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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Although most equity markets performed well in local currency terms in the last quarter, such was the strength of sterling that sterling based investors with an international equity portfolio saw returns close to either side of zero. Returns were dragged down in particular by the largest market, the USA, where significant weakness in the currency caused the US market, as our table overleaf shows, to show a negative return in sterling terms. Sterling strengthened against most currencies. High quality ten year government bond yields, with the exception of Japan, saw yields drift upwards, although there was a reversal of trend at the end of the quarter after the US Federal Reserve unexpectedly did not start to taper its quantitative easing policy.

The tables below detail relevant movements in markets :

International Equities 28.06.13 - 30.09.13

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+9.8	+5.1	+12.2	+7.7
Finland	+21.8	+18.8	+26.8	+21.8
France	+11.6	+8.9	+16.2	+11.6
Germany	+8.2	+5.5	+12.7	+8.2
Hong Kong, China	+7.8	+1.0	+7.9	+3.6
Italy	+14.8	+12.0	+19.6	+14.8
Japan	+5.6	+0.1	+6.9	+2.7
Netherlands	+10.1	+7.4	+14.7	+10.1
Spain	+20.6	+17.6	+25.6	+20.6
Switzerland	+4.7	+2.6	+9.5	+5.1
UK	+5.0	+5.0	+12.1	+7.7
USA	+5.7	-1.0	+5.7	-1.5
Europe ex UK	+9.7	+7.0	+14.2	+9.7
Asia Pacific ex Japan	+6.7	+2.0	+8.9	+4.5
Asia Pacific	+6.1	+1.0	+7.9	+3.6
Latin America	+5.3	-1.9	+4.7	+0.6
All World All Emerging	+5.6	-2.2	+4.4	+0.3
The World	+6.5	+1.3	+8.2	+3.9

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +0.5%

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

Currency	28.06.13	30.09.13
Sterling	2.45	2.73
US Dollar	2.49	2.63
Yen	0.86	0.69
Germany (Euro)	1.73	1.80

Sterling's performance during the quarter ending 30.09.13 (%)

Currency	Quarter Ending 30.08.13
US Dollar	+6.6
Canadian Dollar	+4.2
Yen	+5.4
Euro	+2.4
Swiss Franc	+1.9
Australian dollar	+4.1

Other currency movements during the quarter ending 30.09.13 (%)

Currency	Quarter Ending 30.09.13
US Dollar/Canadian Dollar	-2.2
US Dollar/Yen	-1.1
US Dollar/Euro	-3.9
Swiss Franc/Euro	+0.5
Euro/Yen	+2.9

Significant Commodities (US dollar terms) 28.06.13 - 30.09.13 (%)

Currency	Quarter Ending 30.09.13
Oil	+6.1
Gold	+11.3

MARKETS

For sterling based investors, invested internationally, it has been a quarter of little change as unexpected sterling strength has pared back the gains in foreign markets, in some cases to negative returns. In local currency terms, the total return on the FTSE World Index was 6.5%, in sterling terms 1.3%, in U.S. dollar terms 8.2% and in euro terms 3.9%.

Looking first at local currency returns, the feature is the FTSE Europe ex UK Index which returned 9.7% in local currency terms. There were particularly strong returns from the FTSE Finland Index at 21.8% (Nokia rose strongly during the quarter), as well as the FTSE Spain Index (20.6%) and the FTSE Italy Index (14.8%). There were no particularly weak returns in local currency terms. It was a different matter in sterling terms where the FTSE USA Index returned -1.0%, the FTSE Latin American Index -1.9% and the FTSE All World All Emerging Markets Index -2.2%. Although there was some modest weakness in the European currencies against sterling, the FTSE Europe ex UK Index returned 7.0% ahead of the FTSE UK Index at 5.1%. There was some recovery in the Australian market where the FTSE Australian Index returned 5.1%. Currency weakness pushed back Japan to a mere 0.1% return in sterling terms.

