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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Problems in financial markets have adversely affected international equity markets in the latest quarter with weakness in nearly all areas, mitigated to some degree for sterling investors by sterling's weakness. Although yields on good quality government bonds, as measured by ten year maturities, fell, increasing signs of strain in the eurozone government bond market were apparent with a sharp widening of spreads between German government bonds and those with a lower credit rating.

The tables below detail relevant movements in markets:

International Equities 30.11.07 - 29.02.08

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-12.4	-6.3	-9.4	-12.4
Finland	-11.4	-5.3	-8.4	-11.4
France	-14.6	-8.7	-11.7	-14.6
Germany	-14.0	-8.1	-11.1	-14.0
Hong Kong, China	-13.1	-10.2	-13.1	-16.0
Italy	-13.9	-8.0	-11.0	-13.9
Japan	-13.4	-4.6	-7.7	-10.8
Netherlands	-13.0	-7.0	-10.0	-13.0
Spain	-15.7	-9.9	-12.8	-15.7
Switzerland	-14.1	-4.0	-7.1	-10.2
UK	-7.9	-7.9	-10.9	-13.9
USA	-9.6	-6.5	-9.6	-12.6
Europe ex UK	-13.9	-7.3	-10.4	-13.3
Asia Pacific ex Japan	-10.9	-5.6	-8.7	-11.7
Asia Pacific	-12.1	-5.1	-8.2	-11.2
Latin America	-0.7	+7.6	+4.1	+0.6
All World All Emerging	-5.7	-1.8	-5.0	-8.1
The World	-10.2	-5.9	-9.0	-12.0

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +2.4%

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

Currency	31.11.07	29.02.08
Sterling	4.69	4.47
US Dollar	3.97	3.52
Yen	1.48	1.36
Germany (Euro)	4.16	3.87

Sterling's performance during the quarter ending 29.02.08 (%)

Currency	Quarter Ending 29.02.08
US Dollar	-3.3
Canadian Dollar	-5.2
Yen	-9.2
Euro	-6.5
Swiss Franc	-10.6

Other currency movements during the quarter ending 29.02.08 (%)

Other Currency	Quarter Ending 29.02.08
US Dollar/Canadian Dollar	-1.7
US Dollar/Yen	-6.1
US Dollar/Euro	-3.3
Swiss Franc/Euro	+4.6
Euro/Yen	-2.9

Significant Commodities (US dollar terms) 31.11.07 – 29.02.08 (%)

Significant Commodities	30.11.07 – 29.02.08
Oil	+13.4
Gold	+24.0

Markets

Equities have endured a poor quarter although, for sterling based investors, there has been a significant offset arising from the sharp fall in the currency against all the other major ones. For the quarter, the total return on the FTSE World Index in local currency terms was -10.2%, but this reduced to -5.9% in sterling terms. In US dollar terms, the return was -9.0% and, in euro terms, it was -12.0%. Looking at returns in local currency terms, there were sub-average performances from Europe ex UK -13.9%, Japan -13.4% and Australia -12.4%. The USA, UK, Latin America and emerging markets held up better than the FTSE World Index with returns of _9.6%, _7.9%, _0.7% and _5.7% respectively. But a different picture emerges if the returns are adjusted to sterling. The UK's return becomes sub-average as a result of a quarter of significant sterling weakness. Europe ex UK's sterling adjusted performance becomes _7.3%, that of Japan becomes _4.6% and Australia becomes _6.3%. The USA returned _6.5%, Asia Pacific ex Japan _5.6% and emerging markets _1.8%, whilst Latin America moved strongly positive, +7.6%.

As a result of the turbulence in financial markets, yields on "safe" assets such as government bonds declined. Taking ten year government bonds as a benchmark, gross redemption yields on sterling bonds declined by 22 basis points to 4.47%, those on US dollar bonds by 45 basis points to 3.52%, those on yen bonds by 12 basis points to 1.36% and those on German government euro denominated bonds by 29 basis points to 3.87%. We should, however, note that there have been widening spreads in eurozone government bonds and we will come on to this part later when we discuss Europe.

Currency moves have been large this quarter with sterling suffering a significant fall. Although it is very difficult to predict timing, it has been clear for some time that sterling was overvalued. The UK economy has become very unbalanced. So reality may be taking hold. During the last quarter, sterling declined by 10.6% against the Swiss franc, by 9.2% against the yen, by 6.5% against the euro, by 5.2% against the Canadian dollar and by 3.3% against the US dollar. Perhaps one of the most interesting moves in other cross rates, implied from the figures above, was a 4.6% rise in the Swiss Franc against the euro over the period.

In the commodities market, there has been a further strong rise in the oil price (+13.4%) taking it to over US$100 a barrel whilst gold rose by 24.0%.

Economics

- *Markets remain focused on the fallout from the US sub-prime mortgage market problems* …… as well as affecting individual financial institutions, credit markets tighten again.
- *Whilst some large financial institutions have experienced significant losses, others have remained relatively unscathed* …… for instance, the Big Four banks in the UK all raise their dividends.
- *Central banks are likely to remain active in reducing stress in the inter bank markets* …… margins over base rates start to rise again as banks remain cautious about lending to each other.
- *Although the Federal Funds target has fallen sharply and the Bank of England's bank rate less sharply, the benefit to borrowers is not as large* …… those rates tied to interbank rate will be reflecting money market strains whilst other lenders have, in some cases, been reviewing lending margins.
- *Sovereign wealth funds have been active in providing additional capital for some financial institutions* …… the circumstances in which they have done so are generally not controversial.
- *Sovereign wealth funds have the size to be able to make a difference to markets with equities particularly likely to benefit* …… however, protectionist sentiments lies not far below the surface in the USA and parts of Europe.
- *As a result of problems in financial markets, growth forecasts for this year have been lowered* …… for example, the World Bank's latest forecast is for world growth this year to be 3.3% against 3.6% in 2007 with developing countries growth weakening only modestly.
- *The yield curve has steepened in major markets, particularly the USA, mainly there as a result of the reduction in short term interest rates* …… by playing the yield curve, banks should be able to start rebuilding their profitability and rebuilding their balance sheets.

