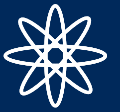


meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Overall, there has been little change in the level of international equity markets over the last quarter with a period of heightened volatility at the end of the quarter reducing or eliminating earlier gains. Yields on top quality bonds, as measured by ten year government bond yields, rose modestly over the quarter.

The tables below detail relevant movements in markets:

International Equities 30.04.07 – 31.07.07

Total Return Performances (%)

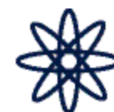
Country	Local Currency	£	US$	€
Australia	+2.9	+1.5	+3.2	+2.9
Finland	+8.5	+7.1	+8.9	+8.5
France	-1.5	-2.8	-1.2	-1.5
Germany	+2.6	+1.3	+2.9	+2.6
Hong Kong, China	+16.9	+15.0	+16.8	+16.5
Italy	-5.1	-6.4	-4.8	-5.1
Japan	+0.6	-0.7	+0.9	+0.6
Netherlands	-2.0	-3.3	-1.7	-2.0
Spain	+4.6	-3.2	+4.9	+4.6
Switzerland	-5.4	-6.7	-5.1	-5.4
UK	-0.8	-0.8	+0.8	+0.5
USA	-1.3	-2.9	-1.3	-1.6
Europe ex UK	-0.7	-2.0	-0.4	-0.7
Asia Pacific ex Japan	+10.8	+10.9	+12.7	+12.3
Asia Pacific	+5.3	+4.5	+6.2	+5.9
Latin America	+9.4	+12.8	+14.6	+14.3
All World All Emerging	+13.5	+13.5	+15.3	+14.9
The World	+0.3	-0.7	+0.9	+0.6

Source FTS E World Indices

FT Government Securities Index All Stocks (total return): +0.4%

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

Currency	30.04.07	31.07.07
Sterling	5.04	5.25
US Dollar	4.63	4.78
Yen	1.63	1.80
Germany (Euro)	4.15	4.32



Sterling's performance during the quarter ending 31.07.07 (%)

Currency	Quarter Ending 31.07.07
US Dollar	+1.7
Canadian Dollar	-1.8
Yen	+1.2
Euro	+1.3
Swiss Franc	+1.3

Other currency movements during the quarter ending 31.07.07 (%)

Other Currency	Quarter Ending 31.07.07
US Dollar/Canadian Dollar	-3.2
US Dollar/Yen	-0.4
US Dollar/Euro	-0.3
Swiss Franc/Euro	N/C
Euro/Yen	-0.1

Significant Commodities (US dollar terms) 30.04.07 – 31.07.07 (%)

Significant Commodities	30.04.07 – 31.07.07
Oil	+10.1
Gold	-2.4

Markets

There has been very little change in international equity markets over the last quarter. Weakness right at the end of the quarter reduced or eliminated earlier gains. The FTSE World Index showed a total return of +0.3% in local currency terms, -0.7% in sterling terms, +0.9% in US dollar terms and +0.6% in euro terms. In local currency terms, as measured by the relevant FTSE World Index, the USA returned -1.3%, Europe ex UK -0.7%, Japan +0.6% and the UK -0.8%. Within the Europe ex UK index, there was a wide range of performance. On the positive side, Finland returned 7.1% as a result of Nokia's strong performance, and Spain returned 4.6%. On the other hand, Italy and Switzerland were underperformers with respective returns of -5.1% and -5.4%. Australia returned a positive performance of 2.9%. But the star performers, as has often been the case recently, have been Asia Pacific ex Japan +10.8%, Latin America +9.4%, and emerging markets +13.5%. Currency movements have not made a significant difference this quarter although sterling investors have generally seen their returns slightly lowered when sterling returns are calculated. The exception is Latin America where the sterling return is enhanced to 12.8% from 9.4%. Japan moves from slightly positive territory, 0.6%, to slightly negative territory, -0.7%, when the weaker yen is taken into account.

Over the quarter as a whole, bond yields, as measured by those on ten year government bonds, rose. Sterling government bond yields rose by 21 basis points to 5.25%, US dollar bonds by 15 basis points to 4.78%, yen bonds by 17 basis points to 1.80% and German government euro denominated bonds by 17 basis points to 4.32%. There were no really significant movements in the currency markets except that we might note the continued remarkable performance of the Canadian dollar against which sterling fell by 1.8% at a time when it was rising against other currencies. Over the quarter, the US dollar fell a further 3.2% against the Canadian dollar and it is now not far off parity against the US dollar for the first time for over thirty years. Sterling rose by almost the same amount against the US dollar (+1.7%), the yen (+1.2%) and against the euro and Swiss Franc (both +1.3%).

In the commodities markets, oil rose by 10.1%, as measured by Brent crude, whilst gold fell by 2.4%.

