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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

For most of the quarter, the eurozone sovereign debt crisis dominated markets causing significant volatility depending upon whether the news from the eurozone became even worse or whether some more hopeful news emerged. At the end of the quarter, there was a strong equity rally which reduced the negative performances of international stock markets. This recovery, following the latest eurozone sovereign debt agreement, was stopped in its tracks after the quarter end by news of a proposed Greek referendum on its second bail out. The high quality bond markets improved and, in currency markets, the main feature was the weakness of the Swiss Franc following Switzerland's central bank's decision to peg the currency to the euro.

The tables below detail relevant movements in markets:

International Equities 29.07.11 - 31.10.11

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-1.1	-2.9	-4.5	-1.6
Finland	-3.7	-5.0	-6.6	-3.7
France	-10.9	-12.0	-13.5	-10.9
Germany	-14.6	-15.7	-17.1	-14.6
Hong Kong, China	-13.8	-12.0	-13.5	-10.8
Italy	-11.5	-12.6	-14.1	-11.5
Japan	-8.6	-8.0	-9.5	-6.8
Netherlands	-8.3	-9.4	-11.0	-8.3
Spain	-5.5	-6.7	-8.3	-5.5
Switzerland	-1.1	-9.0	-10.5	-7.8
UK	-3.7	-3.7	-5.3	-2.5
USA	-2.6	-0.9	-2.6	+0.4
Europe ex UK	-9.1	-11.7	-13.1	-10.5
Asia Pacific ex Japan	-7.4	-8.6	-10.1	-7.4
Asia Pacific	-8.0	-8.3	-9.8	-7.1
Latin America	+0.1	-6.7	-8.3	-5.5
All World All Emerging	-5.8	-9.9	-11.4	-8.7
The World	-4.8	-5.2	-6.8	-3.9

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +6.1%

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

Currency	29.07.11	31.10.11
Sterling	2.87	2.44
US Dollar	2.81	2.13
Yen	1.08	1.05
Germany (Euro)	2.54	2.00

Sterling's performance during the quarter ending 31.10.11 (%)

Currency	Quarter Ending 31.10.11
US Dollar	-1.8
Canadian Dollar	+2.1
Yen	-0.9
Euro	+1.2
Swiss Franc	+8.6
Australian dollar	+1.8

Other currency movements during the quarter ending 29.10.11 (%)

Currency	Quarter Ending 29.10.11
US Dollar/Canadian Dollar	+4.1
US Dollar/Yen	+1.0
US Dollar/Euro	+3.1
Swiss Franc/Euro	-6.9
Euro/Yen	-2.1

Significant Commodities (US dollar terms) 29.07.11 - 31.10.11 (%)

Currency	Quarter Ending 31.10.11
Oil	-6.2
Gold	+7.6

Markets

A rally at the end of the quarter limited the fall in the international equity markets to relatively modest levels. The total return on the FTSE World Index in local currency terms was -4.8%, in sterling terms -5.2%, in US dollar terms -6.8% and in euro terms -3.9%. Looking at local currency returns first, the worst performer was the FTSE Europe ex UK Index which returned -9.1%. Germany, in the recent past a good performer, suffered badly with the FTSE Germany Index returning -14.6%. Elsewhere, Japan was an underperformer with the FTSE Japan Index returning -8.6%. Holding up best of all was the FTSE Latin American Index which showed a positive return of 0.1%. The USA and UK held up relatively well with the FTSE USA Index returning -2.6% and the FTSE UK Index -3.7%. Australia was also a relatively good performer with the negative return on the FTSE Australia Index at 1.1%. In sterling terms, strength in the US dollar meant that the negative return on the FTSE USA Index was just 0.9%, but that on the FTSE Europe ex UK Index widened to -11.7%. Asia Pacific ex Japan, Latin America and the Emerging Markets all underperformed the FTSE World Index in sterling terms with respective returns of -8.6%, -6.7% and -9.9%.

The continued turbulence, particularly in the eurozone, led to a flight to perceived quality in the international bond markets, as our table shows. Whilst the bonds of the weak eurozone credits suffered, those countries considered to be a good risk saw yields fall and, using ten year government bonds as a benchmark, the gross redemption on the UK bond fell by 43 basis points to 2.44%, on US Treasuries by 68 basis points to 2.13%, on Japanese government bonds by 3 basis points to 1.05%, and on German government bonds by 54 basis points to 2.0%.

In the currency markets, the stand out movement was in the Swiss Franc which, following the decision of the Swiss Central bank to peg the currency to the euro, saw its strength suddenly reversed. Against the euro, the Swiss Franc fell by 6.9%, whilst sterling rose by 8.6% against it.

In the commodity markets, the oil price, as measured by Brent crude, fell by 6.2%, whilst gold rose by 7.6%.

