meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

After an unpromising start to the quarter, share prices recovered strongly in September and consolidated those gains in October to leave equity markets returning very satisfactory results for the quarter. High quality international bonds, as measured by ten year bench mark government bonds, saw a significant fall in yields which was partly reversed towards the end of the quarter. Gold was very firm.

The tables below detail relevant movements in markets:

International Equities 30.07.10 - 29.10.10

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.2	+11.6	+14.0	+6.8
Finland	+10.6	+15.6	+18.0	+10.6
France	+6.1	+10.8	+13.1	+6.1
Germany	+7.6	+12.5	+14.8	+7.6
Hong Kong, China	+15.5	+13.3	+15.7	+8.4
Italy	+3.2	+7.8	+10.1	+3.2
Japan	-3.4	+1.8	+3.9	-2.6
Netherlands	+0.1	+4.6	+6.7	+0.1
Spain	+3.2	+7.8	+10.1	+3.2
Switzerland	+4.0	+8.4	+10.7	+3.7
UK	+8.7	+8.7	+10.9	+4.0
USA	+8.2	+6.0	+8.2	+1.4
Europe ex UK	+5.0	+9.7	+12.0	+5.0
Asia Pacific ex Japan	+7.6	+10.9	+13.3	+6.2
Asia Pacific	+2.4	+6.6	+8.8	+2.0
Latin America	+7.5	+9.0	+11.3	+4.3
All World All Emerging	+9.0	+10.1	+12.4	+5.3
The World	+6.4	+7.2	+9.4	+2.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +2.4%

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

Currency	30.07.10	29.10.10
Sterling	3.33	3.08
US Dollar	2.91	2.62
Yen	1.07	0.92
Germany (Euro)	2.67	2.51

Sterling's performance during the quarter ending 29.10.10 (%)

Currency	Quarter Ending 29.10.10
US Dollar	+2.1
Canadian Dollar	+1.0
Yen	-5.0
Euro	-4.3
Swiss Franc	-3.5
Australian dollar	-6.0

Other currency movements during the quarter ending 29.10.10 (%)

Currency	Quarter Ending 29.10.10
US Dollar/Canadian Dollar	-1.1
US Dollar/Yen	-6.9
US Dollar/Euro	-6.2
Swiss Franc/Euro	-0.8
Euro/Yen	-0.7

Significant Commodities (US dollar terms) 30.07.10 - 29.10.10 (%)

Significant Commodities	30.07.10 - 29.10.10
Oil	+6.4
Gold	+15.0

Markets

The last quarter has seen a pleasing performance from international equity markets. In local currency terms, the total return on the FTSE World Index was 6.4%, in sterling terms 7.2%, in US dollar terms 9.4% and in euro terms 2.6%. The only area to disappoint this quarter was Japan which showed a negative return of 3.4%. Elsewhere, there were very satisfactory local currency returns from the relevant FTSE World Index, with the UK returning 8.7%, the USA 8.2%, Europe ex UK 5.0%, Australia 5.2%, Asia Pacific ex Japan 7.6%, Latin America 7.5% and Emerging Markets 9.0%. With sterling mostly weaker over the quarter, returns were enhanced by the currency. Japan moved into positive territory with a return of 1.8%, whilst the returns from Australia rose to 11.6%, of Europe ex UK to 9.7%, of Asia Pacific ex Japan to 10.9%, of Latin America to 9.0% and of Emerging Markets to 10.1%. The USA was an exception where a weak US dollar reduced the sterling return to a still very satisfactory 6.0%.

In the international bond markets, as measured by the ten year government bond yield of the countries in the table, yields fell quite significantly despite price weakness towards the end of the quarter. The gross redemption yield on sterling bonds fell by 25 basis points to 3.08%, on US government bonds by 29 basis points to 2.62%, on euro denominated German government bonds by 16 basis points to 2.51% and on Japanese government bonds by 15 basis points to 0.92%. We will consider the level of bond yields in our review.

As stated above, sterling was generally weaker during the quarter. Against the Australian dollar it fell by 6.0%, against the yen by 5.0%, against the euro by 4.3% and against the Swiss Franc by 3.5%. On the other hand, it rose by 2.1% against the US dollar and by 1.0% against the Canadian dollar.

In the commodity markets, oil rose by 6.4% and gold by 15.0%. Again, we should discuss gold in our review.

Economics

The satisfactory performance of many bond and equity markets this year should not, in any way, make us feel complacent about the economic position in which the world economy finds itself. It remains a very dangerous place. Having said that, there is no reason why stock markets should not perform well in these circumstances. Their cycles are different and stock markets should be looking ahead. Nevertheless, as we shall see later, stock markets themselves are sending our confusing signals.

