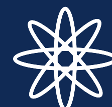

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ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Markets have diverged this quarter with bond prices weakening and equities slightly better for choice. With sterling showing a sharp fall over the quarter, sterling based investors with unhedged international equity portfolios have experienced a significant positive return.

The tables below detail relevant movements in markets :

International Equities 29.07.16 - 31.10.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-2.3	+6.4	-2.2	-0.2
Finland	-2.7	+3.8	-4.6	-2.7
France	+2.6	+9.4	+0.6	+2.6
Germany	+2.9	+9.7	+0.8	+2.9
Hong Kong, China	+4.3	+13.5	+4.4	+6.5
Italy	+1.3	+8.0	-0.7	+1.3
Japan	+6.4	+12.9	+3.8	+5.9
Netherlands	+1.7	+8.4	-0.3	+1.7
Spain	+7.9	+15.1	+5.8	+7.9
Switzerland	-3.1	+3.0	-5.3	-3.4
UK	+4.4	+4.4	-4.0	-2.1
USA	-1.6	+7.0	-1.6	+0.4
Europe ex UK	+0.9	+7.3	-1.3	+0.6
All World Asia Pacific ex Japan	+2.1	+10.7	-1.8	+3.8
All World Asia Pacific	+3.9	+11.0	+2.6	+4.4
All World Latin America	+8.8	+19.8	+10.1	+12.4
All World All Emerging Markets	+3.9	+13.4	+4.3	+6.4
All World	+0.5	+8.1	-0.6	+1.4

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : -3.6%

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

Currency	29.07.16	31.10.16
Sterling	0.80	1.25
US Dollar	1.48	1.84
Yen	-0.27	-0.05
Germany (Euro)	-0.18	0.09

Sterling's performance during the quarter ending 31.10.16 (%)

Currency	Quarter Ending 31.10.16
US Dollar	-7.6
Canadian Dollar	-5.2
Yen	-5.2
Euro	-5.9
Swiss Franc	-5.6
Australian Dollar	-7.8

Other currency movements during the quarter ending 31.10.16 (%)

Currency	Quarter Ending 31.10.16
US Dollar / Canadian Dollar	+2.6
US Dollar / Yen	+2.6
US Dollar / Euro	+1.8
Swiss Franc / Euro	-0.3
Euro / Yen	+0.8

Significant Commodities (US dollar terms) 29.07.16 - 31.10.16 (%)

Currency	Quarter Ending 31.10.16
Oil	+13.2
Gold	-5.2

MARKETS

It has been a mixed quarter for investors, although sterling based portfolios with significant unhedged international exposure have again benefited from sterling's weakness. In local currency terms, the FTSE All World Index returned +0.5%, in sterling terms +8.1%, in US dollar terms -0.6% and in euro terms +1.4%. Looking at local currency returns against a largely unchanged FTSE All World Index, we note a particularly strong performance from the FTSE Japan Index which returned +6.4%, the FTSE UK Index which returned +4.4%, the FTSE All World Latin American Index which returned +8.8% and the FTSE All World All Emerging Markets Index which returned +3.9%. On the other hand, there were below average performances from the FTSE Australia Index (-2.3%) and the FTSE USA Index (-1.6%). However, a different picture emerges for sterling based investors. The sterling based return on the FTSE Japan Index was +12.9%, on the FTSE All World Latin America Index +19.8%, on the FTSE All World All Emerging Markets Index +13.4% and on the FTSE All World Asia Pacific ex Japan Index +8.5%. Negative performances in local currency terms in Australia and the USA, as noted above, became strong, though slightly below average, performances in sterling terms. The FTSE Australia Index returned +6.4% and the FTSE USA Index +7.0%.

Bond markets endured a poor quarter. Taking the ten year government bond yield as a benchmark, the gross redemption yield on the UK gilt rose by 45 basis points to 1.25%, on the US Treasury by 36 basis points to 1.84%, on the Japanese Government Bond by 22 basis points to -0.05% and on the German Bund by 27 basis points to 0.09%. All these yields would have been unthinkable until recent years.