Bonds had a volatile quarter but yields fell back again at the end of the quarter on the surprise announcement at the Federal Reserve's September meeting that it was not, after all, going to start tapering its QE programme just yet. Over the quarter, the gross redemption yield on the ten year UK government bond rose by 28 basis points to 2.73%. The equivalent US Treasury and German bonds showed rises in gross redemption yields of 14 and 7 basis points respectively to 2.63% and 1.80%, whilst Japanese government bonds moved in the other direction with the yield falling by 17 basis points to 0.69%.

In the currency markets, the feature was undoubtedly sterling. Against the US dollar, it rose by 6.6%, against the yen by 5.4%, against the Canadian dollar by 4.2%, against the Australian dollar by 4.1%, against the euro by 2.4% and against the Swiss Franc by 1.9%.

In the commodity markets, oil, as measured by Brent crude, rose by 6.1% in terms of a weak US dollar, whilst gold recovered by 11.3%.

ECONOMICS

The economic and financial issues which have dominated stock markets for so long have not changed but the relative importance of one or more of the issues can change at any time. Leaving out the political and military concern this quarter, Syria, the USA's Quantitative Easing policy has been of prime interest ever since Mr Bernanke's statement last June when he discussed the future course of the Federal Reserve's QE programme in terms of being dependent upon how the economic numbers turned out. Markets reacted negatively to this possibility of early tapering and June was a poor month although, in the quarter just ended, it has recovered. Very late in the quarter and now into October, the order changed again with the inability of Congress to agree a budget meaning the shutdown of the US Government from 1st October and concerns about an even bigger issue, whether Congress will agree to raise the debt ceiling, raising the possibility of a US default on its debt. This is potentially very serious and has caused post quarter end weakness in stock markets.

It is surprising that investors were spooked by what was a very obvious statement from Mr Bernanke because the path of the QE policy, in whichever country it is applied, should be clear even if the details are different. In very general terms it involves the creation of money by a central bank which is used by it to buy assets from the private sector, such as government bonds and mortgage backed securities. The presence of a big buyer of such securities should enable interest rates to be below what they would otherwise have been so the expectation would be that this would provide a stimulus to the economy. Equally, the cash in banks' balance sheets resulting from central bank purchases of securities from them could be circulated around the economy to provide it with a stimulus. In a sense that is the easy part although there are major losers from very low interest rates such as savers, pension funds and those buying annuities. Then it becomes increasingly difficult. Money creation ultimately threatens to become inflationary. Put very simply, an economy has a certain amount of productive capacity. When it is producing below that level there is an output gap. When the new money gets moving round the economy, which will depend upon business and consumer confidence being sufficiently high, increased demand will push up against the economy's productive capacity and, pushed beyond, that will cause inflationary pressures. Increasing amounts of money chasing a limited supply of goods and services will eventually cause inflation. This is where a central bank will become worried because an inflation target is usually one of its remits. This is where Mr Bernanke came in. The Federal Reserve's QE programme is currently running at US$85 billion a month. Tapering does not imply stopping QE, merely reducing the rate at which it is applied in the first instance, and the point at which this would start to happen would be when there are signs of economic objectives being reached, in the case of the Federal Reserve on inflation and unemployment. As confidence grows that objectives are being met so the size of the taper will be increased until, ultimately, it stops. In the case of the USA, this is supposed to be when unemployment reaches 7.0%. It then becomes more difficult still because the money created by QE has to be withdrawn to avoid inflationary pressures building up further and that means selling back bonds to the private sector to suck the cash out of the economy or perhaps requiring banks to place special deposits with the central bank.

No central bank would really want to be in this position in the first place. Quantitative easing was a desperate measure for desperate times and it has probably been successful but it cannot continue indefinitely without having malign effects of which inflation is the most notable. Stock markets were spooked by the implications for interest rates. Whilst central banks can control short term interest rates, it is more difficult to control longer term interest rates. Bond buying can depress yields but other powerful opposing factors can come into play such as foreign countries selling, say, US Treasuries held as part of their reserves. Clients will be aware from many of our past reviews that we considered the level of bond yields to have fallen to levels which bore no relation to reality and which threatened holders with big losses, if sold, or very poor returns if held to maturity. One would have expected the knowledge of how the QE policy would evolve to be in the market but the rise in the level of bond yields suggests that it was not and so the market's reaction was a surprise. Tapering and the ultimate reversal of QE imply higher interest rates especially as governments will continue to issue substantial amounts of debt to fund their borrowing. It is going to be a very delicate balancing act for central banks to get the right trade off between winding down QE and the effect on the economy of rising interest rates implicit in this action.

