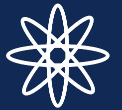

meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Concerns about the Chinese economy, following the country's move to lower the value of its currency, set off a period of weakness in the quarter. Whilst not out of line with previous negative periods, the importance of the Chinese economy heightened investors' concerns although, as the final quarter begins, more settled conditions have been re-established, at least temporarily. Against this unsettled background, bonds performed well whilst, in the currency markets, sterling started to retrace previous strength. Oil price weakness was pronounced in a difficult commodities market and gold, again, failed to inspire.

The tables below detail relevant movements in markets :

International Equities 30.06.15 - 30.09.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-7.0	-11.8	-15.1	-15.2
Finland	-5.9	-2.2	-5.8	-5.9
France	-6.4	-2.7	-6.3	-6.4
Germany	-11.1	-7.5	-10.9	-11.1
Hong Kong, China	-16.3	-13.0	-16.2	-16.4
Italy	-4.4	-0.6	-4.2	-4.4
Japan	-13.3	-8.0	-11.4	-11.6
Netherlands	-8.9	-5.2	-8.7	-8.9
Spain	-11.7	-8.1	-11.5	-11.7
Switzerland	-2.7	-3.3	-6.9	-7.1
UK	-6.1	-6.1	-9.6	-9.8
USA	-6.7	-3.2	-6.7	-6.9
Europe ex UK	-7.1	-4.6	-8.1	-8.3
Asia Pacific ex Japan	-9.6	-12.0	-15.2	-15.4
Asia Pacific	-11.7	-9.9	-13.2	-13.4
Latin America	-10.8	-21.7	-24.6	-24.7
All World All Emerging	-13.2	-15.6	-18.7	-18.8
The World	-7.7	-5.4	-8.9	-9.0

Source FTSE World Indices

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

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

Currency	30.06.15	30.09.15
Sterling	2.14	1.77
US Dollar	2.33	2.06
Yen	0.45	0.35
Germany (Euro)	0.76	0.59

Sterling's performance during the quarter ending 30.09.15 (%)

Currency	Quarter Ending 30.09.15
US Dollar	-3.8
Canadian Dollar	+3.3
Yen	-5.7
Euro	-4.0
Swiss Franc	+0.3
Australian dollar	+5.8

Other currency movements during the quarter ending 30.09.15 (%)

Currency	Quarter Ending 30.09.15
US Dollar/Canadian Dollar	+7.3
US Dollar/Yen	-2.0
US Dollar/Euro	-0.3
Swiss Franc/Euro	-4.3
Euro/Yen	-1.8

Significant Commodities (US dollar terms) 30.06.15 - 30.09.15 (%)

Currency	Quarter Ending 30.09.15
Oil	-23.2
Gold	-5.3

MARKETS

A difficult, but not out of the ordinary, quarter for international equity investors saw a negative total return in local currency terms on the FTSE World Index of 7.7%, of 5.4% in sterling terms, 8.9% in US dollar terms and 9.0% in euro terms. For once, in recent times, sterling based investors enjoyed a tailwind from currency movements rather than a headwind as sterling weakened against the major currencies. Looking at local currency total returns firstly, there were below average returns from emerging markets, Latin America, Asia Pacific ex Japan and Japan with the FTSE All World All Emerging Markets Index returning -13.2%, the FTSE Latin American Index returning -10.8%, the FTSE Asia Pacific ex Japan Index returning -9.6% and the FTSE Japan Index returning -13.3%. Elsewhere, it was noticeable that Switzerland held up very well in local currency terms with the FTSE Switzerland Index returning -2.7%, considerably better than the FTSE World Index. As mentioned above, foreign exchange movements mostly, but not always, benefited sterling based investors. On the positive side, the weakness of sterling against the US dollar reduced the negative return on the FTSE USA Index to -3.2% and on the FTSE Europe ex UK Index to -4.6%. Although the Japanese market underperformed the world equity markets this quarter, the negative return on the FTSE Japan Index fell to -8.0% in sterling terms. On the other hand, weakness in the Australian dollar, emerging market, Latin America and Asian currencies meant higher negative returns in sterling terms with the FTSE Australian Index returning -11.8%, the FTSE Asia Pacific ex Japan Index -12.0%, the FTSE Latin American Index -21.7% and the FTSE All World All Emerging Markets Index -15.6%. Fears about a Chinese economic slowdown, which sparked equity markets' weakness during the quarter, pushed down bond yields and, using ten year government bonds as a benchmark, we saw the gross redemption yield on UK government bonds decline by 37 basis points to 1.77%, on the US Treasury by 27 basis points to 2.06%, on the Japanese Government Bonds by 10 basis points to 0.35% and on German Bund by 17 basis points to 0.59%.

We touched upon currency movements above where the feature was a retreat in sterling against the yen, euro and US dollar. Against the yen, sterling fell by 5.7%, against the euro by 4.0% and against the US dollar by 3.8%. Sterling actually rose slightly against the Swiss Franc by 0.3% and by more against the commodity linked currencies, the Australian dollar and Canadian dollar, against which it rose by 5.8% and 3.3% respectively.

The weakness in the commodity markets continued with oil, as measured by Brent crude, falling by 23.7% and gold by 5.3%.

