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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Notwithstanding the modest rise in international equity markets, it has been an eventful quarter with some remarkable movements in October. The apparent change in sentiment at the end of September and in the first part of October has quickly reversed, although there is absolutely no reason for complacency given all the well known problems. High quality bonds have enjoyed a good quarter. In the currency markets the strength of the U.S. dollar has been a feature, whilst commodity prices have weakened, sometimes sharply.

The tables below detail relevant movements in markets :

International Equities 31.07.14 - 31.10.14

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-0.5	-0.7	-5.9	+0.5
Finland	+3.8	+2.6	-2.8	+3.8
France	-0.4	-1.6	-6.7	-0.4
Germany	-0.4	-1.6	-6.8	-0.4
Hong Kong, China	-2.2	+3.1	-2.3	+4.3
Italy	-2.4	-3.6	-8.6	-2.4
Japan	+4.5	+1.1	-4.2	+2.3
Netherlands	+4.3	+3.1	-2.3	+4.3
Spain	-2.2	-3.4	-8.5	-2.2
Switzerland	+4.6	+4.3	-1.2	+5.5
UK	-1.7	-1.7	-6.9	-0.6
USA	+4.8	+10.6	+4.8	+11.9
Europe ex UK	+1.0	N/C	-5.3	+1.2
Asia Pacific ex Japan	-2.0	+0.1	-5.2	+1.3
Asia Pacific	+1.1	+0.6	-4.7	+1.8
Latin America	-1.1	-1.5	-6.6	-0.3
All World All Emerging	+0.2	+3.2	-2.2	+4.4
The World	+2.6	+5.3	-0.3	+6.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +4.1%

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

Currency	31.07.14	31.10.14
Sterling	2.65	2.24
US Dollar	2.59	2.32
Yen	0.54	0.46
Germany (Euro)	1.19	0.85

Sterling's performance during the quarter ending 31.10.14 (%)

Currency	Quarter Ending 31.10.14
US Dollar	-5.3
Canadian Dollar	-1.9
Yen	+3.3
Euro	+1.2
Swiss Franc	+0.3
Australian dollar	+0.1

Other currency movements during the quarter ending 31.10.14 (%)

Currency	Quarter Ending 31.10.14
US Dollar/Canadian Dollar	+3.5
US Dollar/Yen	+9.0
US Dollar/Euro	+6.8
Swiss Franc/Euro	+0.9
Euro/Yen	+2.1

Significant Commodities (US dollar terms) 31.07.14 - 31.10.14 (%)

Currency	Quarter Ending 31.10.14
Oil	-19.7
Gold	-7.2

MARKETS

What appeared in the early part of October to be the prospect of a negative quarter turned into a mildly positive quarter for most investors as a result of a sharp recovery in share prices. In total return terms, the FTSE World Index showed a return of 2.6% in local currency terms, 5.3% in sterling terms, -0.3% in US dollar terms and 6.5% in euro terms. Looking at local currency returns first, the two best performing markets were the USA, where the FTSE USA Index returned 4.8%, and Japan, where the FTSE Japan Index returned 4.5%. On the negative side, the FTSE UK Index returned -1.7%, the FTSE Asia Pacific ex Japan Index -2.0% and the FTSE Latin American Index -1.1%. The picture changed in sterling terms where a strong US dollar led to the FTSE USA Index returning 10.6% in sterling terms. Because of the weakness of the yen, the sterling return on the FTSE Japanese Index was down to 1.1%. There was no change in the FTSE Europe ex UK Index in sterling total return terms but the relatively good returns from the sterling adjusted FTSE Switzerland Index, 4.3% and the FTSE Netherlands Index, 3.1%, are worth noting.

As the table shows, high quality international sovereign bonds enjoyed a strong quarter. The gross redemption yield on the benchmark ten year UK government bond fell by 41 basis points to 2.24%, on the US Treasury bond by 27 basis points to 2.32%, on the Japanese government bond by 8 basis points to 0.46% and on the German Bund by 34 basis points to 0.85%.

