meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Overall, it has been a satisfactory quarter for international equity markets with modest rises nearly everywhere. Returns were pared right at the end of the quarter as an outbreak of share price volatility in China affected international asset markets. Yields on bonds trended upwards during the quarter.

The tables below detail relevant movements in markets:

International Equities 30.11.06 - 28.02.07

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+7.3	+7.5	+7.1	+7.5
Finland	+6.8	+6.9	+6.5	+6.8
France	+3.9	+4.0	+3.6	+3.9
Germany	+6.8	+6.8	+6.4	+6.8
Hong Kong, China	+7.4	+7.4	+7.0	+7.3
Italy	+1.9	+1.9	+1.5	+1.9
Japan	+9.4	+7.2	+6.8	+7.2
Netherlands	+4.7	+4.7	+4.3	+4.7
Spain	+3.5	+3.5	+3.1	+3.5
Switzerland	+3.7	+2.2	+1.8	+2.1
UK	+2.4	+2.4	+2.0	+2.4
USA	+1.1	+1.5	+1.1	+1.5
Europe ex UK	+4.9	+4.5	+4.1	+4.5
Asia Pacific ex Japan	+5.3	+5.1	+4.7	+5.1
Asia Pacific	+7.6	+6.3	+5.9	+6.3
Latin America	+5.8	+7.0	+6.6	+6.9
All World All Emerging	+3.5	+3.7	+3.3	+3.7
The World	+3.3	+3.2	+2.8	+3.1

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -0.9%

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

Currency	30.11.06	28.02.07
Sterling	4.52	4.80
US Dollar	4.47	4.56
Yen	1.66	1.64
Germany (Euro)	3.69	3.96

Sterling's performance during the quarter ending 28.02.07 (%)

Currency	Quarter Ending 31.01.07
US Dollar	-0.4
Canadian Dollar	+2.3
Yen	+2.1
Euro	N/C
Swiss Franc	+1.6

Other currency movements during the quarter ending 28.02.07 (%)

Other Currency	Quarter Ending 28.02.07
US Dollar/Canadian Dollar	+2.7
US Dollar/Yen	+2.4
US Dollar/Euro	-0.3
Swiss Franc/Euro	-1.6
Euro/Yen	+2.1

Significant Commodities (US dollar terms) 30.11.06 – 28.02.07 (%)

Significant Commodities	30.11.06 – 28.02.07
Oil	-3.7
Gold	+3.3

Markets

Over the quarter, the total return on the FTSE World Index in local currency terms was 3.3%, in sterling terms 3.2%, in US dollar terms 2.8% and in euro terms 3.1%. In local currency terms, the return in the USA was relatively low at 1.1%. The UK also slightly underperformed with a return of 2.4%. Europe ex UK enjoyed a strong quarter, with the local currency total return on the FTSE Europe ex UK being 4.9%. Japan, after recent underperformance, moved ahead strongly with a return of 9.4%. Asia Pacific ex Japan, Latin America and emerging markets, although buffeted by end of quarter volatility, still produced good returns on the basis of strength right up to nearly the end of the quarter. Australia enjoyed an excellent quarter with the FTSE Australia Index returning 7.3% in local currency terms. This quarter's currency movements were relatively mild so currency movements did not greatly alter returns in the major currencies, as is seen by the small difference in the currency adjusted returns. A slightly stronger US dollar enhanced returns on the FTSE USA Index to 1.5%. The return on the FTSE Europe ex UK Index fell slightly to a still very satisfactory 4.5% in sterling terms. Asia Pacific ex Japan's sterling return was only slightly lower at 5.1%, whilst the returns from Latin America and emerging markets were enhanced to 7.0% and 3.7% respectively. The Australian return was slightly boosted to 7.5%.

International bonds, as measured by ten year government bond yields, were weaker. The yield on the ten year sterling government bond rose by 28 basis points to 4.8%, on the US dollar bond by 9 basis points to 4.56% and on the German government bond by 27 basis points to 3.96%. There was a slight dip in yen bond yields, 2 basis points to 1.64%.

In the currency markets, sterling was slightly weaker against the US dollar over the quarter, falling by 0.4%. It was unchanged against the euro but rose 2.1% against the yen and 1.6% against the Swiss franc. Other moves worthy of note are the 2.3% rise of the US dollar against the yen and the 2.1% rise of the euro against the yen.

In the commodity markets, oil fell by 3.7% whilst gold rose by 3.3%.

Economics

- *After a prolonged period of low volatility, there was a sudden change right at the end of the quarter* ...... a sharp fall in Chinese share prices after a strong run up appeared to trigger volatility elsewhere .
- *Over the quarter as a whole, equities outperformed bonds* ...... notwithstanding weakness in the last few days, equity valuations look more attractive than those of bonds.
- *Low volatility and an increased appetite for risk make some investment strategies look distinctly unwise* ...... the yen "carry trade" and search for yield in the bond markets in lower quality issues are obvious ones as well as some areas of the property market.
- *As with the bout of volatility early last summer, the latest market moves do not appear to be due to any fundamental reason* ...... economic conditions remain quite benign.
- *Corporate earnings continue to advance and company directors continue shareholder value enhancing measures* ...... fascinating research from Citigroup quoted in the Financial Times shows the scale of money returned to shareholders through buybacks and special dividends. It also shows the low level of dividend payouts.
- *Certain areas of the market have attracted political and trade union criticism* ...... private equity has been under fire in the UK and Europe. Private equity bids have probably been behind part of the equity markets' rise.
- *Helping equity markets has been at least a stabilisation in the price of oil* ...... over the quarter it declined in price slightly.
- *A possible interesting development is China's management of its foreign exchange reserves* ...... there is a suggestion that part of them may be put into a global investment fund analogous to Singapore's GIC.

USA

- *A downward revision of fourth quarter growth* ...... the annualised rate is now given as 2.2% compared with an earlier estimate of 3.5%.
- *The Federal Reserve seems slightly more relaxed about the economic outlook* ...... both in respect to growth and inflation it seems quite sanguine but it continues to be wary about inflation to give itself flexibility on interest rates.
- *Ben Bernanke's semi-annual testimony to Congress provided a comforting background for investors* ...... the Federal Reserve's forecasters' central tendency for growth and inflation rates this year and next are at the levels investors like to hear, with growth expected to be slightly higher in 2008 than 2007 and inflation a little lower.
- *Resource utilisation and consumer demand are the main concerns* ...... with employment low and capacity utilisation high, the potential for an inflationary threat is there. In the short term, the reversal in the productivity trend in the final quarter of 2006 is pleasing. It came in at an annualised growth rate of 3.0% compared with -0.1% in the third quarter, a faster increase than the growth in labour costs.