ECONOMICS

During the quarter, attention switched abruptly from the eurozone and the Greek problem to China, resulting in significant turbulence in international securities' markets. What investors knew was that China was undergoing a transformation from an investment and export orientated led economy to one where consumption assumed a greater importance and the result of this, if successfully accomplished, would be lower but better quality growth. Less emphasis on exports and more on domestic consumption demand would provide more certain and sustainable demand whilst overinvestment in unproductive fixed assets meant poor or no returns in many cases and problematic loans for the banking system. All this is to be achieved at the same time as ensuring that the economy can create sufficient jobs in urban areas to accommodate those moving from rural areas. So, it is quite a

balancing act for the Chinese government and central bank to achieve this desired outcome which depends upon a certain level of economic growth. It is not only, of course a domestic issue for China. As the world's second largest economy, China's economic fortunes affect many other countries.

China has been targeting around 7% annual growth and the latest official figures showed second quarter annualised growth at just that level. However, many outside observers feel sceptical about the figures and, instead, prefer to concentrate on data such as electricity consumption which points to a lower growth rate. Some observers believe that a more reliable assessment of growth might put it at the 4% to 5% region. Against such an uncertain background, it might have seemed strange to an outsider that the domestic Chinese stock market, essentially "A" shares, which are gradually being opened up to foreign investors, had risen about 150% from the beginning of 2014 to June 2015 only to fall back dramatically after that so that the rise has now been pared back to about 50%. The market had become speculative and some investors had used leverage so that, when the bubble burst, forced sellers exacerbated the downward movement of Chinese shares. With easy money, the availability of credit and official encouragement for stock market investment, shares were propelled higher. However, there was no correlation with economic factors on the way up for shares any more than there was on the way down but, of course, it makes far more news with shares on the way down and international investors are far more likely to relate falls to negative economic news than they would to good economic news when shares are on the way up.

The bottle half empty, as opposed to the half full, attitude to the cause of the abrupt market falls in August were much in evidence. The reason for the fall was the announcement by the Chinese central bank, the People's Bank of China, on 11th August that it was to lower the fix for the renminbi against the US dollar by 1.9%. The currency could trade 2% either side of that and the next day's fix would refer to the closing rate of interbank foreign exchange market on the previous day. The pessimists took this as a sign that the Chinese economy was in trouble and that it was attempting to stimulate the economy through a devaluation of the renminbi. However, a currency depreciation of 1.9% is neither here nor there in terms of giving a stimulus to exports or import substitution and it should be noted that the central bank has intervened to support the currency since then so that it now shows a depreciation of just over 2% against the US dollar from the day before the announcement. The official line is that it was a move away from a managed float more towards a market determination of the currency level which would help China's cause if it wanted the renminbi to be included in the IMF's Special Drawing Rights which includes the US dollar, euro, yen and sterling. This is perfectly plausible and the central bank's action since then in supporting the renminbi is consistent with this explanation.

What has muddied the picture and caused consternation amongst investors were the official attempts to stem the Chinese stock market's fall which was quite at odds with the authorities' stated aim to move towards a more market orientated economy. So taking steps to try to support the market through official purchases of shares, banning others from selling, and stopping short sales to name but some were seen as a panic reaction and helped to magnify the volatility of Chinese share prices. However, it is important to put all of this in context. The effect of a fall in Chinese share prices is less than the effect of a fall in Chinese property prices which are starting to rise again and the size of the Chinese stock market in relation to GDP, around 30%, is small relative to that of some other countries. Both of these factors should limit the effect of the fall in the Chinese stock market on the real economy.

As we have often mentioned in these reviews, monetary policy in many countries has lost its power to be effective because interest rates are so low or even negative. By definition, they cannot go much lower so the normal possibilities, when interest rates stand at around historical levels, of a significant

reduction to attempt to stimulate an economy are non-existent. Furthermore, although quantitative easing helped, in the aftermath of the financial crisis of 2008, to keep down interest rates and give the banks more ability to lend if they wanted to, this tool becomes less potent the more it is used. Companies and individuals need to want to borrow money. Cheap money of itself does not justify every business project or individual lending need so ever greater availability does not lead to a commensurate increase in demand. However, China is different from most economies. It still has some monetary firepower. In a political sense, the nature of its politics means that decisions made centrally can be implemented quickly. For example, infrastructure projects, which in a country like the UK can take years to get off the ground, can be activated quickly in China and have an early economic multiplier effect. The ability to act quickly can be an economic advantage if an economic stimulus is required. In terms of monetary policy, interest rates in China are not at zero bound. The one year lending rate is currently 4.6% and the one year deposit rate is 1.75% so there is room to reduce these interest rates. Perhaps even more effective could be a further reduction in the banks' reserve ratio, recently reduced from 18.5% to 18%. By reducing this, more money can be freed up for bank lending. Then there are China's foreign exchange reserves. Although they have fallen as money has been used to defend the currency, they are still very substantial and can also be used to bolster economic activity, if necessary. At the end of August, they were standing at US$3.557 trillion even though they showed the biggest monthly fall on record in August which amounted to US$93.9 billion. So, whilst there is plenty to worry about in China, a slowdown in economic growth, which needs to be monitored closely, a volatile stock market, a high degree of leverage in the economy as well as the banking system, it has more economic tools at its disposal than most. In its Interim Outlook, just published, the OECD has only slightly reduced its economic forecasts for China for this year and next. Its projection for 2015 is 6.7% (against 7.4% in 2014). This is just 0.1% lower than its projection in June and, for 2016, its projection is 6.5%, down just 0.2% on its June forecast. Those who are nervous about China would be very happy if these forecasts are met, particularly for 2016.