There were some significant moves in the currency markets. Against the US dollar sterling fell by 5.3% and against the Canadian dollar by 1.9%. On the other hand, it rose by 3.3% against the yen and 1.2% against the euro.

There were some significant moves in the commodity markets with oil, as measured by Brent Crude, falling by 19.7% and gold by 7.2%.

ECONOMICS

Although the nine months performance to the end of September has shown a modest but satisfactory return following a strong equity market rise in 2013, sentiment appeared to change significantly at the start of the fourth quarter, and early October witnessed a sharp fall in equity and some bond markets only for there to be a significant reversal of the trend towards the end of the month which resulted in a positive quarter for most investors.

No new issues have arisen but some of those which have been in the foreground for some time have worsened. In a number of our recent reviews, we have remarked upon the insouciance of investors in the face of a number of serious geopolitical and economic issues. Of the economic issues which have the potential to destabilise markets, the re-emergence of the eurozone's economic woes is probably causing the most concern at present. It was always fanciful of the eurozone's politicians and bureaucrats to suggest that the crisis was over. Whilst the monetary union's problems are of a fundamental nature, due to its flawed structure, possibly even more worrying in the short term is the sense of denial which exists.

We suggest that the problems to which investors need to pay careful attention in the eurozone are these. Growth has stalled or gone into reverse in the three largest economies, Germany, France and Italy. Although Germany's finances are very strong, those of France and Italy are in a fragile state. If there is no growth, budget deficits will worsen and the public debt to GDP ratio will expand. Inflation is very low in the eurozone, 0.3%, and, in some countries, there is deflation. This is potentially very dangerous. In a deflationary environment, the value of the nominal debt stock remains unchanged or, much more probably, rises as the relevant government has to borrow more, whilst nominal GDP falls, so the ratio worsens. With a very low inflation rate, there is likely to be a similar effect, although less marked. Either way, the sovereign's creditworthiness lessens, perhaps dangerously. The eurozone's fiscal pact aimed at controlling budget deficits is exacerbating the economic downturn and is a contributor to the very weak inflationary /deflationary background. Economic growth is the best way to address budget deficits, yet the problem in the eurozone is deficient demand, a problem aggravated by current policies. Eurozone politicians look to the ECB to sort out the problems but the ECB is running out of fire power. With very low interest rates, any further lowering will have minimal effect on economic activity. Making available cheap money or engaging in formal quantitative easing, if the ECB is allowed to do so, will only work if businesses and individuals want to borrow the money. To do that, they will need to feel confident about economic prospects. There is very little sign that the politicians have the appetite to take the necessary action to raise the growth potential of their economies through structural reform. France and Italy are trying but much more is needed and resistance to change is strong in Europe. The inability of eurozone countries to enjoy flexible exchange rates relative to each other and the absence of a fiscal transfer mechanism mean that the eurozone's fundamental economic problems are chronic. There seems to be no end in sight for the problem of the eurozone to have the potential to cause volatility in markets.

Commodity prices have been very weak across the board. There are two ways of looking at this. In the glass half empty view of the world, the fall in commodity prices presages a world recession as demand for commodities falls. In the glass half full view, falling commodity prices mean more consumer purchasing power which will raise economic activity. Apart from commodity producers, many other companies' profits will benefit, perhaps leading to an increase in business investment. One reason to take the more optimistic view is that, despite the conflagration in the Middle East, oil prices are depressed and one reason is the growth of fracking in the USA.

Geopolitical events remain as worrying as ever. The turmoil in the Middle East and the continuing Ukraine crisis will always have the power to affect markets. However, markets have not generally been influenced by geopolitical issues, perhaps on the basis that they exist all the time and could always provide a reason not to invest. It is true to say, however, that the Ukraine crisis and the tit for tat on sanctions with Russia are causing some economic and company specific damage.

