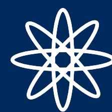
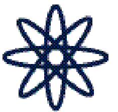


meridian

ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

After a poor first quarter, the recovery which we saw in international equity markets during the second quarter has continued into the third quarter so that now equity markets show quite strong positive performances for the first three quarters of the year and have recovered much of last year's decline. The return on bonds was also positive but at a lower rate than on equities. Our review discusses the reasons behind markets' performances in the third quarter.

The tables below detail relevant movements in markets:

International Equities 30.06.09–30.09.09

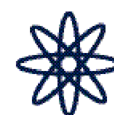
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+22.0	+37.1	+33.2	+27.8
Finland	+8.5	+16.4	+13.1	+8.5
France	+22.0	+31.0	+27.2	+22.0
Germany	+18.8	+27.4	+23.8	+18.8
Hong Kong, China	+12.4	+15.7	+12.4	+7.9
Italy	+22.2	+31.1	+27.4	+22.2
Japan	-1.5	+9.3	+6.2	+1.9
Netherlands	+23.8	+32.9	+29.1	+23.8
Spain	+21.5	+30.4	+26.7	+21.5
Switzerland	+17.1	+26.4	+22.8	+17.8
UK	+22.1	+22.1	+18.6	+13.8
USA	+15.7	+19.2	+15.7	+11.0
Europe ex UK	+20.0	+29.5	+25.8	+20.7
Asia Pacific ex Japan	+19.4	+29.5	+25.8	+20.7
Asia Pacific	+8.5	+19.2	+15.7	+11.0
Latin America	+17.4	+28.5	+24.7	+19.7
All World All Emerging	+18.0	+25.2	+21.6	+16.7
The World	+15.4	+21.8	+18.3	+13.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +3.1%

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

Currency	30.06.09	30.09.09
Sterling	3.69	3.59
US Dollar	3.52	3.31
Yen	1.35	1.30
Germany (Euro)	3.38	3.23



Sterling's performance during the quarter ending 30.09.09 (%)

Currency	Quarter Ending 30.09.09
US Dollar	-2.9
Canadian Dollar	-10.2
Yen	-9.9
Euro	-6.8
Swiss Franc	-7.3
Australian dollar	-11.1

Other currency movements during the quarter ending 30.09.09 (%)

Other Currency	Quarter Ending 30.09.09
US Dollar/Canadian Dollar	-7.6
US Dollar/Yen	-7.2
US Dollar/Euro	-4.0
Swiss Franc/Euro	+0.6
Euro/Yen	-3.3

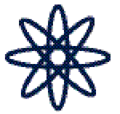
Significant Commodities (US dollar terms) 30.06.09—30.09.09 (%)

Significant Commodities	30.06.09—30.09.09
Oil	+1.9
Gold	+6.2

Markets

A firm tone in markets is evidenced by total returns on the FTSE World Index in local currency terms of 15.4%, in sterling terms of 21.8%, in US dollar terms of 18.3% and in euro terms of 13.5%. In local currency terms, the UK and Australia have been stand out performers, returning 22.1% and 22.0% respectively. The FTSE Europe ex UK Index also performed relatively strongly with a return of 20.0% and, within that return, there were striking performances from the Netherlands (23.8%), France (22.0%) and Spain (21.5%). The FTSE USA Index returned 15.7% and the only exception to the string of positive performances was Japan where the FTSE Japanese Index returned a negative 1.5%. Elsewhere, we continue to see strong performances from the FTSE Asia Pacific ex Japan Index (19.4%), the FTSE All World All Emerging Markets Index (18.0%) and the FTSE Latin American Index (17.4%). With sterling showing significant overall weakness during the quarter, sterling based investors saw their returns enhanced where they held foreign securities. With the Australian dollar showing exceptional strength, the sterling adjusted return on the FTSE Australia Index rose to 37.1%. The sterling return on the FTSE Europe ex UK Index was 29.5% and on the FTSE USA Index 19.2%. The strong showing of the yen meant that the negative local currency return of the FTSE Japanese Index turned into a positive 9.3%. Elsewhere, returns on the FTSE Asia Pacific ex Japan Index, the FTSE Latin American Index and the FTSE All World All Emerging Markets Index were enhanced to 29.5%, 28.5% and 25.2% respectively.

International bond markets, as measured by ten year government bonds, trended firmer. The yield on ten year sterling government bonds fell by 10 basis points to 3.59%, on US dollar bonds by 21 basis points to 3.31%, on Japanese government bonds by 5 basis points to 1.3% and on euro denominated German government bonds by 15 basis points to 3.23%. In the currency markets, sterling's weakness gathered pace towards the end of the



quarter and, as shown above, this made a significant difference to the returns in overseas markets for sterling investors. Against the Australian dollar, sterling fell by 11.1%, against the Canadian dollar by 10.2%, against the yen by 9.9%, against the Swiss franc by 7.3%, against the euro by 6.8% and against the US dollar by 2.9%.

