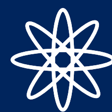

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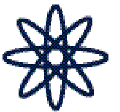
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

With the exception of Japanese shares, equity markets have drifted higher over the quarter in the absence of any worsening of an already well documented troubled economic situation. Very loose monetary policy is contributing to higher asset values and this has also caused high quality bond yields to fall over the quarter. The rise in the gold price reflects inflationary fears down the road arising from the current monetary policies being followed in many countries.

The tables below detail relevant movements in markets:

International Equities 29.06.12 - 28.09.12

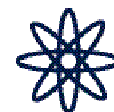
Total Return Performances (%)				
Country	Local Currency	£	US$	€
Australia	+8.6	+7.0	+10.2	+8.7
Finland	+9.1	+7.4	+7.4	+9.1
France	+5.7	+4.1	+7.2	+5.7
Germany	+12.3	+10.6	+13.8	+12.3
Hong Kong, China	+11.2	+8.0	+11.2	+11.7
Italy	+6.2	+4.6	+7.7	+6.2
Japan	-2.6	-3.6	-0.7	-2.1
Netherlands	+6.1	+4.5	+7.6	+6.1
Spain	+10.3	+8.7	+11.9	+10.3
Switzerland	+7.0	+4.7	+7.8	+6.3
UK	+4.2	+4.2	+7.3	+7.7
USA	+4.5	+3.3	+4.5	+4.9
Europe ex UK	+8.0	+6.6	+9.8	+8.3
Asia Pacific ex Japan	+8.6	+7.5	+10.7	+9.2
Asia Pacific	+3.5	+2.8	+5.8	+4.4
Latin America	+4.0	+2.2	+5.2	+3.8
All World All Emerging	+6.3	+4.6	+7.7	+6.2
The World	+5.9	+4.0	+7.0	+5.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +1.1%

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

Currency	29.06.02	28.09.12
Sterling	1.75	1.71
US Dollar	1.66	1.61
Yen	0.84	0.77
Germany (Euro)	1.60	1.44



Sterling's performance during the quarter ending 28.09.12 (%)

Currency	Quarter Ending 29.06.12
US Dollar	+3.0
Canadian Dollar	-0.5
Yen	+0.6
Euro	+1.2
Swiss Franc	+1.9
Australian dollar	+1.5

Other currency movements during the quarter ending 28.09.12 (%)

Currency	Quarter Ending 29.06.12
US Dollar/Canadian Dollar	-3.4
US Dollar/Yen	-2.4
US Dollar/Euro	-1.7
Swiss Franc/Euro	-0.6
Euro/Yen	-0.6

Significant Commodities (US dollar terms) 29.06.12 - 28.09.12 (%)

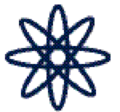
Currency	Quarter Ending 29.06.12
Oil	+14.9
Gold	+14.5

Markets

During the quarter international equity prices have generally improved with the FTSE World Index showing a total return in local currency terms of 5.9%, in sterling terms 4.0%, in US terms 7.0% and in euro terms 5.6%. Looking at returns in local currency terms first, Europe ex UK and Australia performed particularly well with respective returns on the FTSE Europe ex UK Index and the FTSE Australian Index of 8.0% and 8.6% respectively. Asia Pacific ex Japan and emerging markets also performed well with the FTSE Asia Pacific ex Japan Index returning 8.6% and the FTSE All World All Emerging Markets Index returning 6.3%. The FTSE UK Index and the FTSE USA Index showed more modest returns of 4.2% and 4.5% respectively. The one disappointment was Japan where the FTSE Japan Index returned -2.6%.

With sterling generally rising over the quarter, sterling adjusted returns were usually lower than local currency returns. Nevertheless, all, except Japan (-3.6%), produced satisfactory returns with the respective sterling adjusted indices showing returns for Europe ex UK of 6.6%, Australia 7.0%, Asia Pacific ex Japan 7.5%, Emerging Markets 4.6% and the USA 3.3%.

In the high quality government bond market, yields, as measured by ten year government bonds remained extraordinarily low. The gross redemption yield on sterling bonds fell by 4 basis points to 1.71%, those on US government bonds by 5 basis points to 1.61%, on Japanese government bonds by 7 basis points to 0.77% and on German government bonds by 16 basis points to 1.44%.



In the currency markets, sterling fell 0.5% against the Canadian dollar but rose 3.0% against the US dollar, 1.9% against the Swiss Franc, 1.5% against the Australian dollar, 1.2% against the euro and 0.6% against the yen.

In the commodity markets, oil, as measured by Brent crude, rose 14.9% and gold by 14.5% with quantitative easing reducing investors' confidence in paper currencies.

Economics

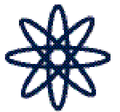
The news continues to be dominated by the eurozone and the problems of the area are likely to remain centre stage for as far ahead as one can see. There are many other pressing problems, such as the possible "fiscal cliff" in the USA, a slowdown in China and a stagnant economy in the UK, all of which are very significant for investors, but nothing approaches the severity of the problems in the eurozone.