- *The biggest concern for the bears of the US economy is the housing market* ...... the different indicators are mixed and problems in the sub-prime market are attracting attention. The industry expects conditions to stabilise later this year but this will depend upon the rate at which the housing overhang diminishes.
- *Corporate activity continues at a buoyant pace* ...... the largest private equity deal has been announced - the bid by KKR and Texas Pacific Group for TXU, the utility. The value of the deal, if it goes through, is US$44.5 billion.

Japan

- *Until the last few days, the weakness of the yen has made the headlines* ...... low interest rates have made some believe that the "carry trade" is a one way bet.
- *The "carry trade" never is or was a one way bet* ...... Japan has a large current account surplus and, whilst capital account flows dwarf current account flows, the yen looks cheap and there are reasons for saying that the currency should be stronger. Some investors will be badly burned by the snap back in the currency over the last few days.
- *The rise in Japanese interest rates expected in January occurred in February* ...... the Bank of Japan votes by 8 - 1 to raise the interest rate from 0.25% to 0.5%. The Bank of Japan could be embarrassed by the lack of inflation although it is keen to get monetary policy on to a more normal footing.
- *However, strong growth in the final quarter of 2006 gives the Bank of Japan a rationale for moving in this direction* ...... growth was 1.2% higher in the fourth quarter compared with the third quarter.

China

- *Against a background of fast economic growth (10%+), the authorities are trying to rein in excesses* ...... in February, the central bank raised banking reserve requirements for a second time by 0.5% to 10.0% as it attempts to restrain lending for property and fixed asset investment.
- *The central bank is concerned about inflation* ...... it reports that consumer expectations for inflation are at their highest since 1999.
- *After a strong rise, the Chinese stock market falls back sharply* ...... it causes jitters elsewhere in world markets leading to the current bout of volatility. It is difficult to see why this should have a link economically but it is the psychological effect which is probably the reason.

Europe Ex UK

- *2006 was a good year economically* ...... in the fourth quarter, the eurozone grew by 0.9%, according to Eurostat's first estimate, and, for the year, 2.7%.
- *Growth forecasts for 2007 are raised as a result of this continuing momentum* ...... the EU monetary affairs commissioner raises his EU growth forecast this year to 2.7% for the EU and 2.4% for the eurozone (both forecasts 0.3% higher than last November's). He credits rising investment and consumer demand for this.
- *The better than expected growth prospects for 2007 will almost certainly encourage the ECB to raise interest rates further* ...... although eurozone inflation was an acceptable 1.9% in January, it is expected to rise. There are capacity pressures and the German pay bargaining round in the engineering and metal industries will be an influence.
- *Most of the short term economic news in the eurozone is positive* ...... unemployment has fallen to 7.5% and the NTC's semi-annual business outlook survey was also positive, although conditions varied between countries.

- *Germany seems to have weathered January's 3% VAT rise well on the information available so far* ...... the government has raised its growth forecast for this year to 1.7% from 1.4%. It is also more optimistic on unemployment and the figures, although very high, are still improving.

- *German economic recovery has brought with it calls for big pay increases* ...... IG Metall is looking for 6.5% on social and economic grounds and some German politicians are supportive of this claim. The ECB, for one, will be watching the outcome very closely.

- *France has fallen behind Germany economically* ...... last year was the first year since 1994 that France had grown more slowly than Germany.

- *France is dominated by the run up to May's Presidential election* ...... the high level of taxation and regulation is an issue but there are some very 1970's policies being put forward. Although one tends to look at the eurozone as a whole, very destructive French economic policies in the areas of taxation and protectionism, for example, could make their mark on the French equity market.

- *Italy's short term economic performance has improved* ...... but the resignation of Romano Prodi, if only briefly, re-ignites old worries about Italy's political stability, very important in the context of a very high level of overall public debt in relation to GDP and the need for structural reform.

UK

- *2006 was a good year for economic growth* ...... growth accelerated in the fourth quarter to 0.8% to give a full year figure of 3.0%.

- *A further interest rate rise is likely* ...... concerns about inflation remain and the Bank of England's quarterly inflation report indicates that its 2% inflation target would probably be overshot if interest rates were not raised again in line with market expectations. Although off its recent peak, the formerly used Retail Price Index still stands at 4.2% and this is often used as a marker in wage negotiations.

- *The property market, in certain areas, is a bubble* ...... there is some tentative evidence that the interest rate rises are beginning to have an effect but it is too early to be sure. The buy-to-let market looks vulnerable.

- *Government finances remain a problem* ...... the Treasury has consistently been too optimistic on the level of borrowing and it looks as if it is going to happen again this year. The danger is that there is no leeway if economic conditions deteriorate in the UK.

Summary

- *There are bubbles in world financial markets* ...... not in shares but in such areas as "carry trade", low grade bonds and certain areas of the property market.

- *Some of these bubbles may unravel* ...... but we think they can largely be isolated from mainstream equity markets.

- *The international economic outlook appears satisfactory* ...... long term investors should concentrate on this and not be distracted by short term volatility.

As we see from the data, equities have enjoyed a positive quarterly performance whilst bonds have weakened. This is not surprising. For a long time, we have considered bonds to be overvalued in absolute terms and relative to equities. Even though, by historical standards, inflation is relatively subdued, bond yields in most markets leave no room for disappointment. Partly, yields are so low for particular reasons such as regulatory pressure in the UK. Gilts with nearly fifty years to go to maturity offering a gross redemption yield of just over 4% are almost certain to be a very poor investment, yet that is what we see at present. On pure investment grounds, selling good quality equities to buy such investments cannot be right and, of course, by leaving shares cheap, we have the paradoxical situation of large UK companies being a target for foreign cash bidders. So, one of the features of the quarter has been a trend to rectify the extreme valuations of bonds against equities.

A parallel theme has been the very low volatility of equity markets until right at the end of the quarter and increased investor appetite for risk. Confidence is returning to the equity markets which have now seen around four years of rising equity prices, admittedly from a very low level. The very comforting fact for equity investors in many markets is that corporate earnings have risen so fast over this period that share ratings have not expanded. But, elsewhere, there are signs of bubble conditions. We have mentioned bond markets above where we were really considering top quality issues such as those detailed in the table at the beginning of this review. In their search for yield, some investors have bid down lower quality issues to yield levels that look foolhardy. Certain areas of the property market in many countries look very expensive. Speculation in the currency markets, with the "carry trade" on the yen being a case in point, is rife, although recent volatility may shake some investors out of their over confidence.