In the commodity markets, oil was little changed rising by 1.9%, whilst gold was 6.2% higher.

Economics

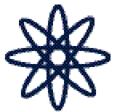
At a time when many people and businesses are experiencing extreme financial difficulty it may seem perverse that the stock market is not simultaneously reflecting the severe problems of the world economy. Apart from the general observation that stock market cycles do not generally move in tandem with economic cycles, as they look forward to the future rather than reflect the present, there are specific reasons for this apparent dislocation between the real world and the investment world.

If we had to pinpoint two reasons for this seemingly paradoxical behaviour, one would be the reduction in fear about a collapse in the international banking system, a feeling of relief in other words, and the second would be the effects of the highly unorthodox monetary measures taken to try to avoid a recession becoming a depression, mainly quantitative easing (effectively the modern day version of printing money) and near zero interest rates.

If we look back one year, the time of the collapse of Lehman Brothers, the sense of fear was palpable. Although an investment bank, its collapse made people worry about their deposits with some retail banks, an unprecedented situation for most people. By taking various actions to reassure depositors about their money, governments and central banks stabilised a very dangerous situation and, now, a year on, all this seems a distant memory. So, although things economically remain very serious, the general absence of this concern has been a positive point for investors. Without wishing to give any hostages to fortune, it is difficult to know now what could shock investors on the economic or financial front. In saying that, one is not being glib. The economic position of the world economy remains very serious but, if the ability to shock investors further has been eliminated or lessened, that is a stabilising influence because investors dislike uncertainty. If things are bad, they prefer to know that and not fear that they might be hit with further shocks which they might not reasonably have expected as was the case last year. So we believe that the absence, or almost absence of this negative shock, has contributed to a more stable position in markets. If any major financial institution did get into trouble, there is a belief that the authorities have worked out how to handle the situation.

This conclusion can be supported by evidence in the markets. For example, the extreme stress in the interbank market, evidenced by very elevated interbank rates against official rates, has subsided to much more normal levels. Corporate bond yield spreads against government bonds, which had become very elevated, have narrowed sharply. In the stock market, during the recent share price rally, it is notable that some of the financial shares, which were very badly hit have recovered very sharply. These random pieces of evidence suggest much lower levels of risk aversion and more confidence in the financial infrastructure.

If one reason for the recovery in markets is the absence of a negative, the other main one, from which other consequences flow, is a more positive one, and that is the effect of quantitative easing ("QE") and near zero interest rates. We have talked about this factor before but we believe it is important. Taking the extreme measure of reducing interest rates to almost zero in the major economies was meant to help businesses and individuals by reducing the burden of interest payments and thereby boosting their disposable incomes. If this helped to keep their spending higher than it would have been, then this would raise the level of economic activity above what it would otherwise have been. For those businesses and individuals of a more optimistic nature, the low cost of borrowing could provide opportunities which could benefit the wider economy. The flip side of this argument is that those who depend upon interest income from bank deposits have been badly affected and their spending power reduced which is a negative factor for the economy. One of the initially favourable but potentially dangerous side effects of this near zero interest rate policy is the distortion of the market and the potential for an asset bubble



to develop. In the search for yield, money which might normally remain on deposit might be diverted into other assets such as bonds, property or shares, causing bubbles. We do not think that shares are in this category, nor property, after its big fall, but we think that bonds are. Looking at the level of ten year government bond yields at the beginning of this review, one is struck by how inadequate they look, given the risks involved. If we take sterling bonds, for example, the yield on ten year government issues, whilst obviously well above what can be obtained on deposit, looks completely inadequate in absolute terms. The danger of near zero interest rates is that they will distort investment decisions and set up problems for later on. They are also potentially inflationary. In the UK, inflation is higher than most observers expected, although negative on the Retail Prices Index measure. But, measured against the government's preferred measure, the Consumer Price Index, real official interest rates are negative and, combined with the potential inflationary effects of QE, could cause inflationary dangers.

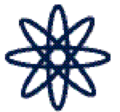
So, very low interest rates worldwide, whilst understandable and helpful to the world economy in the short term, are not desirable for any longer than necessary because of the distortion to the financial system which they cause and the inflation which they may stoke.

