower reading than in August when the figure was 85. A technicality in the building sector is providing a drag on growth which economists estimate at 0.2% or 0.3% in the third and fourth quarters. More complex permit procedures are to blame although there has been some recent easing of the regulations.

We mentioned that the Bank of Japan would like to operate a more normal monetary policy but Japan has been mired in deflation so that, even with the official interest rate at 0.5%, there is still a real interest rate. In October, the core inflation rate, which excludes food, turned slightly positive, rising by 0.1%. This was an energy driven rise but, take energy out, and there would have been a decrease of 0.3%. For the foreseeable future, it is going to be difficult for the Bank of Japan to justify an interest rate increase.

Until recently, the yen has been a weak currency. Although a large current account surplus would make it a candidate for a strong currency, ultra low interest rates have worked in exactly the opposite way as it has been aggressively used as a currency to borrow for "carry trade" purposes to try to earn a higher return by investing in higher yielding currencies. The problems in the international credit markets caused a rapid unwinding of many carry trades although many are still obviously in place. Selling the yen for carry trade purposes has kept the currency competitive and Japan has been doing well in export markets. More risk aversion with less carry trade activity could continue to strengthen the yen. The stock market appears to do better when the currency is weak but, even with a stronger currency, Japanese companies are still competitive in export markets. For this quarter, using the FTSE Japanese Index, sterling investors have seen the index's negative performance reduced in sterling terms whilst, for US dollar investors, currency movements have turned the return slightly positive.

There have been some unwelcome developments on the protectionist front as companies have moved to put in place "poison pill" anti-takeover measures. This deeply regrettable aspect of Japanese corporate behaviour goes against the trend elsewhere and is bound to make Japanese shares cheaper than they would otherwise be because takeovers are so difficult. However, on the other side of the equation, Japanese companies have become more liberal with their dividend payments. All this suggests that the Japanese stock market is not quite like other large ones. The potential for a more sustained recovery in the economy remains, it is very well placed with regard to China as a major exporter to that country and the currency is still very competitive. It is not investors' favourite stock market but the size, fundamentals and profile of the economy make it a risk for it not to be included, particularly with its many world class companies.

We turn now to look at Europe, where third quarter growth has come in at a quite robust 0.7% against 0.3% in the second quarter to give a year on year growth rate of 2.6%. Growth was led by France and Germany. Again, these are backward looking figures and it remains to be seen what will be the effect of the problems in the credit markets. In its latest commentary, the European Commission refers to the danger posed to European economic growth from an unexpectedly sharp correction in house prices. It is concerned about the danger this could cause, drawing upon previous experience of sharp housing downturns. The EC does, however, expect European economic growth to "hold up reasonably well" although investment and consumption growth would be hit. The EC's forecast for economic growth this year is now slightly raised at 2.9% and, next year and the year after, it is forecast at 2.4%. Within the eurozone, growth is forecast at 2.6% this year, 2.2% in 2008 and 2.1% in 2009.

The ECB has always taken considerable notice of money supply growth, more so than any other major central bank. In October, money supply, as measured by M3, accelerated at an annual rate of 12.3%, its highest ever rate of increase. Loans to non financial institutions remained buoyant, growing at an annual rate of 13.9%. Lending to households grew at a lower rate but still a quite strong 6.8%. With the ECB in hawkish mood, this data would be one encouragement to raise interest rates. But the background in financial markets would seem to preclude a rise in interest rates in the short term.

The really frustrating factor for the ECB is that the inflation figures really demand an interest rate increase. In October, eurozone inflation reached a two year high of 2.6% and the preliminary figure for November is 3.0%, over 1% above the ECB's target. This real interest rate, measured against the ECB's benchmark rate, is, therefore, just 1.0% which the ECB would not consider enough in normal circumstances. The danger of keeping interest rates lower than would be considered prudent in normal economic circumstances is that inflation will rise. This is what central banks will be concerned about. On the other hand, with some of the short term eurozone economic indicators pointing downwards at the same time as financial markets were unsettled, it would be a brave central bank which raised interest rates at this time. But, if the ECB feels it can safely do so, it surely will.