Certainly, economic conditions look benign and they will be a determinant on the course of equity and bond prices but, with such conditions, there will be ways to benefit and ways to risk losing money. Let us look at the latter first and, in particular, the yen "carry trade".

Although the Bank of Japan has just doubled interest rates to 0.5%, yen interest rates remain significantly below those elsewhere and, for many investors, borrowing in yen to invest in higher yielding assets in other currencies has seemed a blindingly obvious way to make money. The low volatility in markets and the accompanying higher risk appetite has made it seem a one-way option. But this strategy carries a high degree of risk should sentiment in the foreign exchange market turn round which, at some stage, it will do. It may even have done so already. After all, there are reasons which would support a stronger yen such as the current account surplus. Besides foreign and domestic sales of yen for "carry trade" purposes, the Japanese are investing significant sums overseas. The weakness of the yen, which has been one of the main economic talking points, is due to market forces and not currency intervention. But those thinking that they are on to a one-way bet by indulging in "carry trade" activity may be in for a nasty shock which could result in many investors experiencing significant losses. Although it is very comforting when one experiences a period of calm and low volatility in markets, the complacency, which can result in undue risks being taken, has to be watched. It may be that the volatility of the last few days, which has led to some unwinding of "carry trade" positions, marks a turning point.

Because we still believe that equities offer value, we have been much more comfortable with their gradual upward movement, compared with what has been going on in some other asset classes. The rise in corporate earnings has often more than kept pace with share prices as company profits have reached record levels. But shareholders will have taken a great deal of additional benefit from moves to unlock shareholder value. Takeovers and other aspects of corporate activity have been a feature of markets and these tend to be positive for share prices, both in respect to actual deals but also those which may be rumoured. Again, one has to watch feverish speculation here but we have probably not reached this stage yet. One structural change which is positive for this trend towards heightened M & A activity is that barriers to takeovers in Europe are, in some cases, coming down. Two examples show what we mean. Until recently, it would have seemed very difficult for the UK airports operator, BAA, to be taken over with the government having a golden share. As these were outlawed by the EU, such a takeover became possible. In Spain, the giant utility, Endesa, looked as if it was going to be acquired by the German company, E.ON. This was despite vigorous opposition from the Spanish government. The EC looks as if it is going to win this battle to break down protectionist tendencies although the issue has been clouded by the acquisition of a significant stake by Enel of Italy. However, protectionism is rife in Europe and France will be a far harder case to unlock, partly because of the politics there. But, if previous untouchable companies can become available, consolidation in Europe will gather pace. Despite all the protectionist leanings in Europe, we view the likelihood of strong M & A activity continuing as quite high and positive for markets.

However, other management activity to bolster shareholder value continues apace. We continue to see pleasing dividend growth. This is the long term reason why we buy shares. We also see other ways of returning value to shareholders such as special dividends, returns of capital and share buybacks. Some are sceptical about the value of the latter but they do make shares scarcer and, if undertaken on the right terms, are earnings enhancing. We favour them and, if they act as a discipline on management to weigh up the value of the action against other alternatives, so much the better.

A fascinating piece of research by Citigroup into returns of shareholder value was cited in the Financial Times in February. It reported that, since 2003, £118 billion has been returned to shareholders through buybacks and special dividends. According to Citigroup's research, this represented 63% of total dividends paid during the period. The relative figures were not greatly different for Europe with the percentage being 56% and the amount returned 292 billion. Interestingly, pay out ratios have fallen. Whilst it is estimated that there has been a doubling of corporate earnings in Europe since 2003, dividends have only risen 45%. The respective figures for the UK are given as 55% for earnings growth and 30% for dividend growth. It is said that pay out ratios are at a fifteen year low in Europe and at an all time low in the UK.

Politics is never far from the surface when any section of the investment community is doing well. In the UK, this is currently seen in the area of large City bonuses which is not part of the remit of this review to discuss except in so far as any action which adversely affects the City of London will affect the UK economy and that might be an investment factor.

However, what we are talking about here is the political criticism, not only in the UK but in Europe also, of private equity. In the UK, for example, some trade unions have become very vociferous in their criticism of private equity. As we said, it is not our job here to get into the realm of politics except in so far as it becomes a stock market factor. From an economic perspective, we can say that, if private equity deals lead to more efficient companies, it is likely to be a long term positive for a company. If, on the other hand, the quest for excess returns leads to risks being taken, for example with the excessive leveraging which, perhaps because of rising interest rates, leads to a collapse, then the effect is malign. To some extent, that situation occurs with any takeover although the extent of any problem will depend upon how it is financed. In the case of private equity, the risks could be higher. One call for action from those who are critical of private equity is for interest charges to cease to be a tax deductible expense. This would put private equity on a different footing to the rest of business and would cause a market distortion. If applied retrospectively to existing private equity deals, it would cause serious trouble and, if applied to future deals, they would mostly dry up. Other things being equal, the UK equity market would be likely to be lower than it would otherwise have been because there would be fewer takeovers or speculation about takeovers.

During the quarter, in February, an example of where politics may impinge on the stock market occurred in France. One of the candidates, Segolene Royal, has made proposals, which whatever their political merits, seem likely to have negative short and long term consequences, if enacted. In the field of business, for example, placing "an exceptional tax on the super profits of oil companies", tax firms more on dividends and less on reinvested profits and re-nationalising EdF and Gaz de France as a single utility are not likely to engender investors' confidence in France. Because of onerous personal taxation, France is losing many able people and part of its tax base and there is nothing in the manifesto which is likely to reverse this trend. Ultimately, this is not good for the French stock market and investors and economists note how France has been losing economic ground to Germany. Of course, Segolene Royal may not win the Presidential elections but this is the type of political issue that investors do have to note and consider in their investment policy.

One general issue for the eurozone, which we have discussed in recent months, is the 3% increase in VAT introduced in Germany at the beginning of January. This was a big increase and some customer activity was obviously brought forward to avoid the increase, but the early evidence is that the momentum which was apparent in Germany in 2006 has enabled the country to withstand much of the negative effect. Because of Germany's position as the largest eurozone member, this is crucial. One of the encouraging aspects of 2006 is that growth in the major industrialised countries has become closer together. Such a feature is of some help in reducing the imbalances between the USA and other major industrialised countries. One reason for the very large US current account deficit is the superior growth rate which it has experienced compared with most other major industrialised countries. As a result, it has attracted an increasing level of imports. Although it is early days in 2007, the performance of the eurozone and Japan (as we shall see later) offers some macro-economic comfort.