The same, only perhaps to an even greater extent, applies to QE. Like ultra low interest rates, its aim is to stimulate the economy by raising activity and to make borrowing in the bond markets cheaper for companies and, although not explicit, to ensure very modest inflation. Deflation, as we have discussed before in these reviews, has very undesirable side effects in terms of threatening to turn a recession into a depression as businesses and individuals hold off discretionary spending and the real burden of borrowings rise. QE involves the creation of money electronically by whichever central bank is involved. In the case of the UK, the Bank of England electronically creates a deposit for the seller of, say, gilts to it. The hope is that this money is then circulated around the economy to raise activity. In this environment, prices of goods and services can be expected to rise once the output gap, the difference between actual and potential output, is closed. Asset prices can also be expected to rise. If inflation is entrenched in the minds of individuals and businesses, the willingness to buy now is increased, thereby helping to stimulate economic activity. To many people, this will seem strange as they will have been used to governments and central banks trying to restrain inflation. But modest inflation, say around 2%, a typical target, seems about right. Keeping inflation at this level will not be easy unless QE is carefully reversed.

Once freshly created money starts circulating in the system in a vigorous way (at the moment bank deposits at central banks have increased sharply), we are likely to see asset prices pushed up further as investors see calls on real assets like shares, property and commodities, as a way of protecting themselves against inflation. We may have started to see this already with the rise in share prices and artificially low yields on government bonds, exacerbated by very low interest rates on deposits.

This is the reason for our negative view towards bonds. Notwithstanding very low or negative inflation in some countries, QE, where enacted, has potentially let the inflationary genie out of the bottle. At present, it is quiescent, as output gaps, which exist almost everywhere, suppress the potential problem. With vast budget deficits in many countries, notably the USA and UK amongst the G7 countries, one may have expected problems to develop with selling bonds at this yield level. In the UK, the level of QE authorised, at £175 billion, effectively finances the majority of the budget deficit, but the potential dangers of this will fool no one and the urgency of addressing the dreadful state of UK public finances is greater than ever. One can say the same for the USA and such low yields, in our view, are totally inadequate in view of the potential for inflation and to attract buyers for such vast quantities of government debt. Creating money cannot continue for very long without debasing the currency and the foreign exchange, bond and money markets are the most powerful disciplines on profligate governments.

So, although it is nice to see markets rising on a sea of liquidity and money diverted from low yielding assets, it is important to realise that this not the best quality reason for rising asset prices and, as investors, we will want to feel confident that the money created by QE will be withdrawn from the system before it causes longer term damage in the form of rising inflation. Because, whilst modest inflation may have a positive benefit as described above, high inflation would require a much tighter monetary policy, i.e. sharply higher interest rates, and that would not be good for equity or bond markets.

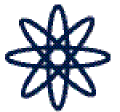


The talk amongst some finance ministers and central bankers is now of exit policies from the extraordinary measures taken to prevent the world economy from falling into a depression. To allow fiscal imbalances on the current scale, monetary policy of extraordinary looseness and unorthodox policies to continue any longer than necessary risks severe problems of a different nature later on. Withdrawal of these measures may be painful but it is necessary to take this stimulus back in order to secure the right monetary and fiscal background for a resumption of moderate growth at low inflation rates.

So what will the painful path be to reach this desirable position for the world economy? In terms of fiscal policy, which is extremely loose at present, it will involve action to restore budgetary disciplines. This will mean cuts in public spending in many countries and/or increases in taxation, probably a combination of the two. As we have seen in the verbal contortions of some UK politicians, it is difficult to admit what everyone knows has to happen. Taking effective action to restore public finances is not optional. If not done, a country's creditors might rebel with hideous economic consequences. In the short term, demand suffers as cuts in public spending and/or tax increases stunt economic growth. For reasons which we have mentioned before, we consider public expenditure cuts to be preferable to tax increases because the latter, in different ways, adversely affects a country's long term economic growth potential. This might be because relatively high corporate tax rates might prompt some companies to move. We have seen evidence of this in the UK. Companies deciding where to place future investment will be deterred by unattractive tax regimes. Individuals, who are wealth creators, may move somewhere more competitive. These negative effects will be cumulative. If a country's long term potential growth rate is reduced because of the effects of an increasing tax burden, investors will note this. The measures which will have to be taken to restore budgetary discipline will be as harsh as most people have ever known and the present situation represents an uneasy calm. Budget deficits are not going to return to acceptable levels, or even disappear, for a long time. The measures taken to rectify the situation will weigh down on economic growth for a long time and, for companies heavily exposed to such countries' home markets, growth prospects will be limited. This obviously has investment implications. Fortunately, however, there are countries which are in a much better economic state than many western ones, such as some in the east, for example, so attractive investment opportunities will continue to exist and companies in low growth economies, which have access to faster growing markets, will also be attractive. Correcting the fiscal wreck will take many years. How governments choose to correct it will be important for investors.