Our table at the beginning of this review shows a fairly modest rise in ten year government bond yields. The early stage of a rise in interest rates would normally be viewed positively as it implies a more optimistic assessment of economic prospects and the demand for money. Shares can live with such an environment as the prospects for companies improve. One of the objectives of the very loose monetary policy introduced after the financial and economic crisis of 2008 was to increase asset prices in order to create a positive wealth effect and, in that, it has succeeded, certainly as far as the stock market is concerned. For shares, they benefited from the comparison with the yields available on cash and high quality government bonds and investors took advantage of the relatively attractive yields on many good quality equities which had the benefit of not being expensive on price/earnings ratio grounds. The yield comparisons between equities and good quality government bonds are still attractive and there is some way to go before bond yields become a threat to the equity market given that, for many years until recent times, equities have yielded less than government bonds.

We have also experienced this year another of the malign effects of QE, the unwinding of flows of money into markets which offered higher yields at a time when yields in the most highly rated developed countries touched unbelievably low levels. Emerging markets benefited initially from QE as funds flowed into them in search of yield. However, it has become apparent that investors have not been sufficiently selective as the mere hint of the start of tapering has caused a major reaction in some emerging markets. It is always important to pay attention to fundamentals one of which is the current account of countries. Amongst those experiencing problems are India, Indonesia, Turkey, Brazil and South Africa, all of which have significant current account deficits which have to be financed. As US interest rates rose, money flows started to reverse pushing up the bond yields of countries perceived to be vulnerable and weakening their currencies. Hot money which went in is now coming out although yields have started to fall again in the USA and emerging market bonds have made a partial recovery.

The continuing problems of the eurozone have moved away from the top position of concerns which investors have had in recent times as they have, at least temporarily, given way to the tapering worries which we have just discussed and the USA's budgetary and debt ceiling issues. However the problem is just slumbering and could come back at any time to take the top place in investors' worry list. Despite attempts to talk up the area, the chronic problems remain. As far as it was possible, everything was on hold until the German election but we can expect the problems to appear again shortly as further bail outs for Greece and Portugal become necessary. Complicating the problem is the outcome of the German election where it is going to be necessary for Mrs Merkel's CDU to form a coalition probably with the SPD, its last partner before the Free Democrats who failed to get representation in the Bundestag. Negotiations may take some time and are not guaranteed to be successful.

Another concern has been China where the implications of a slowdown in the economy's rate of growth were negative given what an important engine of international growth it had become. The latest news from China has become more encouraging. We will discuss in more detail the Chinese situation later.

As this is written, the Syrian crisis, whilst still very serious, seems to have taken a step back. It is very difficult to factor political and military crises into market forecasts, suffice it to say that any conflagration involving outside powers would be very serious and we saw these concerns expressed in the oil price when military intervention looked likely although that does not now seem to be the case.

After its June setback, the stock market has regained some of its composure during the quarter and one reason is a slight increase in optimism about the economic outlook. Markets do react to turning points in the economy and, meagre though the signs still are, there is an upturn in optimism. In its latest Interim Economic Assessment, published at the beginning of September, the OECD sees in a number of economies a quarter by quarter acceleration in the rate of economic growth. So, for the USA, it sees fourth quarter annualised quarter on quarter growth at 2.7% compared with 2.5% in the third quarter. For China, it sees an encouraging 8.1% (7.2%) for France, 1.6% (1.4%) and for Germany 2.4% (2.3%). Slight slowdowns are seen in Japan 2.4% (2.6%) and the UK 3.2% (3.7%). In July, we had the IMF's World Economic Outlook update which saw world output in 2014 rising 3.8% against a forecast for 2013 of 3.1%, an actual reduction in both years of 0.2% against its previous forecasts but still an improving trend. This is what the market needs to see to validate the rise in share prices which we have seen this year. Interestingly, the IMF has changed its view on what is driving the world economy. Rather than emerging markets, it now believes that advanced economies that are driving it.