USA

- *The second estimate of fourth quarter 2007 growth was unchanged at 0.6% annualised* …… this was a lower figure than originally expected.
- *The Federal Reserve lowers its growth estimate for 2008* …… the central tendency of its forecast is now between 1.3% and 2.0% compared with last October's estimate of between 1.8% and 2.5%.
- *Besides the Federal Reserve's aggressive monetary easing, the Administration and Congress agree a fiscal stimulus* …… a US$170 billion package split two thirds to benefit consumers and one third to benefit business.
- *The Federal Reserve indicates it is prepared to do more on interest rates* …… Mr Bernanke says that the Federal Reserve would "act in a timely manner as needed to support growth and provide adequate insurance against downside risk". Until recently his emphasis has been more on the inflationary risks to the economy, now it is on the downside risks.
- *Although the Federal Reserve appears optimistic that inflation will moderate later on, it is above target at present* …… January's consumer price index was 4.3% higher than a year earlier whilst the core rate was 2.5% higher.
- *The housing market, the cause of the present problems in financial markets remains weak* …… nearly all the news in February has been negative.

Japan

- *Recent GDP numbers were surprisingly good* ...... annualised growth in the last quarter was 3.7% and the quarter on quarter growth rate was 0.9%. The figures may well be revised.
- *The diffusion index of leading indicators shows a more encouraging trend* ...... although still below 50, a rise in December to 45.5 compared with 18.2 in November points in the right direction.
- *The yen moves sharply higher* ...... greater risk aversion means the "carry trade" is being unwound. The stronger yen is bad for sentiment but the yen's strength has limited this quarter's negative returns for foreign investors.

Europe Ex UK

- *Difficult decisions ahead for the ECB* ...... whilst growth is slowing, inflation is stubbornly high. The ECB is the most hawkish central bank on inflation and, whilst inflation is well over target, it will be very reluctant to reduce interest rates.
- *January's eurozone headline inflation rate was 3.2%* ...... this was over 1.2% above the top of its target range. The European Commission now forecasts eurozone inflation of 2.6% this year.
- *The ECB will be worried by developments in Germany* ...... public sector unions are pushing aggressively for large pay rises (8%). Some politicians support above average pay rises but this will not find favour with the ECB whose resolve will be hardened.
- *The ECB is under political pressure from France, amongst others, to relent on interest rates* ...... Germany, in particular, will resist any attempts to pressurise the ECB even though the high level of the euro is causing a lot of pain to companies like Airbus.
- *Strains in credit markets have led to a widening gap between different eurozone countries' bond yields* ...... for example, ten year Greek and Italian government bonds yield about 60 basis points more than German ones and French ones yield 25 basis points more. This is quite serious for it effectively means that there is not a single monetary policy.
- *The eurozone, economically, is holding up relatively well* ...... although there have been negative economic indicators, there have also been some positive ones and bank lending growth to business remains strong.

United Kingdom

- *Sterling falls sharply* ...... it has been overvalued for some time but a reality check has occurred.
- *The economy is experiencing significant internal and external imbalances* ...... public finances are in a very poor condition for this stage of the cycle and the current account deficit is far too large.
- *Other factors are likely to have impacted negatively on the perception of the UK* ...... Northern Rock, taxation changes and the non-domiciled UK resident issues which threaten to damage the UK economy. The floating of ideas like a "windfall" tax on energy companies is very dangerous because it causes doubts about the wisdom of investing in the UK.
- *The UK is particularly vulnerable to serious weakness in the housing market* ...... it has supported a lot of consumer spending in recent years and a downturn which leads to a negative wealth effect would have serious repercussions. Most of the news on the housing market has been negative in terms of prices and activity but an acute shortage of supply may help to limit weakness.

- *The Bank of England remains reluctant to cut interest rates too aggressively* ...... inflation, currently 2.2% year on year on the consumer price index, is likely to rise and people's expectations are higher than this. The Retail Price Index is 4.1% higher than a year earlier and many people will consider this to be a more reliable indicator of inflation.
- *The Bank of England is gloomy about short term prospects for the UK economy* ...... in February, the Governor of the Bank of England said that Britons must face up to a "genuine reduction in our standard of living". He was, in the short term, pessimistic about growth and inflation.

China

- *The World Bank forecasts a modest slowdown in economic growth this year* ...... it forecasts 9.6% this year against 11.4% last year.
- *The main concern of the Chinese authorities is inflation* ...... it is currently 7.1% year on year. Raising bank reserve levels, raising interest rates and administrative measures are its chosen weapons to contain inflation but food price increases are a problem.
- *Notwithstanding its problems, China will be important to the world economy this year* ...... with the USA slowing down, there should be enough momentum from countries like China and India to give an acceptable level of growth for the world economy.