Much of the focus in November within the eurozone has been on France where President Sarkozy has faced militant public sector trade union opposition to his economic reforms as well as social unrest in the suburbs of Paris. At present, there is an uneasy truce whilst negotiations continue between the government and the public sector trade unions but this is likely to be the only opportunity which the government has to make the necessary reforms and the outcome will be watched closely. France cannot go on the way it is. Supply side reforms need to be made to free up the French economy to enable its long term potential growth rate to be increased. As the second largest eurozone economy, what happens in France is important to the area as a whole.

In recent times, France has been losing ground to Germany as the latter has made important and hard won reforms and, at the same time, increased its competitiveness quite dramatically as costs have been kept under control. These reforms have been an important contributor to the recent strong performance of Germany. But coalition politics threaten this position. Infighting within the SPD has pushed the party leftwards in its attempt to re-engage the support of activists. This has meant trying to undo some of the welfare reforms, so hard won, made by the previous SPD government. Perhaps mindful of the next elections, the Christian Democrats seem to be following suit with populist measures aimed at bolstering their support. As well as seeming to back some rolling back of the welfare reforms, the latest manifestation of this trend is a protectionist measure to apply a minimum wage to the postal industry. This will disadvantage competitors and is a blatant distortion of the market. Berlin is also in the lead in its concern about sovereign wealth funds and is considering measures to control them. Having done the hard work, it is a disappointment to see events in Germany unfold in the way they have. It seems as if the first signs of success have become a reason to turn back the clock. This is probably due to coalition politics but one would have hoped for more leadership since continuing supply side reforms are essential for Germany as international competition becomes ever more intense and the high value of the euro erodes competitiveness.

For the UK, the problems seem more immediate and appear to be building up rapidly. The Northern Rock affair is a great embarrassment to the UK and is providing the authorities with a real headache in terms of how to deal with it. Confidence in the financial system is paramount. Without that, economic prospects are poor. We have had concerns about the UK economy for a long time although, until recently, these have not materialised. Our concerns were primarily about government finances. Although reported economic growth was strong, we were concerned about the quality of the growth. With strong growth should come sound government finances but the Treasury has consistently been too optimistic about them with deficit forecasts having to be raised regularly. Governments should use a period of strong growth to run, at the very least, a balanced budget and, preferably, a budget surplus so that, when times become more difficult, as they inevitably do, there is room to take offsetting fiscal action to counterbalance the economic slowdown and provide a fiscal stimulus. As it is, the UK has been running a significant structural deficit in good times and now has no room for fiscal offsets. It is quite clear that the Treasury is looking around for any possible source of additional revenue irrespective of the longer term consequences. Tax increases on small businesses, moving the goalposts on capital gains tax and looking to raise revenues from non-domiciled individuals are potentially very dangerous moves. In the case of the first two measures, they threaten entrepreneurs who provide quality growth for the UK. The furore over the tax rises does not represent bleatings from self interested parties. They will be damaging to the longer term prospects of the UK. Whilst, on the surface, it might seem very attractive to try to raise more from non domiciled people in the UK, the beneficial direct and indirect benefits they bring to the UK are very large. Make the UK a less attractive place for them (and there is plenty of competition) and there will be knock on effects on the finance sector, the housing market and all the sectors which benefit from their spending. Reverse multiplier effects will take place and, once these people have gone, it will be very difficult to get them back. Spending cuts would be much more preferable than tax increases, more of which seem likely but which will be damaging to the economy and moving against the trend internationally.

However, the Treasury will be looking for ways in which to plug its finances in the very short term, irrespective of the longer term consequences. October's surplus was disappointing compared with expectations. A surplus of £1 billion was recorded compared with £3.5 billion in October 2007. For the first seven months of the financial year, public sector net borrowing reached £24.2 billion, £6.7 billion worse than at the same stage last year and the highest figure since 1994/5. Corporate tax revenues were disappointing. The current deficit, which excludes net investment, stands at £11.5 billion so far this year compared with £7.3 billion at the same time last year. It seems very unlikely that the position can be recovered. Although, the UK's overall public debt in relation to GDP is not high by international standards, it does not mean that this situation can go unchecked. Although public spending is due to slow down, it will be difficult for the government to take dramatic action on the level of public expenditure.