Economics

It is self evident that the world is experiencing an extraordinary period of economic uncertainty with a background in many advanced countries which is scarcely believable. That we have no real precedent for this makes investment management particularly challenging.

We have an economic situation now when long periods of overspending by many western governments and Japan are catching up with the reality that this state of affairs cannot last indefinitely. Whilst politicians are keen to divert attention to bankers and, of course, they did some extraordinarily dangerous things and, in some cases, received payments which were offensively large, it is politicians who must shoulder a large part of the blame for the current crisis. As investors should take the long view, so should politicians in formulating economic policy. Almost everywhere, where there is a problem now, it is because politicians have developed an economic policy to win re-election and that usually means spending more money than is wise. So, in the USA, Japan, UK and much of the eurozone, deficit spending has become the norm and overall public debt ratios in relation to GDP have risen. Thus, when the financial crisis struck in 2008 leading to a recession in 2009, many countries were in no state to absorb the deterioration in public finances. As with individuals and businesses, but usually with a longer time lapse, overspending also catches up with countries. This is what we are now witnessing. Let us now look at the various areas of the world where this is an issue, starting with the USA.

Although all attention is now focused on the eurozone, the catalyst for the poor performance in stock markets in the third quarter was the USA, where the stand off over the level of the debt ceiling, the possibility of default and a downgrading of the USA's credit rating, seriously unsettled investors. The shocking thing about this state of affairs was that it was so unnecessary. The fact that the stand off went to the wire owed everything to the poisonous relationship between the Democrats and Republicans in Congress, with each party having control of one house, and between the Republicans in Congress and the President. The centre ground has all but been vacated, resulting in a sharp polarisation of opinion on left and right. In truth, the checks and balances in the Constitution make decisive decision taking all but impossible in the present circumstances and, whilst this was understandable way back in the past, it is now a serious impediment to any sensible and timely decision making. The problem is that there are elections next year and that is the fixation of most US politicians. The philosophical issue is one of big government / higher taxation and small government / low taxation. Nevertheless, it does not reflect well on many US politicians that they were prepared to put at risk the country's creditworthiness with their acrimonious quarrelling. A temporary fix was agreed. However, Standard & Poor's has downgraded the USA's long term credit rating from AAA to AA+, quite rightly citing the political issues in the USA as they affect decision making. The budget balance in the USA is likely to show a deficit of over 9% this year and, without action, the long term forecasts for the USA's public finances are dire. What has helped to put the question of the USA's public finances on the back burner for the moment is the crisis in the eurozone, with investors tending to focus on one issue at a time. The fact that the USA issues and can print its own money buys it time, which the eurozone does not have. This is no reason for not addressing the USA's public finances problem but it does buy some time. Despite the credit downgrade, the USA is able to borrow at extraordinarily low interest rates which, again, gives it some temporary respite. So, the position in the USA is that there are very serious problems, but not as serious as those in the eurozone, so the concerns have been "parked" by investors for the time being.

The case of another highly indebted country, the UK, is somewhat different. The very serious budget deficit level, which reached over 11% of GDP in 2009/10, was unsustainable and threatened the UK with a major financial and economic crisis if it had not been addressed. Unlike the US dollar, sterling does not have the advantage of being a major reserve currency, so the UK's external creditors do not need to hold the currency. In the case of the USA, its major creditors would risk cutting off their nose to spite their face if they dumped US dollars in a major way, so the USA has some leverage in dealing with its deficit issue. The UK has none. The UK has no alternative but to try to deal decisively with eliminating its structural deficit and its plans have been well received by investors as government bond yields have fallen to extraordinarily low levels and the UK has, at least so far, maintained its AAA rating. Were siren voices, calling for a more gentle approach to deficit reduction, to be heeded, there is little doubt, in our view, that government bond yields would rise sharply, sterling would come under pressure and the AAA rating lost. Of course, setting public finances on the road to stability is going to make the government deeply unpopular but a look at what is happening to some financially challenged eurozone countries should bring home how important it is to restore order to the UK's finances. For the moment, therefore, the deficit issue in the UK can be put to one side, not because it is not serious but because the eurozone crisis, although it affects all economies to different degrees, is by far the worst of those facing major countries or currency zone in the case of the euro.

In terms of public debt as a percentage of GDP, Japan's situation is the worst of the major economies, with gross public debt at over 200% of GDP. Its budget deficit this year is estimated to be over 8% of GDP. On the face of it, with investors so skittish, this is the stuff of a financial crisis. But it is not, at least not yet. The saving grace for Japan is that most of its debt is internally financed so that it is not at the mercy of foreign investors. Japan's external position is strong. After China, it has the world's largest foreign exchange reserves and it maintains a healthy current account balance. Its problem has been the strength of its currency, which it has attempted to weaken without success. Like the USA, Japan will have to address the state of its public finances which adverse demographics will make worse. But, as with the USA and UK, its problems in an international context pale into insignificance compared with those of the eurozone.