Summary

- *Volatility in markets is likely to continue for a while* ...... but investors should look ahead. In the USA, action, both monetary and fiscal, has been taken and, after the usual time lag, these stimuli should start to take effect.
- *Overall, shares continue to look reasonably valued, more so than bonds* ...... we think it dangerous to react to volatility in markets by suddenly changing policy. There is likely to be an opportunity cost.

January witnessed a time of marked weakness in international equity markets but February has been more stable. The fallout from the problems in the US sub-prime mortgage market continued to spook investors who worried abut the magnitude of the problem and where the losses would turn up. Concerns about a corner of the US financial markets with which investors would not normally concern themselves, the bond insurers, were an added cause of concern.

Investors do not like uncertainty, hence the concern abut the financial sector. However, the relatively significant losses have occurred amongst a few very large well known institutions. Others, so far, have emerged more or less unscathed and continuing evidence of this has helped share prices to recover from oversold positions. For example, in the UK, Barclays Bank, Lloyds Bank, HSBC, Royal Bank of Scotland and HBOS all raised their dividends. Yields in the sector continue to be so high that they seem to be presaging a dividend cut whereas that looks unlikely. It is highly likely that there are some significant anomalies in the financial sectors.

Before the end of 2007, acute stress was evident in the money markets as banks hoarded their cash and were unwilling to lend to each other in the normal way. Central banks relieved the pressures with money market activity and acting in their capacity as lender of the last resort. As a result, the gap between inter bank rates and official rates narrowed to more normal levels but spreads are now starting to widen again. The stress in the inter bank markets is the equivalent of a tightening of monetary policy through interest rate increases for those whose borrowing rates are tied to market rates. However, one of the side effects of the banks' problems has been that they have been raising their lending margins to provide some offset to lower lending volumes and more bad debts. So the reduction in interest rates which we have seen in the USA, in particular, and also the UK has been tempered in their effects by this factor. However, the extent of the decline in short term US interest rates, 225 basis points, still points to a powerful stimulus.

It is correct for investors to look ahead rather than dwell too much on what is happening at present. Stock market history is littered with events that look very serious at the time and may even be so but, in the context of the longer term, appear as a blip in the trend of equity prices. This is not to underestimate the danger which the US sub-prime problems are causing but investors should be considering the remedial action which is being taken and should look forward

Some of the largest financial institutions, which have suffered losses, have turned to sovereign wealth funds to repair their capital base. The possible long term impact of sovereign wealth funds on the stock market is something we have discussed in these reviews on a number of occasions in the past, well before they took centre stage in the issue of providing funds to repair the capital bases of a number of large financial institutions. We had discussed the issue originally in the context of China setting aside US$200 billion from its foreign exchange reserves to invest for higher returns than it had been obtaining. This is something it could easily afford to do given that it had the world's largest foreign exchange reserves and that they continued to accumulate at a rapid rate. There are, of course, many sovereign wealth funds in different forms and some of them, like those in the Middle East and parts of Asia, are vast. At the time we first started writing about the potential impact of sovereign wealth funds and their like, we were concerned about protectionism. Perhaps by a lucky chance for these sovereign wealth funds, they were able to commit quickly substantial amounts to financial institutions which needed to repair their balance sheets in a situation where protectionist politicians usually find it hard to object. As a very broad generalisation, we can say that sovereign wealth funds have plugged the hole left by the aftermath of the sub-prime lending problems.

Whilst we are talking about sovereign wealth funds, it is worth looking at their potential value for long term asset markets and the protectionist issues which threaten to reduce the benefit for investors. Protectionism comes in different forms. It may relate to trade. At present, protectionist sentiment is largely aimed at China. With an election pending in the USA, both candidates for the Democratic presidential nomination are playing the populist card. There is also underlying protectionist sentiment in Europe but the UK, to its credit, has eschewed such populist tactics and generally welcomed foreign investment. Initiating a trade war with China is a highly dangerous game because, as the possessor of the world's largest foreign exchange reserves, it has the possibility to rearrange its reserves and the USA, as the world's largest debtor country, could find this a very uncomfortable position. Because of its lower costs, China has a comparative advantage in the production of many goods and the availability of low cost goods has enabled the world economy to experience a period of decent growth because inflationary pressures have been restrained and, therefore, the authorities have not had to take significant measures to address inflationary problems. But protectionism can also relate to foreign acquisitions and investments. An example occurred when Dubai bought P&O. It had to sell its east coast US ports, ostensibly for security reasons but this was a protectionist move. Some countries in Europe are viewing potential investments by sovereign wealth funds with great concern. They are trying to suggest that there may be ulterior motives behind such investments. There may be a very few industries, defence, for example, where it is necessary to introduce restrictions and safeguards but, generally, there is no good economic reason to discourage foreign investment. Those countries which take a more liberal view, i.e. the UK, stand to benefit. But, assuming protectionist action is limited, the move by sovereign wealth funds to try to raise the return on their investments should be beneficial to equity markets as well as other types of asset which they may choose to buy. Bonds, on the other hand, may see some diversion of money from them towards equities and other assets with other higher return possibilities.

Sovereign wealth funds are, therefore, an important short term and long term factor for investors.

The strengthening of some important balance sheets plus the reporting of banks' results for 2007 has helped to calm fears about the financial sector to some extent and many shares in the sector have recovered from their lowest levels. It has clarified, to some extent, where the problems lie. But, obviously, there is still much uncertainty and share prices fluctuate from day to day in response to the latest news or changes in sentiment.

At the macro level, investors are concerned about the effect of the fallout from the US sub-prime problems on the world economy. Naturally, what has happened has affected growth prospects for 2008 and there are uncertainties as to how it will affect different parts of the world economy.