Economics

- *International economic prospects look generally good* ...... the IMF raises its forecast for global growth from 4.9% this year and next to 5.2% for both years.
- *The IMF says China will be the biggest driver of international economic growth this year* ...... below average growth in the US economy will not affect international prospects in the way it might have done before.
- *Credit markets are spooked by problems with US sub-prime loans* ...... a large number of investors could be affected as the loans were sliced up and dispersed. The problem has already shown up with some hedge funds and more problems are expected.
- *In a number of previous reviews, we have mentioned areas where we felt excessive risk had been taken* ...... these were low grade bonds, certain areas of the property market and the "carry trade". However, we did not then, and do not now, include international equities in this category.
- *Although some investors in speculative securities will experience losses, we believe the effect can be isolated* ...... strong economic growth and corporate balance sheets should hold sway.
- *Sovereign Wealth Funds made the news* ...... although they have been around for many years, the sums involved are potentially enormous because of the large current account surpluses being built up in Asia and the Middle East, in particular. They could be positive for equities and property but also rouse protectionist tendencies.

USA

- *The LDP suffers a heavy defeat in upper house parliamentary elections* ...... this may make continued economic reform more difficult.
- *Conditions remain excellent for Japanese exporters* ...... the combination of nil inflation and currency weakness has given them a competitive advantage.
- *The Bank of Japan would prefer to have higher interest rates to establish a more normal monetary policy* ...... but the core consumer price index is 0.1% lower than a year ago so any increase in interest rates would reflect higher real interest rates, not what the Japanese economy requires at present.
- *Large manufacturers remain positive* ...... the July Tankan survey remained unchanged at quite a high positive balance, +23.
- *A paradox is that, whilst average earnings fell, unemployment does also* ...... the labour market is quite tight with unemployment down to 3.7% in June. One would expect more upward wage pressure which would lead to a higher level of consumer confidence.

China

- *Economic growth gets even faster* ...... second quarter growth was 11.9% higher than in the same period the previous year.
- *The authorities continue to take action to restrain economic growth* ...... interest rates and banking reserve requirements continue to be raised and the tax on bank deposit interest rates is cut to make saving more attractive.
- *The Chinese influence in international stock markets will increase* ...... US$200 billion is to be set aside for the China Investment Corporation and Chinese insurance companies are to be allowed to invest more overseas.

Europe Ex UK

- *The IMF upgrades its estimate of eurozone growth for this year and next* ...... it now expects growth of 2.6% this year and 2.5% next year, increases of 0.3% and 0.2% respectively over its previous forecasts.
- *President Sarkozy makes waves with other EU leaders and the ECB* ...... he wants to increase political control over the latter with a view to influencing exchange rate and interest rate policies. Germany, in particular, and the ECB regret this course of action.
- *Although eurozone inflation is currently within the ECB's target zone at 1.9%, the ECB has given hints that it is prepared to raise interest rates further* ...... the ECB expects inflation to increase from current levels.
- *The short term economic outlook is positive* ...... most recent indicators support this view and the German economy, the largest one in the eurozone, still remains buoyant although a rise in consumer spending would make growth better balanced.

United Kingdom

- *Interest rates rise again* ...... on a split decision, they are increased again in July to 5.75%. The split between "hawks" and "doves" reflects different interpretations of current economic data and the effect of past interest rate increases.
- *Inflation is the Bank of England's main concern* ...... it remains well above target and the Retail Price Index, formerly the standard inflation measure and a more realistic one for many, stands at 4.4%. Against that measure, real interest rates do not look high.
- *The economy continues to perform quite strongly* ...... the ONS's initial estimate of second quarter growth is 0.8% compared with 0.7% in the first quarter.
- *The housing market is crucial for the UK economy* ...... there is some tentative evidence that the series of interest rate increases is beginning to cool down the housing market. London remains a distinct market.
- *The strength of sterling is a problem for UK manufacturing* ...... although much less of a factor in the economy than it used to be, a meaningful manufacturing sector is important for economic balance. Companies are likely to continue to take measures to retain their competitiveness with more outsourcing of production.

Summary

- *Difficulties in the credit markets will have significant but localised effects, we believe* ...... those suffering include some lending institutions and certain hedge funds.
- *There will be second order effects* ...... funds available for private equity transactions will become more limited and spreads will widen. This will reduce certain types of M & A activity. A further effect will be reduced liquidity in some hedge funds together with valuation issues on assets.
- *But we believe that investors away from these localised troubled areas should not be distracted from the fundamentals* ...... equities should continue to be supported by solid economic growth and continued corporate earnings increasing.

At present, the outlook for the world economy appears benign. Overall, it continues to grow well and inflation is manageable despite high oil prices although no central banker is going to have any sense of complacency about it, hence repeated mention of inflationary risks after central banks' meetings. The IMF has just raised its forecast of global growth from 4.9% this year and next to 5.2%. Whilst we may look at temporarily sub-par growth in the USA, the strength of the Asian economies, led by China and India, provides a powerful driver for international

growth. As a result of this quite strong level of international economic growth, many companies should continue to be able to increase their profits and dividends as well as repurchase their own shares, a feature of markets for some time and a support to them. This environment is also favourable for merger and acquisition activity as companies feel confident about expansion although we will qualify this to a certain extent when we discuss economic and stock market risks.