Let us start this review by enumerating some of the major problems facing the world economy. The economic consequences of the financial crisis of 2008 are likely to be with us for a long time. The recession and costs of the bank bail outs have left a deep hole in the public finances of many countries. Unfortunately, a number of major countries were unprepared for what happened because they had been running profligate fiscal policies so that the cyclical deficit which occurred as a result of the recession piled onto structural deficits to leave a very ugly sized overall budget deficit. Whilst many countries struggled to put out the fires in the banking and other financial sectors, attention was not immediately paid to the devastation the problem was causing for many countries' public finances. Now that the banking position has been stabilised, attention is well and truly focused on the public finances of countries, particularly in the eurozone, where a serious situation has developed. If sovereign debt defaults do occur it would affect the banking system, creditors of the relevant banks and the businesses and individuals who borrow from them and have a negative effect on economic activity and so on, perhaps leading to recession or depression. For many years, a number of major countries have succeeded in getting by without addressing their public finance problems as they should. However, this state of affairs is no longer tenable as external creditors make their presence felt and a number of countries are making haste to put their public finances in order before markets force them to take firm action.

These public finance problems are mainly those of the west and Japan, although the latter is not immediately threatened. The problem is compounded because, not surprisingly, it coincides with weak growth in the west and Japan, but not elsewhere in the east. The concern is that action taken to restore public finances in such circumstances risks exacerbating the problem as public spending cuts and tax increases bite into economic activity thus creating a downward spiral in public finances. Whilst this is true, it may not necessarily happen. Addressing public finances should help to reduce the "crowding out" effect on the private sector and faster growth elsewhere might boost export activity. The good performance of the German economy is ideally suited to meeting the demands of fast growing Asian economies. Although, by German standards, its public finances are not in good shape, relative to a number of other eurozone countries, they are. Notwithstanding the dangers involved in resolutely attacking weak public finances, doing nothing or too little is a far more dangerous risk. A country's creditors, those who buy its debt, are not likely to appreciate a "gently, gently" approach and would probably vote with their feet by selling the relevant country's debt, driving up interest rates and, depending upon whether it was in a currency union, weakening its currency. A good example, so far, of a country being rewarded for a resolute approach is the UK where, notwithstanding a terrible deficit, the Coalition government's announcement of its intention to eliminate the structural deficit over the life of the parliament (assuming it lasts five years) has been rewarded with a fall in gilt yields and, therefore, a lower cost of debt than would otherwise have been the case. The hard part is to come but the UK has received a down payment for its declared intention which, so far, has been beneficial.

Another major problem is the battle being fought in the currency markets, this being a function of weak economic growth in the west and Japan and this has protectionist overtones. The main battle is being fought between the USA and China but there are other participants from time to time and the situation could turn ugly. According to IMF forecasts for 2010 contained in its October 2010 World Economic Outlook update, the USA is forecast to run a current account deficit (of which the trade deficit is a part) of 3.2% of GDP whilst China is forecast to run a current account surplus of 4.7% of GDP. Approximately half of the USA's trade deficit arises from its deficit with China. Simple economics would tell us that a country running a persistent current account surplus such as China has done for many years could expect to see its currency appreciate. Because of China's policy of managing its currency, the renminbi has been held down by China against levels it would otherwise have reached in order to protect its export industries. For social reasons, China's economy needs to grow rapidly to absorb people into the labour market and thus limit the chances of social unrest. But whilst it has been running substantial current account surpluses (for example in 2007 it amounted to 10.6% of GDP), it has been accumulating vast foreign currency reserves which has increased its ability to make its presence felt in international financial and commodity markets. From the US perspective, with unemployment close to the 10% mark, China represents a convenient bogey man and some US politicians have needed no second chance to parade their protectionist instincts by calling for trade sanctions against China. But China can respond to the USA with a very salient point. The USA's historically low saving ratio and corresponding consumption spree, which includes a liking for foreign consumer goods, including those made in China, has sucked in imports. Had US consumers been more frugal, they would not be importing all those foreign goods which has caused a chronic trade deficit.