By far the biggest economic and financial problem therefore is the eurozone. In the paragraphs above, we have noted how serious are the problems of the USA, UK and Japan. They all have the potential to be a major market issue but they are nowhere on the scale of the eurozone's problems so that statement alone shows how critical these are. At the risk of repeating what we have written in these reviews over many years, the eurozone is not what economists call an optimal currency area. In other words, for many reasons, it is not a natural geographical area to form a currency union. There are far too many economic and cultural differences. A comparison between the strongest eurozone economy, Germany, and the weakest, Greece, makes the point. They could hardly be more different economically. One, out of many differences, is that Greece usually experiences much higher inflation than Germany. The idea that a "one size fits all" monetary policy with a single interest rate being suitable for both countries is risible. A cultural difference is the Greeks' aversion to a formal system of tax collection. As a result, one of the pillars of a sound economy, a predictable tax base, is completely missing. If a currency union is not an optimal currency area, and the eurozone is not, no amount of temporary fixes and expedients will solve the problem. That is where we are now. The eurozone, as now constituted, is not capable of being fixed. The euro is a politically created currency which has spun out of control. Non eurozone EU members, like the UK because of its important trade links, will also suffer from the eurozone's problems and so will almost every other country to various degrees.

The politicians who devised the single currency, and who still support it, are culpable. Many people who warned about the flaws in the euro were ignored. The single currency was supposed to bring about economic convergence but, unsurprisingly, it has brought about divergence. One of the important convergences should have been inflation. Simply put, if one interest rate is suitable for all the members of a currency union, inflation rates must converge. This is not what has happened and nor was there any valid reason why it should have been expected to happen. With southern eurozone countries losing competitiveness against countries like Germany, it is inevitable that their current accounts should deteriorate. The strongest members of the eurozone, countries like Germany, the Netherlands, and Finland, all have current account surpluses. The weakest ones, Greece, Portugal, Spain and Italy, all have current account deficits. They have consumed more than they have produced, caused, in part, by their reduced competitiveness and, as a result of having to borrow, have become weaker credits. Ireland is a special case because it was brought down by its banking crisis, having, until that time, a healthy economy.

The end game (resolution would not be the correct word here) will reflect one of two courses. One would be a federal eurozone, certainly as far as fiscal policy is concerned. A monetary union which excludes fiscal policy is holed below the water line as soon as it starts. If fiscal policy is determined centrally, then transfers can be made to the countries in difficulty. We would say that this outcome is almost impossible but appears to be the preferred route of eurozone politicians. The electorates and some governments will not wear this. The creditor countries, such as Germany, where there is already strong opposition to the bailouts, would not accept their money being transferred to debtor countries and the latter's electorates would not accept being told what to do by the stronger countries. Whilst the politicians might try to move in this direction, and they do not have a good record of consulting their electorates on EU matters, the rivalry between Germany and France (which is at the low end of the AAA spectrum), which is apparent now, would be likely to scupper the project.

The other outcome, the break up or fragmentation of the monetary union, is far more likely in our view. No end of sticking plaster will shore up a project which has such a fundamental fault line running through it. Break up will be very painful and messy and cause huge problems, but continuing with it will only make matters worse when the inevitable occurs. At least if some or all of the countries in the eurozone leave the currency union, they will be able to regain their competitiveness through devaluation. The fact that they will default on some or all of their debts will provide the discipline not to get into the situation of spending beyond their means again because they will not be able to borrow in the way they did before. There are various ideas as to how the eurozone may split up. If not a complete split, then there are thoughts of a northern and southern eurozone but, unless accompanied by a fiscal union, such a solution would only be likely to have a short or medium term life span. For example, it is not clear into which camp France should go. Like Germany, the Netherlands, Finland and Austria, it has an AAA rating but, as mentioned above, it is at the weak end. The eurozone government bond markets tell a story. As this is written, ten year German government bonds yield 2.00%, those of the Netherlands 2.43%, of Austria 2.90% and Finland 2.46%. Those of France yield 3.24%. France has not balanced its budget for over thirty years and the enormous yield premium which French bonds show over those of Germany suggests an element of divergence which could be difficult to sustain within a smaller currency union. Realistically, there is no way that France would accept a different status from that of Germany. Many people who, perhaps at the start of the euro, did not feel strongly about the warnings given about its stability now recognise that it cannot continue.