As this is written, markets have been firm on the back of a week in September which was perceived to have had three positive events. The first was the German Constitutional Court's approval of the European Stability Mechanism with qualifications, the second was the ECB's decision to embark on a sovereign bond buying programme, again with conditions, and the third was the Federal Reserve's announcement of QE3 or QE Infinity, as some characterise it

In this Alice in Wonderland economic world all these measures were considered to be positive developments. Before we go any further, let us emphasise that we still regard equities as the asset class of choice but the reasons for this view are complex and relate in great part to the extreme monetary economic policies being followed which we believe to be good for equities and commodities, the latter perhaps being accessed through equities as well. Furthermore, as we have stated before, equity markets do not have to operate in the same cycle as the economy so it is not a surprise that share prices have moved modestly higher so far this year against a dreadful economic background.

However, we must look past the euphoria of mid September and see what each of the above measures means and what they say about the state of the relative countries' economic conditions starting with the eurozone.

Markets first got wind of something significant in the eurozone in late July/early August when the President of the ECB, Mario Draghi, said, to paraphrase, that the ECB would do whatever it takes to save the euro. He and his colleagues were working on a plan whereby the ECB would purchase the sovereign bonds of those countries in difficulty with their financing, and here the markets were thinking of the two big countries whose bond yields were indicating distress, Spain and Italy, provided they sought assistance through the bailout mechanisms. If they did that, the countries in question would be subject to external supervision and the theory was that the ECB would feel more secure if they had this guarantee. This idea would seem to be the only way past Germany where there is growing resistance to bail outs. Sometimes, in markets, it is better to travel than to arrive and, certainly, the markets responded to the former as bond yields of troubled eurozone countries fell. However, the assumption that Spain and Italy would, if necessary, ask for support (in the case of Spain outside the support announced for its banking system) is a bold one. The political temperature is rising in both creditor and debtor eurozone countries. Amongst the countries in receipt of a bail out already, Greece faces persistent unrest with a further general strike being called and, in Portugal, seen as a model country for enacting deficit cutting measures and some structural reforms, the temperature has suddenly risen with widespread political protests and a fracturing of the political unity backing the austerity measures with the socialists, who negotiated the three year bail out agreement when they were in government, now saying that they will vote against the 2013 budget proposals when they are put before parliament. Only in Ireland have the protests been more subdued although there is plenty of unhappiness. But protest is gathering pace in Spain and this is where the most immediate threat lies. The decentralised nature of Spain and the autonomy given to the regions is posing an additional difficulty for the Spanish government. Controlling the regions' finances is proving difficult as their deficits contribute to the central government's problems. Several have had to request aid from the centre including wealthy Catalonia

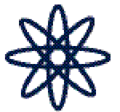


where the calls for independence are becoming increasingly loud (an election has been called for November), thus providing another problem for the central government. There is much external pressure on Spain (from France, for instance) to ask for a bail out but the government is hedging its bets by seeing what the terms might be. The point is that asking for a bail out would involve an enormous loss of face for the government and might be politically impossible. Although Italian sovereign bonds are not as distressed as those of Spain, the interest rates they pay are not affordable in an economy showing no growth. The technocratic government of Mr Monti comes to an end next year and, in the face of increasing opposition to the government's austerity measures, there is no knowing what type of result the election will bring and reforms are likely to become even more difficult. The political backlash against austerity could easily raise the temperature in the eurozone crisis still further and the strength of feeling in the debtor countries against the austerity measures could spill over into something very nasty.

Politicians in creditor countries are also in difficulty. The strength of feeling against the bail outs and the risks which countries like Germany, the Netherlands and Finland are taking in becoming involved are stoking increasing anger. Although the Constitutional Court approved Germany's participation in the European Stability Mechanism (ESM), it was not straightforward and ties the hands of the German government in terms of due process and the extent of Germany's financial commitment which is capped at €190 billion being its proportionate share of the €500 billion ESM. Were Spain and Italy to require financial assistance, not to mention the countries already receiving bail outs, this would not be enough. One of the schemes which has been put forward is for the ESM to have a banking licence which would enable it to borrow and therefore extend more assistance to countries in trouble. This is not now possible because of the ruling. The ECB is not allowed to finance eurozone countries' deficits in the primary market.

All these measures to assist countries in difficulty amount to sticking plaster by trying to deal with the symptoms rather than the causes of the problem. The countries in difficulty (Ireland is an exceptional case) have exhibited a number of characteristics including a loss of competitiveness against Germany, using that country as a benchmark, as relative costs have moved out of line and, connected with this, a deteriorating current account. Government overspending has left public finances very exposed. One of the problems in countries like Ireland and Spain was that interest rates set by the ECB were too low for these countries and this led to the property boom and bust which has so damaged these countries' banks and contributed enormously to these countries' financial problems.