Then there are probable rate increases in the USA and UK next year. With the US and UK economies performing relatively well, the expectation has been growing that the respective central banks will start to raise interest rates. With tapering being completed in the USA this month, quantitative easing will end and the next stage in moving towards normality will be to begin to start interest rate increases. In the UK, with quantitative easing already having finished, the Bank of England will be looking to do the same. Investors have to consider whether markets will react badly to interest rate increases or whether, as one would rationally expect, these are already discounted. If the present fragility of markets persists, the two central banks may stay their hand.

China is an important lead for investors. As the leadership sets about transforming the economy from one where there was overinvestment in fixed assets to one where consumption plays a larger part, the effect on the country's growth rate will be monitored by international investors. If all works out well, China will show slower growth than in recent years, but of higher quality. As the second largest economy, its influence on the international economic outlook is important and, therefore, a marker for investors.

Then there is Ebola. The humanitarian disaster is plain. Could it lead to a major economic issue like SARS threatened to? We do not know at this stage.

Politics form an important investment background to markets. In the USA, mid term elections take place in November. It is possible that the Republicans will gain control of the Senate to add to its control of the House of Representatives, thus reinforcing the present gridlock. This should not be an issue for investors as the US economy is performing reasonably well at present. In the UK, it is a different matter. Next year's May General Election will pit two parties against each other with widely differing economic policies. A strong anti-business culture has been fostered in the UK and, should this find its reflection in government policy, it is likely to be a negative for the UK market.

Looking at the three main asset classes, we remain negative on bonds. It has been a surprise to us how well they have performed this year and, to our way of thinking, this has made them look even more expensive. For the highest quality bonds, if one believed the world is about to enter an extended period of deflation, it is possible to believe that there is some value because there will be a real return. But, for lesser quality credits, for the reasons discussed earlier, the credit risk would increase and we do not believe that the credit risk is currently properly taken into account by investors for a range of government and corporate credits. We think it unlikely that we are going to enter a period of deflation in an international context, although there are individual cases in the eurozone. But even slow economic growth, and the eurozone is particularly relevant here, is unlikely to stop debt increasing and, with it, credit risk which is not priced in at the moment. Good quality equities offer better medium and long term prospects. Relative to bonds, dividend yields are attractive, and corporate balance sheets are strong. Even in a period of low economic growth, dividends for many companies should be safe. When bond yields revert to more normal levels, as they eventually will, there will be significant falls in the prices of bonds outside shorter dated maturities. Equities may not go unscathed but they will recover and move ahead, whereas the losses on bonds or opportunity costs will be irrecoverable. Significant cash holdings remain only for the extremely risk averse.

October saw the latest World Economic Outlook from the IMF and, in the light of recent geopolitical and economic developments, it is no surprise that it lowered its projections from those made last July. It has trimmed its forecast for world economic growth from 3.4% to 3.3% and from 2015 from 4.0% to 3.8%. There is no change in the forecast for Advanced Economies in 2014, it remains at 1.8% but there is a slight reduction from 2.4% to 2.3% for 2013. Within this category, there is a significant upgrade of 0.5% in the forecast for the USA in 2014 to 2.2% but no change in the 3.1% forecast for 2015. Not surprisingly, the eurozone's forecasts have been reduced by 0.3% and 0.2% respectively. Germany has experienced a very significant downgrade of 0.5% for 2014 to 1.4% and of 0.2% in 2015 to 1.5%. France has seen a sharp downgrade for both years. For 2014, the IMF now projects growth of 0.4%, half the rate it forecast in July. The downgrade for 2015 was of 0.5% to take the projection to 1.0%. Italy, too, has seen a sharp fall in the IMF's projections. The IMF now forecasts that the Italian economy will contract by 0.2% this year, a downgrade of 0.5% from June, and for it to grow by 0.8% next year, a downgrade of 0.3%. There is, however, a more cheerful story from Spain where the growth forecast has edged up both 2014 and 2015 by 0.1% to 1.3% and 1.7% respectively. Japan has seen a severe downgrade of 0.7% this year to 0.9% and of 0.2% next year to 0.8%. This follows a very disappointing second quarter. By far the highest growth rate for G7 countries this year is forecast for the UK, at 3.2%, which is unchanged from the IMF's July forecast. Next year's forecast is also unchanged at 2.7%. Canada, a relatively steady performer, sees its growth forecast raised by 0.1% for 2014 and 2015 to 2.3% and 2.4%.