At every stage, the politicians have been behind events in the eurozone, particularly with regard to the solvency of Greece. Disagreements have been apparent everywhere and there is no central leadership. All the leaders are looking over their shoulders at their increasingly hostile electorates and national interests, as they always will, trump the eurozone's interests. Thus, they are trying to muddle through, hoping that this will provide a solution. It will not because of the inherent flaws in the system.

At the moment, looking at distressed or problematic eurozone countries and using ten year government bonds as a benchmark, the obvious problem areas are Greece, Portugal and Ireland, with gross redemption yields of

24.08%, 11.88% and 8.20% respectively. All are in the bailout category. The only one where there is a possibility of emerging eventually in reasonable shape is Ireland which is actually making good progress although not enough to pay those interest rates. Into the worrying category, because they are the eurozone's third and fourth largest economies, are Italy and Spain, with gross redemption yields on their ten year bonds of 6.11% and 5.46% respectively. Both of these countries' bonds have been bought by the ECB to try to keep them below the critical 6% level but Italy's have again risen above that level. At the time of writing, the ECB has been the only vehicle through which significant action can be taken. It has expanded its balance sheet enormously and currently has purchased approximately €173.5 billion of sovereign bonds. It has been very reluctant to do this and this action stands on its head everything that it has represented. As it does this, it is increasing its risks and those of the creditworthiness of eurozone governments. Who is to know the value of the debt which it has purchased? The Eurozone Financial Stability Facility, currently at €440 billion, but clearly inadequate, puts a strain on the creditworthiness of even the strongest credits, with Germany guaranteeing nearly 30% of the total. It is self evident from the yield premium of French government bonds over German bonds that its rating would be at risk from a big increase in its potential exposure to losses on eurozone sovereign debt. Bank recapitalisation, if governments were involved, again would involve increased risks and lower credit ratings.

Our view is that, although not permitted, the ECB may have no option but to monetise some of the eurozone's debt. Unlike countries which do not belong to a monetary union, individual countries in the eurozone do not have this option, but the sheer size of the eurozone sovereign debt market means that if, say, Italy or Spain saw their sovereign debt bond yields move into danger territory, i.e. over 6%, it would need to create money which it could not sterilise in the market. Italy has the world's third largest outstanding amount of government debt.

The point is often made that, taken as a whole, the eurozone's indebtedness in relation to GDP is not high in relative terms - it is just that it is unbalanced. If it was to be suggested that the countries with relatively strong public finances, the ones we mentioned earlier, were to relax their fiscal stance to encourage spending, which would help the weaker countries, this would be regarded as a non starter as far as Germany is concerned. There is no appetite to risk the German model of (generally) prudent finances (the word "general" is used because Germany, at an early stage, broke the Stability and Growth Pact's rules with regard to budget deficits) and low inflation. Encouraging a big increase in spending to reduce imbalances within the eurozone would risk inflation. This may be a way of restoring some relative competitiveness within the eurozone but can anyone see Germany embarking on a deliberate policy to increase inflation? At the end of the day, and this is another flaw in the idea of monetary union, countries will look after their own interests rather than those of the eurozone, none more so than Germany.

In the short term, therefore, the "try to muddle through" approach is the one which the eurozone will follow but it promises no happy ending. Key to the eurozone's short term decision making is a realistic assessment of sovereign debt write downs and ensuring that the major banks have sufficient capital to withstand realistic write downs on troubled eurozone sovereign debt. There are two ways, or perhaps a combination of the two, that banks can achieve this desired end. They can either raise more capital, privately, or from governments or the EFSF, or a combination of them, or deleverage, the latter by selling assets or reducing lending or, again, a combination of the two. Raising capital presents a problem for banks which are often trading well below book value. It will cause further dilution. Cutting back on lending will exacerbate the economic downturn which faces the eurozone. Conditions in the credit markets are tightening as banks become more cautious about lending to each other. The authorities will be anxious to change this situation quickly in order not to damage business. A realistic assessment of the chances of recovering loans to troubled eurozone countries and recapitalisation, where necessary, are essential. If countries have to put more money into banks and, theoretically, expose them to more risk, their credit ratings will be under threat.

The initial reaction to the markets of the latest eurozone package was initially euphoric but the devil will be in the detail. Whilst the politicians present the big picture, they are not so good at the detail and with so many parties involved, there is plenty of room for problems to develop. The latest plan is to boost July's bail out plan for Greece from €109 billion to €130 billion and to encourage private holders of Greek bonds to accept a 50% "haircut" on the face value of their bonds. Banks will have to have a minimum ratio of top quality capital to total liabilities of 9%. There will be attempts to leverage the European Financial Stability Facility to €1,000 billion from the €250 billion remaining. This is the big picture, but the details need to be agreed, and the fact that Italy had to pay 6% on a new ten year bond shows that the eurozone's leaders could well be overtaken by events again. As this review is finalised, Greece has unexpectedly announced that the Greek parliament is going to be asked to approve a referendum on the second bail out. This has thrown eurozone leaders into shock.