It is important to emphasise that the ECB has not solved the eurozone's problems, it has merely offered the possibility of buying more time. The ECB can only address the symptoms not the causes of the problem. The theory behind the optimists' approach is that by buying time for troubled eurozone countries through ECB intervention in the bond market to keep down yields or a bail out of those countries which are unable to finance themselves, it will give the countries time to address their financial and economic problems. The problems are twofold but connected. One is the loss of competitiveness which adversely affects economic growth and therefore government finances through a reduced tax take and increased government spending on social security. Secondly, with the first issue contributing to this, is the need to tackle the budget deficit through public expenditure cuts and tax rises. Given that the standard policy measure of devaluation to tackle the problem of a loss of competitiveness is not available with a single currency, the policies being imposed on bail out countries are those aimed at an internal devaluation. This is achieved by cutting costs relative to competitors, the simplest example being of pay cuts being imposed. A current example of this is in Portugal where it was planned to increase social security contributions on employees by 7% with the equivalent amount taken off employers' contributions. In a purely economic sense, which was the government's line, this would have made Portuguese companies more competitive by reducing their labour costs and it would also encourage employers to take on more employees because their costs would be lower. At a time of great economic hardship, this was likely to cause deep resentment and protest in Portugal, which has happened, and the government is back tracking. An example like this is one reason why we think the euro will break up. In a democracy, it is difficult to believe that the electorates will be willing to pay this price



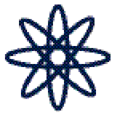
to remain in a flawed monetary union. The irony is, of course, that what the Portuguese government is trying to achieve is a presentationally more unpalatable version of what should theoretically happen in a conventional devaluation whereby the benefits of a devaluation can only be seen, other than in the very short term, if wages are held down to minimise the inflationary impact of devaluation. This would be a pay cut by another name but is presentationally less provocative than a straight pay cut or a version of the same as was proposed by the Portuguese government. The hope for those in the eurozone is that through action to rectify public finances and restore lost competitiveness, the eurozone will work as it was intended to. The reality, in our view, is that the economic divergences between eurozone members are too great for this hope to be achieved and we do not believe that the electorates will stand for the policies being implemented.

It is worth examining what the ECB has said it will do and in what circumstances it would do it. A prerequisite for eurozone countries which find it difficult to raise money is that they must ask for a bailout which will come with conditions which, as we have discussed above, will be hard for governments to accept and which the electorates may reject. Greece, Ireland and Portugal are, of course, already receiving bailouts but the big two would be Spain and Italy, which would take the bailouts' size to another level altogether. These countries would be handing over economic sovereignty, almost certainly fatal for the Spanish government, and leading to great uncertainty in Italy about what it might mean for the outcome of next year's election.

So far with its now suspended bond buying programme at €208.83 billion, the Securities Market Programme, the ECB has sterilised its interventions unlike the activity in this field of the US except for "Operation Twist" and UK central banks where purchases have been unsterilised. This is relevant to future inflation prospects. Intervention which is sterilised means that the money created to buy bonds of troubled sovereigns is offset by the central bank selling securities to suck the cash back out of the system or requiring banks to place deposits with it. The theory is that this will negate the effect of the money created staying in the system and causing inflationary pressures as additional money chases a limited amount of goods and services. In a full blown eurozone crisis, this may not be possible. In the UK and USA, at some stage, the money created to buy assets will have to be withdrawn from the system otherwise when the money starts to circulate more quickly, as it has not done so far, there is a real inflationary threat. The more quantitative easing which is undertaken, the greater the difficulty when it comes to reversing it. This would be undertaken by the central bank selling back assets which it had purchased to the private sector with the threat to interest rates and consequent economic activity which this might have.

So, as far as the eurozone is concerned, investors were pleasantly surprised at the possible extent of the ECB's measures, temporarily causing a "sugar rush" but the practice remains problematical because of what we see as major political difficulties for Spain and Italy, if the need arises in accepting bail out terms. We would expect to see much more social unrest. With so many moving parts in the eurozone's construction, high level plans can easily come unstuck in the detail because total agreement is difficult to reach.

Moving to the USA, the third announcement which excited markets was the Federal Reserve's announcement of QE3 on 13 September. This was a powerful measure, not only in terms of the substance but also the message behind it, and the initial reaction of the US stock market was favourable. The Federal Reserve announced that it was to inject US$40 billion a month into the US economy through the purchase of agency mortgage backed securities. Under Operation Twist, it was swapping short dated Treasury debt for longer term debt and this will bring the Federal Reserve's asset purchases to US$85 billion a month for the rest of the year. Furthermore, the Federal Reserve now forecasts that interest rates will remain "exceptionally low" until mid 2015 thus extending its forecast horizon from late 2014. Equally headline grabbing was the reasoning behind the Fed's action. The Federal Reserve has a broader mandate than the Bank of England or the ECB which not only includes keeping inflation under control but also targeting full employment and it was the latter point which Ben Bernanke emphasised, namely that the asset purchase programme will continue as long as unemployment, currently 8.1%, continues as high as it is. The Federal Reserve will be looking for an improvement before it stops its asset purchases. The

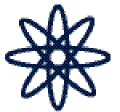


new extended QE policy is therefore quite aggressive and explicit and the market liked it. By concentrating on mortgage backed securities, the Fed is hoping to stimulate the housing market which has been depressed for so long and has cast a negative shadow over the US economy. The US equity market was thrilled with the news and hit a new high since the onset of the financial crisis.