The IMF's forecast for Emerging Market and Developing Economies has been reduced by 0.1% for 2014 to 4.4% and by 0.2% next year to 5.0%. If we look at the BRIC economies, not surprisingly Russia shows a very low growth forecast for both years at 0.2% for 2014 and 0.5% for 2015, reductions of 0.1% and 0.5% respectively. Forecasts for Russia must be very tentative at this stage in view of sanctions. The IMF has slashed its forecasts for Brazil by 1.0% for 2014 to 0.3% and by 0.6% for 2015 to 1.4%. Forecasts for China are unchanged at 7.4% and 7.1% respectively whilst India has seen a 0.2% increase in the IMF's projection for 2014 to 5.6% and no change in its 2015 projection of 6.4%.

The projections from the IMF reflect the profile of the world economy at present. In the advanced economies, the best performances are being seen in North America and the UK whilst the eurozone is performing badly. In the emerging markets, Russia and Brazil are struggling badly. China and India are showing much faster growth but much less than they have done in the past. All the hard data and anecdotal evidence suggests that the world economy is slowing down, at least temporarily, although the IMF expects it to pick up next year as we see from the figures above.

Now, we will look at the individual areas of the world, starting with the USA, where after a mainly weather related disappointing first quarter, the economy has gathered pace and, as we can see from the upgraded IMF growth forecast for this year, is on course to match last year's growth rate of 2.2% before accelerating to 3.5% next year if the IMF's projection is correct. The first estimate of third quarter growth is 3.5% annualised to give a year on year increase of 2.3%. The latest Purchasing Managers Indices for September, whilst not quite as strong as those for August, are still robust. The index for manufacturing stood at 56.6 (59.0) and that for services at 58.6 (59.6) both indicative of quite strong growth. Industrial production, after a minor setback in August, rose by 1.0%, month on month, in September, continuing the trend of monthly growth which has dated back to May, apart from a blip in August. The unemployment rate continues to fall. In September, it fell to 5.9% from 6.1% in August. 248,000 new positions were added. The latest Conference Board index of leading indicators rose by 0.2%, continuing a trend of monthly rises, although the increase was less than in previous months. One disappointing number was the level of retail sales which was 0.3% lower in September than August. All these items of data and many more will be examined by the Federal Reserve and members of the FOMC for clues as to when it would be sensible to start raising interest rates.

With quantitative easing ending in October, although bond redemption proceeds will still be reinvested, the next stage of the road to monetary policy normality will be raising interest rates with the final stage being the reversal of quantitative easing although that is a long way away. Until the recent bout of market nerves and increasingly negative signs from the eurozone, the stage seemed set for an increase in interest rates starting next year. The latest central forecasts from the Federal Reserve point to modest but not unsatisfactory, progression in the US economy's growth path, 2.1% in 2014 (close to that of the IMF), 2.8% in 2015 (a little lower than the IMF's forecast), 2.75% in 2016 and 2.4% in 2017 with a longer run rate of 2.15%. If these central forecasts are anywhere near accurate, then a federal funds rate of effectively zero is inappropriate. What members of the FOMC will be weighing in their deliberations is, amongst other factors, the size of the output gap in the USA, in other words the level of spare capacity. This is very difficult to measure but those FOMC members who think that the output gap is close to disappearing will be wanting to start the process of raising interest rates. The latest median federal funds rate projection is 1.354% by the end of 2015 and 2.85% at the end of 2016. So, if the federal funds rate is raised in steps of 0.25% at a time, we might be looking at five increases by the end of 2015 and eleven by the end of 2016. Apart from the inflationary risks run when the federal funds rate is negative in real terms at a time when the output gap has been eliminated, there is the general concern that asset prices cannot be maintained unless monetary policy is as loose as it is now. Central bankers, not only in the USA, will be concerned to see that interest rates return to normality at some stage to unwind the distortions which we now see in asset markets.

