meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Equities have enjoyed a strong quarter with a number of markets in positive territory but driven by strength in the all important U.S. market, which has been reflected in the performance of the world indices. Bond markets, not unexpectedly, are struggling. In the foreign exchange market, sterling was generally weaker. In commodity markets, the oil price continued to strengthen, whilst gold continued its disappointing run.

The tables below detail relevant movements in markets :

International Equities 29.06.18 - 28.09.18

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.3	+0.4	-0.8	-0.3
Finland	+3.1	+3.8	+2.5	+3.1
France	+3.6	+4.3	+3.1	+3.6
Germany	-0.1	+0.7	-0.6	-0.1
Hong Kong, China	-1.9	-0.4	-1.6	-1.1
Italy	-3.3	-2.7	-3.8	-3.3
Japan	+6.3	+5.0	+3.7	+4.2
Netherlands	+0.2	+1.0	-0.3	+0.2
Spain	-1.8	-1.1	-2.3	-1.8
Switzerland	+5.2	+8.3	+6.9	+7.5
UK	-0.7	-0.7	-1.9	-1.4
USA	+7.4	+8.8	+7.4	+8.0
All World Europe ex UK	+2.2	+3.3	+2.0	+2.5
All World Asia Pacific ex Japan	-0.2	+0.2	-1.1	-0.5
All World Asia Pacific	+2.4	+2.1	+0.9	+1.4
All World Latin America	+6.3	+6.8	+5.5	+6.0
All World All Emerging Markets	+0.5	+0.6	-0.6	-0.1
All World	+4.8	+5.7	+4.4	+4.9

Source : FTSE All World Indices

FTSE UK Government Securities Index All Stocks (total return) : -1.7%

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

Currency	29.06.18	28.09.18
Sterling	1.31	1.46
US Dollar	2.83	3.06
Yen	0.02	0.09
Germany (Euro)	0.26	0.46

Sterling's performance during the quarter ending 28.09.18 (%)

Currency	Quarter Ending 28.09.18
US Dollar	-1.2
Canadian Dollar	-2.7
Yen	+1.3
Euro	-0.6
Swiss Franc	-2.7
Australian Dollar	+1.0

Other currency movements during the quarter ending 28.09.18 (%)

Currency	Quarter Ending 28.09.18
US Dollar / Canadian Dollar	-1.6
US Dollar / Yen	+2.5
US Dollar / Euro	+0.5
Swiss Franc / Euro	+2.2
Euro / Yen	+1.9

Significant Commodities (US dollar terms) 29.06.18 - 28.09.18 (%)

Currency	Quarter Ending 28.09.18
Oil	+5.0
Gold	-5.3

MARKETS

It has been a generally positive quarter for international equity markets. In local currency terms, the total return on the FTSE All World Index was +4.8%, in sterling terms +5.7%, in US dollar terms +4.4% and in euro terms +4.9%. The stand out markets in local currency terms have been the USA where the FTSE USA Index returned +7.4%, the Japanese market where the FTSE Japan Index returned +6.3% and Latin America where the FTSE All World Latin America Index returned +6.3%. On the negative side, the FTSE UK Index returned -0.7% and the FTSE All World Asia Pacific ex Japan Index returned -0.2%. Although in positive territory with a total return of +0.5%, the FTSE All World All Emerging Markets Index also underperformed. In sterling terms, the outstanding performers were the FTSE USA Index, +8.8% and the FTSE Switzerland Index, +8.3%. The Latin American Index improved on local currency performance, returning +6.8%. In sterling terms, the FTSE Japan Index slightly underperformed but still did well, returning +5.0%.

It was a difficult quarter for the international bond markets. Looking at the ten year government bond benchmark yields, that on the UK government bond rose by 15 basis points to 1.46%, on the US Treasury bond by 23 basis points to 3.06%, on the Japanese Government Bond by 7 basis points to 0.09% and on the German Bund by 20 basis points to 0.46%.

In the foreign exchange markets, sterling fell by 2.7% against the Canadian dollar and Swiss Franc, by 1.2% against the US dollar, by 0.6% against the euro, but rose by 1.3% against the yen and 1.0% against the Australian dollar.

In the commodities market, oil continued to perform strongly, rising by 5.0% as measured by Brent crude, but gold continued to perform poorly, falling by 5.3%.

ECONOMICS

International stock markets seem to be treading water with progress being difficult to make with one important exception, the USA. The disparity in performance between the USA and the rest of the world has been remarkable and portfolio performances in the latest quarter have largely depended on the extent of the exposure to the US stock market. One straightforward reason for this is the strength of the US economy. The latest quarter on quarter annualised growth in US GDP was 4.2% and year on year growth is 2.9%. Earnings growth has been very strong, helped by the corporate tax cuts.