Turning now to individual countries and regions in the world, we, firstly, look at the USA where the major news in September, as we have said, has been that the Federal Reserve has decided not to start its tapering programme immediately. We will discuss the budget and debt ceiling impasse shortly, both crucial issues. This decision was against most people's expectations and the immediate reaction was a rise in share prices and fall in bond yields on relief that it was not to start immediately. All the points which we have made about tapering earlier on in this review remain valid because, at some stage, it is going to start. The statement from the FOMC referred to the need to wait for more evidence that the economic progress will be continued but, probably, what was very influential in the Committee's decision was the reaction to the market after Mr Benanke's June comments on tapering. As we have noted, yields have risen very sharply further out along the maturity spectrum of bonds and this implies quite significant monetary tightening, something that the FOMC did not want and probably did not envisage. The decision to hold off tapering may therefore reflect a wish to unwind some of these interest rate increases. Another factor which may have weighed in the Committee's deliberations was the low level of inflation. This would be an issue which the FOMC would take into account if it was above target but the latest figures for the consumer price index and core consumer price index showed a rise of just 0.1% in August. The year on year increase in consumer prices is 1.5%, down from July's 2.0%, with the core consumer price index 1.8% higher than the year before. The personal consumption expenditures index which is closely watched by the Federal Reserve was up 0.1% in August so, for the moment, inflationary pressures are not likely to influence the FOMC unduly. The Federal Reserve may also have been influenced by its internal economic growth forecasts which have been revised down to 2.2% for this year from 2.5% in its last forecast and for 3.0% next year against its previous estimate of 3.3%. The jobs data, another important indicator, have not been sufficiently strong for the FOMC to tighten monetary policy. In August, 169,000 jobs were created, which was slightly below expectations but there were downward revisions for June and July of 74,000. Because of a decline in the number of people looking for work in the USA, the jobless rate actually fell from 7.4% to 7.3% getting near the trigger point of 7% which is the first indicator of an end to tapering. On the other hand, the purchasing managers' indices, which are closely watched by decision makers and investors, have been quite firm. In September, the manufacturing PMI rose slightly to 56.2 compared with 55.7 in August. The non-manufacturing PMI for September fell back to 54.4 from 58.6 in August but still quite well into positive territory.

However, as we have just said, there is one immediate very big cloud on the horizon for the USA and, by extension, to the rest of the world and that is the issues of the Federal Budget and the debt ceiling which caused a short period of quite sharp weakness in the markets in 2012. There are two connected issues. It was necessary to approve a new budget by the end of September or face a government shutdown, which is now what has happened, and there is a need to raise the USA's borrowing limits by around mid October so that spending commitments can be met and this is what caused the problem in 2012 and unsettled the markets when there were fears of a default. The 2012 elections really solved nothing in this respect with a split Congress and hostility between the President and the Republicans. At the time of writing, there is no obvious compromise in sight and, depending upon how this issue plays out, this could be a continuing market factor. The checks and balances in the US political system make it particularly unsuitable for taking important decisions when there is a split Congress as at present. In the short term, political stalemate apart, the FOMC's decision to delay tapering is good news for US shares. Unlike the case of the UK or the eurozone, the dividend yield on US shares is lower than on the ten year government bond but this is a more normal situation in markets. It is necessary for US companies and those elsewhere to start to demonstrate revenue growth of which there has not been any recently and quite bullish forecasts for future earnings on the S&P 500 will depend upon growth in revenue since cost cuts can only achieve so much. For revenue growth to pick up and provide the catalyst for earnings, investors will have to be confident about an increase in the rate of economic growth in the world economy. At present, the current year estimate for the price earnings ratio on the S&P 500 Index is around 14.9 falling to just around 13.5 for 2014. This is not excessive but, as we say, investors will need to see revenue growth among US companies and these valuations are predicated on this happening. Although there are many problems with the US economy, it is in a better place than most in the developed world and its list of world class companies continues to make it an attractive market for international investors. This is not only because it is the largest market but because there is, in our view, less risk than in some other areas of the world, the preset impasse notwithstanding.