Intervening in foreign exchange markets to leave exchange rates at unrealistic levels is a protectionist act because it effectively means giving a subsidy to exporters. Retaliating with trade barriers threatens world trade and a recession or, worse, a depression. The actions and attitudes of a number of US politicians are of great concern and highlight a problem with many politicians all over the world. Their horizon may extend no further than the next election, assuming that they are going to seek re-election. Thus, some US politicians who are calling for sanctions against China, are trying to boost support for populist measures like tariffs on Chinese imports. What is needed, particularly at this very difficult economic time, is a longer term perspective. Most people would understand that it is not China's way to respond to external threats and therefore the threats emanating from some quarters in the USA are likely to be self-defeating. Left to themselves, particularly in view of the Chinese desire to keep a lid on inflation, China would probably continue to allow a steady, if gentle, appreciation of the renminbi. Faced with threats, they are not likely to respond. Furthermore, there is the fact that the US is an enormous debtor nation and needs it creditors, which include China, to help finance its deficit. Rubbing up your bank manager the wrong way is not clever. If China were to retaliate by dumping the US currency or its bonds, even though it could not do this in a big way because of the US dollar's position as the world's largest reserve currency, it could still greatly embarrass the USA even though it would also be costly for them. One has the impression that the US Administration is not keen on provoking China with trade sanctions. The US Treasury announced, in October, that it will delay its twice yearly currency report, citing the recent upward movement in the renminbi. The US Treasury has a better understanding of the delicacy of the relationship with China than some members of Congress.

Currency instability, a threat to the world economy, has become more pronounced in recent weeks and it almost seems a race to the bottom. But, overall, foreign currency movements represent a zero sum game. They cannot all go down against each other but it seems that nearly every country wants its currency weaker for different reasons. Currency markets are being distorted all over the place and this is a threat to the world economy. Because of the level of unemployment in the USA, the USA is relaxed about the weakness of its currency although, as mentioned in the previous paragraph, it wishes the Chinese currency would not stay so close to it. One of the disadvantages of devaluation is that it is inflationary as imported goods cost more. For the USA, however, because it is a relatively closed economy with trade much less important than in other industrialised countries, the inflationary impact is less, say, that it would be in the UK. On this occasion, it seems that the Bank of England's Monetary Policy Committee, with one exception, is relaxed about inflation even though it has been running consistently above target. It is seen as a way of stimulating a sluggish economy. At this stage, the resurgence of inflation seems more of a risk in the UK than in the USA but there are warning signs with food and commodity prices. However, what the USA and UK have in common, is that they both may engage in another round of quantitative easing although preliminary third quarter GDP figures for the UK which were better than expected may stay the Bank of

England's hand. With short term interest rates effectively as low as they can go, conventional monetary policy is seen as the next stop, effectively printing more money by exchanging private sector held bonds for electronically created cash which it is hoped will circulate round the relevant economy to get activity moving. Also, the purchase of bonds, whether government or corporate, would be aimed at keeping down interest rates and thus making it cheaper for companies to borrow which, it would be hoped, would stimulate them into more activity perhaps in the area of capital investment. Newly created money would be expected to depress a currency, which is probably the desired aim of the relevant central banks but it is a course of action fraught with danger. Monetary policy action in the USA, in particular, has its counterparts in areas of the world where the economies are performing better. All this money is looking for a better rate of return than can be earned at home and this liquidity is flooding into Asia, Brazil and some emerging markets and pushing up their currencies. For these countries, this flood of money seeking a better return is unwelcome. Higher currency levels make their economies less competitive and therefore threaten economic growth. So these countries, too, have added to the distortions in the foreign exchange markets. Brazil and Thailand have introduced tax measures to discourage inflows of "hot money" which have driven up their exchange rates and thereby threatened their competitiveness. Japan, too, is concerned about the strength of the yen. It intervened, unsuccessfully as it turned out, in the foreign exchange market to try to weaken the yen. This upset the Americans who did not want to see the US dollar strengthen in relative terms. Switzerland has experienced massive unwanted capital inflows out of the euro and intervened heavily in the foreign exchange market but its central bank suffered losses as a result as the Swiss Franc strengthened against the currencies it had bought, mainly the euro. Even for those countries or monetary unions which did not intervene in the foreign exchange market, the outcome has been undesirable, the obvious currency to which this statement applies being the euro which has made a strong recovery against the US dollar. With the eurozone in turmoil, except for the strong German economy, the last thing that the struggling economies need is a stronger euro which will make their fight to regain competitiveness against non eurozone currencies, which have weakened against the euro, even harder. That leaves aside the issue of these countries' need to regain their lost competitiveness against other eurozone countries like Germany.

So, the "currency wars" now attracting headline attention are a major concern. It seems to be a case of every country for itself and it is true that, when times are bad, as they are now, national interests assume even greater importance against international interests. As a broad generalisation it seems that nearly every country wants its currency lower, or to stay relatively low in the case of China, albeit for different reasons. It is, of course, a zero sum game because not all currencies can go down at the same time. Some have to rise, by definition. This is another example of protectionist tendencies gaining ground and the consequences are uncertain. What we can say is that protectionism is bad for the world economy because it slows down or stops economic growth, misallocates resources and reduces consumer welfare as people pay more than they need for their goods and services leaving them with less spending power. Part of the trouble is that every country thinks that it can gain an advantage by being protectionist which, of course, is nonsense.