Yet, as always, there is plenty for investors to worry about. That, of course, does not mean that there has to be a negative overall view of the market because these concerns have to be weighed against positive factors. The negative factors have to be considered because international equity markets are over nine years into a bull run, admittedly from a low base in 2009. Currently, the prospect of a trade war is the greatest threat and this is being pursued with great gusto by President Trump. Although, in recent years, there have been signs of increasing protectionism, the stakes have been raised dramatically this year by President Trump. Trade wars and protectionism are unreservedly bad so why is he ratcheting up the action? It is quite possible that tactics he has used in business are being transferred to the international stage in the trade area. Come in with a very aggressive set of demands and threats and hope to brow beat the other side into concessions. Whilst that tactic might work in business, it is much more difficult in politics, particularly when the USA is up against China. The USA and other countries are right to be irked about the loss of intellectual property to China and some of its trade practices and these issues cannot easily be resolved by normal negotiations. Nevertheless, the growth of the Chinese economy to become the world's second largest one has been beneficial for the world economy as a whole, especially in the aftermath of the financial crisis and it is a very dangerous game to play with China. China does not like losing face and trying to back the country into a corner is a policy fraught with risk. There is little doubt that President Trump is a protectionist, seeing trade wars as good and easy to win. The evidence suggests that free trade has benefited economic growth by holding down prices as countries seek to import goods from cheaper and more efficient producers and export those where they have a comparative advantage. Consumers have more to spend in these circumstances.

Under the theory of comparative advantage, a country is likely to run trade surpluses with those countries where, overall, it has a competitive advantage in terms of the goods and services which it trades with each other, but it may be the opposite case with other countries. So, in a theoretical example of a country with an overall trade account which balances exactly, it will have a surplus with some countries and deficits with others. This is perfectly normal and desirable in a free trade environment and consumers benefit from being able to buy at lower prices than in a protectionist scenario. It is also not wrong for a country to run a current account deficit, of which the largest component would be the trade deficit, if it can be financed easily. Theoretically, the current account surpluses of every country in the world should balance with some running surpluses and others deficits.

From what we can see, the President seems to view it as a bad thing if a country runs a trade surplus with the USA and, in this context, it is China which he has in his sights. In 2017, the USA's trade deficit with China was US$375 billion, the difference between US$130 billion of US exports to China and US$505 billion of US imports from China. Because of this large imbalance, President Trump believes that he has the upper hand as China will run out of US imports on which to place punitive tariffs. Whilst this may be true, supply chains are highly interconnected these days and unwanted indirect effects can result. China can also make life difficult for US companies based in China and China is also a large holder of US Treasury bonds and notes (c. US$1.18 trillion). Whilst it would be very careful about how it could use this weapon because it could rebound on China, it is a possible, although unlikely at this stage, weapon in its armoury. The US current account deficit, at around 2.5% of GDP, is not overly large and is easily being financed. Given that the USA is the world's largest economy it can, however, be seen to be providing an economic stimulus for elsewhere.

One treaty which President Trump has been very vocal about is NAFTA, the agreement between the USA, Canada and Mexico. A preliminary agreement between the USA and Mexico is a step up in protectionism and therefore a cost to consumers. Under the revised agreement car companies would be required to manufacture at least 75% of a car's value in North America, up from 62.5% to qualify for zero tariffs. There is a requirement to use more local steel, aluminium and auto parts and have 40% to 45% of the car made by employees earning at least US$16 an hour. If this comes to pass, whilst there will be some winners, consumers will find themselves paying more for these cars and have less money to spend elsewhere with knock on economic consequences. As Canada is part of NAFTA, it is difficult to know how this will end, except that, at the end of September, an agreement was reached with Canada and NAFTA will be replaced by USMCA (the United States-Mexico-Canada Agreement). Canada has offered more market access to US dairy farmers and effectively agreed to cap automobile exports to the USA. There will also be provisions on digital trade and intellectual property. So far, as we can see from the performance of Wall Street, investors do not seem greatly perturbed, although some other markets appear to have been affected, although not greatly as yet. This is not a case where one side is 100% right and the other 100% wrong, but the concern is that attitudes are becoming entrenched and one thing we can say for certain is that a trade war involving protectionist measures is a thoroughly bad policy, with few winners and plenty of losers, including investors. One reason why President Trump is being so aggressive on this front is probably the need to position himself correctly, as he believes, in front of November's mid term election. Bearing in mind that the constituency of voters who propelled him into the White House is one of the few which may benefit from the tariffs on steel and aluminium, President Trump is making the point that, unlike many politicians, he does what he says. A hopeful view would be that, once the mid term elections are over, a more pragmatic approach might emerge. We will see.