The World Bank, in its latest forecast, is now expecting world growth to slow to 3.3% this year compared with 3.6% in 2007. Within that, it is expecting growth in higher income countries to be 2.2% and in developing countries to be 7.1%. In expecting developing country growth to weaken only modestly, the World Bank points to a risk of a much sharper slowdown in the USA which would affect growth in those areas. One reason for being reasonably optimistic about growth prospects for the world economy as a whole is because of the momentum in developing countries. For example, the World Bank forecasts that GDP in East Asia and the Pacific will increase about 9.7% in 2008 compared with 10.0% in 2007. This is only a very modest slowdown. In Europe and Central Asia, the World Bank is expecting growth of 6.1% in 2008 compared with 6.7% in 2007. In Latin America and the Caribbean, it is expecting growth of 4.5% in 2008 compared with 5.1% in 2007. Here, it remains quite positive on Brazil where it expects growth to remain robust and it is expecting Mexico to rebound from a weak 2007. In the Middle East and North Africa, helped by high oil prices, the World Bank forecasts an acceleration in economic growth to 5.4% in 2008 compared with 4.9% in 2007. In a survey of the world economy, the United Nations is expecting global growth this year of 3.4% compared with 3.7% in 2007 but points out risks to the downside arising from a deep housing slump in the USA. The President of the Asian Development Bank was reported, in the Financial Times, as saying that when the next set of economic forecasts is published in March, they would put regional growth, including China but excluding Japan, at "slightly less" than 8% compared with last September's forecast of 8.2%. Right at the end of January, the IMF cut its growth forecast for the world economy to 4.1% compared with 4.9% last year and its previous forecast of 4.4% in October. It may be necessary to change these forecasts as we gain more experience of the effects of the problems in the financial markets but, at present, these forecasts look satisfactory in the environment which we have witnessed. But central bankers and politicians will react to the unfolding news as they think fit. There are constraints on both the actions of central bankers (inflation prospects) and politicians (a country's fiscal position) but they will do what they can to improve the prospects and this is the situation on which investors should concentrate rather than what is exactly happening at the moment. Reacting to scary headlines does not make good investment policy ; rather, investors should look ahead to see the policy reaction that is likely to occur and the effects which this may be expected to have on medium term prospects for the world economy.

In this respect, the most aggressive actions to ward off a recessionary threat have come from the USA where both monetary and fiscal tools have been used in this quest. We will discuss this in more detail in the section on the USA but, suffice it to say, the much wider brief given to the Federal Reserve has enabled it to act decisively and quickly on the monetary front whilst the fiscal position of the USA just about allows for the stimulus package agreed between the President and Congress. The ECB and Bank of England are more constrained by their inflation remit.

Over the last quarter, the yield curve has steepened in major markets, particularly in the USA. In the USA, this is partly a function of the Federal Reserve's aggressive reduction in short term interest rates and also the flight to quality which pushed down short term Treasury bond yields below normal levels relative to the target federal funds rate at the time. By way of example, the spread in gross redemption yields between very short dated US Treasury bonds and 30 year Treasury bonds moved from about 136 basis points at the end of November to about 262 basis points at the end of February. This may represent a way of strengthening financial institutions' balance sheets as happened in the savings and loan crises. By playing the yield curve, institutions can make good profits and recapitalise themselves.

The yield curve could also be telling us something else, namely that investors are becoming more concerned about inflation. Whilst the main reason for the steepening of the yield curve has been the depression in short term yields, particularly in the USA, it has also been because yields in long dated bonds have risen. The spread between index linked bonds' yields and conventional bonds' yields has also risen suggesting investors are becoming more concerned about inflation. Energy and food prices are giving a push to inflation even as economic growth slows down. We have long been cautious about the historically low level of bond yields and still do not believe they are realistic in relation to inflation. Whilst they may temporarily have benefited from a perceived safe haven status, to us this still does not justify the yields they offer. We will be looking at the inflation picture as we review each area of the world economy.

Turning now to the USA, we note that the first and second estimates of fourth quarter 2007 GDP annualised growth were the same, a lower than expected figure. However, as we have noted, the prospect of an economic slowdown or, at worst but unlikely, a recession, has prompted an aggressive monetary and fiscal response from the authorities. Perhaps not reflecting the most up to date news, the Administration's growth forecast for fiscal 2008 ending on 30th September 2008, presented with the budget proposals, was 2.7% and, for the year to 30 September 2009, 3.0%. The Federal Reserve's latest growth expectations, published with the minutes of its January meeting put the central tendency of its growth forecast for 2008 at between 1.3% and 2.0% compared with last October's estimate of between 1.8% and 2.5%.

Both the Federal Reserve and the US Administration have elevated the thrust of their policy to try to ensure that the economy recovers its strength, with inflation being less of a consideration. In the middle of February, the President signed into law a US$170 billion fiscal stimulus package, split two thirds to benefit consumers, with the balance to benefit business. For individuals, the tax rebates will amount to between US$300 and US$1,200 and it is hoped that at least 40% of the rebates will be spent. For business, the incentives are aimed at encouraging business to invest in large items of equipment. The cost of this stimulus is a rise in the budget deficit, which had been falling from its peak of 3% of GDP in 2004 to 1.2% in 2007. The latest forecasts, encompassing the fiscal stimulus, suggest this will rise to 2.8% of GDP in 2008. It is very difficult to curtail federal spending so one must treat these forecasts with caution. However, if they are reasonably accurate and given that they are designed to stimulate the economy in a downturn, the forecast deficit as a percentage of GDP is not irresponsibly large. In better times, it will be necessary to aim at least for a balanced budget.