There was some better news from the eurozone where the second quarter showed growth of 0.3% over the previous quarter or 1.2% at an annualised rate. These numbers were driven by Germany and France with second quarter annualised growth of 2.9% in Germany and 1.9% in France. There were negative figures, calculated on the same basis, for Italy (-1.2%), Spain (-0.4%) and the Netherlands (-0.7%). It would be wrong to become excited about these figures because very serious problems remain and the eurozone is nowhere near being clear of its severe structural difficulties which we have outlined in many reviews. The ECB has tweaked its growth forecasts for the eurozone since its previous forecasts last June. It now expects a slightly more modest contraction this year of -0.4% against -0.6% in June but, for next year, it has slightly reduced its growth forecast to 1.0% from 1.1%. Its forecasts for inflation are 1.5% this year and 1.3% next year so inflationary concerns are unlikely to be an influence on its interest rate decisions.

In Germany, Mrs Merkel has had a good election result, spoilt only by the fact that her FDP coalition partners have fallen below the 5% threshold and therefore will not be represented in the Bundestag. The FDP with its pro business and free markets policies is the most natural ally for the CDU but this is no longer possible. If there is to be a coalition it looks like being the SPD in a re-run of the earlier Grand Coalition. If that is the case, its influence is likely to make life a little more difficult for some companies. Whilst Germany has eased through this crisis well it does have problems building up for the future. One very important one is the cost of energy which is high compared with the rest of the EU. It threatens to undermine the competitiveness of German manufacturing. All this is for the future but, for the moment, Germany is in a strong position to get what it wants within the EU as a result of its relatively good economic performance and strong public finances. One reason that German industrialists like the euro is that it has made German companies very competitive given how well they have contained their costs.

France, though, is a different issue. It has consistently been losing competitive ground against Germany as relative unit costs have risen against those of Germany, reflected in a deteriorating current account, and has shown a marked reluctance to reform its economy to increase its potential growth rate. With the public sector accounting for about 57% of GDP, the private sector faces being "crowded out". The emphasis on tax increases to try to stabilise public finances does not send out a good message and one has to have a concern as to how France will emerge from its present travails. Its budget deficit targets are proving hard to meet. For this year the budget deficit could reach 4.1% of GDP, 0.4% higher than last April's forecast. Public spending is forecast to be 57.1% of GDP this year and 56.7% next year right out of line with its competitors. Most commentators are saying that France cannot take any more tax increases (and there are still some to take effect) but the government finds it very difficult for ideological and political reasons to make the necessary structural reforms whilst most of the attention is paid to the bail out countries, any loss of confidence in France could be disastrous for the euro project. The same is the case for Italy. Here the budget deficit is not as large as that of France but the outstanding level of debt as a percentage of GDP is much higher at 127.0% at the end of 2012 and still higher now. Political instability militates against decisive action on structural problems and, where progress was made under Mr Monti, reforms have often been watered down. The latest forecast from the Italian government is that the economy will shrink by 1.7% this year, 0.4% more than it thought in April and it revised its growth forecast for 2014 to 1.0% from 1.3%. The Finance Minister says that the budget deficit target for this year, agreed with the EU, will be exceeded at 3.1% against 3.0% and that corrective measures will have to be taken.