It is clear, however, that the US economy is performing well and one by-product of that is the need for monetary tightening by the Federal Reserve. However, this is causing problems in Emerging Markets from where money is moving to the US dollar which is seen to be a safer haven. Emerging Markets are not a homogenous group. Some countries are in a much stronger position than others but a group of weaker ones would include Turkey, South Africa, Argentina and Brazil. Problems in these countries can cause contagion and a more general flight to the US dollar. With large amounts of US dollar debt taken on, a depreciating local currency raises the cost of repaying and servicing their debt. The Bank of International Settlements says that, at the end of March, US dollar denominated debt to non-bank borrowers reached US$11.5 trillion. The BIS lists 13 countries which constitute 62% of all US dollar denominated debt held by emerging markets. The countries are Turkey, Argentina, Mexico, Chile, Indonesia, Brazil, India, South Korea, Malaysia, Russia, South Africa, China and Saudi Arabia. This is not a problem for all of them, certainly not China or Saudi Arabia, but it is for others. Emerging Markets need to be watched closely for the size of their US dollar denominated debts and the problems a rise in the US dollar could cause. Rising US interest rates, which are almost a given because of the continued strength of the US economy, pose a threat to some Emerging Markets because of the level of their US dollar indebtedness.

Nearer home, all eyes within the eurozone are on Italy where the new populist coalition's budget is set to increase the budget deficit to 2.4% of GDP in 2019, 2.1% in 2020 and 1.8% in 2021, setting off significant weakness in the Italian bond and equity markets. The Italian government sees growth of 1.5% in 2019, 1.6% in 2020 and 1.4% after that but many economists feel that these forecasts are over optimistic and, if they are, there are implications for the budget deficit. Deeply eurosceptic, its plans to raise spending and cut taxes threaten the EU's budgetary discipline and thereby the integrity of the euro. It remains to be seen whether the constraints of office will temper the coalition's plans over the course of time but, if they are to challenge the EU's budget disciplines, this could be the biggest economic threat of all to the world economy and stock markets. That Italy is heavily indebted is well known. Outstanding public debt is over 130% of GDP. Should interest rates start to rise, the gradual increase in servicing costs as cheaper debt is repaid and replaced by more expensive debt will place an additional burden on the budget. The disparity in performance between the eurozone's highest rated credit, Germany, and Italy shows the potential danger to Italy's credit rating if the EU's budgetary rules are flouted. At the moment (early October), the ten year Bund has a gross redemption yield of 0.548% against 3.406% for the equivalent Italian government bond and if we go out to the 30 year government bond yields the relevant figures are 1.146% and 3.827%. We also have to remember that, unless anything unexpected happens, the ECB will stop its bond buying programme at the end of the year which will remove some indirect support from the Italian government bond market. Italian bond yields will, therefore, be more dependent on purely market factors. Italy is due to present its draft 2019 budget shortly to the European Commission for approval but the 2.4% budget deficit planned for next year is likely to create conflict. The Italian economy minister, Giovanni Tria, is seen to be a moderating influence amongst the two deputy Prime Ministers but looks to have been overruled. Italian government bond yields are undoubtedly the canary in the mine and the outcome of the negotiations will be an important influence on eurozone markets and beyond. As the third largest eurozone economy, Italy has the power to destabilise the euro. Domestically, Italian banks are highly vulnerable to problems in the Italian government bond market. At the end of July, Italian government bonds held by banks operating in Italy amounted to €383.5 billion, the highest level since May 2017 and the seventh monthly increase in a row. This increase has come as foreigners have reduced their holdings of Italian government bonds. According to the Bank of Italy, foreign investors sold a net €33 billion of Italian government bonds in June which followed on from a €25 billion disinvestment in May.

We have talked before in these reviews about Target 2 balances which, in the case of Italy, are effectively the Bank of Italy's liabilities to other eurozone central banks, particularly Germany. Whilst the euro exists, these are not a problem but, if the euro were to break up, losses would be enormous. According to the latest ECB figures, the Bank of Italy's Target 2 liabilities were €471.1 billion at the end of July whilst the Bundesbank's assets were €913.3 billion. The second largest liabilities were of the Bank of Spain at €402.8 billion. Investors like to feel that Italy will muddle through and that some sort of compromise will be reached but populist politicians, if they do reach power as in the case of Italy, will be expected to produce on their promises. The proposed budget will therefore be a key market influence for investors and, as a sign, the yields on the different maturities of Italian government bonds will be an indicator of sentiment. The doom loop between Italian banks and Italian government debt is very obvious for these figures. Italian banks own about 16% of outstanding Italian government debt and they represent around 20% of the total assets of the banks, according to the Bank for International Settlements.

A specific concern for sterling based investors is the toxic political scene in the UK which has been driven by Brexit. Our view is that Brexit may or may not turn out to have been a good decision but we will not really know for some years and, of itself, should not be a major market factor. But its indirect effect has been enormous and may lead to a constitutional crisis if Parliament is not prepared to accept the result of the referendum. This is, of course, a simplification of the matter but it could be a very dangerous and uncertain time. If somehow, it were to lead to a change of government with Labour's economic policies, as recently outlined, very different to those followed at present and in the past, the markets and sterling would be likely to weaken substantially. Therefore, because it is so difficult to have any visibility on how Brexit and the UK political scene will evolve in the next few months, we maintain our view that the UK is a high risk market with overseas diversification an essential part of any prudent investment policy.