In the aftermath of the financial crisis and the recession which it caused, politicians, regulators and central banks are trying to clear up the debris both in terms of establishing regulatory background which is more robust for the future and addressing, with various degrees of alacrity, the necessity to restore their countries' respective public finances. The first issue is for another time suffice it to say that, although the banks have been given a long time to build up their capital to the required levels, the progress towards this goal will take a slice off economic growth. This is because the process will involve restraining their lending against what would have been the case before capital requirements were raised. The shorter term danger is that, in their enthusiasm to bash banks, the politicians will achieve the opposite of what they desire. In the UK, for example, where bank bashing is a popular pastime of politicians, including those in government, the requirement to build up capital, impose bank levies, threaten perhaps more taxation and, at the same time, press banks to lend more are incompatible. The last thing that any politician should want is for banks to make more imprudent loans so that we arrive at the position we are trying to get away from. However, the immediate issue which we need to discuss is the progress being made to address many countries' seriously weakened public finances and how it might impact on the world economy.

The measures to be taken to address the crisis in public finances in the relevant countries are, of necessity, going to be severe whether they be tax increases or public spending cuts or, as will almost universally be the case, both. Demographic changes as well as longer life expectations render present pension funding systems unsustainable in many countries which is why retirement ages are being raised in some countries. In terms of monetary policy in the affected countries or the eurozone we can be fairly certain that interest rates are going to remain very low, supplemented, perhaps, in the USA and UK by further quantitative easing. Very loose monetary policy will provide some degree of offset to very tight fiscal policy. What is dividing politicians and economists is the pace of the fiscal retrenchment. Whilst more or less everyone agrees that large public deficits have to be addressed, the pace at which the deficits are tackled excites great discussion. The UK is perhaps the best example of the polarisation of opinion. When in government, and the position has not been officially switched in opposition, the Labour party planned to reduce the budget deficit by half over the life of the current parliament whilst the Coalition government has decided to try to eliminate the structural deficit over the same period. The argument for the former position is that to cut too quickly risks a double dip recession whilst the latter case is that it is essential to retain the UK's top credit rating and that by delaying the cuts, outstanding debt builds up even further. In economics, the term "crowding out" means that the demands of the public sector crowd out the private sector from the debt market thus pushing up interest rates and also the labour market by bidding up prices. What the Coalition government is aiming to achieve is the opposite by giving the private sector the opportunity to take over the space provided by a contracting public sector. The UK, perhaps, has the boldest policy of all as other countries are more tentative. What we can say about the Coalition's policy, as we touched upon earlier, is that the UK has had a down payment in terms of lower interest rates and that creditors are less likely to take fright and demand to fund the UK's deficit at a higher interest rate and lower exchange rate. The "gently, gently" approach is quite likely to receive the thumbs down in the bond and foreign exchange markets thus taking matters partly or wholly out of the control of the relevant government. That is the risk with not acting decisively and, to us, tips the balance in favour of resolute action to tackle the deficit. It is a reasonable question to ask what factors may help an economy to avoid a "double dip" recession if public spending is being cut (or more accurately falling in inflation adjusted terms) and taxes raised. It may be that increased confidence arising from the fact that public finances are being put in order will encourage businesses to invest. Companies around the world battened down the hatches very quickly when the financial crisis blew up and now find themselves in a strong financial position. Lord Keynes talked about "animal spirits" and he was referring to a subjective confidence feeling which, if positive, might encourage businesses and consumers to invest. We are beginning to see these "animal spirits" appearing in the corporate world with M & A activity noticeably on the increase. Secondly, because, overall, the world economy is growing at a reasonable pace again, given the circumstances, there is the opportunity for countries afflicted by poor domestic demand to benefit from exports to faster growing economies. We mentioned Germany earlier. In a very weak eurozone, it has managed to perform very well because its manufacturing profile is well suited to meeting the demands of fast growing economies. Admittedly, after a very poor 2009 when the German economy contracted by 4.7%, the IMF, for example, is forecasting growth of 3.3% this year. Thirdly, as we have seen since the stock market's low point in March 2009, very loose monetary policy together with quantitative easing where it was instigated, has pushed up asset prices. This was a largely unspoken aim because higher asset prices give a positive wealth effect, something which might activate Lord Keynes' "animal spirits".