The feature of currency markets has, of course, remained sterling. Against the Australian dollar, it fell by 7.8%, against the US dollar by 7.6%, against the euro by 5.9%, against the Swiss Franc by 5.6% and against the Canadian dollar and yen by 5.2%.

In the commodity markets, oil, although off recent highs, rose 13.2% as measured by Brent crude, whilst gold retreated by 5.2%.

ECONOMICS

Economic policy has followed such an extraordinary path since 2008 that we are all in danger of believing that its current profile is the new normal position. By this, we mean the extreme laxity of monetary policy which, in many countries and the eurozone, is being used as the main lever of economic management. The fact that equities and bonds have performed well has tended to relegate the causes of stock market strength to the background. If stock markets had been in free fall, much more attention would have been paid to the causes.

The effect of very loose monetary policy is, however, increasingly exercising politicians' minds because of its effects on widening inequality. This consequence was obviously never in mind when interest rates were lowered to zero or below, nor when quantitative easing was started. In fact, it was quite the opposite. Interest rates were lowered to try to stave off recession or depression after the financial crisis. As these possibilities gradually fade into the background and the world economy recovers, albeit modestly, attention focuses on other issues, including widening inequality. The main reason is that those with assets, whether they be stock market securities or property, have seen the value of

these rise whereas those without significant assets, or who have relied on interest income or who are about to retire and find annuity rates deeply unattractive, are in a difficult financial situation. With interest rates virtually zero in important countries and real incomes squeezed, the gap between the two sides has widened with political consequences. Clearly, a rising stock market is generally desirable, provided it does not lead to a bubble which then bursts with malign economic consequences. It creates wealth, should help companies to raise funds for expansion, helps the solvency position of pension funds and can create a positive wealth effect which can permeate through an economy thereby assisting economic growth and reducing unemployment. The criticism is not so much that stock markets have been doing well but that, by doing well, they have opened up a gap between those who are struggling financially.

Secondly, one would say that low interest rates are also desirable. After all, for many years people were adversely affected by high interest rates and the cost of servicing mortgages and borrowings. One of the serious problems is for pension funds. They discount their liabilities at a market fixed interest rate benchmark so that when bond yields collapse, as they have done, the low rate at which they discount future pension liabilities raises their present value which has to be filled by companies. This leaves them with fewer available funds for investment, thereby indirectly weakening a country's economic growth prospects. We have already mentioned savers who, as they approach retirement, would be looking for income from bank deposits or fixed interest securities amongst other sources. Besides affecting their purchasing power, and this adversely affects an economy through their curtailed expenditure, it could also encourage them to buy riskier investments with the lure of higher returns. We have already mentioned property prices being driven higher by low interest rates. In places like London, would be first time purchasers are priced out of the market but, if prices become too extended and interest rates rise towards normal levels, defaults could rise, and, if as a result, house prices collapse, then that could affect the banking system as mortgages cannot be serviced or repaid. Low interest rates can adversely affect economic growth in less obvious ways. The famous Austrian economist, Joseph Schumpeter, talked of "creative destruction" meaning that some firms have to fall by the wayside only for others to grow, and this latter class, being more dynamic, helps to increase economic growth. If firms are surviving because, whilst they cannot grow, they can still service their borrowings, then these "zombie" companies are holding onto business which their more dynamic competitors might gain which would enable them to grow. As it is, "zombie" companies are holding back their growth to the detriment of the relevant economy.