These, then, are some of the main specific issues which investors and investment managers will be considering over the next few months and the visibility is not clear, so making a big investment decision on the basis of these issues when we do not know how they will work out could be dangerous and we are not inclined to change our policy. So far, markets have tended to shrug them off. There are always plenty of potential reasons to be worried but recent history has taught us that one should also be prepared to consider the positive factors and these have, at least so far, carried more weight judging by market movements, especially in the USA. For instance, as this is written President Trump has placed a 10% tariff on about US$200 billion worth of Chinese imports starting almost immediately and has said that he will raise the rate to 25% in 2019 if no trade deal with China is reached. With the latest round of tariffs imposed by the USA, the total amount of Chinese exports to the USA, which have been targeted, stands at around US$250 billion, about half of last year's exports. The President threatens more action on the rest if China retaliates. For an investor, this sounds as if it is getting really nasty but immediate market reaction has been subdued. Those with an optimistic view might say these are the negotiating tactics of a tough businessman who will expect to get his way and that, if he does and there is a trade agreement between the USA and China, markets will move up. Those of a pessimistic disposition will say that a full scale trade war will lead to a recession and damage the stock market. The point is that we just cannot tell at this stage.

In the absence of these specific high profile issues, we would probably be considering the development of monetary policy as the main influence on investment policy. The world economy is in a satisfactory position. As we have often said in these reviews, it is important that there are moves taken in the USA, UK, the eurozone and Japan to begin regularising monetary policy to provide some monetary ammunition for the future when policy has to be aimed at stimulating an economy in recession. Swollen central bank balance sheets carry potential risks, perhaps ultimately on inflation, so a reduction in their size is desirable to help to protect against inflation risks. The fact that inflation has not been a problem since central banks' balance sheets started expanding does not mean it will stay this way.

The policy concern for investors is how a change in the direction of monetary policy can be accommodated by equity investors without causing significant price falls. This, we felt, was going to be the main challenge for equity markets in 2018 even though attention has been elsewhere as described earlier in this review. Monetary tightening, albeit from a very loose position, can take one of two forms or both. The more high profile one is to raise interest rates and the other one is action on Quantitative Easing (QE) either by reversing it, as in the USA, or stopping it as the ECB plans to do at the end of the year. In the case of the USA, the size of the Federal Reserve's balance sheet is starting to shrink (current level US$4.257 trillion) whilst, when the ECB has stopped its QE at the end of the year its balance sheet will stabilise (current level €4.634 trillion - US$4.853 trillion). The Bank of Japan's balance sheet is still expanding (current size JPY551.7 trillion equivalent to c. US$4.853 trillion) as it is the most aggressive proponent of QE whilst the Bank of England's balance sheet is unchanged (current size £593 billion) as it long ago stopped QE.

Extreme monetary policy measures following the financial crisis ten years ago, even though they are being reined back a little, seem to be developing some air of permanence which is highly undesirable. Interest rates, except to an increasing extent in the USA, are well below what anyone could think of as normal and the longer this state of affairs continues, the longer the distortions in asset values, especially in the fixed interest market, and economic behaviour continues. So, the question arises, is the current level of economic growth being seen around the world only able to be achieved as a result of extremely low interest rates and quantitative easing or has it enough momentum of its own to be able to withstand tighter monetary conditions, however implemented? In the USA, the answer may be "yes" in the sense that, although interest rates are being raised on a regular basis in the face of strong economic growth and rising inflation, the economy is gaining for the moment a stimulus from the corporate and personal tax cuts. Whilst tax cuts are generally to be welcomed, implementing these pro cyclical measures at a time when the economy is doing well, risks causing the US economy to overheat and therefore probably cause inflation to rise. This particular stimulus to the US economy probably means that the US economy can continue to perform well as interest rates are moved to a neutral level whereby they neither stimulate or depress the economy or they reach an equilibrium level. As this is written, US Treasury ten year bond yields have pushed through 3.0%, now standing at 3.233%, again but Wall Street is hitting new peaks. It is too early to be sure but, for the moment, investors have taken this psychological barrier of 3.0% in their stride. In normal times, we would expect to see a real rate of interest. So with the US consumer price index showing a year on year increase of 2.7%, it would not have been unusual, in more normal times, to have expected the ten year US Treasury bond yield to be approximately 4%. The Federal Reserve's preferred measure of inflation, the core personal consumption expenditures index, shows a year on year increase of just under 2% so, on that measure, monetary policy is tighter. One of the unusual features of monetary policy everywhere, and until recently in the USA, which resulted from monetary policy measures was that equity yields compared very favourably with short term deposit yields and ten year bond yields. This was one of the distortions arising from monetary policy which lives on except in the USA where the dividend yield on the S&P 500 Index (about 1.8%) is below the target federal funds rate of 2.00% - 2.25% and is about 1.4% below that of the ten year US Treasury bond. In a dynamic situation, when corporate profits and dividends are rising, these ratios should not be an issue. The current year on year rate of dividend growth is approximately 8% and earnings growth is about 20%. Part of this growth, perhaps about 7% or even more, is due to the tax cuts so they will drop out of the comparison shortly. On current projections, investors will have to be comparing the dividend yield on the S&P 500 Index with a much higher federal funds rate, probably over 3% by the time it has peaked for this cycle. So, all of this will be a challenge to investors in the USA. Signalling from the Federal Reserve will be very important and bond investors, in particular, will want to be sure that the Fed is not behind the curve in raising interest rates if inflation accelerates. Disabling the automatic stabilisers, which is what the President has done by executing tax cuts against a background of good economic growth, threatens a risk of the US economy overheating. The most important point of all, although it may not seem this way at the moment, is that when the next recession arrives the Federal Reserve has enough monetary ammunition in reserve to loosen fiscal policy. It needs to be building up to that position when the US economy is in as strong position as it is now. It is the best placed of all central banks to confront the next recession because US interest rates should be at levels where they can meaningfully be reduced.