On the political front, November sees the mid term elections in the USA. It is quite possible that the political deadlock will be reinforced as the Republicans are expected to tighten their hold on the House of Representatives and may well gain control of the Senate. Because the Republicans are certain to keep control of the House of Representatives, there will be political deadlock anyway. For investors, this should not be a cause for concern since the absence of legislation can be no bad thing especially with the US economy performing quite well.

With US shares quite highly rated, it is important that corporate earnings show a reasonable increase. In 2013, the US stock market performed exceptionally strongly and it was always going to be important that earnings rose meaningfully this year. Large share buy backs have assisted in supporting US equities and increasing earnings per share faster than revenue increases. It is important that US companies begin to show growth in their top line. With the US economy being a relatively closed one, it stands a better chance than some more open ones, such as the UK, of withstanding slower growth elsewhere. As one looks around the world, the US stock markets looks one of the safer havens.

We have discussed the eurozone at some length earlier on in this review and little changes in terms of its fundamental problems. Looking at individual items of data starting with the important purchasing managers indices, we note that the composite index rose slightly in October with a reading of 52.2 compared with 52.0 in September. Within the sub sectors, the manufacturing index rose slightly to 50.7 (50.3), and the services index was unchanged at 52.4 and the very weak construction sector fell to 43.0 (43.9), this latter being September's reading. Eurozone industrial production fell by 1.8% month on month in August to be 1.9% lower year on year. The German figures were very bad, down 4.0% month on month and 2.8% year on year. France's industrial production was flat month on month in August and down 0.3% year on year. Italy's industrial production index showed a 0.3% rise in August but was down 3.7% year on year. Spain's figures in August are distorted by the holiday period but the year on year figure was down 1.8%. Preliminary purchasing managers indices for October in Germany show a composite reading of 54.3 (54.1) but France's remain a very disappointing 48.0 (48.4) with both the manufacturing and services sub-sectors reading below 50, the dividing line between expansion and contraction. Meanwhile, unemployment in the eurozone remains unchanged at 11.5%. It is very difficult to see what will get things moving in the eurozone. The strongest country, Germany, remains wedded to its balanced budget policy which renders it incapable of injecting a major policy stimulus into the rest of the eurozone. Its current account surplus remains very high at around 7% of GDP. Yet those in most need of economic growth, amongst the largest eurozone economies, France and Italy, are hampered by budgetary constraints. Confidence is universally low in the eurozone and there are no "animal spirits" in sight to set off a period of expansion. It is difficult to be anything but pessimistic about the eurozone's prospects but it is worth repeating what we have said many times in these reviews that there remain companies, based in the area, which continue to be good investment prospects. Outside the area, but in Europe, Switzerland remains a favoured area, a relative haven of stability with some world class companies which have provided good returns for investors over the years.