Monetary policy and the reversal of quantitative easing will be extremely delicate. There is more room for subjectivity in policy here than there is with the fiscal situation. With the latter, there is no real disagreement that the current level of budget deficits is intolerable. It is a question of how quickly action should be taken to attack the problem. At present, in most economies, money supply growth is subdued with the extra money which is being created ending up with central banks and not yet being lent. In these circumstances, it is not dangerous as far as inflation is concerned, but this is not the point as far as policy makers are concerned since they want the money supply to grow at a reasonable rate to kick start the respective economies. Withdrawal of the QE will have to start as soon as there is sufficient evidence that economic growth has resumed. Done too early, and economies may slip back into recession, done too late, and the threat of inflation will become real. It will be a difficult task for bond markets to absorb central banks' sale of bonds and other assets at the same time as government bond issues are so substantial. It is difficult to see how this can be achieved without significantly higher bond yields being experienced. It is potentially a dangerous situation.

These, then, are the macro economic issues which have to be addressed, all centred round the problem of having an exit strategy from the huge stimulus which has been given to the world economy to prevent it from moving into a depression after the financial shocks of 2008. But, for political reasons, bankers' pay and bonuses have been pushed to the forefront of the political debate. Understandably, people are furious that bankers who contributed to last year's financial catastrophe should have been so handsomely rewarded but politicians, who have tried to



make this the main issue, are culpable of grandstanding. The important micro issues are proper prudential control of the activities and balance sheets of the banking sector so that there is no repeat of what happened last year and which started before then. Many organisations share the blame for what happened and it is important that political leaders focus on the financial and economic issues which are so important at this time. By focusing on non mainstream issues like bankers' pay, politicians risk making the job of economic recovery more difficult. So, after the huge stimulus administered to the world economy, where are we now in economic terms?

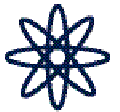
In its latest World Economic Review, the IMF points to economic growth turning positive as the sharp dip in output earlier in the year gives way to some recovery. This would be typical after a sharp drop in output as stocks have to be rebuilt and this gives a boost to production. It is as if the world economy temporarily stopped and now various actions like the macroeconomic stimulus and the turn in the stock cycle are helping it to recover from its near death experiences. So, after the recession this year, the IMF is looking for quite a strong recovery next year, albeit to levels of growth below those which prevailed in 2003 to 2008. After negative growth of 1.1% this year in world output, it expects a recovery to a positive 3.1% next year.

We show below excerpts from the latest IMF projections in its World Economic Outlook of October 2009 :

Real GDP Growth (%)

	2008	**2009** (estimate)	**2010** (estimate)
Advanced economies	0.6	(3.4)	1.3
USA	0.4	(2.7)	1.5
Eurozone	0.7	(4.2)	0.3
Germany	1.2	(5.3)	0.3
France	0.3	(2.4)	0.9
Italy	(1.0)	(5.1)	0.2
Japan	(0.7)	(5.4)	1.7
UK	0.7	(4.4)	0.9
Newly Industrialised Asian economies	1.5	(2.4)	3.6
China	9.0	8.5	9.0
India	7.3	5.4	6.4

Source: International Monetary Fund - World Economic Outlook - October 2009 (excerpt)



Consumer Prices (%)

	2008	2009 (estimate)	2010 (estimate)
Advanced economies	3.4	0.1	1.1
USA	3.8	(0.4)	1.7
Eurozone	3.3	0.3	0.8
Germany	2.8	0.1	0.2
France	3.2	0.3	1.1
Italy	3.5	0.7	0.9
Japan	1.4	(1.1)	(0.8)
UK	3.6	1.9	1.5
Newly Industrialised Asian economies	4.5	1.0	1.9
China	5.9	(0.1)	0.6
India	8.3	8.7	8.4

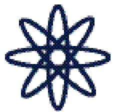
Source: International Monetary Fund - World Economic Outlook - October 2009 (excerpt)

General Government Fiscal Balances as a % of GDP - G7 countries

		2008	2009 (estimate)	2010 (estimate)
USA	actual balance	(5.9)	(12.5)	(10.0)
	structural balance	(3.4)	(5.1)	(5.3)
Germany	actual balance	(0.1)	(4.2)	(4.6)
	structural balance	(0.6)	(2.2)	(2.7)
France	actual balance	(3.4)	(7.0)	(7.1)
	structural balance	(3.3)	(4.0)	(4.1)
Italy	actual balance	(2.7)	(5.6)	(5.6)
	structural balance	(2.7)	(3.7)	(3.8)
Japan	actual balance	(5.8)	(10.5)	(10.2)
	structural balance	(5.2)	(7.6)	(8.0)
UK	actual balance	(5.1)	(11.6)	(13.2)
	structural balance	(5.5)	(9.0)	(9.6)
Canada	actual balance	0.1	(4.9)	(4.1)
	structural balance	0.4	(2.2)	(1.6)