The sovereign debt jitters in the eurozone started earlier this year when Greece revealed that its budget deficits had been understated and therefore that its public finances were in a much worse state than previously revealed. Subsequently, Ireland, Portugal and, to a lesser extent, Spain, have been under the microscope and a look at their bond yields relative to those of the best credit, Germany, shows that these countries' debt issues are regarded with suspicion. All over the eurozone, action is being taken to reduce deficits but nowhere with the alacrity of the UK. The combination of tax increases and public spending cuts together with the longer term action to improve the finances of the state pension system is being used. To us, the current trial of strength being acted out in France between the government and the trade unions over the plan to raise the retirement age from 60 to 62 is of enormous significance. France is currently at the lower end of the AAA rated spectrum. As this is written the yield premium against Germany of ten year government bonds is 38 basis points, a large figure when we are talking about yields beginning with a "2". France's generous pension provision is unaffordable and many people's lack of realism is symptomatic of a country unable to get to grips with its public finances. It has not balanced its budget for thirty years. Should President Sarkozy lose his stand off with the trade unions, the scene would be set for France to lose its top credit rating with all that entails. In many ways, the French situation is more important than the issue of some smaller eurozone economies. As the second largest eurozone economy, failure to put its house in order could set off all sorts of problems for the eurozone. President Sarkozy cannot afford to give way on the pension issue. Changing the retirement age and the age of drawing the state pension affects future deficits but, for the present, the IMF estimates the French structural deficit (ie the part of the deficit not due to the economic cycle) at 5.0% for this year compared with 3.1% for Germany and 3.6% for Italy. France needs to get an urgent grip on its public finances otherwise it could open up another fault line within the eurozone.

Whilst the UK's public finances are bad enough, it does at least have the advantage of its own currency. For struggling southern European members of the eurozone and Ireland (although the scale of the banking crisis there makes this a different case), the inability to restore competitiveness through devaluation is a millstone around their necks. They need to regain their competitiveness against countries like Germany but, even then, the different profile of their economies would not ensure success. Greece, for example, does not make the capital goods for which Germany is famous and devaluation, even if it could occur, would not make that much difference on the manufacturing side. In another area, like tourism, it would be helpful as it attracts many eurozone tourists on holiday and would attract many more if its currency was cheaper. For the eurozone's weaker members, membership of the euro could increase the chance of a "double dip" recession although because of the resilience of Germany that is not likely to be the fate of the eurozone as a whole. The financial indiscipline in the eurozone prior to the financial crisis, evidenced by the flouting of the Stability and Growth Pact's budget deficit rules, has rendered the monetary union very poorly equipped to deal with the crisis in the area's public finances. The euro project was purely a political one. The economics of the proposed monetary union was never properly considered. If it had been, then surely the idea would not have got off the ground. The paradox now is that there is so much political capital invested in the project that the sheer embarrassment of its failure seems to be giving the politicians the necessary backbone to address all the financial issues which have been put off for years. Austerity and reform measures being activated or proposed in countries like Greece, Portugal, Spain and Ireland would have been unthinkable until recently especially if introduced by left of centre politicians. They may end in failure but, because they are in the last chance saloon economically speaking, they are at least trying. That is why, as we have just been discussing, France is such an interesting case. It has a history of backing down in the face of protests but, as this is written, President Sarkozy is standing firm in the face of very ugly protests. How this confrontation ends will be of vital importance, not only to France but to the eurozone as a whole. We cannot see the eurozone surviving as a monetary union in the longer term, and perhaps in the shorter term, if the protestors get their way. The eurozone's public finance problems remain a major issue for the world economy. Connected with this issue is the threat to banks if there should be significant sovereign debt defaults in the eurozone. As we have detailed in earlier reviews, the European banks are heavily into the sovereign debt of eurozone countries which are facing serious public finance problems.

The USA is in a serious debt situation but attention has focused on the eurozone and, although there are warning signs, such as the weakening in the US dollar, there appears to be no feeling of crisis. This is a function of two connected factors, the USA's control of its own currency, unlike the eurozone, and its position as the world's foremost reserve currency which means it has to find a place in other countries' foreign exchange reserves. As we mentioned when talking about China, the holding in reserves of a substantial US dollar position acts as a restraint on dumping the currency because of the effect on the value of the remaining US dollar holdings. The relatively closed nature of the US economy makes currency depreciation less alarming than it does for more open economies where trade and, therefore, imports represent a higher percentage of the economy's activity and therefore raise the inflationary threat from a depreciating currency. But the seriousness of the USA's fiscal position is shown by the very high level of the country's structural deficit which the IMF estimates to be at 8.0% of GDP this year, on a par with that of the UK. In one important respect, the UK is at an advantage to the USA. The governing party, or Coalition as it is now in the UK, can announce plans, as it has done to eliminate the structural deficit in the UK, and, providing it can hold together its majority in Parliament, it has the means to execute the plan. In the USA, this is not so. Congress is far more independently minded and the mid term elections provide the prospect of the Republicans, who are more fiscally conservative, gaining control of the House of Representatives and possibly also the Senate. There may well be stalemate whereas what the USA needs is decisive action to address its fiscal problems. At some stage, the USA's fiscal problems will come more to the fore.