We repeat that, for the foreseeable future, this very loose and aggressive monetary policy is good for a number of asset classes including shares and commodities, but it is important to be realistic. The Federal Reserve and other central banks such as the Bank of England, ECB and Bank of Japan are only undertaking these measures because of the very serious financial and economic situation. A few years ago, the profile of current monetary policy would have scarcely been believable and it is borne of desperation. To repeat, the danger of printing money is that it risks a significant rise in inflation as money becomes debased and investors look to invest in assets which might give some protection against inflation such as equities, commodities and inflation linked bonds. The greater the amount of money printed by central banks, the more difficult it becomes to withdraw it from the economy by selling the purchased assets back to the private sector. The resulting rise in the prices of shares and commodities does not therefore come about for the best of reasons. So, besides shares, we have seen some commodity prices rising as investors have looked for stores of value as a hedge against inflation. With the world economy being subdued at present, the newly created money has not circulated quickly but, if the velocity of circulation were to increase, inflation could be expected to rise quite sharply. So, no one should be fooled by current low inflation levels because quantitative easing is setting the scene for inflation later on. As the actions and accompanying statement from the Federal Reserve showed, reversal of quantitative easing is a long way off. Dangerous though quantitative easing may be, it is a counterpart to very tough fiscal policy which is having to be followed in many countries, notably in the eurozone and the UK. Insofar as monetary policy raises asset prices and thereby creates a positive wealth effect which does stimulate economic activity, this would be a positive short term development. If it helped to stimulate "animal spirits" as Lord Keynes said, it would raise growth rates. Many companies, for instance, are sitting on a lot of cash but lacking the confidence to invest because they have poor visibility about economic prospects.

It is the case in the USA that, with US politics in a state of paralysis because of the forthcoming elections and split control in Congress, the Federal Reserve is having to carry the weight of managing economic policy. The US political system, as we have often said before, is not well placed to deliver decisive action when needed if Congress and the Presidency are not aligned, as is the case now and likely to remain so after November's elections. US politics are becoming increasingly partisan with little middle ground and seemingly little desire to address the serious fiscal position in which the USA finds itself. This is what makes the potential "fiscal cliff" so serious. This would come into existence at the beginning of 2013 if nothing is done beforehand with the most pessimistic estimates suggesting that it could knock 5% off US GDP although 4% is a more often quoted figure. It would come about if the Bush era tax cuts expired, a payroll holiday expired and sequestration came about because of lack of agreement on measures to deal with the serious fiscal deficit in the USA. The just completed budget year shows a deficit running at 7% of GDP. Because of the growth in the entitlement bill in future years, the problem of US finances needs urgent attention yet, such is the antipathy between the Republicans and Democrats, it is very difficult to find any common ground. When the bipartisan Simpson Bowles Commission came up with a report on the issue which should have been the basis for progress the President did not follow it through.

As we have often remarked, the USA enjoys a major advantage over the eurozone in that it has its own currency, unlike the individual countries within the eurozone, and can therefore literally print money as it is doing at the moment. It is, therefore, unlikely to default but runs the danger of serious currency debasement. As the largest reserve currency, the US dollar has to be a major component of countries' foreign exchange reserves so large scale selling by countries holding large reserves of US dollars threatens to be self defeating because it reduces the value of their remaining US dollar reserves. As we are seeing at the moment in the aftermath of QE3, the



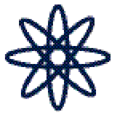
US dollar has weakened so, notwithstanding the serious problems of the eurozone, the USA cannot carry on regardless because it, too, will have to address its problems. The aggressive action of the Federal Reserve as evidenced by QE3 can only be a short term palliative for the economy and is no substitute for the hard decisions on spending and taxation which have to be made. It is, unfortunately, the case that politicians generally look no further than the next election and are afraid to spell out the realistic options to the electorate for fear of losing votes and, consequently, failing to get elected. The result is that no proper long term plans are put in place to plot a sustainable path for the economy. The problem now is that politicians are running out of road, with the economic problems so great so that something has to give. It is much more likely to be in the eurozone that it happens first because of the advantages which the USA enjoys as described above but the USA cannot put off the day of reckoning for ever. The slide in the currency is a warning. Although the USA is a relatively closed economy and therefore the effects of a weak currency are less serious for inflation than in more open economies, it will still have an adverse effect on inflation if it persists.

We have noted quite a benign quarter for stock markets on the back of further stimulatory monetary measures, announced or proposed, and the absence of any bad news which the market was not expecting as opposed to the bad news which is evident in so many countries. However, it would not be realistic to expect this state of affairs to continue without unpleasant surprises occurring. Where might these be?

On the international political front, Iran is becoming an increasing source of concern. The build up of naval power in the area is evidence of how concerned the international community is. On an economic front, a blockade of the Strait of Hormuz would be reflected in the oil price even though stockpiles are high. A military conflict between Israel and Iran is the major fear. Then we see a flare up in tension between China and Japan over disputed islands which has already caused problems for Japanese businesses in China.

Of course, if fears of conflict and general political tension kept investors out of the stock market, many would never be in it. Realistically, markets know about the Iranian situation and investors have been prepared to take a view on it but, if there were to be a military conflict, markets would be hit, at least in the short term. The Japan/China stand off should, hopefully, be much less serious but it is unpredictable.