It is, therefore, reasonable to have some cause for optimism that the USA will continue to make moves towards monetary policy normality. However, it is difficult to make the case elsewhere, certainly amongst the major developed economies. Although the economic performance of the eurozone has been improving, it has been a laggard. The latest annualised quarter on quarter growth rate for the eurozone was 1.5% which compares with 4.2% for the USA. The latest projection from the OECD sees growth in the eurozone at 2.0% which compares with 2.5% in 2017 whereas for the USA it is 2.9%. Whilst, if this projection is realised, it is certainly a satisfactory rate of growth in normal circumstances, it has taken significantly negative real interest rates to achieve this projected rate of growth, and one wonders what would happen if interest rates were, in historical terms, normal. The latest rate of inflation in the eurozone, as measured by the consumer price index, is 2.0%. The ECB's official interest rate is zero and many depositors are earning a negative rate of interest on their balances. The ten year German government bond is showing a gross redemption yield of 0.548% (early October), a significantly negative real yield and Italy, a much more lowly rated credit, is yielding 3.406% which gives a small real yield for a much higher perceived risk. In addition, although on a much reduced scale, the ECB is still buying bonds. Should recession strike the eurozone again, one would be hard put to see what monetary ammunition the ECB had left to counter it. It cannot indefinitely mop up bonds in the secondary market without putting even more risk on its balance sheet. Whereas, in the USA, the relative yield attraction of equities versus bonds and cash has disappeared, in the eurozone the gap remains substantial in favour of equities. So, whilst cash yields nothing or a negative sum and ten year German Bunds (admittedly the highest rated bonds and lowest yield) yield 0.548%, the dividend yield on the Euro Stoxx 50 is around 3.7%. Notwithstanding all the problems of the eurozone, one can see value in the equity market which one must keep quite separate from the problems of the eurozone. What it does mean is that the eurozone has only achieved current levels of growth because of the life support provided by monetary policy. It suggests that the next economic crisis could test the single currency's resilience severely.

The biggest implementer of QE is Japan and here there seems no end in sight. In Japan, it is not just fixed interest securities which are purchased but also equities through exchange traded funds. But the Bank of Japan's asset purchase programme has not succeeded in raising inflation to the Bank of Japan's target of 2%. The year on year consumer price inflation is 1.3%. Japan has the advantage of having its debt substantially held internally so does not run the risk of having its bond market targeted by foreign investors. When a country engages in quantitative easing on the scale of Japan, one cannot be complacent but it would seem in a less difficult position than the eurozone next time a recession occurs. It is an odd situation when a central bank becomes a large holder of equity positions. It holds roughly US$227 billion of equities which is equivalent to nearly 4% of the market value of stocks traded on the first section of the Tokyo Stock Exchange. It is a major shareholder in nearly 40% of listed companies. One could assume that the Bank of Japan would not be comfortable with this position indefinitely. Its buying may well be one of the reasons why the Japan stock market has performed relatively well this year notwithstanding sales by foreign investors of nearly US$85 billion of Japanese equities. Japan tends not to make the stock market news these days which may well be a good thing.