Although the oil price has been moving upwards towards the end of the quarter, it has still ended it slightly lower than at the end of November. The world economy has absorbed remarkably well the sharp rise in the oil price although, as we have often noted in previous reviews, the relative importance of oil is less than it was in the oil price spikes of the 1970's and 1980's. The steadiness of the oil price in the last quarter has been helpful background support to the international equity market.

We talked earlier about investors' heightened appetite for risk which went side by side with very low levels of volatility in markets. Yield differentials in the bond market, for example, between lowly rated bonds and top quality ones have been compressed dramatically as investors have chased return in a low interest rate environment. One reason why investors may have felt confident about increasing the risk profile of their bond portfolios is the very low level of defaults which have been seen. The Financial Times of 23 February, for example, reports that, in 2006, Moody's Investors Services said that only 1.57% of all junk rated debt defaulted compared with 1.8% in 2005. This represents the lowest level since 1981 according to Moody's. However, and this makes the point we are talking about, Moody's warns that the default rates would almost double to 3.07% by the end of this year. Moody's also warns that the historical average of 4.9% could be breached over the next two years as the quality of junk issues in the sector declines. This just emphasises the point we are making that, in certain sectors of the investment world, excessive risk is being taken. We would pinpoint some areas of the bond market as one example and the quarter-end volatility in markets will have brought the risks home to some investors.

One item of news that caught our attention in February which possibly has long term significance is the tentative move by China to manage its vast foreign exchange reserves more actively. China's foreign exchange reserves have been growing rapidly as a result of the country's ever increasing current account surplus and now stand at over US$1,000 billion - larger now than Japan's reserves. The Financial Times reported in the middle of February that consideration was being given to the establishment of a US$200 billion global investment fund. It is only a tentative suggestion at present and agreement needs to be reached but, if this were to happen, it could have a significant influence on securities' markets. In its report, the Financial Times drew the analogy with Singapore's Government Investment Corporation. It will be interesting to see how the debate within the Chinese hierarchy develops on this issue but it could be significant.

It is relevant also to discuss longer term issues concerning the euro as a result of two recent events, the politicising of the ECB's role as part of the French Presidential election campaign and the resignation of the Italian Prime Minister, Romano Prodi, after losing a foreign policy vote in the Senate. The French Socialists want to change the role of the ECB to make it more susceptible to political control. It is unlikely that this will happen but it would serve to undermine the credibility of the euro and, almost certainly, by pushing growth up its agenda, would ignite inflationary fears. As we have often indicated, we are not confident about the long term future of the euro because we believe that the "one size fits all" policy is not sustainable. The political problems in Italy, where there are chronic economic issues surrounding the overall level of public debt and loss of economic competitiveness, mean that economic reform and the actions which are necessary to secure the direction of the Italian economy are going to become even more difficult. Both within the EU, where it can no longer devalue its currency, and against non EU competitors, where the strength of the euro is unhelpful, Italy faces difficult problems which could, in due course, become the eurozone's problems.

We turn now to look at individual areas of the world, starting with the USA, where the latest figures show economic growth to have been weaker in the final quarter of 2006 than suggested in earlier estimates, the annualised rate being 2.2% compared with an initial estimate of 3.5% and this compares with 2.0% in the third quarter. The stock market had earlier reacted well to the statement by the Federal Reserve, following the decision not to change interest rates from their 5.25% level. The Federal Reserve was more positive on growth and inflation than it has been at its December meeting. It remained very vigilant on inflation noting the high level of resource utilisation which could have inflationary consequences. Its references to the housing market, a key source of uncertainty amongst economists, were very wary referring only to "tentative" signs that the housing market could be stabilising. It thought that the US economy would expand at a "moderate pace over coming quarters". When the minutes of the January FOMC meeting were published towards the end of February, the caution and wariness on inflation were well documented. The minutes noted that "participants did not yet see a downward trend in core inflation as definitively established". They did consider a gradual decline in the core inflation rate as the most likely outcome, very much hedging its bets whilst leaning slightly to the optimistic view of inflation. The uncertain effect of oil price movements is one major cause of uncertainty.

One of the important events in the economic calendar to which investors pay a great deal of attention is Ben Bernanke's semi-annual testimony to Congress, which occurred in February. Investors liked what they heard. In terms of economic forecasts the Federal Reserve's forecasters suggested a central tendency for economic growth in 2007 to be 2.5% - 3.0% and for 2008 to be 2.75% - 3.0%. The Federal Reserve's preferred measure of inflation was forecast to be in the range of 2.0% - 2.25% in 2007 and 1.75% - 2.0% in 2008. The central tendency for inflation forecasts this year is slightly above its preferred upper limit of 2% but next year's forecast would bring it just under the top of its preferred range. The testimony was about as good as it gets for investors, giving them the feeling that Mr Bernanke sees the US economy growing at a sustainable rate within acceptable inflation boundaries. Of course, the words have to be hedged very carefully but his pronouncements seem to be less delphic than those of his illustrious predecessor, Alan Greenspan. Where the main area of caution in his testimony lay was in the area of resource utilisation. The labour market shows some tightness as Beige Book reports observe. The Federal Reserve expects unemployment to remain low this year and next, in the 4.5% - 4.75% range. If demand rises sufficiently to raise capacity utilisation above its effective full level or places further pressure on the labour market then the risk to inflation is clear. The Federal Reserve will be looking at the level of demand to see if it poses an inflationary threat. But, overall, it is hard to believe that investors could be much better pleased by Mr Bernanke's testimony.

In respect of risks to inflation caused by strong demand, investors can draw some comfort from the latest productivity figures which were better than the earlier ones of 2006. In the fourth quarter of 2006 productivity growth came in at an annualised 3.0%. There had been a negative reading of -0.1% in the third quarter and the full year's productivity growth was 2.1% compared with 2.3% in 2005. However, the fourth quarter figures were more encouraging because productivity growth rose faster than unit labour costs, 3.0% annualised against 1.7%. Figures are erratic but there is some modest comfort from these figures in the context of the Federal Reserve's concerns and possible threats to US inflation.

Therefore, on the evidence currently available, the best guess is that growth is strong enough not to cause the Federal Reserve to reduce interest rates but that inflation is sufficiently contained to preclude an interest rate rise. So no change in US interest rates for some months is one's best estimate at present. The threats on the upside surround strong demand producing an inflationary pressure on resource utilisation - i.e. the labour market, mainly and, on the downside, the housing market being weaker than expected and having a knock on effect on the rest of the economy.

In terms of inflation, core prices rose by 0.1% in January. The producer price index fell by 0.6% in January as a result of lower energy prices and, stripping out food and energy prices, it was up 0.2%. The core consumer price index rose by 0.3% in January (a little higher than expected) whilst the headline figure rose by 0.2%.