Interest rates are quite clearly at emergency levels and they have been for a long time. Who could believe that in some of the European countries and Japan we could see negative interest rates, whilst in the UK and USA they are at negligible levels? But the danger is that they could come to be seen as the norm. This is highly undesirable. The huge imbalance between monetary and fiscal policy has created enormous economic distortions. Quantitative easing has expanded central banks' balance sheets so much that, if the newly created money turns over in the economies more quickly and, therefore, the velocity of circulation increases, one can expect inflation to become a problem again, assuming that the economy in question comes up against capacity constraints. That this has not yet happened, is due, partly, to the fact that demand for money has been low because of a lack of economic confidence. If, for any reason, economic confidence grows and the demand for money increases, one would expect inflation to become a problem as firms come up against capacity problems and increased prices to reflect increased costs. Although there is less talk of deflation now, particularly in the UK now that sterling has fallen sharply, it is surprising how many seemed to think that quantitative easing on the scale we have seen in the main economic areas would not threaten a resurgence of inflation later on. In the very simplest terms, if one imagined a limited number of goods and services available for sale in the world economy and a large increase in the money available, prices could be expected to rise if that money was turned over quickly. That may take some time if people felt so uncertain that they just held on to the money instead of spending it but, if and when their confidence grew and their money started chasing a limited number of goods and services, a manufacturer of goods or provider of services would be in a position to raise their prices. This is obviously a gross over simplification but it makes the point about the dangers of expanding central banks' balance sheets whilst being

complacent about the inflation risks. Just because inflation is not generally a concern now, it does not mean it will not be in the future. The quantitative easing machine is being cranked up again in Japan, the eurozone and the UK and it is a measure of central banks' desperation that this is happening. To avoid the danger of inflation accelerating in future as a result of the expansion of their balance sheets, central banks will want to find a way of unwinding this expansion and an obvious way would be to sell back to the private sector the bonds which they had bought thus affecting their ability to pass money through the system with its inflationary consequences. However, although that might have been the plan at the start of the quantitative easing programmes, these have become so ingrained in the system and, as we say above, are still being used and expanded, that it is going to be a hard task to unwind them. A large seller of bonds to the private sector could be expected to raise interest rates. This leads on to another problem arising from very low interest rates. In many countries, debt levels have been expanding. Government debt ratios are of a concern in these cases, particularly in some eurozone countries and Japan and, increasingly, in the UK and, in China, overall debt levels are very high. The very low level of interest rates and, hence, servicing costs has masked the problems of rising debt levels. Many governments continue to rack up budget deficits which add to the overall level of outstanding public debt as a percentage of GDP and, when interest rates recover to more normal levels, the burden of debt will show up as a significant problem, probably leading to action on the fiscal front. For banks and, therefore, potentially for the relevant economies, negative or very low interest rates provide significant problems. They rely on a rising yield curve for margin but the suppression of yields by central banks' quantitative easing programmes has limited their profitability prospects. Where central banks' reference yields are negative, it is very difficult to pass on negative interest rates to customers and this is damaging to profitability and the ability to build up capital reserves, all of which limit banks' ability to lend with a consequent detrimental effect on economic activity. It is fashionable to bash banks but a realist has to recognise that a combination of very low interest rates and huge fines for bad behaviour have malign economic consequences as it limits their ability to finance expansion.

What all of this means is that the present distortion of economic policy in many parts of the world, including most of the main economies, is setting up a very difficult and dangerous outlook for the world economy. It seems as if the only way the world economy can move forward is by a regular fix of central bank action, whether it be money printing, as exemplified by quantitative easing, or negative or ultra low interest rates. Stock markets become fearful if there is a whiff of an interest rate increase or monetary policy tightening in the air. In more normal economic conditions, where monetary and fiscal policy are more aligned, a reduction in interest rates would be one way of stimulating economic activity. That policy measure would no longer be available if the world were to face another period of economic weakness since there is little or no scope to reduce official interest rates. Fiscal policy is very stretched in most major economies or areas, although there are signs of it becoming easier. However, the level of public and private (in some countries) debt is at dangerously high levels, the consequences of which are only masked by current very low levels of interest rates. One of the areas where this is a particular issue is the eurozone. The Stability and Growth Pact is fraying at the edges. This is meant to prescribe budget deficit levels and overall public borrowing ratios to GDP but one can see that this is not being enforced as strongly as it was. Yet highly indebted eurozone economies will face significant problems as and when interest rates rise towards more normal levels. If monetary policy can do very little when the world economy is next faced with a recession because there is no room to lower interest rates, that only leaves fiscal policy and some countries are in no position to use this lever without damaging their credit ratings and, hence, the ability to borrow. So, it is vital that monetary policy starts a move towards normalisation as soon as possible, even though the pace is likely to be slow. Interestingly, politicians seem to be beginning to realise this in some countries. In the UK, the Prime Minister has been making noises in this direction by pointing out the difficulties which monetary policy is causing. This has been seen as a veiled attack on the independence of the Bank of England with the Governor responding in a coded way. In the USA, the Federal Reserve has come under attack from some politicians. Interestingly enough, these are the two countries where interest rates may be raised first in the tightening cycle although for different reasons. In the USA, moderate economic growth, solid employment numbers and inflation at well above the federal funds rate argue