The UK is running second, by a long way, to the USA in reversing monetary policy. QE stopped after it was temporarily reintroduced on a limited basis after the Brexit vote and the process of raising interest rates has started. An increase at the end of 2017 and another one this year, 0.25% in both cases, has taken the Bank of England's official rate to 0.75% and interest rates are likely to be increased gradually although there is no sign as yet of a reversal of the QE undertaken, currently standing at £435 billion. But as with the eurozone, although not so extreme, the relation between interest rates, inflation and growth is wrong if one were looking at normal conditions. A Bank of England official rate at 0.75%, the ten year UK gilt yield at 1.68% and inflation at 2.7% is abnormal with negative real interest rates a potential threat to inflation. Even though growth is sub par at the moment, the latest quarter on quarter annualised rate being 1.5%, the country has record employment levels and there is, as yet, no sign of a recession. This means that, although it has more scope than the ECB to act in a recession, the absolute amount it can do is very little. It is important, because of the potential inflation threat and also to provide scope for monetary action in the future, that interest rates continue to be raised gradually in the U.K.

Moving from the general to the particular, it remains useful background to note the latest forecasts from the OECD in its September Interim Economic Outlook. Whilst investors have to consider particular issues as they arise, and we have mentioned a number of the important ones earlier in this review, stock markets are influenced by the day to day performance of economies. Accompanying the latest forecasts from the OECD, there is emphasis on the economic uncertainties, a number of which we have detailed above, and it concludes that there is high uncertainty weighing on global growth. Against these uncertainties, it now forecasts growth of 3.7% for this year, a reduction of 0.1% on its May Economic Outlook figure. For 2019, it has reduced its forecast by 0.2% to 3.7%. For its G20 forecast, it has pulled back this year's growth forecast by 0.1% to 3.9% and, for next year, by 0.3% to 3.8%. Picking out the G7 countries first, the OECD has left its forecasts for the USA unchanged at 2.9% this year but has reduced it slightly next year by 0.1% to 2.7%. The reductions in the eurozone's forecasts are larger. For 2018, it now sees eurozone growth at 2.0%, down by 0.2% on its May forecast and at 1.9% in 2019, also 0.2% lower. Within the eurozone, there has been quite a significant downgrade for Germany by 0.2% for 2018 to 1.9% and by 0.3% to 1.8% for 2019. France has seen a significant reduction in the OECD's forecast for 2018, one of 0.3% to 1.6%, and a smaller reduction of 0.1% next year to 1.8%. All eyes are on Italy for reasons discussed earlier. For this year, the OECD has trimmed back its forecast by 0.2% to 1.2%, although it has left next year's forecast unchanged at 1.1%. The projections for Japan remain unchanged at 1.2% for 2018 and 2019. The forecasts for Canada are 2.1% for 2018, unchanged, and 2.0% for 2019, a reduction of 0.2%. For the UK, the forecasts for 2018 and 2019 have been trimmed by 0.1% each year to 1.3% and 1.2% respectively. Elsewhere, for the all important Chinese economy, the OECD has left its forecasts unchanged at 6.7% and 6.4% respectively, whilst for India (fiscal year to April), it has raised its current year forecast to 7.6%, up 0.2%, and reduced it slightly by 0.1% for the following year to 7.4%. As this is written, India is undergoing problems with its currency and one would feel that forecasts may have to be reduced as events unfold there. Other notable changes in the forecasts are for Turkey, not surprisingly, where the forecast for this year has been pared back by 1.9% to 3.2% and for next year the OECD's previous forecast growth rate for 2019 has been almost eliminated with a reduction of 4.5% to just 0.5%. Again, with events moving fast, those forecasts may well change over the next few months, one would imagine. Brazil, also in economic difficulties, has seen a sharp reduction in the OECD's forecast for this year, down 0.8% to 1.2% and down 0.3% to 2.5% next year. Argentina, in severe difficulties, is now forecast to contract by 3.9% this year to -1.9% and the growth forecast for 2019 is just 0.1%, down 2.5% on the OECD's May forecast. South Africa, one of the struggling emerging markets, has seen its growth forecast more than halved this year to just 0.9%, having been in recession in the first half of the year, whilst next year's forecast has been pared back by 0.4% to 1.8%. So, as the above figures show, there have been some significant changes in the OECD's projections since May, mainly reflecting specific country issues, whilst smaller changes reflect more caution given the events and other issues which we discussed earlier in this review. Overall, however, in the absence of a notable deterioration in the overall economic outlook, a forecast for world economic growth at 3.7% for this year and next, compared with 3.6% in 2017, should not, of itself, alter the outlook for stock markets.

It is, however, worth looking at the OECD's assessment of the effect of the restrictive trade measures already announced. So far, the OECD suggests that the economy-wide direct effect of measures announced is relatively mild. If the USA stops at the measures already announced, the OECD believes that the overall price level in the USA could rise by 0.3% to 0.4%. This is assuming that the second round of tariffs on Chinese imports are eventually raised to 25% and that there is no reduction in pre-tariff import prices. But if additional tariffs on Chinese imports, autos and auto parts are levied subsequently at 25%, the OECD estimates that the impact on the overall price level could rise to a little over 1%. For China, the OECD estimates that the higher tariffs on US imports could raise import costs by nearly 1% but this is offset in part by lower tariffs on passenger car imports. The rise in inflation in the USA as a result of tariffs on Chinese imports could well influence the Federal Reserve's monetary policy, something that President Trump would not welcome.