Source: International Monetary Fund - World Economic Outlook - October 2009 (excerpt)

Assuming that the broad thrust of the forecasts is correct, it leads to some fairly solid conclusions. One is that growth is still very much a two speed process. Compared with China, India and, to some extent, the Newly Industrialised Asian economies, growth in the main industrialised countries, whilst mostly expected to return to positive territory next year, will be anaemic. This highlights how economic power is transferring away from the major industrialised countries to Asia, as well as the Middle East and countries like Brazil. There are investment conclusions to be drawn from this trend, namely that investors should recognise this in their portfolio asset allocations. The second

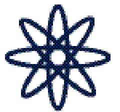


conclusion comes from the inflationary forecasts. There is much less talk of deflation now and one of the outcomes of QE is, as we described earlier, that prices, whether of goods and services or assets, should rise, especially when the newly created cash starts circulating. Whatever method the relevant central bank has chosen, the implications point in this direction. Measured by the consumer price index, of those countries which we have included in the table, only Japan is forecast to have negative CPI growth next year. Apart from short periods of falling prices, we have never felt that deflation, defined as several quarters of persistent price declines, was likely, and the IMF is certainly not forecasting that outcome.

However, what is alarming is the last set of figures we have shown, those relating to central government fiscal balances. In 2008, before the full force of the crisis was felt, only Canada, of the G7 countries, did not show a deficit, although Germany's was only marginal. 2009's figures show the devastating effect of the financial and economic crisis on countries' finances, with the figures for the USA, UK and Japan particularly serious, with even worse expected for the UK in 2010.

Deficits fall into two parts, cyclical and structural. They are linked with automatic stabilisers. When an economy is in recession or very weak, tax revenue suffers because of difficult times for companies and individuals, whilst government spending in areas such as social security rises. If these factors are not offset by public spending cuts or tax increases, then the resulting move to, or increase in, a country's budget deficit helps to stabilise the economy. The converse, and this is something governments do not always like to do, is that, in good times, the benefits of higher tax revenues and lower social security costs are retained so that there is a cushion when conditions deteriorate. The USA and UK have been spectacularly guilty on this score. These cyclical surpluses and deficits contribute to economic stability and enhance the prospects for sustainable growth. This IMF table, however, includes an estimate of the undesirable part of the deficit, the structural deficit. As its name implies, it is the deficit which is built into the structure of an economy, meaning that there is a chronic deficit of income against spending irrespective of the economic cycle. Unless significant steps to address this problem are taken, public finances become cumulatively worse, with overall debt levels and servicing costs rising. The dangers of this are, firstly, that deteriorating public finances will make lenders more wary and they may demand higher interest rates. If the country's credit rating is downgraded as a result, this would be likely to ratchet up borrowing costs even further. If allowed to continue indefinitely, a financial crisis will inevitably result. Secondly, the private sector is "crowded out" by a government's increasing demand for funds, making growth more difficult for the productive part of the economy which helps to provide its tax base. The table taken from the IMF's World Economic Outlook shows the extent of the devastation with the UK and Japan in a particularly serious position. On the other hand, Canada, of the G7 countries, came into the crisis with strong finances and has emerged relatively unscathed.

The stark nature of these figures shows the size of the task ahead for many countries. Deficits of the size shown here are unsustainable. There are more figures from the IMF's World Economic Outlook relating to expected trends of a country's net debt in relation to its GDP and, given the size of the current budget deficits being run, it is no surprise that they are rising in most countries.



Net Debt as a % of GDP (G7 countries)				
	2008	**2009** (estimate)	**2010** (estimate)	**2014** (estimate)
USA	47.9	58.2	66.8	84.9
Eurozone	59.0	68.6	74.6	83.7
Germany	60.5	70.3	76.2	81.6
France	57.8	67.0	72.9	82.9
Italy	103.6	112.8	117.0	125.7
Japan	88.1	104.6	115.0	143.5
UK	45.6	62.1	75.1	91.8
Canada	22.2	28.2	31.3	29.4

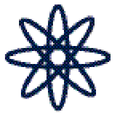
Source: International Monetary Fund - World Economic Outlook - October 2009 (excerpt)

Worryingly for the future, the very low levels of interest rates currently prevailing make the servicing costs of debt currently being built up much cheaper than usual, but this situation cannot last. As interest rates rise, as they must in due course, increased servicing costs piled upon increased debt will be very painful.

A major concern is that for politicians implementing the harsh measures needed to set different countries' finances on an improving path, the political cost is likely to be high. Unfortunately, in many countries, it is difficult to feel confident that politicians will not try to fudge the situation for fear of upsetting the voters. Opposition politicians will often try to make mischief by siding with those who complain about the effect of the measures on them. By putting off the necessary measures, a bad situation becomes worse before the discipline of the markets and, perhaps, the IMF comes to bear down. That may actually be the best way out of the problem for governments which lack the will to take the necessary action themselves.