Those who are negative about the USA's short term economic prospects tend to concentrate on the weakness of the housing market. So far, it appears not to have spilled over into the rest of the economy and, from the nuances of the Federal Reserve's statements, it does not appear that it is high on their concerns relative to, say, excessive demand causing inflationary pressures. Recent figures have probably been influenced by good weather in the USA which might have flattered recent months' figures to the detriment of ones at the beginning of 2007. The January figures were weak with housing starts falling by 14%. More positively, there was only a modest fall in building permit applications which is considered a good guide to future trends. Before a substantial upward trend can be seen, the large inventory overhang of unsold houses will have to be cleared. Sales of existing homes rose by 3% in January which was the biggest rise for two years but there was a 17% drop in sales of new homes in February. The median price of a new house fell by 2.1% in January compared with a year earlier. So it may be towards the end of the year that housing starts begin to recover. One issue has begun to surface recently in the USA which is the problems incurred by sub-prime lenders as defaults rise. This, too, could be an influence on the housing market. But, overall, the early weeks of 2007 do not suggest that the housing market is going to derail the US economy but, on the other hand, it is not going to give it any impetus until much later this year.

Short term news has been mixed. The Chicago purchasing manufacturers' index fell to below 50 in January and the ISM's latest manufacturing index for February rose to 52.3 from 49.3. However, personal incomes were robust in January, rising by 0.5% and this is relevant to the Federal Reserve's concerns about excessive consumer demand leading to inflationary pressures. The employment market, another indicator which the Federal Reserve is watching, also remains firm. Although the addition of 111,000 jobs in January was below expectations, there were previous months' upward revisions which left an overall impression of firmness in the job market and is consistent with the forecasts which we noted earlier from the Federal Reserve.

Helping sentiment in the US equity market is the continuing flow of corporate deals. Whilst short term interest rates might be described as being at around neutral levels, they are not at a level which will deter most bidders; longer term interest rates are still historically low. So, as this is written, the largest private equity deal looks like it may take place in the USA as KKR and Texas Pacific Group make an US$44.5 billion bid for the US utility, TXU. Whilst the world economy is performing strongly and interest rates are no more than historically low or neutral, bidders have the confidence to do such deals. We are seeing a backlash against private equity bids, particularly in the UK and Europe, and it remains to be seen whether politicians are influenced by trade union pressure in those areas. This does not seem to be such an issue in the USA but with the Democrats more confident after they gained control of Congress, it could, too, become an issue in the USA. For the moment, M & A activity is likely to provide a positive catalyst to the US market.

Although US corporate earnings growth is slowing down after a long period of very strong growth and will almost certainly be in single figures this year, it should provide solid support for a market that does not seem expensively rated.

Japan has attracted a lot of attention recently because of the weakness of the yen, continuing "carry trade" activity and the speculation over interest rates. It will be recalled that, until the last moment, January's Bank of Japan rate setting meeting had been expected to raise interest rates. At the last moment, speculation increased that there would be no change in interest rates and that speculation, informed or not, turned out to be correct as the Bank of Japan board voted 6-3 to keep interest rates at 0.25%. However, in February, the vote was 8-1 in favour of raising the interest rate from 0.25% to 0.5%. Although a doubling of interest rates might sound dramatic, it means very little when we are dealing with such a low interest rate, and the difference between Japanese interest rates and, say, US dollar, Australian dollar and New Zealand dollar interest rates remains very substantial. Although foreigners have recently been strong buyers of Japanese equities, the "carry trade" has seemed for many investors and speculators an almost riskless deal. Very low levels of volatility in currency movements have made borrowing in yen and investing in higher yielding currencies seem a "no brainer". This, of course, is wrong. Yen weakness is accompanied by a Japanese current account surplus, something like 4.5% of GDP. Although capital flows dwarf current account movements, there is the probability that the yen will snap back at some stage causing some serious losses. Japan has not been intervening to hold down its currency, while some countries in Asia have done just that to remain competitive, China being a prime example with its previous fixed link to the US dollar, now slightly loosened. With deflationary conditions in Japan having obtained until recently and having not really gone away, nil or minimal rates of interest still represented a real rate so Japan could not be accused of manipulating the currency by artificially depressing interest rates. The weak currency has made Japanese companies very competitive and we have seen excellent profit growth from many of them. In terms of the currency, it will be interesting to see how far the "carry trade" unwinding takes the yen on its recovery path.

Whilst most governments and central banks fret about inflation, the opposite is true in Japan. Getting rid of years of deflation is proving to be a real challenge. The headline consumer price index is just positive at 0.2% year on year but, excluding energy and fresh food, it is negative. Yen weakness has not made much difference so we are witnessing a very unusual situation of significant currency weakness impacting on inflation. It is a wonderful situation for many companies.

Because the headline consumer price index could go back into negative territory, if energy prices fall, the rise in Japanese interest rates to 0.5% could be an embarrassment to the Bank of Japan. Although Japan has had four years of economic recovery, consumer sentiment is still brittle, scarred by what has happened in the past, and it has to tread carefully in its quest to restore what, in most countries, would be considered a more normal monetary policy. But the difficulty of moving out of a deflationary environment has led to some politicians to call for a stay on any interest rate rises and there was suspicion that January's surprise decision not to raise interest rates was influenced by political pressure.

However, positive news on Japanese growth in the final quarter of 2006 will have encouraged members of the Bank of Japan's board to press ahead with its second interest rate increase. Growth in the fourth quarter was 1.2% higher than in the third quarter of 2006 to give annualised growth of 4.8%. Personal consumption grew at an annualised rate of 4.4% following a 4.2% fall in the previous quarter. However, the Bank of Japan has indicated a very cautious view about future interest rate increases, indicating that they would be "very gradual" and that monetary policy would remain "extremely accommodating". That was all the "carry trade" investors needed to hear but it does not alter the fact that they are taking a major risk which they might now be realising. In its statement, the Bank of Japan also alluded to this phenomenon, being concerned that "sustained economic growth will be hampered by misallocation of funds".

This combination of a weak currency and very low interest rates has been good for many large Japanese companies and this is reflected in a strong performance by large companies on the Japanese stock markets. For the moment, gains have been pared for foreign investors by the currency movement but their heavy investment in the Japanese stock market recently reflects an appreciation of the attractions of the market. The prospect continues for reasonable economic growth in the economy and an accommodative monetary policy provides a positive background for Japanese shares.