Following its aggressive 225 basis point cut from the recent peak federal funds target rate of 5.25% to 3.0% currently, the Federal Reserve still makes clear that it is prepared to act further. In a testimony to the Senate Banking Committee in the middle of February, Mr. Bernanke said that the Federal Reserve would "act in a timely manner as needed to support growth and provide adequate insurance against downside risk". He emphasised the downside risks of current conditions, referring to the housing and labour markets as well as credit conditions. He was more optimistic about prospects as the year progressed. There was not the emphasis on inflationary risks which one might have heard, even towards the end of last year. In fact, when Mr Bernanke did mention inflation it was to suggest that inflation would moderate from recent rates. This testimony suggests that the Federal Reserve will not hesitate to cut interest rates again if it believes it to be necessary.

But, as in many countries, inflation is a concern in the USA. Historically, in most major countries, the levels are not alarming but, in relation to the more benign experience of recent years, the picture has deteriorated. January's consumer price index showed a month on month rise of 0.4% to give a year on year rate of 4.3%. The core consumer price index, excluding energy and food, rose by 0.3% in January compared with December to give a year on year increase of 2.5%. The Federal Reserve's favoured inflation measure, the core personal consumption expenditure deflator, showed a 2.2% year on year increase in December above its upper target level of 2.0%. At the producer price index level, there was a 1% increase in January compared with December to give a year on year increase of 7.4%. These are quite big numbers, certainly in the cases of the consumer price index and the producer price index. It is also relevant to note the large disparity between the consumer price index and the core consumer price index. Excluding two of the most inflationary sectors, food and energy, to give the core figure is an increasingly questionable distinction since they are two of the most high profile sectors whose influence could spread to the economy and boost the core rate. It is also an important influence in pay negotiations and negotiators will naturally tend to look at the higher figure. It is not surprising, therefore, that Federal Reserve officials have raised their inflation forecast for this year from a range of 1.7% to 1.9% last October to 2.0% to 2.2% now. The Federal Reserve still seems to be quite sanguine about inflation eventually moderating. What happens to food and energy prices will obviously be important here.

This time last year, one had hoped that by now the US housing market would have shown some signs of improvement but that has not happened and, as we all know, the fallout from the US sub-prime mortgage problems has been widespread. News in February has been mostly negative. The National Association of Realtors index of pending sales for existing homes fell to 85.9 in December from 87.2 in November. This is the second lowest reading on record. The number of permits issued for new residential construction in January was the lowest for more than sixteen years. It was 3% lower than in December. The National Association of Realtors reported a fall of 0.4% in January's house sales compared with December. This was the lowest level for nine years. The S&P / Case Shiller index of house prices fell by 5.4% in the final quarter of 2007 and for 2007 as a whole the decline was 4.6%. As the figures imply, there was an acceleration in the decline in house prices in the final quarter of 2007. One possible glimpse of better times ahead, and this will happen at some stage, is that there has been a fractional improvement in sentiment amongst US home builders. The National Association of Home Builders / Wells Fargo housing market index rose by 1 point in February to 20. It is obviously not a big move but it is in the right direction. The latest new home sales figures showed a 2.8% decline at an annual rate and unsold home inventories rose to the highest level since 1981.

Although the short term economic news has been mixed, it has tended towards the negative, as one might expect, and given enough reason for the Federal Reserve to indicate that it would be willing to cut interest rates further, if necessary. The latest employment data has been weak. The January payroll data showed that non farm payrolls fell by 17,000 which was the first fall since 2003. The separate household survey showed a fall in unemployment from 5.0% to 4.9%. There was a dramatic fall in the ISM's non manufacturing index which reflected weakness in the important services sector. Between December and January, the index fell from 54.4 to 41.9 which was its largest ever monthly fall. Consumer sentiment as measured by the Reuters / University of Michigan consumer sentiment survey fell to 69.6 in February from 78.4 at the end of January. There was some evidence of weakness in manufacturing. For New York State, the Empire State general business conditions index fell to -11.72 in February from 9.03 in January. There was similar evidence from the mid Atlantic regions. The Federal Reserve Bank of Philadelphia's manufacturing index fell to -24 in February from -20.9 in January. The latest figures for manufacturing orders show their biggest decline for five months with orders for big ticket manufactured items falling by 5.3% in January. The Conference Board's index of leading economic indicators showed a slight drop in January, falling by just 0.1%, the same as in December.

However, it is important not to overdo the gloom for there have been some encouraging indicators in the US economy. Although the ISM services index was weak in January, the manufacturing index was strong, rising from 48.4 in December to 50.7 in January. December factory orders rose by 2.3%, up from November's rise of 1.7%. Retail sales rose by 0.3% in January. The trade figures also give some encouragement. Although the deficit is still very large, it has been narrowing and the weaker US dollar has been having its expected effect on exports which grew by 12.7% in 2007.

In investment, it is important not to dwell too much on current data, but to interpret the policy response which the data may draw from economic policymakers. In this case, evidence of weakness in the economy has driven the monetary and fiscal response which we have described earlier. If the desired result occurs, i.e. a recovery in growth towards the end of the year, one would expect markets to start to anticipate this recovery.