These issues with France and Italy, whilst they may not attract some of the more sensational headlines which surround the bail out countries, are really more threatening to the eurozone because they are the number 2 and 3 economies in the eurozone. Mr Draghi's statement in the summer of 2012 to the effect that the ECB would do what it takes to save the euro has been remarkably successful in holding the line and this without a single bond being bought. But the present position cannot continue indefinitely because it is unsustainable and we continue to believe that the eurozone's problems have the power to destabilise markets to provide one of the setbacks which will enable investors with liquidity available to build up their equity holdings. Now the German election is out of the way and it is Germany which calls the shots in the eurozone, we may see, subject to the coalition negotiations referred to above, a quickening of pace of events as Greece and Portugal almost certainly will need further bail outs. The European elections next year are likely to see a stronger bloc of MEPs which is hostile to the EU. Investors must not be lulled into a false sense of complacency about the eurozone. The fundamental structural problems remain. However, as we have stated many times, the distinction between high quality companies based in the eurozone and the sovereign is very important and investors should not be put off from investing in these companies. Many large eurozone based companies benefit from their geographical diversification even if their country of domicile is being caught up with the eurozone's problems. Valuations on European companies are supportive with a current year price/earnings ratio on the Euro Stoxx 50 estimated at around 13 and with a dividend yield of around 3.9% projected and, as the performance of some of the markets shows this quarter, have been attracting more international support.

Turning to Japan, home of an enormous monetary experiment, the Cabinet Office has revised its estimate of second quarter GDP to show an increase of 0.9% instead of 0.6% which makes the annualised rate of growth 3.8%. The annualised quarterly growth rate for the first quarter of the year was also raised from 3.8% to 4.1%. So far, so good for the government's and Bank of Japan's efforts to get the country moving. The latest Nomura/JMMA Seasonal Purchasing Managers Index showed a rise from 52.2 to 52.5 which is a move in the right direction. The big decision for the government now is whether to proceed with the rise in consumption tax in two stages to 10% in 2015 and it is now confirmed that it will rise to 8% next April and then they will see what happens.

Arguments in favour surround the necessity to tackle Japan's enormous level of outstanding public debt at around 240% gross and 150% net of GDP. The budget deficit is likely to be over 8% of GDP this year. As well as an extremely loose monetary policy to offset fiscal tightening, the Japanese Prime Minister announced some offsetting fiscal measures of the equivalent of US$817 billion covering public works spending and other stimuli.

Japan has been able to rely on very low nominal interest rates although, of course, in a deflationary environment, the real rate would be higher. Although the vast majority of outstanding debt is held internally, making Japan less vulnerable than most to a loss of international support, a loss of confidence in Japan's determination to tackle its acute public debt problem could result in a sharp rise in interest rates which would clearly be serious given the debt profile. This is something which Japan cannot afford to risk and was the strongest argument in favour of raising consumption tax. Whilst it will have a dampening effect on the economy, backtracking on the plan would certainly be very badly received abroad almost certainly leading to a rise in interest rates and a fall in the yen. The counter argument was that it would reduce the rate of economic growth which the government and Bank of Japan are trying to stimulate and negate the effect of a very easy monetary policy. Tougher fiscal policy and very loose monetary policy are being widely used by countries to recover from the recession and, ideally, very loose monetary policy in Japan will give sufficient cover for the rise in taxes. What the Japanese government must do is to complement the monetary and fiscal policy with effective supply side reforms in labour and product markets to improve the potential growth rate of the Japanese economy. The policy is much more likely to be successful if supply side reforms are vigorously promoted. The jury is out on Japan. If the huge monetary experiment goes wrong, Japan faces currency debasement and higher interest rates. If it goes well and the experiment with monetary policy, coupled with supply side reforms, enables the economy's long term potential growth rate to rise, investors might well change their view on Japan which, because of disappointments in the past, has tended to be negative.