As the OECD's Interim Economic Outlook points out, the weakness in Chinese imports has affected world trade with a slowdown evident with world trade growing by just 0.7% in the first quarter of 2015. One of the reasons is the fall in Chinese demand for commodities like iron ore and the weakness of commodity prices, notably oil, which is responsible for current very low inflation levels and, in some cases, deflation. This lack of inflationary pressure has caused a big debate amongst economists as to what it signals. It feels churlish to question the desirability on low or no inflation or deflation since, for many people, a significant economic worry over the years has been the level of inflation. To complain about its absence seems counterintuitive and, prima facie, one would think that investors would welcome it. Looking at various countries and regions, we see inflation on a year on year basis as nil in the UK, 0.2% in the USA, 0.1% in the eurozone, -0.1% in Japan and 2.0% in China. Core CPI figures, which exclude volatile items like food and energy, show a stronger figure but, nevertheless, are still at very low levels. This does matter for investors and the policy they follow. If they feel it is "good" deflation, they will be in a positive frame of mind and, if they think it is "bad" deflation, they will feel negative. By "good" deflation, we mean one which is driven by supply side factors. This could be falls in prices driven by productivity and more efficient manufacturing processes or, in a commodity context, it could literally be more supplies of, say oil coming to the market. This deflation or low inflation will be good if accompanied by real increases in wages as, for example, is starting to happen in the UK. This is likely to drive demand and increase activity in an economy. For companies, it might increase profits or margins if input prices fall and the increase in demand for its products could stimulate investment. This has been lacking in the post financial crisis recovery but it looks as if that position may be changing which would be good economic news. For countries or areas which are big oil importers like India and Europe, the fall in oil prices is as helpful as it is unhelpful to oil exporters. We believe that the current lack of inflationary pressures is good

economic news for investors because it should stimulate growth. But there is "bad" deflation and a notable sufferer from this is Greece. Here, deflation is driven by a collapse in demand which forces companies to reduce their prices to make sales. In a country like Greece, where wage cuts have been imposed on some employees, demand falls as their buying power reduces, forcing price reductions. This creates a vicious downward demand spiral in an economy. On balance, we believe there are more "good" deflation cases than "bad" cases at present. If one believes that this low inflation, no inflation or deflation situation is going to last for a long time then it is reasonable to expect that interest rates will remain very low, if not quite at current levels. Just as when inflation was high and seeming to represent an intractable economic problem which would not disappear, so it would be dangerous to believe that the present low inflation situation is going to be the norm.

An important reason for the weakness in inflation is depressed commodity prices. In the case of food and agricultural products, non economic factors like weather and disease can influence prices so it would be unwise to assume that prices will remain depressed. In the case of oil, all sorts of issues come into play. Political instability is one. The Middle East is an unpredictable area. The development of fracking is another one. It has changed the dynamics of the US supply position significantly. However, what can be turned on relatively easily as fracking can in some areas, can also be turned off with the fall in oil prices already affecting the economics of fracking. Oil companies are cutting back their exploration and investment programmes in the light of the weak oil price. Market forces are likely to make themselves felt with oil prices rising in due course as a result of current cutbacks in exploration. So, investors should certainly not count on the low oil price lasting indefinitely and, when it does start to recover, inflation is likely to rise.

Countries find themselves in different phases of the economic cycle which call for different approaches to monetary policy. It is likely that, had the recent volatility in stock markets not occurred, the Federal Reserve would have started the process of raising interest rates. Even with inflation, as measured by the Consumer Price Index, at minuscule levels in the USA, a federal funds rate of around zero would not be appropriate. With annualised economic growth running at 3.7% in the second quarter, admittedly a freakishly high figure, and unemployment at 5.1%, even against a background of a low participation rate, such a level hardly seems appropriate. The latest OECD estimate of the output gap, defined as the deviation of actual GDP from potential GDP as a percentage of potential GDP, shows it falling from 2.5% in 2014 to 2.4% this year and 1.6% next year. An elimination of the output gap will increase inflationary pressure. This might occur as a result of a shortage of suitable staff resulting in wages being bid up or input items where shortages could cause prices to rise, putting upward pressure on the price of the final goods or services. There is little doubt that, if the external situation were a little more settled, US interest rates would now be on the way up to ensure that artificially cheap money did not lead to bubbles in the housing and stock market or to the economy growing too fast, extinguishing the output gap and causing inflation to rise. The UK is in a similar position. Second quarter annualised growth was running at 2.7%, below that of the USA but still satisfactory, whilst unemployment stands at 5.5%. The OECD estimates a lower output gap than for the USA at 0.5% for 2015 and 2016 compared with 0.6% in 2014. It is more likely that the USA, rather than the UK, will lead the way but, whatever the order, it would seem desirable that the process of normalising interest rates begins sooner rather than later to avoid sharper and larger interest rate rises later on. From a stock market investor's point of view, whilst it may seem comforting if interest rates remain at current levels, it would be a negative factor later on if interest rates had to be raised to much higher levels because inflation was becoming problematic. Interestingly, equity markets did not react well to Federal Reserve's decision on 17th September to leave interest rates unchanged. One would hope that, when the Federal Reserve does move, investors will appreciate the rationale and that it may be a medium and long term positive influence on markets if there is a move towards normality.