But it is in the economic area that investors should be on the alert for problems and, here, we go back to the eurozone. As indicated earlier, we do not go along with the view that the ECB has the potential to solve the intractable problem of the euro as we see it. The fundamental problem, as we have often said, is the inability of countries to devalue their currency. So the potential policy lever which could stimulate growth is denied to these countries. We do not believe that the reductions in the standard of living demanded of the citizens of the debtor countries, whether they are in bail outs or not, will be accepted. It is not as if the remedies are temporary. They will stretch long into the future. We mentioned the internal devaluation measures proposed by the Portuguese government which were to raise social security levies on employees with a corresponding reduction in the levies on employers. The aim was to reduce the cost of employing anyone so cutting general costs and thereby making the country's goods and services cheaper to those buying from abroad. Whilst this may be a textbook example of an internal devaluation, the population was not going to stand for it and took to the streets in large numbers thus forcing the government to dump the proposals in favour of tax rises. In Spain, life is becoming increasingly difficult for the government which is finding it very hard politically to ask for a bail out and is locked in conflict with some of its regions, particularly Catalonia, where the possibility of a breakaway persists or at least an attempted one. Meanwhile, in Greece, another bail out looms as the country falls behind with its financial targets and agreed reforms. In Italy, too, where elections are to take place next year, Mr Monti has had to dilute his proposed reforms in the face of opposition and it is anyone's guess how next year's election will turn out. The point is that, notwithstanding pro euro leaders, the electorates in these countries are near breaking point and it will be impossible for governments to enact the proposals necessary to observe the necessary budget disciplines and take the electorate along with them. Opportunist politicians will take the chance to promote opposition to



them and because the euro is a cause of so many of their problems, the possibilities of a country's or countries' exit will rise. But perhaps the biggest challenge will be in France. The country faces severe difficulties arising from its loss of competitiveness and the size of its public sector in relation to GDP. Because in this year's elections so few French politicians presented the electorate with the stark reality of France's public finances, the adjustment needed to reach its 3% budget deficit target by 2013 will be severe. The populist act of increasing taxes on the rich and big business was the easy part but the other side of the targets for budget consolidation will be much less palatable and will come as a shock to many voters who were led to believe that there was an alternative to austerity.

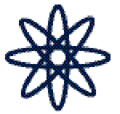
What investors should look for in the continuing problems of the eurozone is evidence that popular support for the euro is lost and that the political momentum for departure and reversion to their own currencies is growing. There is only so far that electorates will be prepared to go in accepting measures to keep them in the euro.

The other side of the equation, as we have said previously, is that creditor countries draw the line at increasing support for bail out countries. If Spain and Italy were to fall into that category, it would overwhelm the eurozone's ability to support troubled countries unless the ECB operated the printing presses and financed their debts. This is not permitted but a desperate situation calls for desperate measures. This is what we have indicated in previous reviews is what we thought would happen eventually. The German Constitutional Court should have put a brake on this as far as Germany is concerned and it remains to be seen if this is an insuperable problem. In another example of creditor countries taking a stronger line, it appears that Germany, the Netherlands and Finland have pulled back on their commitments to support bank bail outs, separate from the sovereign, on all legacy problem lending, as opposed to future problems. This is not how the European Commission or debtor countries see last summer's agreement.

Our reading of the situation is that, notwithstanding the temporary euphoria surrounding the ECB's announcement of a bond buying programme for troubled sovereigns, provided they agreed to request a bail out, the problems in both creditor and debtor countries regarding what is required to support the euro are growing. We are likely to see more evidence of this in the coming months with perhaps the Portuguese government's volte face on social security just one example of things to come. This could provide a temporary jolt to stock markets and call into question the future of the euro.

Before we go on to look at items of economic news from different areas, we might take note of the latest interim assessment from the OECD of the economic outlook published in early September. For the G7, comprising the USA, Japan, Germany, France, Italy, the UK and Canada, it expects growth of 1.4%, the same as last year. Within that figure it sees the USA growing by 2.3% (1.8%), Japan by 2.2% (-0.8%), Germany by 0.8% (3.1%), France by 0.1% (1.7%), Italy by -2.4% (0.5%), the UK by -0.7% (0.8%) and Canada by 1.9% (2.4%).

The UK forecast is qualified by uncertainty over the effect of the Diamond Jubilee and Olympics on activity and its timing effects. Given that the best way to tackle the debt problem is through economic growth, these forecasts do not look very encouraging, especially for the eurozone where the OECD estimates that the three largest economies in the eurozone, Germany, France and Italy will show an economic contraction this year of 0.2% and a number of the weaker members will show a much more significant contraction. Set against that is China where growth should be above 7%, disappointing by its standards, and a number of other countries in Asia and Latin America which will show much higher growth levels than most industrialised countries. How will growth occur when there is so much public and private deleveraging taking place? Some help to international growth levels will come from countries in those areas mentioned above where their public finances are in good order. Interestingly, within the EU but not a eurozone member, Sweden has announced a stimulus which it is able to do because of its strong public finances with outstanding public debt only 37.2% of GDP at the start of 2012. Sweden is to cut its corporate tax rate from 26.3% to 22.0% and undertake more infrastructure spending. Heavily indebted countries do not have this freedom. But mainly the hope in heavily indebted countries is, as we said earlier, very

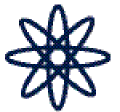


loose monetary policy which will encourage spending and investment. By giving visibility on the outlook for interest rates, as the Federal Reserve has done in particular, the hope is that it will kick start spending and that higher asset prices, an objective of monetary policy, will engender a positive wealth effect. That is the theory but we will have to see how things work out in practice. Although a fragmentation or break up of the eurozone will cause serious temporary dislocation, the problems have been well flagged and many companies will have taken measures to minimise the disruption. As it is, there are enough countries driving growth in the world to ensure, in all probability, that low to modest international economic growth will continue and that a global recession will be avoided.