for an interest rate increase. Interest rates are below the level at which they were expected to be last December and there has always seemed to be a reason why they should not be increased, the UK's referendum on EU membership, for example. A federal funds rate of 0.25% to 0.50%, which is where it has been since last December, seems quite out of line and risks inflationary pressure building up. In the UK, the expectation is that the fall in the pound, most pronounced since the vote on the 23rd June, will almost certainly mean much higher inflation next year and a central bank rate of 0.25% seems quite unsuitable to the circumstances. If sterling were to experience a further sharp fall and, consequently, a deterioration in the inflation outlook, it would be difficult to see how the Bank of England could sit on its hands as far as interest rates were concerned. So, this is a scenario for an increase in UK interest rates. In the eurozone and Japan, there seems to be hardly any prospect of an increase in interest rates in the foreseeable future.

We mentioned earlier that very low interest rates meant low servicing costs on debt incurred since the steep fall in interest rates started, and, for many countries, the level of outstanding public debt in relationship to GDP has risen sharply. One can see clearly how an increase in interest rates will increasingly impact on government finances and really force some action to restrain government spending and debt. Such action will weigh down on growth rates. The link between ultra low or negative interest rates and economic growth works through the easing of pressure on government budgets through low debt servicing costs but at the same time increasing debt levels so that when interest rates and servicing costs gradually increase and force action on governments to deal with the threat to their solvency or credit rating, the economic growth rate is likely to slow down.

Inadvertently, as we stated at the beginning of this review, income and wealth inequality has expanded. Very loose monetary policy has raised asset values and made those with assets, be they securities or property, wealthier. Many have seen real incomes stay unchanged or decline and this has driven the anti-globalisation movement. This is a very unfortunate by-product of the aftermath of the global financial and economic crisis and the measures taken to stabilise the situation. So, as this is written, we see the Trans Pacific Partnership, comprising the USA and 11 other countries, looking as if it is going to fall victim to the US Presidential election with the more likely winner, Hillary Clinton, reversing her earlier support for it in the face of criticism from party activists and, in Europe, the EU/Canada trade agreement which was 7 years in the making and was in trouble because of opposition from within Belgium. This was sorted out at the last moment. Even in the UK, on a slightly different note, the Prime Minister seems to be indicating a more critical examination of foreign takeovers of UK companies, something which is surprising in one of the most open economies in the world and even more so given that, post Brexit, the UK will want to attract foreign investment. It needs this to continue, given the UK's very large current account deficit which has to be financed. For investors, the move against globalisation, or free trade, should be a concern because protectionism reduces economic growth. A politician might naturally want to protect the interests of his or her electorate, for example by supporting import tariffs or quotas which will make production of the affected items more competitive in their area and therefore preserve jobs. However, the gain there will be offset by a greater loss for the country as consumers elsewhere pay more for the goods in question than they would if imported goods without tariffs or quotas were available. This reduces their purchasing power to the detriment of other goods they could have bought and, therefore, other economic activity. Free trade increases consumer welfare as goods are produced in countries with comparative advantage and consumers are able to maximise their purchases. Stamp on this through protectionism and economic growth suffers. Down at the company, employee and shareholder level, growth, employment and dividends are affected. This is obviously a very simplistic model but illustrates the threat to investors. So, protectionism is not good for the stock market because of its threat to earnings and dividends. The growth of anti-globalisation movements is disturbing and advocates of free trade, which should certainly include investors, need to state their case strongly, otherwise stock markets could suffer in the medium and long term because of lower economic growth than would otherwise be the case.