It is highly undesirable that economic growth cannot be achieved without interest rates being around zero but the longer the position remains as it is, the more difficult it will be to wean the world economy off zero interest rates. The distortions they cause in the financial system and the resulting misallocation of resources which occur in economies will lead to malign effects. So, investors in equities should not fear a start on the long road to normality in interest rate setting. Much worse would be to delay increases only for interest rates to be ratcheted up sharply to correct for lack of early action which has led to inflation becoming a concern. The issues for the bond markets are more problematic. Unless one believes that the long term prognosis for inflation is that it will be around zero, it remains difficult to believe that there can be value in bonds yielding so little. If one looks at the gross redemption yields on the ten year government bonds shown in the table at the beginning of this review, it is hard to see many circumstances in which returns will be attractive relative to equities. They have been depressed by quantitative easing, where applied, and the consequential large purchases of government bonds and other fixed interest securities. At some stage, this will need to be reversed to avoid inflationary conditions which, logically, one would expect to place upward pressure on interest rates.

The eurozone is, of course, in a different phase of the economic cycle and interest rate increases are the last thing on the ECB's mind at present. In its latest macro-economic projection for the euro area, published in September, the ECB sees growth in the mid range of its forecasts in 2015 at 1.4% (down from its June forecast of 1.5%) against actual growth of 0.9% in 2014. It sees growth in 2016 at 1.7% (down from its June forecast of 1.9%) and of 1.8% in 2017 (down from its June forecast of 2.0%), both these figures being its central forecast within its range. Its central forecast for inflation this year is 0.1% (down from its June forecast of 0.3%) and for 2016 it is 1.1% (down from its June forecast of 1.5%). Going out to 2017, its central forecast is 1.7%, 0.1% lower than it forecast in June. The core figures for the ECB's forecasts for this year and next i.e. excluding volatile items like energy and food are 0.9% for this year and 1.4% for next year, emphasising that inflation is not dead which is why investors have to be so sensitive about the level of interest rates. On the basis that energy and food prices are not going to be permanently depressed, investors, even in the eurozone, have to be concerned about the implications of interest rates around zero. But the problem for the interest rate setters in the ECB is that the eurozone does not comprise an homogenous group of countries and the "one size fits all" interest rate is a major fault line in the eurozone given the different prospects for the various countries comprising the area. The ECB's quantitative easing has at least a year to run and one would expect that it would spark some increase in economic activity as monetary growth accelerates. It is not out of the question that the ECB may even extend its stimulus. However, as mentioned above, the eurozone does not comprise an homogenous group of countries and we can see wildly differing economic performances, even amongst the largest eurozone economies, which makes policy management difficult. If we look at the latest annualised quarterly economic growth data for the four largest eurozone economies, we see a wide divergence of performance. For the largest economy, Germany, the figure was 1.8% but, for the second largest economy, France, there was no growth. The third largest economy, Italy, which has been through a difficult time, showed some improvement at 1.3% whilst the fourth largest, Spain, has performed really well from a low base, with a level of 4.1%. Mr Draghi, President of the ECB, has often emphasised the importance of structural reform in the eurozone. Although it may not seem a problem at present, very low eurozone interest rates, quantitative easing and structural rigidities which limit an economy's potential growth rate do create a background for "stagflation" (economic stagnation and inflation). This has implications for debt dynamics given the weak budgetary position of some eurozone countries. We can be fairly certain that interest rate increases will not be on the ECB's agenda for some time but the structural flaws in the euro project which we have often mentioned in these reviews need to be on investors' minds, particularly in relation to the eurozone's sovereign bond market. Quantitative easing can

suppress bond yields but can make credit differentials unrealistic at a time when the debt dynamics are not favourable for some countries. Bond holders need to be aware not only of the unrealistically low level of yields but also credit risk compression which does not allow for the deteriorating creditworthiness of some countries.

With China at the front of investors' minds, Greece has been relegated to second place but that does not mean that concerns have lessened in any way. The general election, just held, has returned Syriza which has allied with the right wing Independent Greeks party. It has to implement the requirements of the third €86 billion bailout, agreeing to conditions for social and economic reforms which Syriza had opposed in the recent referendum. The money will only come as and when Greece observes its creditors' conditions. The country has gone backwards this year with valuable time being lost. It will be difficult to enact the reforms which its bail out creditors require and another crisis is quite possible. The Greek economy will contract this year whereas economic growth is required to start making inroads into the country's debt position. The continuing Greek crisis shows the problems of constructing a sub-optimal currency zone and we continue to believe that it will fragment in time, beset by its own internal contradictions. So, Greece remains an economic problem which could take centre stage at any time.