Moving on to Japan, the jury remains out on "Abenomics" although negative views are in the ascendancy at present as the economy's recent performance has been disappointing. The second quarter was always going to be difficult because of the 1st April increase in consumption tax to 8% from 5%. The first quarter was bound to be boosted by anticipatory buying in front of the tax increase with a corresponding negative effect in the second quarter and this has been larger than expected. The first quarter's quarter on quarter growth rate was 1.5% but negative by 1.8% in the second quarter with the respective quarter on quarter annualised rates at 6.1% and -7.1%. August's industrial production was down 1.9% and there was a year on year decline of 3.3%. The Tankan survey of businesses has been showing progressively lower readings and was down to 4 in September against 12 in the first quarter and 7 in the second quarter. The purchasing managers indices have, however, improved in September which is mildly encouraging. The composite index stood at 52.8 (50.8), that for manufacturing at 51.7 (52.2) and that for services 52.5 (49.9). One of the objectives of the very aggressive monetary policy being followed by the Bank of Japan following Mr Abe's election was to raise inflation to 2.0%. Whilst the year on year inflation figure, currently 3.3%, reflects April's rise in consumption tax, it will drop out of the index next April and the core figure is well below 2%. The month on month figures show very little inflation and suggest that the underlying 2% target may not be met. One of the key economic reasons for aiming for this level of inflation is that it should encourage spending. If prices are expected to fall, non essential expenditure can be delayed with negative economic consequences leading to economic contraction. This has been a long standing concern in Japan which has now spread to the eurozone with a scarcely positive inflation rate of 0.3%. The next big decision for the Japanese government, which will be taken in the light of third quarter growth figures and other current data, is whether to push ahead with next October's planned consumption tax increase to 10% or whether to hold back. It is not an enviable task to make such a decision. If the government goes ahead then it risks the sort of negative effect which has been seen after last April's increase. If it does not go ahead then the risks posted by Japan's mountainous level of debt could come to the fore with the level of outstanding public debt as a percentage of GDP at around 230%, there is always a risk that confidence in Japanese debt could be affected. Whilst the majority of public debt is held internally and therefore the risk of a flight of foreign capital is less than elsewhere, it should not be ignored. The risks of such a high level of public debt are highlighted if interest rates rise and the cost of debt servicing increases. The budgetary position is very poor with the deficit likely to be around 8% of GDP this year. It is against such a background that the currency could be vulnerable to outflows. The famous current account surplus is disappearing as a result of the trade deficit being aggravated by the need for energy imports following the nuclear disaster. Whilst Japan has very large foreign exchange reserves, these are all potentially negative straws in the wind for Japan. In our view, it remains a market with much potential if "Abenomics" works but with a lot of problems if it does not. What is now needed in Japan is a big push on the third arrow of "Abenomics", the structural one, where meaningful supply side reform measures attacking the rigidities in the Japanese economy open up the possibility and necessity of raising the potential long term growth rate of the Japanese economy. Just as this review was being completed, the Bank of Japan surprised markets by announcing an expansion of its quantitative easing programme. It now plans to increase purchases of longer term Japanese government bonds from the current account rate of JPY 60 trillion - 70 trillion to JPY 80 trillion. This caught investors by surprise. Furthermore, there are going to be increases in the official purchases of equities both at home and overseas which could be significant.

Investors' eyes remain firmly fixed on China given its importance to the world economy and the fortunes of many economies and industries, such as mining. They will be watching to see how successful is the transformation from over reliance on fixed asset investment to a more consumption led economy and how concerns about the property market and some of the banks play out. The economy is, as expected, slowing down. The transformation will not be easy but the objective is to achieve better quality growth. Amongst the drivers of the high levels of growth in recent years has been the high levels of fixed asset investment leading to overcapacity and poor returns and potential difficulties for the banking sector. This was not sustainable and, if some of it was not economically viable, it posed dangers to China's economy. The year on year rate of economic growth at the end of the third quarter was down to 7.3% compared with 7.5% at the end of the second quarter with the quarter on quarter third quarter growth rate at 1.9% compared with 2.0% the previous quarter. This was the slowest pace for five years and was affected by weakness in the property market. After a weak August, industrial production picked up in September to show a month on month increase of 0.9%. The purchasing managers indices for September were marginally weaker than for August with the manufacturing index at 51.0 (51.1) and the non manufacturing index at 54.0 (54.4). With inflation low at 1.6% year on year in September, China's central bank does not have to worry, as it has had to on some previous occasions, about any inflationary issues arising from an expansionary monetary policy and, more than most central banks, its task is easier coming from a position of strength. It is much easier to pull the economic levers in China than in most other countries. In an encouraging development, it was announced that the state council will expand the role of private investment in important sectors like telecoms and transport. Encouragingly, the Asian Development Bank sees annual growth in China running at least 7% over the next five years as the country rebalances its economy to lift domestic demand.