Of course, the adverse effects of protectionism, if that is what the world economy is moving towards, will not show up overnight. A more immediate concern to us, one that we have flagged for a long time,

is the bond markets. In absolute terms, bond yields remain extraordinarily low, but they have started to rise quite sharply and therefore with the opposite effect on prices. Because to many people, including ourselves, bonds seem very expensive, the danger of a rush for the door by investors is a concern because of its ability to destabilise markets. Where quantitative easing is taking place, there should be some mitigation but no more than that. So, in these circumstances, one must consider how equities may react. For a long time now, we have been in the unusual position whereby equities yield more than bonds, and by a considerable distance in many markets, which may give some protection to equities. In the recent shake out in bond markets, after which yields still remain at extraordinarily low levels, equities have been relatively unmoved and they may still have plenty of headroom if bond yields rise further but a really sharp rise in bond yields caused by investors fleeing the fixed interest markets could pose problems for equities. We do not think that we are at this stage at the moment, but equity investors need to remain vigilant.

Before we write the next economic review, the result of the US elections will be known. We have all become very wary of opinion polls but, on the recent evidence before us, it would be a surprise if Hillary Clinton did not become the next president, although the latest news from the FBI seems to have removed some of her opinion poll advantage. Given that probability, the results of the elections for both houses of Congress will be very important. The best outcome for investors if Hillary Clinton wins would be a stalemate with the Republicans holding on to the House of Representatives and the Senate, although the latter looks more doubtful as the Trump campaign appeared to have imploded before the latest news from the FBI. The reason why this would be a more desirable outcome for investors, and this is not making a political point to favour either party, is that less political action would probably lead to a better economic result. Given the centre of gravity for the Democrats has moved sharply to the left, a Presidency and Congress controlled by one party whose policies are not likely to be helpful for investors, would not be a desirable outcome for the latter. To stress again, this is not to make a point favouring either political party, rather to suggest that a more centrist approach could be more helpful for the US economy given that the two main parties seem to have moved away from the centre. The US economy is moving ahead at a modest pace under its own steam but, policies which are hostile to business, raise taxes, make Wall Street a target and are sympathetic to protectionist measures are likely to be unsettling for stock markets. On the Trump side, although it looks unlikely that he will win the Presidency, measures to put protectionist tariffs on Chinese imports, for example, would almost certainly set off a very damaging trade war which could lead to a recession, or even depression. This policy has nothing to commend it. As the world's largest economy, it really does matter who is in charge in the USA. One must hope from an economic and stock market perspective, that the checks and balances in the US political system do what they were originally meant to do. Less political activism may lead to a better economic outcome.

The eurozone faces a series of elections and a constitutional referendum in Italy before the end of 2017. In Spain, however, the threat of a third general election has been averted as the Socialists have agreed not to vote against Mr. Rajoy, thus ensuring that his party will have enough votes to form a government, although it may be difficult for it to pass individual items of legislation which the opposition opposes because the government does not have the numbers. In the context of what we were saying above about the USA, with a party split between the Presidency and control of Congress giving a reasonable background for the economic stability, it is interesting to note that the Spanish economy has performed quite well without an effective government. The next major event, which has the potential to destabilise the eurozone, is the Italian constitutional referendum at the beginning of December. The aim is to reduce the power of the Senate so that legislation can be passed more quickly enabling reforms to be made. The Italian Prime Minister, Mr Renzi, has made this an issue of confidence, although he appears to have backtracked on a threat to resign if he loses. The reason why this referendum is so important is that Italy, as the third largest eurozone economy, has the power to destabilise the eurozone, given its enormous debt burden and the very large levels of non performing loans in the Italian banking system. It badly needs structural reform to kick start growth which has been absent from the Italian economy for a long time but which represents the best way of attacking the debt problem. A "no" vote on the constitutional issue in December's referendum, which would be