In Japan, there have been some surprisingly strong GDP figures for the final quarter of 2007. The annualised rate of growth was 3.7%. The quarter on quarter growth rate was 0.9% and the year on year growth rate was 2.0%. Strong exports and rising capital spending were growth catalysts. The latest industrial production figures for January showed a decline of 2.0% over December but the year on year figure was up 2.5%. GDP figures are notoriously volatile and there could well be some revisions to what seems a surprisingly strong number. We will soon know when the figures are revised in March. Elsewhere, there has been a more encouraging trend in the diffusion index of leading indicators. December's reading of 45.5 compared with 18.2 in November. By itself, the figure suggests a difficult time but the trend is encouraging.

The main feature of the quarter has been the strength of the yen. On fundamental grounds, such as the size of the country's current account surplus, the extreme weakness of the yen has been hard to square. However, as is well known and as we have often written about in the past, the yen has been the main currency to be used for the "carry trade" whereby yen have been borrowed at minimal interest rates to invest in higher yielding currencies. With risk aversion having increased as a result of developments in financial markets, carry trade activity has been reduced as positions have been unwound and the yen has recovered strongly, with sterling falling by 9.2% against the yen over the last quarter, the US dollar by 6.1% and the euro by 2.9%. This has meant that, for foreign investors in Japanese equities, the result has been better than in most other markets.

The reason for the low interest rates in Japan was the country's deflationary experience which made it virtually impossible for the Bank of Japan to run a normal monetary policy. In an environment of rising inflationary pressures in energy and food, the yen's current strength will be some offset to higher US dollar denominated commodity prices. The latest consumer price index from Japan for January shows a decline of 0.2% in prices compared with December whilst the year on year figure is for a rise of 0.7%. If fresh food is excluded, the relevant figures are -0.4% and +0.8%. Later data from Tokyo show its consumer price index for February down 0.3% compared with January and up 0.4% year on year.

The recent recovery in the yen will make life more difficult for exporters but with nil inflation or deflation for so long, many Japanese exporters have been extremely competitive. Important influences on the Japanese economy in 2008 will be trends in the important US export market and China, an important trading partner. Because of the relative strength of the Asian economies, exports may hold up well in those regions but the USA is more problematical. There may not be much help from Japanese consumers. Despite low unemployment, wages have been squeezed and consumer confidence is not high. Whilst this situation persists, it is right to be cautious about Japan's economic prospects. However, everything has a value and with a low P/E ratio for the market by historical standards and a dividend yield higher than Japanese government bond yields, value remains in this market.

In Europe, the ECB faces difficult decisions on interest rates. On the one hand, lower growth forecasts might argue for a reduction in interest rates but, on the other hand, inflation is well above its target range. Looking backwards, the fourth quarter of 2007 saw slowing growth in the eurozone. Compared with the third quarter of 2007, growth halved to 0.4% according to official figures. We can expect some new estimates for growth and inflation from the ECB in March but, meanwhile, the European Commission has downgraded its growth estimates for 2008 from 2.2% in last November's forecast to 1.8% now. Within that figure Germany is now forecast to grow 2.1% (1.6%), France 2.0% (1.7%) and Spain 2.7% (3.0%). Its inflation expectation has been raised to 2.6%. For the EU as a whole, it has raised its inflation estimate for 2008 to 2.9% from its previous forecast of 2.4%. The EC Commissioner for Monetary Affairs was particularly concerned about a rise in inflation expectations which have nearly risen to a high reached in 2001.

Early in February, before these forecasts were published, the President of the ECB, Mr Trichet, had moderated his stance somewhat from earlier statements. The ECB was, and still remains, the most hawkish of the central banks, partly because of its mandate on inflation. Until recently, it was hinting strongly at the possibility of higher interest rates. In January, Mr Trichet warned about a possible pre-emptive rise in interest rates to head off the threat of higher inflation caused by rising pay deals. In previous reviews, we have referred to the position in Germany where, following a long period of pay restraint, some politicians, as well as trade unions, were calling for well above average pay rises to share the cake, following a period of strong profit increases, and to put more spending power into the economy. The ECB looked with concern on this pressure and the threat of rising interest rates was there, partly to address this threat. The ECB's concern will be elevated by the current wave of industrial disputes in the public sector in furtherance of a substantial pay claim. The movement in the position of the ECB in February was not to consider an interest rate increase although not to consider a reduction either. When the ECB meets in March, it will be considering a reduced growth forecast but Mr. Trichet thinks that, nevertheless, the eurozone remains in a better state than the USA, partly because there were no major imbalances in the economy. It is clear that the concern to the ECB is that inflationary expectations in the eurozone have not become sufficiently anchored. When individuals expect inflation to rise above a central bank's target level, the expectation informs their actions, perhaps on pay expectations, and a central bank will feel moved to act to try to change those expectations through interest rate increases. The dilemma for the ECB is quite clear.

The strength of the euro is also causing difficulties. For many businesses, competing in international markets, it has reached a critical point. We have used the example of Airbus and Boeing before. Both companies have vast order books as a result of the civil aviation boom but Airbus has a real headache with its costs largely denominated in euros and its revenues in US dollars. Its hedges are gradually maturing and it is left with a very difficult situation in trying to cut its costs. The central bank's lack of action on interest rates might make things worse. With the Federal Reserve having cut interest rates by 2.25% and the ECB not at all, the interest rate differential has moved in favour of the euro. Our table at the beginning of this review shows that the US dollar fell by 3.3% against the euro in the quarter. That represents, in a short time, a significant loss of competitiveness for eurozone based companies. The ECB might argue that this sort of pressure encourages companies to be as efficient as they can be which will help to bear down on inflation. This difficult situation is leading to political pressure being put on the ECB, particularly by France, but it seems very unlikely to be successful, as Germany, in particular, opposes political interference with the ECB. The best guess is that, with inflation so far above its target rate, the ECB will hold rates where they are for the time being.