It is self evident that investors are facing an unprecedented situation as the volatility of the markets, especially since July, bears witness. It is noticeable that, in the absence of further bad news, equity markets have tended to move up. If there is some further bad news, there is a setback. With the eurozone politicians in disarray, it is little wonder that markets are so febrile. We think, however, that there is a clue for investment policy in the upward movement which equity markets are showing on days on which the news does not get worse.

This tends to suggest that many investors regard equities as the place where there is some realistic value. If we are correct in believing that short term interest rates are going to remain exceptionally low for the foreseeable future in the industrialised countries, then cash is certainly going to yield negative real returns. That can only look an attractive proposition if everything looks worse or if an investor is so risk averse that he or she is happy to accept such a situation because it reduces the element of concern. If we look at top quality government bonds, such as those shown in our table at the beginning of this review of ten year government bond yields, we note that all of them, with the exception of Japan, have negative gross redemption yields in real terms. There looks to be no value here and it should be remembered that if yields move to significantly higher levels, perhaps more realistic levels when inflation is taking account, the loss on capital values would be large and, unlike equities, prices could not be expected to bounce back for a long time. If we go back to the 1960s, before inflation took off, a typical UK government bond of long term duration could be issued on a coupon of, say 5½%. An example would have been Treasury 5½% 2008/12, yet in the next decade, with inflation rampant, the Bank of England was issuing a Treasury 15½% 1998 bond. Those who bought the 1960s issue had their capital decimated in nominal and real terms. Those examples may be extreme but they make the point about how dangerous bond markets can be in certain circumstances. It is important for bond holders to appreciate that in countries where quantitative easing has been used, such as the USA and, perhaps especially, the UK, an inflationary outcome can be expected later on, unless the quantitative easing is reversed by the relevant central bank selling the bonds it has purchased to withdraw the cash from the private sector. Whilst investment grade corporate bonds obviously have higher yields than AAA or, in the case of the USA as far as Standard & Poor's is concerned, AA+ government bonds, their yields are not obviously appealing.

This leads back to the position of equities in this extraordinary environment. Whilst the third quarter was a poor one for equities, with the FTSE World Index returning, in sterling terms, a negative 14.7%, it was noticeable that defensive stocks, such as consumer staples and utilities, held up well and, in some cases, advanced. The reason for this is their perceived defensive qualities which are that, even if economic times are difficult, as they are now, demand for their products will be stable and profits and dividends will be reasonably predictable and secure. The dividend issue is particularly important in the context of very low short term interest rates and bond yields. Investors are looking for yield and these types of stock score heavily in present conditions. Conversely, when investors are less risk averse, more volatile stocks, like those of mining companies, for example, can usually be expected to perform better. Since the financial crisis of 2008 and the economic recession the following year, companies have moved to strengthen their balance sheets and preserve cash whilst they have been cautious about investing. Whilst this does not help economic activity in the short term, it is quite positive for dividends as, even in these difficult times, companies' ability to pay dividends is good. Of course, if the world economy falls off a cliff and moves into severe recession or depression, this point will not be valid, but it is not our view that this is going to be the case because of growth elsewhere in the world, mainly developing and emerging markets. If we take market valuations of equities in terms of ratings and dividend yields, they look good value. We know that profit margins are high and may revert to mean, but there is quite a large margin of comfort which has built up for companies as a result of their prudent approach to their finances since the 2008 financial crisis. It is also true that the finances of most big companies are in much better shape than those of the country in which they are registered. The paradox of the current situation is that eurozone banks were encouraged to build up their "safe" assets such as eurozone sovereign debt which, in some cases, have proved to be nothing of the sort. The point which we are trying to make is that it is not necessarily true that equities are the riskiest class of asset in current circumstances. Within the eurozone, the creditworthiness of even the strongest countries like Germany is bound to be reduced by its efforts to support the weaker credits. Equity dividends should provide some hedge against the inflation risks mentioned above. This is particularly true of a market like that of a high inflation country such as the UK. Even with inflation over 5% (it should fall back somewhat next year as higher VAT drops out of the year on year comparisons), there are still a number of good quality companies which yield around the inflation rate and have dividend growth potential. The same is true in the eurozone. Whilst it is right to be pessimistic about almost everything to do with the eurozone, the same is not true for its many world class companies which, whilst often experiencing difficult conditions with the eurozone, can still benefit from their international exposure. If investors can live with the volatility of equities as they respond to news, mainly from the eurozone, and accept that they appear to represent the only main asset class which has any value, then the flow of income from company dividends which could well still be on a rising trend has a great attraction for, eventually, the value which appears apparent in equities should emerge in higher share prices.