Japan has debt problems of a different kind. It has a very high structural deficit, estimated by the IMF to be 7.6% of GDP this year, close to the levels of the USA and UK and an enormous ratio of outstanding public debt to GDP, estimated by the IMF to be at 120.7% at the net level this year and 217.6% at the gross level. However, unlike the USA and UK, Japan regularly runs a surplus on its current account. Most of its public debt is held internally and, historically, interest rates have been low. Its current problem is that it regards its currency as standing at too high a level, hence its unsuccessful move to intervene in the foreign exchange markets to weaken the yen. Although its public debt problem is bad, for the reasons mentioned above, it is unlikely to be an early candidate for the cause of an international financial or economic crisis. This is more likely to be the eurozone or the USA.

So far, being conservative, we have tended to accentuate the negative aspects of the current economic situation which seem to be at odds with the satisfactory stock market performance this year. There are obviously positive aspects and excerpts from recent forecasts in the IMF's World Economic Outlook of October 2010 show that there are areas of very satisfactory economic growth which benefit those economies in the west and Japan struggling with low growth and high levels of debt.

Real GDP Growth (%)

	2009 (actual) %	**2010** (estimate) %	**2011** (estimate) %
USA	-2.6	2.6	2.3
Eurozone	-4.1	1.7	1.5
Germany	-4.7	3.3	2.0
France	-2.5	1.6	1.6
Italy	-5.0	1.0	1.0
Japan	-5.2	2.8	1.5
UK	-4.9	1.7	2.0
Canada	-2.5	3.1	2.7
Australia	1.2	3.0	3.5
Newly Industrialised Asian Economies	-0.9	7.8	4.5
Russia	-6.5	4.3	4.6
China	9.1	10.5	9.6
India	5.7	9.7	8.4
Brazil	-0.2	7.5	4.1

Source: IMF World Economic Outlook - October 2010 (excerpt)

If these projections are broadly correct, then there is some cause for the optimism which has sustained the stock markets this year with the exception of the second quarter. Most western countries and Japan which experienced a significant recession in 2009, are expected to make a partial recovery this year which is expected to extend into 2011. Australia, which escaped recession thanks to its commodity exports, is expected to perform well this year and next. The Newly industrialised Asian Economies, comprising Hong Kong SAR, Korea, Singapore and Taiwan Province of China, having experienced a modest recession in 2009 by the standards of the west and Japan, will rebound strongly this year and are expected to grow satisfactorily next year. Russia, having experienced a serious recession in 2009, is expected to bounce back well this year and next to recover 2009's decline in GDP. The other three BRIC countries, Brazil, India and China are forecast to power ahead emphasising the shift in world order that is taking place before our eyes. If we look at the share of aggregate world GDP as calculated by the IMF for 2009 on a purchasing power parity basis, emerging and developing economies are estimated to account for 46.2% of the total. If we pick out various areas and countries from the Advanced Economies section we see the USA accounting for 20.4%, the eurozone 15.1%, Japan 6.0% and the UK 3.1%. In the Emerging and Developing Economies section, we see China at 12.6%, India at 5.1%, Russia at 3.0% and Brazil at 2.9%. With the rapid growth of emerging and developing economies relative to the west and Japan, the picture will continue to change dramatically. These growth rates, and the consequent demand for goods and services from the advanced economies, will help to offset the contractionary effect of the measures to address the severe problems in public finances. This is a bright spot in the international outlook.