more likely to be seen as a vote of no confidence in Mr Renzi, could unsettle the eurozone, particularly if he decides to resign. At the moment, the opinion polls are close with "no" slightly ahead. Next year, there are the French and German elections, also very important. France needs major structural reforms if it is to move to a higher economic growth trajectory but President Hollande has found it difficult to implement even very modest reforms to the labour market. Whilst not at Italian levels, public debt keeps rising and the inability to balance budgets is a chronic problem for France. As things stand, it looks as if the centre right candidate will go head to head with the FN in the final round. With the FN promoting populist policies and hostile to the EU and euro project, this is another hurdle for the eurozone. It is not expected that the FN would win in the final round but it is evidence of populist sentiment turning against the status quo and, eventually, the dam may burst and represent a threat to the EU and eurozone. Then there are the German elections, with the polls showing declining support for the CDU/CSU and a rise in the populist eurosceptic party, the Alternative for Germany (AFD), which has grown from its academic origins as a party opposed to the euro to a right wing populist party which has been polling quite strongly in state elections. There is little doubt that, as well as Brexit, the EU faces significant problems, many of them caused by the euro. Whilst there remains an unwillingness to face up to the problem of the eurozone lacking the essential properties of an optimal currency area, it is difficult to see how it can make progress on its debt problems.

Japan has had major difficulties in kick starting economic growth despite heavy doses of monetary and fiscal activism. The Bank of Japan gave a comprehensive assessment of developments in economic activity and prices as well as policy effects since the introduction of quantitative and qualitative monetary easing in September. The Bank of Japan's price stability target of 2% has not been achieved and its report lists reasons for this with the fall in commodity prices, particularly oil, obviously one, and this has had the effect of reducing inflationary expectations. In September, the Bank of Japan outlined a new approach called "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control" by strengthening the policy frameworks of "Quantitative and Qualitative Monetary Easing (QQE)" and "QQE with a Negative Interest Rate". The new policy framework comprises two major components, yield curve control and an inflation-overshooting commitment. In the first component, the Bank of Japan will control short and long term interest rates and, in the second, the Bank of Japan commits itself to expanding the monetary base until the year on year rate of increase in the observed consumer price index exceeds the price stability target of 2% and stays above the target in a stable manner. The short term policy interest rate decided upon was -0.1% to the Policy-Rate Balances in current accounts held by financial institutions at the Bank. For the long term rate, the Bank of Japan will purchase Japanese Government bonds so that 10 year yields will more or less remain at zero and purchases will remain at about JPY80 trillion (US$762 billion) a year. Also the guideline for the average remaining maturity of the Bank of Japan's JGB purchases will be abolished. Amongst the changes were a modest increase in the purchase of exchange traded funds and Japan real estate investment trusts so that their amounts outstanding will increase at an annual pace of about JPY6 trillion and JPY90 billion respectively. The reason that the Japanese authorities are so keen to reach their inflation target is to banish the deflationary mindset of Japanese consumers and businesses which holds back consumption and investment. If prices are expected to rise, money is more likely to be spent and economic activity increased. Consistent with this is the desire to see the yen lower. It was not expected that the earlier move to negative interest rates would push the yen higher. The result of this for sterling investors is that, whilst the Japanese equity market has been one of the weaker ones this year and down in absolute terms, it has provided some of the best returns in sterling terms.