There is now no question that the housing market, a key variable for the UK economy, has taken a turn for the worse and, if it should turn really nasty, which is possible although supply constraints will reduce the impact, the UK will have a serious problem. Previously, we had been able to argue that the evidence was not conclusive - now, one almost certainly can. Every significant indicator published in November relating to the housing market pointed to a downturn. The Halifax reported a fall of house prices of 0.5% in October following a 0.6% fall in September. Its measure of annual house price inflation fell to 8.9%. The FT House Price Index showed the annual rate of increase down from 10.1% in June to 8.9% in October and it reported that half of England's regions had experienced falling house prices since the summer. According to the RICS, the house price balance dropped to 22.2 in October from -14.9 in September. This represented the fastest pace of fall since July 2005. The Nationwide has forecast that house price inflation would fall to zero next year from 9.7% at present. Meanwhile, it reported that house prices fell by 0.8% in November to give annual house price inflation, on its index, of 6.9%, down from 9.7% in October. The Land Registry reported a 0.1% rise in house prices in England and Wales in October to show an annual increase of 8.1%. London was the weakest region in October. Home repossessions are rising rapidly. The Council of Mortgage Lenders reported a sharp fall in the number of loans for house purchase in September to 81,000 compared with 103,000 in August, the value being down to £12.7 billion from £16.2 billion. The Bank of England reported that mortgage approvals fell in October to 88,000 from 100,000 in September, the lowest level since February 2005.

All this information points one way and the Bank of England's decision on 6 December to cut rates by 0.25% to 5.5% will have been influenced by data such as this. In giving the reasons for its decision, the Bank of England cited the tightening of credit for households and businesses which threatened to depress growth and allow inflation to fall too far below its 2% target. The negative wealth effect arising from falling house prices in the UK would be substantial. However, whether inflation would fall that low in those circumstances would depend on the factors driving inflation, food and energy, for example. In its statement, it was clear that the Bank of England is still concerned about inflation. Output inflation, for example, was up 0.6% in October to give a year on year increase of 3.8%. The latest CPI figures showed a rise of 2.1% in October compared with 1.8% in

September whilst the Retail Price Index, which many would regard as a more accurate measure of inflation, was rising at 4.2% compared with 3.9% the previous month.

Most of the short term indicators produced over the last month point to a negative trend in the UK economy with perhaps the fall in sterling indicating a change in perception about the UK. Because of the importance of the housing market and the financial sector to the UK economy, it is particularly vulnerable to current negative factors.

Turning now to China, we see an economy which continues to grow very rapidly and is a vital driver of world economic growth. The People's Bank of China expects the economy to expand by 11% this year with inflation at 4.5%. Its concern is about the influence of food prices in entrenching expectations of further increases in inflation. In fact, the year on year inflation figure in October was 6.5% compared with 6.2% in September. The rapid build up of the Chinese trade surplus, amongst its other results, causes inflationary pressures in the Chinese economy. For the first ten months of the current year, the Chinese trade surplus has reached US$212.4 billion, 59% higher than at the same stage in 2006. The build up of the surplus is providing funds for the sovereign wealth fund we discussed earlier, as well as causing angst in the countries on the other side of the surplus which worry about the influence these investments may have in their countries. China will move on its currency at its own pace and, with the world's largest foreign exchange reserves, it is not a country to upset. We continue to regard the influence of China on the world economy as positive and it should help to sustain growth next year which is welcome given the uncertainties prevailing.

So far this year, international equity markets have provided satisfactory returns despite having to experience the unsettled conditions in the international credit markets. This has led to widely differing returns between various sectors although markets have mostly been in an uptrend. As always, media attention focuses on the bad days in stock markets, rarely on the good days which tend to be more common. It is always easier to isolate the negative factors rather than offsetting positive factors. The negative factors, which we can see, are the problems in certain parts of the financial sector which will slow down economic growth and problems in the housing markets for some countries. These will affect corporate earnings but by how much remains to be seen. But we think positive factors such as interest rates, perhaps the impact of sovereign wealth funds, the impact of China and India, and the modest ratings of most shares should limit the impact. At present, we do not see a situation which could justify a reduction in equity exposure for we remain wary of incurring opportunity costs. After a long run of mainly positive quarterly returns, one or two negative ones are inevitable but, in our view, this does not justify the risk of having a lower equity exposure. Bonds, we believe, still remain expensive.