We turn now to look at different areas of the world starting with the USA where we have already discussed the latest quantitative easing policy announced by the Federal Reserve. We discussed the fiscal problems facing the USA and the seriousness of the situation was emphasised by Moody's threat to take its top credit rating away from the USA as Standard & Poor's has already done. Whilst it is unlikely that the USA would ever default in the accepted sense (not a default caused by Congress not lifting the debt ceiling) because it can always create its own currency, a serious erosion of its credit rating would debase the currency and raise interest rates in a way that not even additional quantitative easing could contain. Whilst the market shrugged off Standard & Poor's downgrade, that should give no room for complacency. Data in September has been slightly downbeat in the USA. The closely watched ISM Purchasing Managers Index for manufacturing in August remained was 49.6 (49.8) whilst that for the non-manufacturing sector stood at 53.7 (52.6). Taking both readings together, this suggests very modest growth in August. The closely watched employment data recorded disappointing numbers in August with 96,000 jobs being created which was a lower number than expected. However, the September figures, just announced, show a rise of 114,000 in non farm payrolls and upward rervisions of 40,000 for July and 46,000 for August. The unemployment rate fell to 7.8% from 8.1%. There was a rise in wholesale goods inventories in July which may presage some weakness in manufacturing output as wholesalers seek to meet orders by reducing inventories. The rise in wholesale prices in August should also flash a few warning lights. On a seasonally adjusted basis, the index rose by 1.7% which was the largest rise since June 2009. It is true that the core figure was much lower, 0.2%, but the components which drove the index up so much, food and energy, which are excluded from the core and clearly an important part of consumption expenditure for individuals and, in the case of energy, for business. Inflationary pressures would be the expected outcome of money printing when the velocity of circulation picked up. With the emphasis of the Fed's latest announcement of quantitative easing being on reducing unemployment levels, the second part of its mandate, inflation, may be taking a back seat. If inflation were to rise, it would make US Treasuries even worse value than they look today.

On a positive note, there is some better news on the housing front, the initial cause of all the financial troubles. US house builders are feeling more optimistic as measured by The National Association of Home Builders/Wells Fargo housing market index which rose to 40, its best level since June 2006, compared with a reading of 37 in August. The S&P/Case Shiller index of home values in twenty leading US cities rose by 1.2% in July. A further item of positive news was that the Conference Board's index of the level of optimism rose from 61.3 in August to 70.3 in September. However, we come back to the point we made earlier which is that the really important hurdle for the US economy is to circumvent next January's possible "fiscal cliff" in as constructive a way as possible given the magnitude of the crisis facing the USA's public finances.

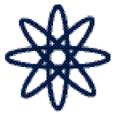
For the US equity market, which has been performing well in US dollar terms but less so for many foreign investors as the US dollar has weakened, there are conflicting forces at work. On the negative side, the year on year rate of growth of corporate earnings has been slowing down, just 0.8% in the second quarter for S&P 500 companies and expected to be negative in the third quarter. Margins remain high but top line growth is needed in order for earnings growth to accelerate again and this will not be easy in the current environment. It is difficult to say that US shares are expensive. The estimate showing on Bloomberg for the price/earnings ratio on the S&P 500 index is 13.9 for the current year and 12.5 for next year. But these are not normal circumstances given the



extremely aggressive monetary policy which is being followed and, for reasons given earlier, this enhances the attractions in equities. The dividend yield on the S&P 500 index is estimated at 2.1% for the current year and 2.4% for next year whilst the yield on the ten year Treasury bond is 1.61% at 28 September. Even though US shares are traditionally amongst the lower yielders, they have yield attractions against Treasury bonds, a very unusual state of affairs.

We have discussed the high level position of the eurozone and the challenges which it faces and that is really the most important aspect from an investment point of view rather than individual items of news. So it is no surprise that, if we were to look at individual items of data from the eurozone, they are unremittingly bad. Unemployment stands at 11.3%, a new high. Inflation shows a rise to 2.6% in August compared to 2.4% in July. This is not a desirable state of affairs when interest rates are so low. Although the eurozone economy is very depressed at present and therefore internally generated pressures on inflation are minimal, there is an obviously inflationary threat further out. The eurozone's Markit manufacturing PMI index was 45.1 in August, a level which signals contraction. The Markit Composite Output index (manufacturing and services) showed a reading of 46.3 in August, telling a similar story and the flash estimate for September is 45.9. In July, Eurostat reported that retail sales fell by 0.2%. In Germany, the Ifo business climate survey reported a reading of 101.4 in September compared with 102.3 in August, the fifth month in a row in which it fell. The "flash" index for September showed a further fall to 45.9 (although this is subject to revision). The only slightly more optimistic note was struck by Germany where its composite Purchasing Managers Index showed a reading in September of 49.7 compared to 47 in August.