In China, the third quarter's GDP growth came in at 6.7%, the same level as in the previous 2 quarters. The closely watched purchasing managers indices returned levels consistent with, by Chinese, but not anyone else's standards, moderate growth. The manufacturing PMI at 51.2 was higher than August's level of 50.4, whilst the non-manufacturing index stood at 54.0, marginally ahead of August's level of 53.7. However, the property market is a concern with prices in the top two tier cities rising very sharply. According to the National Bureau of Statistics of China, newly built house prices in September were 11.2% higher than a year previously. In October 2015, the year on year figure had been just 0.1% and the year on year increase in prices has risen every month since then. This is the fastest pace

on record. In Beijing and Shanghai, the rises were spectacular at 27.8% and 32.7% respectively. As a result, the authorities are trying to stop prices rising as quickly because of the dangers that house price inflation can cause to the economy. This is one warning sign about the economy. Although China has massive foreign currency reserves, US$3,166.82 billion at the end of September which compared with a peak of around US$4,000 billion in March 2014, the trend has been downwards. Given that China enjoys a substantial current account surplus, US$59.4 billion in the second quarter of 2016 and US$39.3 billion in the first quarter, this suggests a significant capital outflow. Of course, when a country runs a significant current account surplus, that is what one would expect but China does control the export of capital so it may reflect some internal concerns and also support for the currency which stands at approximately 6.74 yuan to the US$ compared with 6.36 a year ago, which represents a weakening of about 6%. So, whilst the third quarter GDP growth level looks satisfactory, and excellent by other countries' standards, issues like the property bubble (and associated issues for the banks if there is a property price collapse), the level of borrowing in the economy generally and capital flows are ones to watch, especially so given the importance of China to the world economy.

Finally, some observations on the UK in the aftermath of the Brexit vote. The most obvious result in the short term has been the significant weakness in sterling which may reflect a realistic adjustment in an economy with a large current account deficit. The consequence of this will be a rise in inflation which could put a squeeze on real incomes and weaken consumer spending. The beneficial result should be to make visible and invisible exports more attractive and perhaps help to rebalance the economy, although, with manufacturing accounting for about 11% of GDP and not at the more low value price sensitive commodity end, it may not be as important a factor as it would have been in the past. In the short term, the UK economy has held up better than many expected with the first estimate of GDP growth in the third quarter at 0.5%. It is far too early to say whether or not Brexit will be beneficial for the UK and data needs to be interpreted cautiously. The government has to formulate its negotiating stance and cannot give a running commentary on it as it would weaken its negotiating position. This could lead to bouts of currency speculation which could affect investor confidence from time to time, but is almost inevitable. We can almost be sure that the fiscal stance will be loosened compared with the pre referendum trajectory planned by the previous Chancellor. In current circumstances, this is sensible, but it can only be a postponement of plans to eliminate the budget deficit since it is dangerously high and the UK cannot risk a loss of confidence in its economy and creditworthiness. The twin deficits are the Achilles heel of the UK economy. What is certain is that the government must do everything it can to ensure that the UK is an attractive place in which to do business. It is not clear that the government is at one on this for comments and actions which could be seen as hostile to business or foreign investment are completely counterproductive. Opportunities which do rise from Brexit must not be squandered by loose political talk to gain votes. For the foreseeable future, whilst Brexit negotiations are pending and then started after Article 50 is triggered, the UK's investment risk is elevated. Although sterling has fallen sharply since the vote and may be roughly correctly valued, there seems little reason to believe that it may recover much from here and could still be vulnerable to bad news. In these circumstances, it still seems prudent to invest internationally and to be unhedged to reduce the risk.

As we write, international bond markets have become unsettled and some significant falls have been seen in bond prices. This is not surprising. Bonds are, in our view, seriously overvalued and a feeling is beginning to develop that monetary policy has run out of traction. One of the dangers to stock markets is that there is a stampede out of bonds so this is an issue to watch but, for the moment, we believe that, where the mandate permits, a diversified portfolio of international equities represents the best position. It must be emphasised that, after such high sterling returns this year, an important part of which is due to sterling's weakness, expectations of future performance must be more realistic with some inevitable setbacks along the way but, for long term investors, we believe that our current stance remains the appropriate one.

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