We now turn to Europe where economic growth in 2006 provided a pleasant surprise and this year is shaping up quite encouragingly, too. The eurozone grew by 0.9% in the fourth quarter of 2006 according to a first estimate from Eurostat. This figure compared with 0.5% growth in the third quarter. For the year, growth was a very acceptable 2.7%. Fourth quarter growth was helped by another good performance from Germany, which grew 0.9%, and by a recovery in France where a standstill in the third quarter was followed by growth of 0.6% - 0.7% in the fourth quarter. The better than expected outcome for 2006 and the momentum which this has brought with it has raised expectations for this year. The EU monetary affairs commissioner has raised his forecast for EU growth this year to 2.7%. For the eurozone, 2.4% growth was forecast. He credits this encouraging state of affairs to investment and reviving customer demand. Amongst the caveats he mentioned were the risks of global imbalances and oil volatility. The weakness of the yen is also mentioned as it has been a problem for European exporters. Both forecasts for the EU and eurozone were 0.3% higher than the forecasts made last November. His individual country forecasts were for growth in Germany of 1.8%, Italy 2.0%, the UK 2.7%, Spain 3.7%, Poland 5.0%, France 2.2% and the Netherlands 2.8%. Importantly, the forecast for eurozone inflation was reduced from 2.1% to 1.8%.

The stronger than anticipated economic outlook for the eurozone will give further encouragement to the ECB to raise interest rates. A disappointment for the ECB is that, since the introduction of the euro, inflation has consistently been above target. One worry for policy makers has been the effect of the German 3% VAT rise on 1st January. So far, it does not seem to have had as much effect as feared. January's eurozone inflation rate was 1.9% but output prices were at their highest level since they started being monitored in 2002. Heavy hints have been dropped that the ECB will raise interest rates in March. After February's ECB meeting, the ECB President, Mr. Trichet, said that it was exercising "strong vigilance" and gave a strong warning about inflation gathering pace later on.

One thing which is likely to worry the ECB is the wage bargaining position in Germany. After a long time of pay restraint which has helped to restore some of Germany's competitiveness and enabled exports to thrive and the economy to expand fast in 2006, trade unionists and some politicians are calling for substantial pay rises. This is not what the ECB wants to hear and the course of wage bargaining in Germany this year will be closely watched by the ECB and, depending upon the outcome, could be an influence on eurozone interest rates. Mr Trichet referred to pressures on capacity utilisation which is approaching 2000's peak. All the indicators from the ECB's statements and body language suggest at least one more interest rate increase, almost certainly in March, and probably more.

Although it varies by country, most of the news from the eurozone has been positive so far this year. Unemployment fell to 7.5% in December, the lowest since records began in 1993. Although it fell slightly from 56.5 in December to 55.5 in January, the NTC purchasing manufacturers' index was still strongly in positive territory. Germany's reading was particularly strong but there were weaker trends elsewhere. NTC's semi-annual business outlook survey also struck a positive chord. Overall, European manufacturers are more optimistic about raising output, profits and employment this year than they were a year ago. They are also more confident about being able to raise prices, something the ECB will note, as capacity utilisation rises. One of the fundamental weaknesses of the euro is that the "one size fits all" interest rate policy is not suitable for all the countries in the eurozone because conditions differ. What the NTC business outlook survey highlights is that conditions and expectations differ quite markedly. French manufacturers, for example, are quite pessimistic. Relative to Germany, France had a poor 2006. France has been losing ground internationally. Its share of world trade has been falling. Only 17% of French manufacturers are expecting higher sales this year than last, whereas, in the Netherlands, the figure is 80%. Although the eurozone has serious structural rigidities which limit its growth potential, say, against the USA, its short term prospects are more encouraging and we think should continue to be reflected in another satisfactory performance for European equities this year.

In Germany, the government has raised its forecast for economic growth this year to 1.7% compared with 1.4% previously. Forecasts for this year had been lowered because of the possible effect of the 3% VAT increase on 1st January. However, early indications are that its effect has not been as bad as had been feared. It also expects the number of job seekers to fall below 4 million this year as the economy grows. January's unemployment figures showed a seasonally adjusted drop of 106,000 to bring the unemployment figure down to 9.5%. There was a positive adjustment to December's figures to 130,000. Overall, in the fourth quarter, 452,000 more people were in work than a year earlier. Probably in advance of the VAT increase, consumer spending rose by 2.4% in December. This has been a weak spot in the German economy even though, overall, it performed well in 2006. The Ifo business confidence index fell slightly in February to 107.0 from 107.9 in January but this is a minor decrease and the overall level is still encouraging. On the negative side, there was a slight decline in industrial output in December, down 0.5%. We touched earlier upon how the ECB would be watching the progress of pay negotiations in Germany when setting interest rate policy. In this respect, IG Metall is seeking a 6.5% pay rise in the engineering and metal sector which it said was justified on social and economic grounds. The employers' body said it would "decisively oppose" the claim. Unemployment continues on an improving trend with a fall of 79,000 in February to give an overall unemployment rate of 9.3%, still very high but not as bad as it was. Because of the grand coalition in Germany, political tensions are never far from the surface and one of the current ones is a revolt within the SPD about proposed corporate tax cuts.

In many ways, the most interesting country is France in front of the forthcoming Presidential election. France is not a confident country at present and, as we saw above, the French economy grew at a slower pace than Germany last year, the first time this has happened since 1994. France's distinctive social model does not stand up well in the modern world, rendering the country increasingly uncompetitive. A high tax, high spend, heavily regulated economy, cannot compete against freer ones. Profits and wealth are widely despised in France and this attitude is contributing significantly to the country's economic problems. It is symptomatic of what has happened to much of the talent in France that Mr Sarkozy opened his campaign in London where many French people have moved to in order to enhance their opportunities. Business leaders have warned that, if Ms. Royal is elected President in May, many people in the financial and biotechnology sectors will leave France. The tax base is gradually being eroded by the loss of people paying the wealth tax. According to a Senate Finance Committee report, France loses two people each day in this category, contributing to a 2.2 billion loss of taxable assets for the government in 2005. Her manifesto is very 1970's, with tax and spending programmes which are at odds with what is happening elsewhere in the world. The plan for "an exceptional profit on the super profits of oil companies" to fund public transport is an example of populist politics which may play well to a certain audience but does nothing to encourage businesses to invest in France. In a reference to the problems which France already faces as a result of excessive red tape, the French Trade Minister said this is preventing small and medium sized companies from exporting as much as their German rivals. He was speaking in the context of the biggest French trade deficit for 25 years, 29.2 billion. Germany's recent surplus, by contrast, was 162 billion.