One of the issues arising from the possibility of an early start to a rise in US interest rates is the effect on emerging markets. They are not an homogenous group and some are in a much stronger position than others. The weakest ones are those with a commodity bias, given the low price of many commodities, those with weak current accounts and those connected with China which have been affected by a slowdown in some aspect of its economy. But others are in a stronger position. Those like India, which is a large energy importer, are benefiting from lower oil prices. Others have strong current account positions or substantial foreign exchange reserves and, overall, although growth forecasts for emerging markets have been coming down, they are still well ahead of those for developed markets. Of the original BRIC countries, Brazil and Russia are struggling for different reasons with both certain to turn in negative economic growth this year. Brazil has been adversely affected by following inappropriate economic policies and, latterly, weak commodity prices, although it is obviously a country which still has huge potential. Russia, being largely dependent upon the energy sector, is being affected by low prices and lack of diversification in its economy, not to mention sanctions arising from the Ukraine situation. On the other hand, notwithstanding what is widely accepted to be a slowdown in China, the latest OECD forecast, in its September Interim Outlook, is still projecting growth of 6.7% for China this year and 6.5% next year. Those forecasts are just 0.1% lower than its June projection. So, it is very much a mixed picture. Countries, whether developed or emerging, which are always vulnerable to changes in sentiment, are those with large current account deficits which rely on capital inflows to finance their deficits or have insufficient foreign exchange reserves to support their currencies. Countries such as Turkey, Indonesia, Brazil, Colombia and South Africa, to name but some, are running significant current account deficits. All of these countries' currencies are significantly weaker than a year ago and insofar as companies based in weak currency countries have corporate debts, in particular, denominated in strong currencies like the US dollar, that creates concern about creditworthiness. Whilst there are always plenty of issues to worry investors, and most of those which are concerning them have been around for some time, until the latest quarter, they have been able to shrug them off as the rise in equity markets in earlier quarters has shown. However, it is important to note the positive features in the current economic background which support our view that equities remain the preferred asset class. Importantly, there is some moderate growth in the world economy and we believe that the current weakness of the oil price will provide a stimulus to a number of important economies. We have referred to the OECD's Interim Outlook, just published, and its latest projections suggest world economic growth this year of

3.0%, a 0.1% reduction on its June forecast, and 3.6% next year a 0.2% reduction on its June forecast. We talked about the projections for China, India and Brazil earlier but, for the developed countries, it sees growth in the USA this year at 2.4%, an increase of 0.4% on its June projection and 2.6% next year, a reduction of 0.2% against June. It has raised very slightly by 0.1% its projection for the eurozone this year to 1.6% growth but reduced it by 0.2% for next year to 1.9%. Although it sees accelerating growth next year in the eurozone, there have still been some quite large cutbacks in its estimates for the largest eurozone economies since its June publication. So, Germany, which is projected to see 1.6% growth this year has seen a 0.4% reduction in the OECD's forecast for next year to 2.0%. France has seen a 0.3% reduction for 2016 to 1.4% and Italy one of 0.2% to 1.3%. The ECB's latest forecasts for the eurozone are slightly lower at a midpoint of 1.4% for this year and 1.7% next year. For the United Kingdom, it has left its projections unchanged at 2.4% for this year and 2.3% for next year. Japan has seen a modest reduction in the OECD's forecast by 0.1% this year to 0.6% and by 0.2% next year to 1.2%. The other member of the G7, Canada, affected by the weakness of commodity prices has seen a significant reduction in its forecast for this year by 0.4% to 1.1% and a smaller reduction next year of 0.2% to 2.1%. Obviously, forecasts change as new influences come into play but we consider that there is enough growth potential in the world economy, and, therefore, for many companies, to be supportive of equities. It is a mixed picture, of course, for companies. Those in the commodity sector are having a very difficult time although some of the high quality ones appear oversold but the current price weakness in many commodities is sowing the seeds of the next price recovery as investment is cut back. There are signs of some sense of normality returning to the banking system. This is necessary to ensure that there is a supply of funds from the banking sector and that the financial transmission system is working properly so that the benefit of very low interest rates and plentiful availability of money is passing through to businesses, in particular. There is some evidence that the transmission effect is beginning to be more potent in the eurozone.

Whilst we understand why bond yields are so low, it does not make them realistic on a longer term view and we think that the comparison between equity and high quality bond yields remains valid in assessing the attractions of equities. If we take the UK and the USA, we are back to the 1950s which was the time when the crossover between the yields on bonds and equities occurred. Up to that time, equities had yielded more than bonds on the basis that they were more risky. The crossover took place then but, as a result of the financial crisis and the suppression of yields caused by quantitative easing, we are back to that position. Over many years, of course, the performance of equities has far exceeded those on bonds and cash so the original rationale for equities yielding more than bonds because they were riskier looks doubtful other than on a short term view. So, has the investment world changed and have we reverted to a 1950s situation? We think not. Bond yields are highly likely to rise significantly which will help to reduce the gap between bond and equity yields where it is large, like the UK and eurozone, unless equity prices fall sharply as a result of the upward movement in bond yields which we think unlikely to happen. The economic outlook globally is such that we would expect to see modest increases in dividend payments which, on unchanged prices, would raise dividend yields. We think the balance of the risk is skewed to seriously overpriced bonds rather than equities. If we take the UK as one example, the dividend yield on the FTSE 100 index is currently around 4% and that on the ten year gilt at the end of September is 1.77%. In the absence of a very severe economic recession or depression, the anomaly looks glaring. One cannot realistically see such a cut in dividends as to make 4% look a freakishly high figure. More likely, as we said above, dividends will grow modestly. A more probable scenario is that bond yields will rise sharply and, historically, 4% would not be out of line for a ten year bond although it is not likely to reach that level for a while. This could happen if inflation started to rise and quantitative easing started to be reversed, placing upward pressure on interest rates. It would have to be an economy in severe stress to have equities yielding more than high quality bonds for any significant period of time. Almost

everywhere one looks, this is the case, even in the USA where ten year Treasury bond yields are higher than in any other G7 country. A particularly extreme example is Switzerland, which has been struggling to restrain its currency, as is evidenced by negative gross redemption yields on its ten year government bonds as holders are prepared to accept negative returns, if the bonds are held to redemption, because they perhaps believe that they will obtain a currency gain. So, at the time of writing, the gross redemption yield on the ten year Swiss government bond is -0.116% whilst Bloomberg is showing the current year's estimated dividend yield on the equity market at 3.42%. Absent extreme circumstances, which we cannot presently foresee, the attractions of equities against bonds appear clear.