So, where do these conflicting factors, severe public finance problems in many industrialised countries set against fast growth prospects in emerging and developing economies, leave the stock markets? Firstly, we reiterate our negative view on bonds. In the aftermath of the financial crisis in 2008 and 2009 when there was genuine uncertainty about the safety of the banking system, the rush into high quality government bonds and Treasury Bills was understandable. It was a question of ensuring that money was not lost in a banking crash and not of the return one could earn, this latter issue being of almost no importance at the time. Even if the return had been an issue, the extreme monetary policy that ensued ensured that it would be only a limited issue as interest rates in the main centres approached zero. Then quantitative easing was introduced in the USA and UK, essentially money printing, and this was aimed at keeping down interest rates through the purchases of bonds. But we are now in a different situation. The financial crisis has eased and the authorities have proved adept at ensuring that depositors need no longer fear for the security of their deposits. So, we should be entering a more normal era. As is quite obvious from the economic background that we all acknowledge and which we have discussed in this review, there are many problems but there are also enough positive pointers to enable us to look at more fundamental issues. If we take the ten year government bond yields for the different countries illustrated in the table at the beginning of this review, it is very difficult to see how yields like this can offer any value. For there to be any value, we would need to see a prolonged period of deflation so that the real yields were higher than the nominal yields or, alternatively, such a bad economic situation that holding bonds like these avoided losses in any other type of asset. By definition, we do not know what is round the corner but we can only invest on the basis of what we know at present and the sort of projections contained in, for example, the October 2010 World Economic Review of the IMF do not suggest we should be so negative as to avoid assets like equities. Nor do we believe the deflation story. It is difficult to see how, with growing populations, food price inflation is not going to exist and demand for commodities will continue to rise against the background of fast growing demand in the emerging and developing economies. We now have a situation where equity yields in many markets are higher than ten year bond yields. The US is a partial exception because, in the USA, although that applies to the Dow Jones Industrial Index it does not to the more representative S&P 500 Index. This anomaly could be because dividends are expected to be cut but we regard this as unlikely because profits and dividends are currently on the rise and the economic forecasts for next year suggest that this is going to continue. With monetary policy likely to remain very loose, the difference in yields between bank deposits and those on equities (not the normal comparison because we would generally use ten year government bond yields) is likely to remain wide. We believe, as indicated above, that the anomaly lies with bond yields which are far too low. On the positive side for equities, corporate profits are rising and so are dividends and this is most important for supporting current share prices and for justifying further rises. Corporate profits are rising because companies were quick to pare their costs when the crisis hit in 2008, so any recovery in the volume of business, which there has been, has boosted profits. Top line revenue growth is needed to support a continuation of profits growth and forecasts for the level of economic growth expected next year suggest that this will happen. However, it will not happen everywhere. In the deficit stricken west and Japan, domestically orientated companies may find depressed demand unhelpful but for international companies based in these areas the opportunities for revenue growth arising from exposure to fast growing countries remain good. So the expectations for earnings and dividend growth remain positive for this year and next and, against the background of modest price/earnings ratios and attractive dividend yields, it is hard to argue that shares are expensive. Nevertheless, there are so many economic problems around that equity market progress cannot reasonably be expected to continue unchecked. It would seem likely that we may see more setbacks such as occurred in the second quarter. But we are long term investors. We would not wish to risk selling shares when they do not look expensive because we think a temporary setback might occur. It is just too dangerous in terms of the potential opportunity cost in case shares then recover quickly before one is ready to buy them back.

Further out into the future, but obviously not for some time, investors will have to consider how they react to the withdrawal of quantitative easing. This is just a question, at present, of marking investors' cards. Quantitative easing, the modern day version of money printing, has caused asset prices to rise. Very basically, more newly printed new money chasing a limited amount of assets will push up prices not only in the countries where it has occurred, the USA and UK, but also elsewhere as leakages occur. We talked about the problems countries such as Brazil and Thailand were having with their appreciating currencies. This has been partly caused by leakages from countries engaging in quantitative easing, the action of which depresses the value of their currencies relative to others. The inflationary threat further out is quite clear. In countries such as the USA and UK where quantitative easing has occurred, the depreciation of the currency and asset price inflation, where it occurs, threaten inflation. In the countries, such as Brazil and Thailand, which are the unwanted recipient of these capital flows, asset price inflation could also lead to inflation in the economy. Whilst a rising currency dampens inflationary tendencies, it may not be enough to offset inflationary tendencies arising from asset price inflation. This mechanism occurs when consumers' positive wealth effects arising from, say, higher house prices or higher share prices spills over into rising consumption causing inflationary bottlenecks in an economy.

Creating money is relatively easy but withdrawing it from an economy is likely to prove more difficult. Put at its simplest, bonds purchased by the relevant central bank for newly created bank deposits for the seller of those bonds need to be sold back to the private sector so that the cash returned from the sale can be cancelled and withdrawn from the economy. But the appearance of a big seller of bonds in the market at a time when the relevant country's government is still borrowing heavily to finance its deficit will pose a threat to interest rates which, if raised significantly, would pose a threat to economic growth and securities' prices. This is for the future but no one should feel complacent about money creation. It is an extreme measure to meet extreme circumstances and, if not handled carefully, could have malign effects on the world economy.

If we have seemed to accentuate the negative aspect of the world economy at present, it is because of our natural caution, and the balance of day to day news still remains slightly negative. However, in recent reviews, as the world economic situation appears to have stabilized and improved, we have tried to balance our assessment by detailing some of the positive features in the world economy by looking at different areas. The stock market, after all, has enjoyed a modest advance so far this year and it would have been unlikely to have done this if the news had been exceptionally bad, notwithstanding the factors which we have mentioned, like quantitative easing, which have pushed asset prices higher.