It is very difficult to know where this will all end for France. As we have touched upon, it is losing economic ground rapidly to its arch rival, Germany, where there has been a greater sense of realism about the challenges facing it. As we have noted, 2006 has been a much more successful year than expected for the German economy and it appears to be addressing successfully some of the challenges facing it. It is difficult to say this about France. Although it is a relative term, Mr Sarkozy is more of an economic liberal but, even if he were to win, he will face strong vested interests opposing change.

At the individual level France, like Germany, has world class companies, well diversified geographically, and the negative concerns expressed above about France's loss of competitiveness do not apply to individual companies. Indeed, if the EC manages to curb France's protectionist instincts, which sees it protecting certain national champions, the country could see a lot of M & A activity. A prelude might be the pressure which the EC placed on Spain to lift or modify conditions which made it difficult for E.ON to buy Endesa in the face of an original preferred Spanish solution. It looks as if the EC has won, even if E.ON does not gain control, but France will be a more difficult challenge. May's election will be very interesting and important in determining the way ahead for France.

Whilst the decline in France's relative economic performance has been clear, perhaps the most immediate problem for the eurozone is Italy. Italy is notorious for the frequency with which its governments fall, though Mr Berlusconi ran the full term, and the resignation of Romano Prodi after a foreign policy defeat in the Senate is of concern. Italy badly needs major structural reforms to enable it to boost its potential growth rate and its competitiveness which has suffered as a result of being in the eurozone. It no longer has the option to devalue. It has a very high level of public debt as a percentage of GDP, over 100%. An uneasy coalition covering a wide spectrum of political parties has made governing Italy very difficult and, although some progress has been made in freeing up the economy, a lot more needs to be done. Raising taxes has been an easier option than cutting public spending as a way to address the budget deficit and that is not the current way to tackle the problem. Even if Mr Prodi manages to reunite his coalition and restore the status quo before the Senate defeat, the fractious coalition will make it very difficult for Italy to progress its reforms.

That said, short term economic prospects for Italy have shown some improvement. Last year's growth rate of 2.0% was the best since 2000. The EC has raised its growth forecast for Italy this year also to 2.0%. Although the budget deficit was 4.4% of GDP last year, it was inflated by special factors such as the VAT refund the European Court of Justice ordered the government to give to company car owners. The forecast this year is 2.8% and the overall public debt level, as a percentage of GDP at 107.6%, is far too high.

We have commented before on the relatively low yield differential between German and Italian government bonds. Currently, if we take ten year government bonds as a benchmark, the yield differential is 23 basis points. Given the rating differential AAA against AA-, that is surprisingly low. One gets the feeling that some investors regard euro denominated government bonds as nearly on a par with each other. Given wide differences in debt levels, that looks too sanguine an approach.

Spain is a particularly interesting country to analyse within the eurozone. At the corporate level, its companies have been very active acquisitors of overseas assets. For example, in the UK, O2 was taken over by Telefonica and BAA by Ferrovial. The Spanish banks have also been active overseas. The Spanish economy has been a major success story showing strong growth. However, asset prices have risen substantially - we are thinking here of property ; and interest rates, because of Spain's membership of the eurozone, are below the level they would be if Spain was able to run its own monetary policy. The result has been some overheating of the Spanish economy as evidenced by a very large current account deficit, around 10% of GDP. In a recent interview, the Spanish finance minister expressed some optimism about prospects. He pointed to a sharp rise in capital investment which would be a help in reducing bottlenecks which would normally be an inflationary factor. The finance minister pointed to a deceleration in the pace of house price increases and a slowdown in consumer spending. He expected growth levels to settle down at nearer 3% than 4%; the figure for 2006 was 3.9%. He saw some rebalancing of the economy away from the booming construction sector towards tourism, agriculture and services. Spain is a very interesting test of the eurozone because, with a free standing currency, the level of current account deficit which it is running, would almost certainly have led to significant currency weakness and rising interest rates. When the currency cannot move against other eurozone members, inflation will gradually reduce competitiveness and growth will slow and unemployment rise. That is the challenge facing Spain. Fast growth and a lot of corporate activity has made Spain a very profitable market in which to be invested. We should not, however, take our eye off the economic challenges which it faces which are different to those of Italy.

In the UK, the rate of economic growth accelerated slightly in the final quarter of 2006, 0.8% against 0.7% in each of the previous three quarters, to give full year growth of 3%. Drivers of growth in the final quarter were household consumption (+1.0%) and investment (+2.5%) but trade (-0.2%) was a drag.

Quite a fast growth rate like the 3% achieved last year brings with it inflationary concerns and the general expectation remains that there will be at least one further interest rate increase in the UK in the near future. At the February meeting of the MPC, the vote in favour of leaving rates unchanged following the surprise increase in January was 7-2, the minority of two favouring a further interest rate increase. The minutes of that meeting, published in late February, made interesting reading. To raise interest rates again might be seen to represent "excessive tightening", according to the majority. They saw little movement in pay settlements although there have been some high profile settlements of around 4% in the private sector and there are capacity constraints evident in business and the labour market. The majority wanted to see what would be the effects of recent interest rate rises. But the two hawkish members may have their day. They argued that "the degree of policy tightening since August was still modest relative to the rise in inflation .... ". They also referred to further inflation risks from business being willing to raise prices and heightened inflationary expectations. Earlier on, the Bank of England's quarterly inflation report had indicated that its 2% inflation target would probably be overshot if interest rates were not raised again in line with market expectations. The Bank of England indicated that, if interest rates remain at 5.25%, the chances of inflation rising above 3% over the next two years was 18%.

We might now look at some of the indicators of inflation or contributions to inflation at present. The latest Consumer Price Index showed a fall from 3.0% in December to 2.7% in January. The sharp month on month fall of 0.8% was largely a direct or indirect result of lower fuel costs. The Retail Price Index, the former measure and one to which a lot of attention is paid in wage negotiations, was down from 4.4% to 4.2%. Import prices also benefited from lower energy costs. Seasonally adjusted input prices fell by 2.0% to give a year on year decline of 1.6%. Of course, energy prices are volatile and unpredictable. As this is written, the oil price has been rising so we may expect at least a short term reversal in these trends. Output price inflation was 0.3% higher in January than December with the year on year figure at 2.1%. Although the Consumer Price Index is now the government's chosen measure of inflation, the Retail Price Index, which includes housing costs, has a lot more credibility with many people and it must be disturbing that it is still above 4%.