We have talked about equities, with their generally large yield advantage over high quality bonds, being able to absorb the expected rise in bond yields in their stride but it is important to emphasise the challenges which will face investors in these circumstances. To be clear, the newly created electronic money which central banks have created to purchase fixed interest securities risks creating inflationary pressures later on. If those institutions which have exchanged their fixed interest securities for cash, start the process of circulating it more quickly and create extra demand in an economy, then an economy could soon close its output gap leading to bottlenecks and inflationary pressures. A larger amount of money chasing a limited amount of goods and services will push up prices. A good example would be a bank holding extra cash from the bonds it has sold and lending it out creating an economic multiplier effect. At some stage, the process of quantitative easing will have to be reversed, creating a major challenge for markets. In the USA and UK the process of quantitative easing has stopped although has not been put in reverse as bond maturities are reinvested rather than used to reduce the outstanding stock of bonds purchased under the fixed interest purchase scheme. In Japan and the eurozone, quantitative easing is being undertaken now. The simplest way of reversing the programme would be for the central bank to sell back to the private sector the bonds purchased which would reverse the original expansionary effect. One would expect this would put pressure on interest rates. But, as we saw with the taper tantrums in the USA in 2013, which the market got over, the threat of a change in the status quo, which might involve relative or absolute tightening but should have been discounted as it was obvious that it was going to happen sometime, still caused temporary jitters in the US market before it recovered. A similar situation is likely to occur with the prospect of a reversal in quantitative easing by one method or another. This is something for the future but investors need to be aware that it will be a major challenge which they will face.

Turning now from the general to the particular and looking at the USA, we have already noted that the Federal Reserve shied away at its September meeting from raising interest rates in the face of unsettled economic conditions abroad. Had that not been the case, domestic conditions would surely have settled the issue, particularly as the latest estimate of second quarter GDP growth has been raised up a second time from 3.7% to 3.9%. Although certain sections of the US economy have been affected by the big fall in energy prices, the benefit to consumers and industries which use oil heavily will have been significant and probably the latest strong growth figures are starting to reflect this. Looking at various economic indicators, the latest ISM purchasing managers indices were down on the previous month's figures at 50.2 (51.1) for manufacturing and 56.9 (59.0) for non manufacturing, the latter reflecting a much larger sector of the economy. However, on balance, those figures reflect moderate growth albeit that the participation rate has fallen again. The unemployment rate has continued its steady drift downwards. In January, it was 5.7% and the latest figure is 5.1%. House prices as measured by the FHFA House Price Index continue to rise month on month. The Conference Board's index of leading indicators has been rising steadily throughout the year even if the recent pace has been slower than earlier on in the year. Retail sales have been rising modestly. Where US

companies have been finding life more difficult is overseas where the strong US dollar has given them currency headwinds. Furthermore, the USA is a relatively self-contained country so that the slowdown in China and its knock on effect elsewhere should be felt less keenly in the USA. The US stock market will soon be taking a closer interest in the political scene with just over a year to go before the Presidential and Congressional elections but at the moment that is not the main focus of attention. The US economy is performing relatively well and the prospects look reasonably good. The 2.6% growth rate forecast made for 2016 by the OECD looks achievable at the moment and could even be exceeded if the fall in the oil price makes its influence felt in terms of consumer confidence and spending. The USA looks to be one of the safer areas in which to be invested.

As we see from the forecasts made by the OECD and the ECB, eurozone growth is forecast to accelerate this year and next from 2014's figure of 0.9%. Neither organisation expects it to reach 2.0% although the ECB does provide a range, the upper end of which for next year is 2.6%. Notwithstanding its inferior economic performance to that of the USA and UK, there are some better signs albeit against the background of a dysfunctional monetary union which is likely to continue to hamper its performance overall. Monetary growth is accelerating, although August was an exception, as the effect of quantitative easing feeds through to the transmission system and one would expect this to lead to increasing economic activity. The closely watched purchasing managers' indices are telling a moderately good story, certainly in terms of where the eurozone has been. The latest composite purchasing managers index stands at 53.6 which points to modest growth. Within that, the dominant services index stands at 53.7 (54.3) with the smaller manufacturing sector at 52.0 (53.0). Construction remains in the doldrums at 47.2 (47.1) with any reading below 50 implying contraction. Industrial production has been looking up slightly. The latest month on month figure for the eurozone showed a 0.6% increase compared with a contraction the previous month of 0.3% whilst the year on year increase accelerated to 1.9%. The concern here was France. As mentioned earlier in this review, the French economy showed no growth in the second quarter and the latest industrial production figures showed a month on month decline of 0.8% and one of the same amount year on year. The star was Spain with a month on month increase of 4.9% and a year on year increase of 5.8%. Spain is an economy where significant economic reforms have taken place, particularly in the labour market, but in spite of efforts by some French government ministers to make or hint at modest reforms, particularly in the labour market, the country remains resistant to change, perhaps best symbolised by the 35 hour week which is sacrosanct to many politicians. Although unemployment remains very high at 10.9%, that has come down from 11.4% at the beginning of the year.