January's headline rate of eurozone inflation was 3.2%, over 1.2% above the ECB's target rate whilst the "core" rate dropped from 1.9% to 1.7%. The difference between actual and core rates is unusually large because it excludes items like energy and food which are rising rapidly in price. It is being increasingly unrealistic to ignore actual inflation rates because these are the ones which anchor inflationary expectations. The annual rise in factory gate inflation in December was 4.3%.

As we have argued ever since the outset, the eurozone is not an optimal currency area and the "one size fits all" policy for interest rates is very unsuitable. For some countries, interest rates are too high and, for others, they are too low. We think the strains are set to worsen. An example of increasing strains can be seen in the eurozone bond markets. If we take as an example ten year government bonds, it is instructive how the yield differentials between the various credits have widened. At the time of writing this, the difference in yield between ten year German government bonds and Greek or Italian bonds is about 60 basis points. Even between French and German bonds, it is 25 basis points. If these differences persist, debt servicing costs are going to make a difference to economic performance effectively marking out different monetary policy regimes for the countries which comprise the eurozone. This widening of differentials is one result of the uncertainty in credit markets and is another sign of stress which could be appearing in the eurozone.

Recent economic indicators from the eurozone have been mixed but there have been enough positive signals to suggest that, relatively speaking, the eurozone is performing well. A survey by NTC Economics reported a relatively optimistic picture painted by European manufacturers about their sales prospects in 2008. The overall purchasing managers index for February rose to 52.7 in February from 51.8 in January. A more positive reading for the services sector more than offset a lower reading for the manufacturing sector. Money supply growth remains strong. Whilst this may concern the ECB from an inflationary angle (the ECB pays significant attention to money supply growth), it does suggest some robustness in the economy. There was a record growth in business borrowing in January. Lending to non financial corporations increased at an annual rate of 14.6% in January, the fastest rate since the launch of the euro in 1999. Negative indicators from the eurozone include weak retail sales figures for December. There was a fall in eurozone industrial output in December of 0.2% compared with November. Eurozone industrial orders fell by 3.6% in December compared with November. At the end of February, the ECB reported that its eurozone economic sentiment indicator had fallen from 101.7 in January to 100.1 in February, the lowest level for just over two years. So, overall the data painted a mixed picture but with enough positive features to support relative optimism about the eurozone's economic prospects.

It is difficult to be so optimistic about the UK. The sharp fall in sterling over the last quarter tells a story of declining optimism about the outlook and a fall in confidence, a mixture of political and economic issues.

These reviews steer clear of political issues as far as possible but, in the case of decisions which may have an economic or stock market effect, it is obviously necessary to discus them. There are two issues here, the proposed change in capital gains tax rules and the proposed changes in taxation for UK residents who are non-domiciled. Both have caused an immense furore. In the case of the former, and we might also include corporation tax increases for small businesses, they appear to amount to a change in policy by the Treasury towards small businesses and entrepreneurs. Whilst public finances are in a poor state, the government needs all the money it can lay its hands on but there must be questions about the wisdom of raising the tax burden on this sector of the economy. One understands why there was political pressure on the government regarding capital gains tax but the law of unintended consequences appears to be applying. The business sector, and perhaps small businesses, in particular, needs all the encouragement it can because it represents the productive parts of the economy and the rise in taxation appears to be going against the trend almost everywhere else. The proposed changes to the tax regime for UK residents who are non-domiciled are potentially very serious. Whether it is right or wrong in a political sense, the economic consequences are likely to be very serious for the UK, particularly given the importance of the financial sector for the UK economy. Hindsight is a wonderful thing in investment or economic changes which have unforeseen consequences but, in this case, the dangers can be seen well in advance, hence all the warnings to the Treasury from many quarters. Far from raising money from the tax changes, it is likely that the Exchequer will lose money as people and business move away from the UK and the secondary effects in the housing market and businesses which rely on the spending of individuals or businesses associated with non domiciled individuals. These issues are immensely damaging to the UK and, apart from anything else, can be expected to have a negative effect on sterling. One might add a third issue which is damaging to the UK economy. There is talk of a windfall tax on certain utilities if they do not agree to things the government wants to do with energy bills for certain consumers. Capricious taxes like these have no place in an economy which wishes to attract investment. They send out completely the wrong signal and, even if they are not eventually implemented, they represent another negative about the UK economy. Perceptions are important and what is happening now could well impact on sterling and therefore be an investment issue and this is without mentioning the negative impact of the Northern Rock affair.

For a long time, sterling has, in our view, been defying gravity. It is very difficult to anticipate short term currency movements as currencies often overshoot or undershoot fair values but, when sentiment changes, it can often be quite dramatic as we can see in the case of sterling over the last quarter. Our concerns about the UK economy have centred on the external and internal imbalances. Although the UK economy has enjoyed a long period of good growth, the quality of the growth has been poor, sustained by a rapid growth in public and consumer spending supported by a positive wealth effect from the boom in house prices. The very weak current account poses a threat to sterling. If capital flows dry up, the currency is vulnerable. The internal deficit is a major worry. A large structural deficit is being run. Conventional economics would suggest that the good times should be used to run a budget surplus or at least balance the budget. This has not happened and now the government has no room to take reflationary action in the face of an economic downturn. The outlook for public finances is poor and the UK's dependence on the financial sector, whilst very helpful in the past, now threatens to make it vulnerable. The actions on non-domiciled individuals, many of whom are involved in the finance sector, are even harder to understand in this context. The desperate search for more money from taxation is symptomatic of the Treasury's concerns but they threaten to prove counter productive.