Within the G7 group of countries, with the exception of Canada, the problems are quite clearly serious but different. Japan's problems look very severe, taking the current deficit and the overall deficit in relation to GDP. It derives some help from the fact that its interest rates are usually much lower than in those of other countries, although that is obviously not the situation now. If Japanese interest rates in ordinary times were more in line with those of other countries, its debt servicing costs would cause a real problem. There is also a further helpful factor arising from the high Japanese savings ratio which helps to absorb the large debt issues necessary to finance the deficit.

The USA's position is quite obviously serious with borrowing increasing at an alarming rate. The political system in the USA makes control of spending very difficult. In a country like the UK, if the government of the day decides that a certain course of action is necessary to address a serious economic situation, it can usually count on its majority in Parliament to achieve what it needs to do. In the USA, for a number of reasons, it is more difficult to obtain agreement on what is to be done and then to action it. The advantage which the USA enjoys comes with size. It is the world's largest economy and the US dollar is the world's largest reserve currency. Therefore, however concerned the USA's creditors may feel about the US economy or its currency, their action will be circumscribed by the threat to the value of their holdings of US assets if they start to dump them. The threat to this rather comfortable position for the USA lies in the rapid switch in economic power to China, the holder of the world's largest foreign exchange reserves. It has made noises about an international currency and, whilst accumulating US dollars and keeping down the value of its currency may have served the USA and China well, despite US complaints about the value of the Chinese currency being kept artificially low, this state of affairs cannot last indefinitely. Protectionist sentiment is rising in the USA as the imposition of an import tariff on Chinese made tyres shows but the danger of antagonising a major creditor when a country like the USA is having to borrow so much appears to have escaped some US politicians.

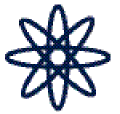


The average overall economic position, although bad, is not in the league of countries like the USA, UK and Japan, for example, amongst the G7 countries. Germany's position, for example, looks relatively good. But the overall position of the eurozone hides some economies with very serious problems. Spain, Ireland, Greece, Portugal and Italy come to mind. Spain has just had to raise taxes to address its weakened finances. Membership of the euro precludes currency devaluation, such as has been seen in the UK, as a means of regaining some competitiveness. The lack of convergence, which was supposed to happen as a result of monetary union, could yet impose impossible strains on the euro project, given the regaining of competitiveness for countries like Spain would involve a depression of real incomes, something that is likely to prove politically impossible. The eurozone never was, and is certainly not now, an optimal currency area and huge strains built on increasing divergences of economic performance are building up within the eurozone. Realistically, however, this is not likely to be the first problem which needs a resolution and which arises out of the current financial and economic crisis.

Of all the countries with serious economic difficulties, the table of IMF forecasts for current government borrowing shows the UK to have one of the worst positions. We have often noted in previous economic reviews going back a long time that the explosion in public spending, way above the rate at which the UK economy could grow, would lead to problems. Of course, we had no idea of what was coming in the financial markets but the point is that, instead of allowing the automatic stabilisers to work in good times, that is to say accumulating surpluses ready to offset the deficits arising in bad times, the money and more was spent. Therefore, coming into this crisis, the UK was in the worst possible position to face it. The IMF estimates that the structural deficit alone this year will amount to 9.0% of GDP and that, next year, it will be even worse at 9.6% of GDP. In 2014, it is forecasting that it will be 6.2% of GDP, with only Japan in a worse position. It goes without saying, that this is not a tenable position for any economy to maintain. At some stage, an economy in this state will exhaust its ability to borrow, threatening economic collapse. But, even before matters get to that stage, such an economy is liable to experience a sudden loss of investor confidence which may be manifested in an inability to sell its debt or severe weakness in the currency. Intervention in the foreign exchange market is not an option. In the case of the UK, the foreign exchange reserves would be exhausted in no time. The UK saw a serious fall in the currency in 2008, a surprisingly strong partial recovery so far in 2009 which lasted until recently and, as this is written, it is starting to slip again. That is why, in the case of the UK, it is urgent that realistic action is taken to provide solid evidence of a deficit reduction path. The issue is bedevilled by politics with none of the parties giving specific enough details of what they plan to do to address the situation. There is now at least agreement amongst all the parties that action will be necessary but none has spelt out how far reaching it will have to be. The cuts in public expenditure, whether or not they are accompanied by further tax increases, will have to be of an order that will change the profile of the economy. That is how serious is the UK's position and it is difficult to overstate how dangerous further delays in reassuring investors, domestic and foreign, may be.