Over and above the two issues which sparked the fall in share prices in the third quarter, the US debt ceiling stand off and the eurozone's sovereign debt crisis, there are two general issues which could be of concern to investors. The first is increasing protectionist sentiment and the second is the rise in anti business sentiment and activity, often centred around the banks.

When economic times are difficult, there are often undesirable side effects, one of which is protectionism, as countries seek to protect their own interests. The world as a whole loses by protectionism as trade slows and the benefits of comparative advantage are lost, thus making poorer the majority of the world's population as they pay more for goods and services than they would in a free trade environment. Particularly dispiriting is the move in Congress to impose protectionist measures against China, although the Bill is not phrased that way, but everyone knows its target. The Bill seeks to impose tariffs on goods from countries believed to be manipulating their currencies lower than they should be to gain a competitive advantage. It is true that China manages its currency, but the trend of the yuan against the US dollar has been upwards and China's inflation rate is higher, which reduces its competitive advantage. The USA is the world's largest debtor nation and China holds the largest pool of foreign exchange reserves. In these circumstances, it does not seem right to pick a fight with China, for one can be sure that China will not bow to the USA's demands. A trade war will benefit no one and it is depressing to see US politicians promoting this self defeating action. The so called leading moderate Republican Presidential candidate, Mitt Romney, has said that he will name China as a currency manipulator on Day One of his Presidency. The Republicans are supposed to be greater supporters of free trade than the Democrats. This is another example of populist politicians looking to gain votes to the exclusion of sensible long term policy. It is a pretty depressing prospect and frightening that supporters of these types of measures seem to understand so little about the consequences of what they are proposing. At this stage, if it comes to the point where the President can veto the measure, it is not clear what his attitude would be. The measures would probably be illegal anyway under WTO rules.

When times are difficult, as at present, and given the financial crisis of 2008, it is easy to pour opprobrium on businesses, especially bankers. So, we are seeing an outbreak of anti business sentiment generally and anti banking sentiment particularly to which opportunistic politicians, often keen to deflect anger from themselves for their inadequacies, are often happy to join in. Whilst there will always be a hard core of anti capitalists, opportunistic politicians have to be careful what they wish for. At a time when most governments' finances are seriously overstretched and the government sector has to retrench, any growth has to come from the private sector which governments should encourage to invest and spend. In the USA, the President is targeting millionaires and billionaires as a political tactic. Irrespective of the rights or wrongs of whether they pay enough tax, it sends out the wrong message to the private sector regarding wealth creation. Companies are increasingly global and mobile and do respond to positive or negative signals from their governments. In the EU, France and Germany are pressing ahead with plans to introduce a financial transaction tax, ostensibly to raise money for individual countries in the EU and the EU generally and to get something back for supporting the banks. Quite clearly, this strikes a populist chord. The financial sector is extremely unpopular. But if it is looked at objectively, the plan unravels. Firstly, although 0.1% of a trade, say in conventional equities or bonds, might seem mild and politicians would like people to believe that it is painless, it is nothing of the sort. All those who buy or sell shares, say pension funds, will be poorer and therefore so will pensioners and savers. They may want to target high frequency traders, for example, but in doing so they will harm what we would call regular investors. Secondly, in a global market place, business will move because one can be sure that this tax will not be applied universally. It is admitted by its proponents that it will reduce economic growth and that business will move. It might make politicians feel better but what is the point of damaging a country's economic prospect and people's jobs? The point about both of these examples is that investors in a particular country or region need to be aware of the unintentional consequences of the increase in anti business rhetoric and measures which politicians under pressure for re-election are proposing at present.

Elsewhere in the world, we have seen Brazil raising tariffs on imported cars to try to protect its own industry. Although the Brazilian real has fallen in value recently, it, like some other currencies of faster growing countries, suffered from strong speculative capital inflows which caused the authorities to take action. By raising the value of the currencies, these inflows made life difficult for businesses. This is one of the side effects of the USA's quantitative easing as money has leaked out to faster growing economies in search of better returns. Thus, we have distorted currency values which encourage protectionist behaviour.

So, what is the conclusion from these thoughts? It is clear that parts of the world economy are in a very bad way, with at least one eurozone member insolvent and possibly others. Whilst countries like Italy and Spain may not have a solvency problem, they do have a liquidity problem. For these reasons, the eurozone is going to have a period of slow economic growth at best. For example, the latest economic growth projection from the IMF is 1.6% for this year and only 1.1% for next year, reductions on its June forecasts of 0.4% and 0.6% respectively. The USA is not expected to provide a huge boost either. The IMF's forecasts there are now 1.6% and 1.9% respectively, reductions of 1.0% and 0.9% from last June's forecast. But, for the world as a whole, its growth forecasts for 2011 and 2012 are 4.0%, not wonderful but not disastrous. These forecasts may have to be downgraded again but the point is that growth in developing and emerging markets should be strong enough to prevent a world recession. So, it is important to say that, whilst we, in the west, read really only gloomy economic news, this state of affairs is not universal. The corollary of this is that it is possible to invest directly and indirectly in areas which are doing relatively well. One can escape from one's own poor economic environment through the stock market and it is therefore important to look at the big picture.