As well as vulnerability to a downturn in the financial sector, the UK is also vulnerable to a downturn in the housing market. Whereas the strong rise is house prices in recent years has helped to sustain consumer spending, a negative wealth effect might arise from a downturn in house prices. Supply constraints might preclude the magnitude of price falls seen in parts of the USA but even modest price weakness has the ability to cause economic problems for the UK. News on the housing market in February continues to point to a deteriorating situation. According to the Halifax, house prices remained unchanged in January and were up 4.5% on a year previously. The FT House Price Index reports a small rise in house prices in January, 0.1%, following falls in the previous two months. Year on year house prices rose 6.5% against 7.4% in December. The Department for Communities and Local Government reported a rise of 0.4% in house prices in December to give a year on year increase of 9.1% compared with 9.7% in November. The RICS reported a 10% rise in the stock of unsold property in January and a negative balance of 54.7% of chartered surveyors seeing house price falls compared with 49.1% in December. The Land Registry reported a sharp fall of 22% in the number of houses sold in November compared with a year earlier. It reported a 0.9% rise in house prices in January to give a year on year increase of 6.4%. The Nationwide reported a 0.5% fall in house prices in January to give a 2.3% fall since November. The annual rate of house price inflation fell to 2.7%. These figures are complemented by information suggesting sluggishness in mortgage lending.

But, as with the ECB, the difficulty for monetary policy makers is that inflation is higher than the target, yet the economy is sluggish. This explains the minor fall in UK interest rates compared with those in the USA. The official target measure against which inflation is measured, the consumer price index, stands at 2.2%, year on year, above the target level of 2.0%. Most people, faced with rising energy and food bills, will not find that inflation rate reflecting their own experience. The former measure, the Retail Price Index, shows inflation at 4.1% in January and this is the level which wage negotiators will use as a bargaining tool. Manufacturers are facing significant cost pressures. In January, input inflation reached an annual rate of 18.9% and the producer price index rose by 1% alone in January to give an annual rate of 5.7%. The decline in sterling's value is reflected in a rise in import price inflation to 3.5% in December and the experience will have become worse since then as sterling's decline has continued. Anecdotal evidence shows strengthened pricing power amongst manufacturers. The CIPS / NTC Economies output prices index for January was the highest yet recorded. There is a slightly rising trend in wages. In the last three months of 2007, UK wage inflation was an average 4.0% compared with 3.5% during the same period in 2006. The latest survey from the CBI shows retailers' pricing intentions at the highest levels for more than ten years.

Part of the difficulty for the Bank of England revolves around the fact that some cost push influences on inflation are not easily addressed by interest rate policy. An overheated economy may be cooled down by rising interest rates with inflation responding accordingly but food and energy prices are rising not only because of what has been strong growth in the world economy. Land diverted to more profitable use, i.e. for biofuels and the OPEC cartel, which limits oil output, are examples of what is driving cost push inflation. Drive interest rates too low and inflation may be exacerbated, keep them too high and "stagflation" may follow. In mid February, the Governor of the Bank of England gave rather a bleak assessment of short term prospects for the UK economy referring to the fact that Britons must face up to a "genuine reduction in our standard of living". In the short term, he was pessimistic about growth (or lack of it) and inflation. The Bank of England's forecast allowed only for a small fall in interest rates if inflation was to stay on target.

The problems which currently face the UK economy should be no surprise as it has been possible to see them coming for a long time. Increases in public spending way above what the economy could sustain have led to the current problems with government finances. Raising taxes to deal with the hole in public finances will make matters worse and go against the trend elsewhere.

Whilst we are not optimistic about the outlook for the UK economy, there remains some value in the stock market, particularly in those companies with large overseas earnings which should benefit from sterling's weakness.

Whilst the US economy slows, the hope is that Asia and some emerging markets will keep momentum going in the world economy. We think particularly of China and India in this respect. In its latest forecast, the World Bank suggests that growth in China will slow this year to 9.6%, nearly 2% lower than last year when it grew 11.4%, but still a significant level. For China, the main concern is to control inflation, currently standing at 7.1% year on year. It has been using additions to bank reserve levels, rising interest rates and administrative levers to try to control inflation which has largely been caused by rising food prices. It has also been allowing the currency to drift upwards against the dollar against which it has risen approximately 13% since mid 2005. However, it has fallen against the euro. The probability is that China will produce another strong year of growth which will help to maintain some momentum for the world economy before the US picks up again. India, too, will be helpful but it is finding it difficult to sustain its target of an average growth rate of 9% between 2007 / 8 and 2011 / 12. The Finance Minister has forecast growth of 8.7% in the year to 31 March 2008, down from 9.6% the previous year.

After a long series of mostly positive quarters, it was inevitable that there would be one or more negative quarters. However, as we have always emphasised, long term investors should not be intimidated into selling good quality assets at prices they may regret. Only if we felt very negative about equity markets would we consider a dramatic move in asset allocation for those portfolios geared towards long term capital growth. Although there will be more bad news, we are aware that shares do not look highly rated and that reflationary policies are under way in the USA. Investors should look forward and we do not want to incur an opportunity cost by selling shares at current levels when we believe that higher values are justified down the line. We expect continued volatility with day to day movements being difficult to call but longer term prospects should be the focus of our attention.

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