Looking at individual areas of the world, the outperformance of the US stock market is striking and the strong economic data coming out of the USA has clearly influenced investors' thinking about the attraction of the US equity market, even at a time when bond yields have been rising. We have already mentioned the strong rate of economic growth in the USA, 4.2% annualised in the latest quarter, and the OECD's quite strong growth forecasts for 2018 and 2019. Looking at other individual items of data from the USA, the strength of the purchasing managers indices is notable. The latest manufacturing PMI for August stands at a very high level of 61.3 and that for the services sector at 58.5. The employment data remains strong with the unemployment rate at 3.4% and non farm payrolls consistently strong, the latest month's figures showing a rise of 134,000 (the previous month's figures were revised up to 270,000). The Conference Board's leading indicators show consistent monthly rises and retail sales are strong with year on year growth to August up 6.6%. Productivity growth appears to be improving with the latest quarter on quarter figures to June showing a rise of 2.9%. Encouragingly, business investment is increasing, as one would hope and expect after the tax cuts. In the second quarter, business investment grew at an annualised rate of 7.3%. Capacity utilisation is creeping up, standing at 78.1% in August. Consumer confidence is very high with the latest University of Michigan index standing at 100.8. Back in January, it was 95.7. All this is very positive and, combined with large share buybacks, has created a positive environment for the US equity market. The issue, as discussed earlier, is that these pro cyclical tax cuts, at a time when the economy is performing strongly, can store up problems later on in terms of inflation but also the budget deficit if the tax cuts do not pay for themselves as the President hopes.

The eurozone is rather less robust than it was and the implications of this are reflected in the reduced forecasts for economic growth as shown in the latest OECD forecasts. The latest annualised quarter on quarter growth rate was 1.5%. The important purchasing managers' indices, whilst still consistent with modest growth, are well down on levels at the beginning of the year. The latest composite PMI for the eurozone stands at 54.2. In January, it was 58.8. Within that composite figure, the manufacturing PMI stood at 53.3 and the services PMI at 54.7. The deterioration in the readings for the two largest economies is quite striking. In Germany, the composite PMI has fallen from 59.0 in January to 55.3 in August. Whilst the services PMI has fallen modestly from 57.3 to 56.5, the manufacturing decline has been quite precipitous from 61.1 to 53.7, perhaps reflecting fears about a trade war. In France, the composite PMI has fallen from 59.6 to 53.6. Within that overall figure, the manufacturing PMI has fallen from 58.4 to 52.5 and the services PMI from 59.2 to 54.3. Italy, a major concern within the eurozone because of the uncertainty about the economic policies of the coalition government, is showing quite weak PMIs. The latest composite figure is 51.7 and, within that, the manufacturing PMI stands at 50.1 and the services PMI at 52.6. Amongst other data, the EC Consumer Confidence index has been weakening with the latest reading being -2.9. Retail sales have been sluggish with July showing a month on month decline of 0.2% and the year on year figure showing a rise of just 1.1%. We need to remember that this sluggish data is against the background of extraordinary monetary easing. It cannot be said to be a healthy position yet it is necessary, for reasons described earlier, that the eurozone is weaned off ultra loose monetary policy.

To some extent, Japan is insulated from international events. It is less exposed to fickle foreign flows of money because most of its debt is held internally and it is the largest creditor nation in the world. At the end of 2017, the net value of assets held by the government, businesses and individuals stood at the equivalent of US$3 trillion. This is not to say that Japan will not be affected by a trade war but the country has a certain amount of resilience. Second quarter annualised growth was quite strong at 3.0% but the purchasing managers indices are consistent with the fairly modest growth rates forecast by the OECD, which we detailed earlier. The latest composite PMI stands at 52.0, slightly lower than the January level of 52.8, with the manufacturing PMI at 52.5 (54.8 in January) and the services PMI at 51.5 (51.9). The unemployment rate has actually been edging up, standing at 2.5% compared with 2.2% in May. Yet inflation at 1.3% is still well below the Bank of Japan's 2% target level. With Mr. Abe in a strong position, he must fire the third arrow of his programme, structural reform, to complement the monetary and fiscal arrows which have been fired earlier. The big test for Japan will come in October 2019 when the consumption tax rate is due to increase from 8% to 10%. The previous history of consumption tax increases has not been happy but Japan has an enormous burden of outstanding debt and it has a large budget deficit estimated to be around 3.8% of GDP this year. It has pushed back its target date for achieving a primary budget balance from 2020 to 2025 and fiscal discipline is very hard to enforce in Japan which faces very difficult demographics. Japan is not investors' favoured destination, as the figures for foreign disinvestment show earlier, but it is not at the forefront of countries posing especially difficult problems for investors.