Whatever the outcome of the eurozone's sovereign debt crisis is, it is not going to be a happy one. This is a man made problem which has spun out of control. The normal checks and balances associated with a national currency when economic problems arise are absent. A country which loses competitiveness, like those in the southern eurozone, will see its currency depreciate and interest rates rise, thus exerting some discipline on wayward countries. In the eurozone, countries could borrow money at low interest rates, thus losing all economic discipline until their cover was blown and the edifice came tumbling down. It would be seriously remiss of those in the European Commission and ECB if work was not being done behind the scenes on plans to dismantle the currency union so that it could be done with minimum damage. Meanwhile, we believe that some form of money printing will be involved to sustain the financial structure, whether it be of individual countries or banks. The sums involved are just too large for a bail out of countries like Italy and Spain. Everything the ECB ever stood for will be turned upside down. The damage done by the creation of such a large non optimal currency area will take years to put right and inflict serious damage on the eurozone members' growth prospects and collateral damage to the rest of Europe and, to a lesser extent, other parts of the world. For reasons we have stated, high quality bond markets, which have benefited from a flight to quality, cannot offer any fundamental value and, with some growth in the world economy, worldwide company profits should be able to show modest growth. The valuation of shares does not look excessive and investment in, or calls on, real assets look to be the best way to benefit from the background which we have described.

The high level picture is the one which matters at the moment given the gravity of the eurozone's sovereign debt crisis so we will not deal as much as usual with detailed economic data and news from the different countries and regions. Nevertheless, we will pick out a small number of significant issues starting with the USA.

Whilst the UK has gone for a further bout of quantitative easing, the USA chose a different course of action in September with its "Operation Twist" which sought to influence longer term interest rates, with the Federal Reserve switching shorter dated government debt holdings into longer term ones to push down yields along the yield curve and thereby help businesses and mortgage borrowers. The Federal Reserve remains relatively downbeat about the USA's prospects. In a testimony to Congress, in early October, it said that recent indicators "point to the likelihood of more sluggish job growth in the period ahead". The minutes of the Federal Reserve's September meeting reported that "a number of participants saw large scale asset purchases as potentially a more potent tool that should be retained as an option in the event that further policy action to support a stronger economic recovery was warranted". Such language indicates that a third round of quantitative easing is a possibility. The closely watched ISM figures for the manufacturing and services industries were both in positive territory, but not significantly so. The index for the manufacturing sector stood at 51.6 in September, slightly higher than August's reading of 50.6, whilst the services' index was slightly lower at 53.0 in September compared with 53.3 in August. Towards the end of the month, the durable goods orders came in slightly better than expected. If the volatile transport orders are excluded, they were 1.7% higher in September. One swallow does not make a summer, but it is right to note that not all the news is bad, and third quarter earnings coming through from American companies have been satisfactory. US companies look in reasonable shape to face the unsettled economic weather which is coming.

There is an interesting footnote to the proposed Bill in Congress to penalise China for manipulating its currency. A report from Boston Consulting predicts that rising labour costs in China could contribute to the creation of 3 million new manufacturing jobs in the USA by 2020. They describe this phenomenon as "reshoring".

The importance of individual items of data and news from within the eurozone is partially diluted by the crisis facing the monetary union, but we will, nevertheless, point out a small number of items of news. The Franco-Belgian-Luxembourg bank, Dexia, heavily involved in sovereign eurozone debt on its balance sheet but short of funding, had to be rescued and broken up. One of the major problems for banks exposed to eurozone debt as a supposedly safe asset is that the exposure has discouraged other banks from lending to them. In this way, the insidious effects of the eurozone debt crisis spread and, of course, make life difficult for those businesses and individuals who require bank finance. This helps to cause a contractionary effect on the economies concerned. At October's ECB meeting, when the decision was made to keep its repo rate at 1.5%, the ECB also announced that it would offer banks unlimited twelve month loans and would do it again in December to run through to 2013. Sovereign credit ratings continue to come under pressure. Moody's downgraded Italy's credit rating by three notches to Aa2 from A2.