As we saw earlier in this review, the UK is the star of the G7 with the economy expected to grow considerably faster than any other economy in the group, 0.9% ahead of Canada and 1.0% ahead of the USA. On most counts the news has been generally good, although with signs of a slight slowdown which is not surprising given how badly the eurozone is performing. The biggest economic concern is the size of the budget deficit which is not responding to the rapid growth in the economy. At this half way stage of the UK fiscal year, the government has had to borrow £58 billion against £52.6 billion at the same stage last year. There are reasons to believe that these figures paint an unduly bleak picture of the prospects for the rest of the fiscal year but it is, nevertheless, a worrying state of affairs. One reason is that, despite the robust employment figures, it is not a tax rich recovery as many of the jobs created are low paid jobs and the rise in the tax free personal allowances for income tax has meant that this buoyancy in the jobs market is not captured in the tax receipts. It remains a long hard path to putting the UK's public finances on a sound footing. Compared with the eurozone, however, the UK's position is favourable. The UK economy's second quarter growth rate was revised up to 0.9% in the second quarter although the first quarter's figure was revised down to 0.7%. The first estimate of third quarter growth is 0.7% to give year on year growth of 3.0% down from 3.2% in the second quarter. The purchasing managers indices in September were strong albeit slightly weaker than those for August. The composite index was 57.4 (59.3), the manufacturing index 51.6 (52.2), the services index (the most important part of the economy) was 58.7 (60.5) and the construction index was 64.2 (64.0). Unemployment continued to fall with the August rate being 6.0%, down from 6.2% in July. Encouragingly, business investment seems to be increasing. Despite its relatively fast rate of increase, the UK economy is unbalanced and needs to rebalance in favour of capital investment and exports and downplaying the housing market and consumption. So there is some encouragement here. There are some signs that the housing market is cooling after its strong rise, particularly in

London. For example, the latest Nationwide figures showed a 0.2% drop in house prices in September and a decline in the year on year rate of growth to 9.4% from 11.0%.

The USA and UK were the two countries which were expected to be the first to raise interest rates but, with the world economy slowing down, at least temporarily, the feeling is growing that rate increases in both countries may be pushed back further into next year. The sharper than expected fall in UK inflation to 1.2% year on year in September may make the Bank of England's Monetary Policy Committee less hawkish. The latest minutes show that members were concerned about weakening global growth and the threat of a downturn which could affect the UK's recovery. They thought a premature increase in UK interest rates could leave the economy vulnerable to shocks and there was a 7-2 majority in favour of leaving interest rates unchanged and keeping quantitative easing at £375 billion. It would be surprising if the UK economy was not affected by external events but it is relatively well placed to deal with the position. The levels of public borrowing is a concern particularly when a General Election is imminent because politicians may not be keen to lay out fully to the electorate how much further the period of austerity has to go for the UK to regain control of its public finances.

However, our main concern for the UK stock market remains the political one. The next General Election is going to be very important for investors because the two main parties have very different visions of the economy and how to deal with the problems caused by the financial crisis. There is a wide difference in policies and the rise of anti-business sentiment, encapsulated in proposed policies which could be damaging for some sectors, could adversely affect the UK stock market. Given the fragmented state of British politics, it may well be that no party gains an outright majority and, therefore, there will have to be some horse trading between the parties resulting in some unpalatable policies for investors. The recent indecisive election result in Sweden has led to a coalition of parties which has resulted in agreed policies which will not be good for companies. We will be watching closely the development of the opinion polls over the next few months.

October has been a strange month with sharp volatility and ultimately a turnround in sentiment. If one looked at the indices at the end of September and October, which show little change, it would appear to have been an unremarkable month. What we think it shows is that the underlying tone of the international equity market is quite firm. As in the previous recent sharp setbacks, recovery soon came. As our review indicates, geopolitical and economic problems remain serious but, of the three main asset classes, equities remain our profound option. Our view expressed at the beginning of the year that equity markets would grind higher with some quarterly setbacks remains the same.