The latest official figures for wage inflation do not include some of the high profile 4% + awards (British Airways, for example) but, for the final quarter of 2006, average earnings, excluding bonuses, rose by 3.7% and, including bonuses, they rose by 4.0%. The EEF reported fairly modest increases despite the tight employment market. It said that, for the three months to the end of January, annual pay settlements averaged 2.9%. A big test is to come in the public sector where the government is seeking to keep down pay awards. The jury is out on this issue but obviously the MPC will be watching it closely. It has other sources of information. For example, the Financial Times reported that Incomes Data Services said that the median level of annual settlements has risen to 3.5% during the three months to January, a high figure by recent standards. Income Data Services reported that the last sustained period when settlements were at or above this level was 1998.

Asset price inflation is also an issue which will affect the MPC's interest rate deliberations. Although the stock market has shown a substantial recovery since its low point four years ago, the MPC is unlikely to be concerned about share prices because they do not look expensive. Property is the issue which will concern it, in particular price movements in the residential housing market. An acceleration in house price growth is likely to be a strong factor contributing to further interest rate increases. The latest FT House Price Index for January shows a 0.7% increase over December and a 6.9% year on year increase. According to Rightmove, average asking prices for houses and flats rose at an annual rate of 11.5% in February compared with January's 13.5%. Different indices provide a range of answers but there is some evidence of previous interest rate rises having some effect; it is early days, though. However, the potentially unstable state of one area of the market, the buy-to-let market, shows an area of vulnerability for the economy. This is an asset class where there is undoubtedly a bubble. The Council of Mortgage Lenders reported in February that, in 2006, 11% of all lending was to buy-to-let investors. The amount involved was £38.4 billion and represented a 57% increase over the previous year with the trend accelerating in the second half. Furthermore, lenders have been prepared to raise "loan to value" ratios from 75% to 85%. In a set of circumstances including rising interest rates or a weakening economy, this bubble looks potentially dangerous for lenders, borrowers and the economy. This is why the MPC will be concerned to ensure that its interest rate policy is robust enough to stop this market from getting out of control. In a different way, what is happening in the USA provides a warning.

Although the economy showed strong growth in 2006, public finances remain a concern given the level of growth which has been experienced. They should be in much better shape than they are and official forecasts have consistently underestimated the scale of borrowing. Although one month's figures should always be treated with caution, the current budget deficit level so far this year is running at a higher level than last year and well above the level forecast for the whole year. Whether or not the figures so far are representative of what will happen in the full year, which has two months to run, what is not in doubt is that, if the UK economy hits stormy weather, there is no leeway to stabilise the economy by loosening fiscal policy. If a surplus were being run, which would be a desirable position after a run of good growth, then fiscal policy could provide an offset to deteriorating economic conditions. That option is not now available and some unpleasant decisions could have to be taken in the event of a deterioration of the UK economy.

For the moment, though, most of the short term news is positive. The CIPS / RBS index of manufacturing activity rose slightly in January to 52.8 from 52.0. Positive features of the report were widespread production growth, increased plant efficiency, higher productivity, stronger orders from domestic sources and from Asia Pacific and, to a lesser extent, the USA, and higher unemployment. There was evidence, however, that exports to the USA were being affected by the strong pound. A similar survey for the services sector showed that, although the index was down slightly in January against December, it was still at a high level, 59.2.

It showed evidence of some price inflation with an increase in the prices charged index to 55.2 in January from 53.4 in December. Although industrial production fell by 0.1% in December, that was due to special factors, a mild winter and higher fuel imports. Manufacturing itself showed a small rise of 0.2%. The CBI reported in February that order books were at their highest level for twelve years. In the retail sector, the British Retail Consortium reported sales up 5.2% on a year ago.

We mentioned that private equity had come into the political arena with attacks on the industry by certain trade unions and politicians. Takeover bids have been a support for the stock market. The main focus of the attacks appears to be on the tax relief which borrowings attract with some suggesting that, for these vehicles, tax relief should be disallowed with a 'quid pro quo' for business being lower corporate tax. It would obviously be very dangerous to change the rules for existing deals and that seems unlikely. Because the government rightly values the contribution of the financial services industry to the UK economy, it looks unlikely that anything material will be done to the disadvantage of the sector. Nevertheless, this cannot be taken for granted.

Turning to China, we mentioned earlier in this review the interesting news, with significant potential, about the possibility of a global investment fund being established from part of the country's vast financial reserves. In the short term, the authorities, quite rightly, appear intent on ensuring that the economy does not overheat. The central bank has reported that consumer expectations for inflation are at their highest since 1999 (the year on year rate in December was 2.8%). In February, the central bank raised banking reserve requirements a second time by 0.5% to 10.0%. The aim is to restrain lending for property and fixed asset investment. Overall, strong Chinese economic growth is set to continue with many benefits for the world economy. Although, as this is written, markets are jittery because of a sharp one-day fall in the Chinese stock market after a sharp run up, sustainable Chinese growth is a much more attractive proposition for the world economy, rather than super normal growth followed by some sort of asset price deflation.

In India, too, the authorities are trying to curb excessively rapid growth to avoid unwelcome inflationary consequences. At the end of January, India's central bank raised interest rates by 0.25% to 7.5% at the same time as it raised the Indian economy's growth forecast to March 2007 to 8.5% - 9.0% from 8.0% (the government subsequently estimated 9.2%). The previous year's growth rate was raised upwards from 8.4% to 9.1%. There are many bottlenecks in the Indian economy which limit its ability to grow rapidly without causing excessive inflation and so the central bank has to keep interest rates relatively high by international standards. Nevertheless, India, too, remains an important catalyst of world growth.

The determined effort by Asian countries to attract more business from the west is seen by Singapore's reduction in the corporate tax rate from 20% to 18%. Intra Asian competition is very strong as well but countries like Singapore are working hard to attract extra business. This is all part of an unmistakeable trend which sounds a warning to some highly taxed western economies.

In conclusion, it is important for investors not to be swayed into making incorrect investment decisions based on short term market movements even if they are quite sharp. The profile of investors now is greatly different to what it was. Many of them have very short time horizons and the rationale for their decision making can be quite different from that of the long term fundamental investor. The latter category should not be intimidated into believing that the former category knows something that they do not. The message of last May and June is clear. There was significant change in the economic background to cause the fall in markets. Short term operators were following a trend. Those who were not influenced by these movements and who maintained their investment policy enjoyed a satisfactory year. We believe that this is likely to be the case this year. So far, market movements have generally not been as sharp as those of last year and we would say, on the evidence available, that economic conditions or prospects have not changed significantly over the last week or so. That being the case, our best estimate is that moderate growth in corporate earnings this year should translate into satisfactory share price gains given that equity ratings do not appear excessive. We also believe that shares remain attractively priced relative to bonds where we think that yields are too low.