As a large oil importer, one would expect the eurozone to be a large beneficiary of lower oil prices but enthusiasm may be restrained by the general and continuing problems of the eurozone and the austerity being practised in a number of countries. But the arguments employed to show the relative attractions of equities in the UK by comparing dividend yields with, say, ten year bond yields, apply here too. According to Bloomberg, the estimate of this year's dividend yield for the Euro Stoxx 50 is 3.91%. At the time of writing, the ten year German government bond yields 0.61%, the French one 0.98%, the Italian one 1.83% and the Spanish one 1.96%. As we have noted before in many of these reviews, it is important to distinguish between the sovereign and the companies in which one can invest. The latter have much more flexibility than the sovereigns and can prosper even if the sovereign has problems. European equities look much more appealing than their equivalent countries' bonds.

Although the Japanese stock market has performed relatively well this year, more and more questions are being asked about "Abenomics". The economy has taken a long time to recover from the 3% consumption tax increase in April 2014 to 8% and ways are being considered to reduce the burden on some people of the final 2% increase in 2017 which will bring the rate to 10%. The second quarter's

annualised GDP growth rate was -1.2% with the quarter on quarter figure at -0.3% and the year on year figure of +0.8%. Japan's long brush with deflation means that the mindset this imbues is difficult to shake off and the ironic situation is that the central bank is trying to nudge inflation up to 2% yet has been stymied by the fall in the oil price with the result that it is difficult trying to shake off this mindset and get people to spend and move the economy forward. The latest consumer price index shows a month on month increase of 0.2% and a year on year increase of 0.2%. Industrial production in July fell by 0.8% month on month and was flat year on year. Meanwhile, the Bank of Japan is engaged in aggressive quantitative easing to try to kick start the economy. It is the third arrow of "Abenomics" which is generally thought to have been the least successful one, namely structural reform aimed at increasing the economy's potential growth rate. The labour market remains very rigid whereas it needs to be flexible to give the young and women greater opportunities so that promotion and opportunities can be given on merit to benefit the economy. Vested interests make change very difficult. The agricultural products market also needs to be liberalised. In short, some important supply side reforms have not yet been made. But others have. Corporate governance improvements with more outside directors being appointed to boards and government directions to increase substantially the holdings of equities in public funds, not in a market support operation but as a way of introducing supply side reforms to emphasise the importance of share ownership in an economy and what shareholder pressure can do to improve company performance, is one example. The recent accounting scandal at one of Japan's major firms, Toshiba, emphasises the point. Modest exposure to this market offers the potential for high rewards if "Abenomics" goes to plan. Japan's enormous level of outstanding public debt as a percentage of GDP at around 240% is easily the largest of the major economies as is its budget deficit, estimated to be around 6.8% of GDP this year. What happens to China's economy will also be important for Japan. At the end of September, Mr. Abe introduced three more arrows, taking the total to six now which form the platform for "Abenomics". The three additional arrows relate to an aim of increasing the size of the Japanese economy from JPY491 trillion to JPY600 trillion by 2020, an attempt to improve Japan's awful demographics by attempting to drive up the birth rate by improving childcare provision to bring women back into the economy and, thirdly, to improve social security provision for the elderly to enable people to remain in employment who might otherwise have to leave the workforce to care for elderly relatives. These last two arrows will cost money, something the government does not have given the size of the budget deficit. So, news is awaited on these latest developments in "Abenomics".

We have discussed China at some length in this review but we need to discuss some of the latest economic data as well as other aspects of recent news from China. One of the disappointments for bulls of China has been that, at the first sign of turbulence in the Chinese stock market, the authorities intervened to try to manage the market by giving various directives and intervening to buy stock to try to stem the slide as well as trying to find scapegoats for the dramatic fall in the equity market after, it must be said, an even more dramatic rise. Once governments or central banks try to micro manage markets, investors lose confidence as they sense a government or central bank not in control of events. In a similar vein, whilst China has enormous foreign exchange reserves, there have been attempts to limit capital outflows directly or indirectly by making some companies repatriate foreign currency held overseas. The irony of this is that China runs a large current account surplus, estimated to be running at around 3% of GDP. Usually, it is countries which run large current account deficits which are considered to be vulnerable but uncertainty about the course of economic policy in China has raised capital outflows plus foreign exchange reserves have been used to support the renminbi. Another very recent disappointment has been the limited reforms planned for the running of State Owned Enterprises (SOEs). It had been hoped that with the market elevated in importance in the new Chinese regime, there would be much more freedom allowed to SOEs to run themselves along the lines of privately owned companies. That this needs to happen is shown by the low returns made by

SOEs compared with private companies. The latest news on SOEs is not encouraging. The forces arguing for the status quo have had some success in retaining their influence on SOEs and their move forward to embrace much more strongly the disciplines of the private sector have been partially blocked. Freeing SOEs to run on the lines of the private sector would have given much more confidence to investors, for example, full privatisation of at least some of them. In summary, recent events have not encouraged those who felt the new Chinese regime's commitment to the disciplines of the market would result in major changes in the way the country's major businesses were run.