All eyes remain on China. The annualised second quarter growth rate fell to 7.0% but the evidence since then suggests a slight push up in activity. Industrial production in August was 10.4% higher than a year previously compared with 9.7% in July. The latest Purchasing Managers Index for September for the manufacturing section was 51.1 against 51.0 the previous month whilst the non-manufacturing PMI for September stood at 55.4 against 53.9, well into positive territory. Retail sales growth in August accelerated from 13.2% in July year on year to 13.4%. Fixed asset investment on a year to date basis was up 20.3% compared with 20.1% in July. The difficult balancing act for the Chinese authorities is to try to rebalance the economy away from fixed investment, of which there is too much, and exports towards consumption and, at the same time, maintaining growth at a sufficient pace to ensure social cohesion. Keeping inflation under control is also important in this respect. At 2.6%, that is the case at present. China's fast growth (the target is 7.5% this year) is positive for the world economy but its recent slowdown has caused concerns in markets and is manifested, for example, by the movement in commodity prices which sometimes act as a proxy for the direction of the Chinese economy. The trajectory of the Chinese economy remains very important for world stock markets given the lack of meaningful growth in many western economies.

In the UK, there have certainly been an increasing number of "green shoots" and economic growth estimates are being raised as a result. Whilst this is certainly good news, there can be absolutely no complacency. The overall level of debt remains awesome and the eurozone's troubles, not to mention the stand off in the USA, could yet set back further the UK economy as it has done in recent years. However, pessimism is giving way to guarded optimism. In its latest forecast, the

OECD suggests that the UK economy will expand 1.7% between June and December. It suggests that, if that rate of growth were to continue into 2014, the recovery would begin to resemble a normal upswing. The Bank of England too, has raised its forecast. For the third quarter, it now expects growth of 0.7%, up from its previous forecast of 0.5%. There were a number of individual items of positive news with the Purchasing Managers Indices particularly encouraging. The Markit/CIPS manufacturing PMI for September came in at 56.7 against August's 57.1, still a strong reading. Markit/CIPS reported that the number of new orders rose at a quicker rate than at any time in almost two decades. The services PMI was even stronger, at 60.3 in September against 60.5 in August, whilst that for construction was at 58.9 against 59.1, both good figures. Overall, the all sector PMI rose to its highest level since the series began in 1998. Manufacturing output continued to increase, rising by 0.2% between June and July following a 2% rise the previous month. Unemployment fell slightly in the three months to July falling to 7.7% from 7.8%. The housing market continues to strengthen. In early October, the UK received some good news from the IMF which reversed its April position of criticising the austerity programme. It has now upgraded its growth forecast for this year to 1.4% and to 1.9% next year.

As we approach the next General Election, due in May 2015, investors in the UK (and elsewhere where this is relevant) must increasingly take note of the relevant political situation. Party conference time in the UK has just finished but what is becoming increasingly clear in the UK is that there is a widening gulf between the political outlooks of the parties. As the political rhetoric ratchets up, there is a danger of a policy accident occurring which could well have significant stock market implications. Hostility to business in some quarters is alarming. Investors must be aware of this in what is otherwise a positive case for UK equities with shares on modest ratings and reasonable dividend yields. There is still a long hard slog for the UK economy but there are glimpses of daylight as the figures above show.

As this last paragraph of the review is written, we are no wiser as to what is going to happen in the USA regarding the stalemate on a new federal budget and lifting the debt ceiling, the latter being the more important of the two. Underlying our review has been a basic assumption that agreement will be reached, as it will have to be at some stage, but the question is how much damage will be done in the interim. Already, some damage will have occurred in terms of shaving a small amount off GDP as a result of the government shutdown but, if there is no agreement on the debt ceiling being raised, it will be much more serious and will have significant spill over effects throughout the world. Given the fragile state of the world economy but some evidence of slightly better times, this is the last thing which is needed. But, on the basis that there will be agreement at some stage, we retain our views that equities are the most attractive of the asset classes and bonds the least. The former are not expensive with ratings quite reasonable, in our view, but the latter are very expensive. The recent rally in bond prices is due to the deferral of tapering in the USA but, at some stage, it will happen and, for the reasons mentioned in this review, bond yields will have to rise. So our working assumption is that equities will progress upwards but in an uneven fashion with some negative quarters as a result of the difficult economic background and events such as those we are just witnessing. Any reasonable downturn in equity prices gives an opportunity to top up holdings but investors must, as we have said before, be ready for an uneven ride upwards.