If we look at the USA, there was a slight upward revision in second quarter GDP of 0.1% to an annualised rate of 1.7% with a slight upward revision in consumer spending to 2.2% from 2.1%. Although the ISM's index of US manufacturing fell slightly in September it was still quite well in positive territory at 54.4 against 56.3 in August which signifies growth albeit at a slower rate. The Commerce Department reported a 0.4% increase in consumer spending in August after a 0.4% increase in July. The housing market, of course, was where all the problems started and the background is still very difficult but there have been a few items of news which shed a less gloomy light on the situation. The National Association of Realtors index of pending home sales in August rose by 4.3%. To put it in context, it remains 20.1% below its level a year earlier. The National Association of Home Builders housing index rose to 16 in October which was the highest level since last June. US housing starts rose in September by 0.3%, the third consecutive monthly rise. The National Association of Realtors reported that sales of previously owned houses rose 10% in September compared with August. Sales of new homes rose by 6.6%. In the services sector, the ISM index rose to 53.2 in September from 51.5 in August.

The eurozone is encountering severe problems because of the sovereign debt crisis and, as this is written, concerns seem to be growing again about Greece, Ireland and Portugal as evidenced by movements in the relevant countries' bond yields. Nearly all the good news, however, seems to be emanating from Germany and, rather than converging as monetary union was supposed to encourage, the area is diverging rapidly which will throw further strain on monetary union. For the eurozone as a whole, GDP grew by 1% in the second quarter which will have been driven by strong growth in Germany. Industrial output in the eurozone grew strongly in August, up by 1%, which is the biggest rise since May. In the eurozone, the latest new orders figures show an increase of 24.4% year on year which is the highest gain since comparable records started in 1996. In Germany, there were a number of positive announcements. September unemployment fell by 40,000 to a seasonally adjusted level of 3.146 million. The Federal Labour Office said that this was the lowest figure since the early 1990's. Industrial orders in August rose by 3.4% compared with a fall of 1.6% in July. The car industry is believed to have been doing especially well. Industrial production in Germany in August rose by 1.7% following a 0.1% increase in July. The Ifo index for October rose to 107.6 points compared with 106.8 points in September to represent the fifth consecutive monthly rise. GfK reported that German consumer confidence stayed at its highest level since May 2008 with a reading of 4.9. At the end of October, it was announced that German unemployment slid to an 18 year low at 2.945 million. In France, the statistics office, at the beginning of October, increased its estimate for full year growth to 1.6% from 1.4%. However, since then, the major industrial unrest in the country is bound to have affected growth prospects although they have not officially been downgraded yet.

Japan, which has been suffering from the high yen, and which had indicated a quantitative easing programme is likely, had one piece of good news with exports rising 14.4% in September compared with a year earlier.

In the UK, the main item of recent interest has been the Comprehensive Spending Review which put flesh onto the bones of the plan to eliminate the structural deficit over the life of this parliament. As we said earlier in this review, the fall in public spending in real terms over the life of this parliament is going to necessitate the private sector taking up the slack and in that respect there was some tentative good news from the first third quarter estimate of GDP growth at 0.8%, much higher than had been expected. This figure may be revised in future estimates but, at least, it did not surprise on the downside being about twice the rate of growth that had been expected. Items of individual good news in the UK included the latest Markit/CIPS Purchasing Managers' Index for the services sector which rose from 51.3 in August to 52.8 in September and, of course, the services industry is far bigger than the manufacturing industry in the UK. In terms of profitability, there was some good news from the ONS which reported that the net rate of return by non financial corporations in the second quarter stood at 11.6% compared with 11% and its highest level for more than a year. The CBI's quarterly survey showed that expectations for a rise in output over the next three months rose at their sharpest rate since April 2007. The CBI also said that its recent sales index in October was 36 showing a strong rate of growth. Very importantly, in terms of the UK's international credit standing, Standard & Poors raised its outlook for the UK's AAA credit rating to "stable" from "negative" saying that the government's spending review showed its resolve to cut the deficit.

In summary, our view of the various asset classes remains unchanged. Bonds we regard as in bubble territory with yields driven down to unrealistically low levels by very loose orthodox and unorthodox monetary policy. Cash is only for the very risk averse or available as an opportunity to buy shares as a setback. In terms of value, shares seem the best placed asset for the reasons given in this review. This is in spite of the still very uncertain international economic background which we have dwelt on at some length here. Shares are likely to incur periods of weakness simply because of the uncertainty but, for long term investors, the asset class looks reasonably rated.