We are spending more time on problems in the UK because most of our clients are sterling based investors. Against this background, one wants to have an investment strategy that reflects the implications of the UK's economic position.

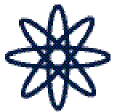
One issue is the currency. As clients know, as far as the equity position of our portfolios are concerned, we regard geographical diversification as of paramount importance and do not consider it correct to bulk up on UK equities simply because they are denominated in sterling. The risk of being overweight in the UK market, unless it is particularly attractive, on currency rather than fundamental grounds, is not considered worth taking. The UK equity market accounts for less than 10% of the world's market capitalisation and having, say, a multiple of that in the UK, unless it is felt to be especially attractive, seems to us to be a high risk strategy. Last year is a particularly good example. The difference in return on the FTSE World Index in local currency terms and sterling terms was approximately 20%. Currency movements are very difficult to forecast in the short term but it is difficult to see even one supportive factor for sterling at present. The budgetary situation, as we have described above, is dire and carries a high risk for the economy. Measures to address the problem will inevitably mean that growth is restrained



by the probable combination of public expenditure cuts and tax increases. A relatively low growth economy is unlikely to be good for the currency. The policy mix looks likely to be a combination of extremely tight fiscal policy and loose monetary policy, i.e. the continuation of very low interest rates and this is not conducive to currency strength. A further issue arising out of very low UK interest rates is that sterling is likely to be an attractive funding currency for the carry trade, i.e. it will be borrowed with very little interest cost and invested in higher yielding currencies. Our table at the beginning of this review indicates how strong the Australian dollar has been and we could add the New Zealand dollar to that. Both these currencies offer what, in the present very low interest rate environment, could be called attractive interest rates. If investors feel, as would probably be the case absent a severe currency crisis which caused interest rates to be raised, that sterling may be used as a low cost funding currency for the carry trade strategy, their investment policy will call for an important direct and indirect foreign currency exposure. This could be plenty of direct exposure to foreign equities or indirect exposure to UK companies which have significant foreign exposure to markets which may be growing faster than that of the UK. The large UK companies represented in the FTSE 100 Index are good examples of this strategy. In a situation where it is difficult to overstate the risks to the UK economy if a credible path to restoring the country's finances is not mapped out shortly, exposure directly or indirectly to real assets on an international basis seems the prudent course of action. In terms of equities, for example, dividend yields and price/earnings ratios do not appear extended, notwithstanding the recovery in share prices since March. For reasons we mentioned earlier, inflation could be problematical for the UK and some other countries as a result of quantitative easing not being reversed at the right time and calculating that right time will be very difficult. Looking for assets which it might be appropriate to hold in such circumstances, equities, property and commodities come to mind and the latter two asset classes can, of course, be accessed by the equity market. For reasons mentioned earlier, bonds look to be very poor value. Cash has the advantage of flexibility if one felt very negative about other asset classes or was waiting for a setback to augment, say, existing equity holdings if cash levels did not form a major part of the existing asset allocation.

In completing this review, we will, as in previous months, point to some of the "green shoots" which investors have focused on in recent months. It cannot be overemphasised that the majority of news remains bad and that the position of the world economy remains very serious. However, as the IMF forecasts earlier in this review show, the relative position is starting to ease and next year, although in normal circumstances the forecast growth would be considered very disappointing, certainly looks as if it is going to be much less bad than this year. The main headwinds facing the world economy and, therefore, markets, will be the measures which will have to be taken in many countries to reduce public borrowing, whilst over-borrowed private individuals will also have to continue to rein in their expenditure. This combination of action on public finances, which we detailed earlier, and on private finances, will exert a drag on recovery in many economies. We have not mentioned in this review, in any detail, the position of the financial sector. Although many financial stocks recovered strongly this year from very depressed levels, many of them remain in a parlous condition, relying on state support directly or indirectly. As the world economy emerges from the recession, this will be a dangerous period for many companies which need to increase their borrowing to finance increased working capital and company failures often rise at this stage of the cycle. So, no investor should be carried away by the recent improvement in share prices, although, as we have said, as an asset class it remains one of our most relatively favoured. However, if we look for some "green shoots" these are some of the indicators coming out of various economies which give some cause for muted optimism. We should emphasise, again, that these may be merely less bad indicators than previously, or even show stability and, on a few occasions, showing actually positive trends, but no one should carried away with what is happening.