Fitch downgraded Italy to A and Spain by two notches to AA-. Moody's has marked France's card over its credit rating, suggesting that it may change its "stable" outlook on its rating to "negative" because the government's financial strength "has weakened". The eurozone's sovereign debt crisis has taken its toll of the eurozone's economy. The October eurozone purchasing managers index fell from 49.1 in September to 47.2 in October. The German Ifo Institute reported that its business climate index fell from 107.4 in September to 106.4 in October. As the economic powerhouse of the eurozone, weakness in Germany is worrying. Its manufacturers have reported the first fall in production for more than two years.

With everything which has been going on in the USA and, particularly, the eurozone recently, Japan, after the terrible natural disasters and resultant nuclear scare in March, has rather been sidelined as an economic issue. The economy has recovered more quickly than expected in that the disruption to production has not been as serious or lasted as long as expected. This is not to downplay the extent of the tragedy. We mentioned earlier the fact that Japan is carrying the highest level of public debt in relation to GDP of any major industrialised country and that this issue will have to be addressed. For the moment, the fact that most of this deficit is funded internally and that Japan has financial strengths which some of the weaker eurozone countries do not have, such as the world's second largest foreign exchange reserves and a healthy current account balance, means that it is not in the firing line. In fact, its problem is the strong yen and, as a consequence of this, and it would be typical, it was reported that Toyota was looking at producing its family sized Camry in Kentucky for export to Korea. Japan's efforts to hold down the yen have not been successful. Japan also has to decide how to fund its reconstruction programme resulting from last March's disasters. Nevertheless, because its economic problems are quite different from those of the eurozone, Japan is not an investment issue at present. In fact, on a positive note, the latest Tankan survey of large manufacturers moved into positive territory at +2 in the third quarter compared with -9 in the second quarter.

China is still growing rapidly compared with elsewhere, but a slowdown in the rate of growth is evident. The rate of growth slowed from 9.5% annualised in the third quarter to 9.1% in the third quarter. Its trade surplus has been narrowing and, at US$14.5 billion in September, was 5% lower than its July figure. As we noted earlier, besides the effect which the international economic slowdown is having everywhere, China has been losing some of its competitiveness as a result of the rise in the currency and relatively high inflation. Some business is moving to lower cost Asian economies. Nevertheless, China, now the second largest economy, continues to provide some offset internationally to weakness in many western economies.

For the UK, the eurozone disaster is a case of what might have been. It hardly bears thinking of the consequences of the UK being tied into a single currency. Nevertheless, there is absolutely no room for smugness and complacency about the eurozone's woes. Europe is the UK's largest trading partner and meltdown in the eurozone would put the UK in a very bad place. Whilst the UK, with a terrible budget deficit situation, has no alternative in our view but to address rigorously the need to eliminate the structural deficit, slower than expected economic activity in the UK's main trading markets will damage the UK's growth prospects and damage the UK's projected path of recovery for its public finances. The UK economy grew by just 0.1% in the second quarter. As we mentioned earlier, siren voices are calling for a more measured approach to eliminating the deficit, something we believe would be taken very badly in the bond and foreign exchange markets. At the beginning of October, Standard & Poor's affirmed the UK's credit rating as stable, but warned that the rating would come under pressure if the UK eased its deficit cuts. Against a background where the Bank of England has reduced its growth forecast for the rest of 2011 to "close to zero", the Bank has announced a further round of quantitative easing. On top of the £200 billion of quantitative easing already in place, a further £75 billion is to be injected into the economy. As before, the idea is that by buying mainly government bonds, interest rates will be kept down to help borrowers, and the money created will find its way through the economy to stimulate growth and raise asset values to create a positive wealth effect. Separately, the Chancellor of the Exchequer has announced a policy of credit easing, different from quantitative easing, which is aimed at providing funds to businesses at acceptable rates of interest which might be denied to them in the current difficult circumstances for some creditworthy businesses which are finding themselves denied funds.

A particularly difficult problem for the UK is inflation, which is running well above target level. The latest consumer price index for September stood at 5.2%. The dangers of having a huge negative real official rate of interest as the UK has with the repo rate at 0.5%, and then printing more money, are clear. Unless this money is withdrawn from the economy at some stage, even more serious inflation threatens later on. But in these extraordinary economic times, very loose monetary policy has to be followed to offset what necessarily has to be a very tough fiscal policy.

Although international equity markets have shown a very strong rebound in October, investors should certainly not become complacent. There is an existential crisis for the euro with uncertain economic consequences only to the extent of knowing the degree of seriousness. Faced with this situation and with so little value around in the bond markets and on cash deposits, the value of investments in high quality businesses paying regular dividends and being exposed to areas of the world which are showing good growth (we must certainly not forget this amidst all the gloom in the west) is apparent. As we have seen this year, it will be an uneven ride but we should be guided by the value which, in our view, exists in good quality companies.