In China, the difficulties are mounting for President Xi. Having accumulated such power, it is inevitable that the spotlight focuses on him, which cannot be a good position to be in given the pressures China is facing. It will also be important for China not to be seen backing down in the face of US pressure. President Trump is counting on China running out of US exports to its country on which to place tariffs. At the same time, the Chinese authorities are trying to bring domestic debt down and to place more controls on the shadow banking sector and to bring property prices under control. Property prices are rising strongly in second and third tier cities and the government will try to find curbs on prices which work. Against this background, the second quarter was a strong one for China with second quarter annualised growth running at 7.4%. Investors will also be watching the currency which has been weak against the US dollar. If it falls too much, China will encounter the ire of President Trump who may feel that China is trying to work its way round the tariffs placed on its exports to the USA. It will also be very sensitive to any feeling that there is a capital flight from China. Earlier on, as Chinese foreign exchange reserves dropped to around US$3 trillion, there was concern about capital flight and the Chinese authorities took action to limit the possibilities for capital flight. Now the reserves have risen to around US$3.1 trillion but they are a sensitive measure of confidence. Whilst the inclusion, at a modest level so far, of Chinese "A" shares in the MSCI Emerging Markets Index will increase demand over time, worries about corporate governance and the party's influence on companies will be an issue for foreign investors. There is also a concern that the Chinese government will not want the big technology companies to become so powerful that they pose a threat to government influence over the economy. If we take the example of Tencent, its shares have been affected by the Chinese government's plans to limit the number of new games planned for release and the total number of titles. Investors will be aware of arbitrary decisions made by the government which can unexpectedly affect a company's prospects and Tencent is a case in point. As the stock market shows, China is out of favour at present with many uncertainties around, especially the trade war with the USA.

Finally, we turn to the UK. In a sense, the economics is irrelevant because it is politics in the form of Brexit and a potential government with policies more extreme than previously put forward by any mainstream party in the UK that creates concern. We would rate the latter as the more important issue for investors and may be the reason that international investors find the UK stock market one of the least attractive. It is very difficult to have any visibility on Brexit at the moment but the UK economy should be flexible enough to deal with it and then consider the opportunities beyond the initial difficult period. Although growth is modest at present, on the OECD's forecasts it is not the lowest of the G7. It forecasts that Japan and Italy will have lower growth rates this year than the UK. The purchasing managers indices suggest modest growth. The latest composite PMI stands at 54.2, actually higher than it stood in January when it stood at 53.4. Within that, the manufacturing PMI at 52.8 is lower than in January but the important services PMI (services account for about 80% of the economy) stands at 54.3 compared with 53.0 at the beginning of the year. Also, but almost out of the news, government borrowing is gradually coming under control. At 85.3% of GDP, it is uncomfortably high. Although August's figures for public borrowing were higher than expected, the previous four months' figures had been encouraging. So far this financial year, the government has borrowed £17.8 billion, which is £7.8 billion less than at the same stage the previous year. Whilst this progress does not get the headlines which the methods to improve public finances do, always negative ones, it is vital that progress continues to be made so that public finances are able to withstand the next recession when revenue and public spending will move in different directions, or at least at a different pace, and put pressure back on public finances. The UK stock market is one of the least loved of those of developing countries and one can understand why. Absent the political uncertainties, it would look good value but it is not a risk which we feel we can take at the moment. For sterling investors, being heavily invested overseas seems to us a sensible precaution given the high stakes at play.

Looking at all these conflicting strands, our opinion is this. Firstly, bonds remain very expensive in most markets and should be avoided because of the danger of substantial negative returns as one moves out along the yield curve. The safest end of the market is the short end where yields are very low although the rise in short term US interest rates does provide a very modest return. Equities have had an extraordinarily good run, propelled by very loose monetary policy. The challenge for equities, as we have described in this review, is tightening monetary policy. At present, we consider that the probable level of economic growth in the world economy is sufficiently good to deal with rising official interest rates providing central banks' signalling is good. We have discussed the potential problems facing the world economy, including protectionism and problems in the eurozone if the Italian situation turns ugly. But, as yet, we do not feel that the possibility of a major crisis is strong enough to make us reconsider equities as our preferred asset class. For sterling based investors, the potential risks are very real and significant overseas exposure is essential as an insurance policy although, even without the uncertainties, the danger of home bias should be avoided. Finally, we are long term investors and always appreciate the opportunity costs of being out of the market so, whilst investors must expect some negative quarters after the rises in share prices which we have seen, we do not see reasons for taking such a negative view of prospects as to carry out significant sales. We have, however, been building up cash from dividends in certain portfolios which we would commit to the market if there were any meaningful setback.