In the USA, if we look at the housing market, the place where the trouble originally started, the National Association of Realtors reported, in September, that its pending home sales index rose by 3.2 points to 97.6, which is the highest level since June 2007. Pending sales home contracts have risen for a record six straight months. Sales of new homes increased by 0.7% in August, which is the highest level for almost a year. Builders cut prices to compete with foreclosures which are flooding the market. In early September, the ISM reported



that its index for the manufacturing sector rose to 52.9 in August, with anything over 50 showing a positive trend in the economy. Its index for the service sector also rose from 46.4 in July to 48.4 in August, with this being an example of conditions being less bad rather than positive, but the trend was in the right direction. The Federal Reserve's Beige Book is a useful indicator of economic activity around the country. Its latest book, published in September, reported that conditions had stabilised. In early October, revised estimates of US GDP in the second quarter showed the contraction at 0.7% rather than the 1.0% which had previously been reported. This compares with a 6.4% pace of decline in the first quarter. Earlier in this review, we talked about the stock cycle as a positive driver for the economy, given that stocks had been run down when the world economy came to a halt. In July, US businesses reduced inventories at the wholesale level. They declined by 14% in July following a revised 2.1% fall in June. US retail sales rose by 2.7% in August, the highest rise since January 2006. July's figure was revised down slightly to a decline of 0.2%, compared with the first estimate of 0.1%. The USA's current account deficit in the second quarter shrank to US$98.8 billion, representing 2.8% of GDP and the smallest percentage since the first quarter of 1991. All things being equal, that should be of some assistance to the US dollar, notwithstanding the fact that economic weakness will have contributed to the shrinking deficit. The Reuters/University of Michigan index of US consumer sentiment increased to 73.5 in September to the highest level since January 2008.

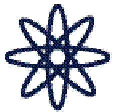
In the eurozone, purchasing managers indices for the manufacturing and services sector indicate a less bad situation. In the manufacturing sector, the index rose from 46.3 in July to 48.2 in August. This represents a fourteen month high. In the services sector, the Markit purchasing managers index saw activity rise to 49.9, the highest level since May 2008. Neither of these figures are in positive territory but they represent a less bad picture. GDP in the eurozone is estimated to have grown by 0.1% in the second quarter, compared with a 2.5% contraction in the first quarter. Consumer spending in the eurozone is estimated to have risen by 0.2% in the second quarter following a 0.5% fall in the first quarter. Overall, official figures showed that the manufacturing and services industries expanded in September, with the reading rising from 50.4 in August from 50.8.

In Japan, the main news of the month is political with the LDP being ousted from office by the DJP. We await the economic developments from the new government. However, we have noted the very serious borrowing figures in Japan which will have to be addressed at some stage, notwithstanding very high Japanese savings which help to finance this deficit.

In China, the government has confirmed that it is to stay with its pro growth policies but it said that economic recovery is not yet stable. It reported that the "overall economic position is improving" but that "the basis for our country's economic revival is not stable, solid and balanced". However, the Asian Development Bank said that China is on track to exceed its key target of 8% economic growth in 2009.

One of the best performing economies in the downturn has been Australia which entered the financial crisis with strong finances and has been able to use this position to provide credible policies without straining the financial situation. Official figures showed that the economy expanded by 0.6% in the three months to the end of June compared with the previous quarter and the Reserve Bank of Australia has sufficient confidence to start raising interest rates again.

In the UK, the area where the "green shoots" have been most apparent is the housing market. The British Bankers Association reported that approvals of loans for house purchases had fallen slightly in August, compared with July, but were 81% higher than in August 2008. Net mortgage lending rose to £2.8 billion in August, compared with £1.9 billion in July, an increase of 4.6% on a year ago. Data on house prices showed a firmer trend possibly because the supply of houses remains very low but with quantitative easing aggressively pursued in the UK, one would, for reasons we mentioned earlier, expect asset prices to be affected and this would include houses. For example, the Halifax reported that the average house price rose by 0.8% during August, although it left the annual fall in house prices at 10.1%. The RICS said, in September, that a net balance of agents noted a rise in prices compared with -6% in July, this being the highest proportion since May 2007. Hometrack, the property data company reported that house prices in September rose by 0.2%, compared with August, easing the annual rate of decline to 5.6% from 6.7% in August. Official figures showed that house prices rose by 1.4% in July, easing the annual



decline to 8.3% from 10.7% in June. Elsewhere, the CIPS/Markit services purchasing managers index rose from 53.2 in July to 54.1 in August representing expansion. UK industrial output was stronger than expected in July, rising by 0.5%, helped by increase in car production. The Recruitment and Employment Confederation and the KPMG report on jobs showed that the number of people getting new jobs in August had risen, this being the first time for seventeen months. There was also a slight increase in the number of temporary staff appointments, the first time that they have risen for a year.

In conclusion, although it is pleasing to note that much of last year's decline in equity markets has been reversed, there is absolutely no room for complacency. Minuscule interest rates, money creation and the weight of money looking for reasonable income returns continue to favour equities as an asset class but investors must keep very focused on economic and financial developments for pointers about future investment policy.

September 2009

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