The latest economic data from China suggests a lower economic growth rate than that indicated in the second quarter's figure which was 7.0% higher year on year and quarter on quarter annualised. The latest Purchasing Managers Indices for September showed that for manufacturing at 49.8 (49.7) and for non manufacturing at 53.4 (53.4). Taken together, these suggest an economy growing below the latest quarter's 7% annualised growth rate. In August, imports were 14.3% below the level of the previous year, a further sign of slowing growth. The country's leading indicators show a level which has hardly changed since January. Yet it is important not to get too gloomy about China or emerging markets in general. They account for over half of world GDP and, whilst some countries like Russia and Brazil are showing negative growth, others show growth of which industrialised countries can only dream. If one wants evidence of how important outside politicians and business people consider China to be, one only has to look at President Xi Jinping's recent visit to the USA and how much attention was paid to it. An agreed purchase of 300 Boeing commercial aircraft is not to be sneezed at even in these days of large aircraft purchases. Even though relations between the USA and China are difficult in some areas, there is still mutual recognition of the importance of each country to each other. In the UK, we have seen the Chancellor of the Exchequer carry out an extensive tour of China trying to increase trade links and particularly encourage Chinese investment in the UK in very high value projects. If a country is running a current account deficit as large as that of the UK, even though it contracted to a three year low of 3.6% of GDP in the second quarter, foreign investment is very important to help to bridge that gap. As we said earlier, notwithstanding its current economic slowdown, China still has major fiscal and monetary tools available to it to try to stimulate economic growth and, so, a sense of perspective needs to be kept by investors. Emerging markets and China, in particular, are crucial to the world economy, given their economic importance.

As we turn to look at the UK, we note an economy, like that of the USA, which is performing relatively well and, in normal circumstances, would not have interest rates at the current very low levels for fear that this would set off a rise in inflation. As we noted earlier, the OECD reckons that the UK's output gap has almost closed and, had the volatility in the Chinese market not influenced US interest rate setters to keep their powder dry on an immediate increase, we feel that the UK would not have been far behind in moving up interest rates. In fact, recent growth has been faster than previously estimated. The ONS has revised recent years' growth estimates as follows in percentage terms with the previous estimate in brackets : 2010 1.5 (1.9), 2011 2.0 (1.6), 2012 1.2 (0.7), 2013 2.2 (1.7) and 2014 2.9 (3.0). The UK economy was 5.9% larger than its pre crisis size against a previous estimate of 5.2%. It grew faster than any other G7 nation in 2013 and 2014. This could partly explain the UK's recent strong employment record. Recent data has supported the view that the UK economy is on track for moderate growth which, certainly compared with what is happening in the eurozone's G7 economies (Germany, France and Italy), Japan and Canada, with only the USA in the same league. The weakness of the eurozone, because of its importance as a trading partner for the UK, is certainly unhelpful. If we look at the latest purchasing managers indices for the UK for September, whilst below those for August, they are still quite healthy being well above the level of 50 which signals the dividing line between expansion and contraction. The August composite index for the UK was 53.3 (55.2) and, within that, the dominant services sector index stood at 53.3 (55.6) whilst the much

smaller manufacturing and construction indices stood at 51.5 (51.6) and 59.9 (57.3) respectively. Unemployment has remained steady at 5.5% (it started the year at 5.7%). Second quarter GDP showed an annualised quarterly growth rate of 2.7% and year on year growth of 2.6%. Pay growth is quite strong compared to where it was and, with year on year headline inflation at nil, real wages are increasing which one would expect to feed through to economic activity. Most importantly, if inflation is not to become a problem, productivity must increase and there are some signs of this happening at last. With the Chancellor intervening in the employment market to fix wages at much higher levels than at present, firms will have every encouragement to try to raise productivity further. This will be necessary to sustain UK growth. But there are some economic clouds which may or may not blow away. The latest figures for public borrowing were much worse than expected. It is never right to read too much into one month's figures but the August borrowing level was around £3 billion more than anticipated at £12.1 billion. The major threats to the UK economy are the twin deficits, the budget deficit and the current account deficit and, in certain circumstances, they have the potential to cause the UK difficult problems. At the moment, this is not the case but there is no room for complacency. Manufacturing, although a relatively small but symbolically very important part of the UK economy, is suffering from the strength of sterling (a little weaker as this is written) and a slowdown in Asia and the eurozone. All the evidence we have about the UK at present would suggest cautious optimism but with some fragilities to contend with.

As the final quarter starts, international equity markets have staged a useful recovery although it is very early days and it remains to be seen whether this will carry through to the end of the year. Our view has been that markets would grind higher this year albeit with some negative quarters. For the markets to end in positive territory, the final quarter will have to be a good one but our broad view, expressed at the beginning of the year, remains the same. Despite the difficult economic and political background, the relative attraction of shares against bonds remains. Unless the world economy enters a prolonged period of deflation, which we do not see, it is difficult to see how medium and long term investors in bonds can derive satisfactory returns whereas, for equities, assuming modest growth in the world economy, the prospects are better albeit against the background of modest returns. As ever, it is important not to be intimidated out of the market by short term setbacks, unless the position fundamentally changes which we believe not to be the case. That way lies the path to poor returns. We must expect further volatility against a modest upward trend in equity markets on the evidence that we have before us at present.

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