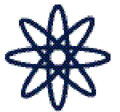
In Japan, one hopes that the stand off between Japan and China over disputed islands passes, for Japan has multiple problems with which to deal. The energy issue is going to loom large over the economy following the nuclear shutdown last year. Only two nuclear power stations are currently operating and this means a much increased import bill for alternative energy supplies, pushing the country into a trade deficit although not yet a current account deficit. Frustratingly for many Japanese manufacturing companies this is not being reflected in a weaker yen. Japan's public finances are in a woeful condition with gross outstanding debt at around 230% of GDP financed mostly internally which reduces the dangers arising from a situation where a country relies heavily on external finance and then loses the confidence of foreign investors. Although Japan has the world's second largest foreign exchange reserves, it cannot forever exist in its relatively untroubled way with the mismatch between public expenditure and revenue. Consumption tax is planned to be raised in stages from 5% to 10% to start to address the problem. When consumption tax was raised in the past it had a depressing effect on the economy and the danger is that it will lead to more precautionary saving. But Japan has to do something for the demographic projections are frightening for public finances. By 2050, it is estimated that 42% of the population will be over 60 compared with 31% now whilst the birth rate is at a record low. Its serious budgetary position means that Japan has no room for a meaningful stimulus even if it would work so, as elsewhere, monetary policy is doing the heavy lifting and it has been quite aggressive. The problem with the US Federal Reserve's latest announcement of quantitative easing is that it weakens the US dollar and puts upward pressure on the yen making life more difficult for Japanese companies and adversely affecting the Japanese economy's growth prospects. The Bank of Japan has announced that an increase in the size of its asset purchasing programme to JPY 80 trillion which is the equivalent of US$ 1.02 trillion by buying another JPY 10 trillion of government bonds. It is also extending the deadline for buying these by six months to the end of 2013. It is also no longer going to put a minimum yield of 0.1% on bonds which it purchases. Japanese shares appear cheap but many foreign investors shun them. Japanese companies are facing heavy competition from other parts of Asia which they can partly meet by sourcing more of their manufacturing from overseas. In the past, it would have been a very strange thing to say but no longer and that is that Japanese shares have attractive dividend yields by their standards and very attractive compared with Japanese bond yields. Currently the ten year Japanese government bond yields 0.82% whilst the dividend yield on the Japanese market is around 2.5%.



China is being watched closely by investors because, with the dire state of many western economies, particularly in Europe, its growth rate is of crucial significance to the world economy. Unfortunately, China gets caught up in US politics and, this being election year, anti China rhetoric is being ratcheted up. In September, it was announced that the USA planned to take action against China, claiming that there are illegal subsidies on car exports and automotive parts. Whatever the rights and wrongs of the complaint, China is the biggest creditor of the USA and this type of political action threatens to create an economic accident because increased protectionism will do no country any good. It is one of the issues for which investors should look out. The Chinese economy is slowing down. In August, the year on year rate of growth in industrial production fell to 8.9% from 9.2% and the month's growth was the lowest since May 2009. The final reading of HSBC's China manufacturing Purchasing Managers Index for August was 47.6 against 49.3 in July. A reading below 50 is not good news. It is against such a background that the Chinese Prime Minister said that more would be done to boost growth when he addressed the World Economic Forum in September. The authorities are trying to increase domestic consumption rather than investment because substantial investment in fixed assets in the past has led to poor returns because of over investment and misallocation of investment. Infrastructure investments have been announced but, in trying to stimulate the economy, they have to be economically justified. China also has to move up market in manufacturing as a result of rising manufacturing costs caused by large wage increases. China is losing some business to other Asian economies and there are also early signs of "reshoring" in the USA whereby US manufacturing companies are repatriating work outsourced to China. So, it is a delicate balance for the Chinese authorities. They need to rebalance the economy in favour of consumption at the same time as they minimise the risks of social unrest. Large rises in minimum wages have been introduced to avoid such problems especially when food price inflation is high but they have to be introduced in a way which minimises the competitiveness consequences for China. There is also uncertainty about the consequences of the forthcoming change in power at the top of the Communist Party. It is a paradox that the Chinese equity market has performed poorly at a time when its economic growth remains well ahead of most other countries albeit that its growth rate is decelerating. The latest annualised quarterly growth rate was down to 7.4%. As the world's second largest economy, its influence on markets is obviously increasing which is why data coming from China continues to move stock markets, if only temporarily.

Economic concerns about India have been increasing as its growth rate has decelerated and its current account and budget balance situation have been poor. These factors have contributed to currency weakness and the threat of a sovereign debt downgrade to junk status. There are serious structural rigidities in the economy and economic policies which distort the market as well as political interference. Politicians find it hard to agree on any reforms and the impression of political paralysis at the top is strong. But there is a glimmer of hope with the government perhaps jolted by the currency weakness of the rupee and the threat to India's credit rating. Having recently withdrawn reforms which would have allowed more access by foreign food retailing companies in the face of pressures from traders and politicians, the government has felt emboldened to announce a change of heart on retailing and to announce other reforms.

One of the major economic distortions has been the increasingly expensive fuel subsidy which has been playing havoc with India's budgetary finances. As fuel prices have risen, the cost of the subsidy has become prohibitive. In mid September, the government announced a cut in the diesel subsidy. From an economic perspective, subsidies are generally a poor way of addressing cost issues for they misallocate resources and encourage consumption of the good or service in question because it is priced below the market level. In the case of India, they also constitute an open ended threat to India's budget where the deficit is around 6% of GDP. The problem with a long standing subsidy programme is that it is very hard on the immediate losers and this is where the political opposition to the move lies. Around the same time, the Indian government, again emboldened by the deteriorating economic position and threat to its credit rating, announced a series of proposed reforms to stimulate activity and encourage foreign capital. A new finance minister with reforming tendencies is probably helping here. As indicated in the paragraph above, foreign investors will be allowed to own 51% of supermarkets and department stores, with the



qualification that individual states can block this and some certainly will. In the struggling airline market, foreign airlines will now be permitted to own a maximum 49% stake in domestic carriers. Foreign investors will also be allowed to buy minority stakes in power trading exchanges and the limit on foreign investment in broadcasters is increased from 49% to 74%. Four state owned companies are to be partly privatised. These announcements are significant moves in the right direction and send out a more hopeful message to investors attracted by India's huge potential which could be unleashed if structural rigidities could be overcome. However, politics has intervened before to derail plans such as these. Nevertheless, it is a more hopeful sign for investors given the influence which the size of the Indian economy can exert on the world economy.

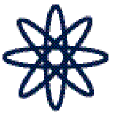
For the UK, the position remains very difficult but with something of a puzzle in that the employment and GDP figures appear to tell a different story with the employment numbers relatively encouraging and the GDP figures rather discouraging. Having said that, the second revision to second quarter GDP figures shows a slightly less bad position with a revision to negative growth of 0.4% against the previous estimate of negative growth of 0.5%. It has been an unusual year for the UK with the Queen's Diamond Jubilee and the two sets of Olympics which makes interpretation of the economic data difficult. There were a number of factors behind the data revision. Consumer spending fell less than originally estimated, -0.2% against -0.4%. Business investment instead of falling by 1.5% rose by 0.9%. Construction output fell slightly less than previously estimated down 3.0% rather than 3.9%. Industrial production fell slightly less than previously estimated, -0.7% against -0.9%.

What economists are trying to puzzle out is why the employment figures are as robust as they are. The numbers in employment are the highest since May 2008 and the second quarter's rise of those in employment was 236,000. This data is not what one would, prima facie, expect in the face of poor GDP figures so something is wrong somewhere or it may just be very poor productivity levels i.e. more employees producing less. No doubt the puzzle will resolve itself in due course but it is not helpful to policy making when there is conflicting data. The GDP figures are expected to resume their growth in the third quarter and, apart from the employment data, there have been some encouraging items of news. The ISM Purchasing Managers Index for August rose to 49.5 from 45.2 in July. That for the services sector, the dominant part of the economy, rose to 53.7 from 51.0. On the other hand, the reading for the construction sector, the smallest of the three data items, fell to 49.0 from 50.9. In July, industrial production rose by 2.9% although it is 0.5% lower than a year ago and 7.8% below its 2008 peak.

However, the real nightmare for the Chancellor remains the level of public borrowing and the debt trajectory. In trying to deal with the problem he faces a barrage of criticism from interested parties but the reality is that the current trajectory of public debt is bad enough without taking policy decisions to make it worse i.e. trying to give the economy a stimulus by borrowing more. Although slightly better than expected, August's public sector borrowing total was the same as August 2011 at £14.4 billion but is 22% ahead of last year for the first five months of this fiscal year casting into doubt the targets for the full year. The problems of the eurozone are significantly hampering the UK's effort to restore order to its public finances given that it is such an important trading partner. As we said earlier, the hope has to be that very loose standard and non standard monetary policy will eventually encourage businesses and individuals to spend more aided by the positive wealth effect arising from rising asset prices, an objective of the policy.

We can be more sanguine about the prospects for UK companies given that they derive significant business from faster growing areas of the world. Given the poor state of the world economy, profits are holding up well and the dividend experience, very important because of very low returns available on cash and the quality bond market, is good with dividends still rising.

In summary, we consider that very loose monetary policy is driving asset price inflation. We can be very confident that monetary policy will continue in this vein for the foreseeable future as an offset to tough fiscal policy being followed in many counties. Quantitative easing has resulted in depressed bond yields which have reached scarcely believable levels. This market is a bubble waiting to burst and, at some stage, when reality returns, bond investors



will suffer severe losses. With low yields and the prospect of currency debasement, we see commodities like gold rising as investors look for a store of value in politically inflationary times. One asset class which is not in bubble territory, we believe, is equities. Although shares are ahead for the year so far, they do not look expensive, even if the outlook for the world economy is uncertain. They also, in certain areas, have yield attractions and, although one may have to pay up for yield, their income attractions against high quality bonds and cash are likely to be apparent for the foreseeable future. However, whilst we still consider equities to be the asset class of choice, investors must expect an uneven performance, with setbacks occurring as bad news develops on the economic or political front. If investors hold surplus liquidity at such a time, a further commitment to shares may be justified as we still see them offering value.

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