What are the risks? We have mentioned in previous reviews that we believed that certain areas of the financial and property markets had seen too much speculation as a result of complacency creeping into investors' thinking because, as one example, volatility had become very low. The areas we had in mind were low grade bonds, the "carry trade" and certain areas of the property market. On the other hand, we considered international equities to be reasonably valued against the international economic prospects as we saw them.

An early hint of problems came in the U.S. sub-prime lending market late last year. Investors, seeking higher yield at a time of relatively low interest rates, sought to buy these assets which also were sliced up into other securities such as asset backed securities of various types, collateral debt obligations and collateralised loan obligations. The exposure, to different degrees, deepens through the system and amongst investors. Some of these assets are highly complex. Valuations of assets can be marked sharply lower and liquidity issues arise perhaps in some hedge funds which hold them. We have already seen some pain occurring for instance with two high profile US hedge funds and cases also in the UK and Australia. In talking to the Senate Banking Committee, Ben Bernanke said that losses associated with sub-prime mortgages could reach US$100 billion. A tightening of credit markets will affect leveraged acquisitions, for instance by private equity. Funds might dry up and it is interesting to note that some of the weakest stock market performers towards the end of July, when markets fell, were those companies which had experienced speculation that they might be the target of a private equity bid. On the other hand, the corporate sector internationally is in a strong financial position and we would expect a continuation of conventional takeover activity - i.e. one public company buying another. Also, with many authorised buy backs in position, any market weakness is likely to provide an opportunity to accelerate companies' buy back programmes. The problems of the US housing market, which were at the root of the difficulties, continue. The rise in US interest rates, which has occurred, has made the servicing of mortgages more expensive and with borrowers of poor credit quality, delinquencies increased. It is a vicious circle as foreclosures have the effect of weakening house prices. There are many investors who, although they would not have known it at the time, have exposure through the various derivatives and will come to regret their exposure. But this does not mean that the outlook for the world economy has deteriorated significantly. The hope and, on balance, the belief is that the effect can be isolated and we will come to this later on.

An area, which we have highlighted in previous reviews, and connected more generally with the above, is property. The UK may be an example of where problems could lie. In the commercial property market, yields fell significantly at the same time as the Bank of England was tightening monetary policy by raising interest rates. As some investors ignored shares to go into the latest "hot" asset, overheating took place. Asset allocations have been moving away from commercial property and this has caused some issues for open ended funds which have to sell property to raise funds to meet redemptions. So some funds have gone on to a bid basis.

Another area of obvious speculation has been the "carry trade" whereby some investors have borrowed cheap funds, notably in yen, to buy higher yielding assets in other currencies. With a large interest rate differential and seemingly low volatility in the market, the opportunity for profit seemed too good to be true. A currency like the New Zealand dollar has, until the last few days, been very strong as the central bank steadily raised interest rates to 8.25%. But New Zealand has a current account deficit of around 9% of GDP and the New Zealand dollar is not a widely traded currency and is extremely vulnerable to a change in sentiment. Japan, on the other hand, runs a substantial current account surplus and has potentially very strong fundamentals for the currency. The apparent "no lose" situation with the carry trade is the opposite for many investors.

But can conventional investors in equities afford to ignore what is going on in credit markets if they, themselves, are not directly involved? "Ignore" is a strong word but they can probably feel comforted by macro economic fundamentals which point to continued satisfactory economic growth. The IMF, towards the end of July, raised its forecast for world economic growth this year and next to 5.2% from 4.9%. Whilst, for historical reasons, it is natural to look at events in the USA, as the world's largest economy, for an economic pointer, investors should, of course, be looking increasingly towards Asia, the current driver of world economic growth. In the case of China, growth is turning out to be even faster than expected whilst India is also powering ahead. So the new world order provides some comfort should there be an economic shock in the west. We should also be comforted by the strong financial position of the corporate sector. Years of rapid profits growth have left many companies in a very strong financial position which they are exploiting in a number of ways including, importantly, measures to increase shareholder value. We have seen significant dividend increases and returns of capital and very active share buy back schemes. Should the market pull back significantly, we can expect more aggressive share buy backs which may be expected to provide some support for shares. Even though share prices have risen considerably, so have corporate earnings, more so very often, and, even with interest rates higher than they were, the mathematics of share buy backs is still positive for many companies. Whilst equities have had to face competition from other forms of investment, including relatively new ones, measures to limit their supply should provide good support for them. If things were to become really serious in the credit markets, such that they threatened economic trouble, central banks may be expected to intervene, as before, to lower interest rates. We are nowhere near that situation at present but, when there is trouble, investors should bear in mind that offsetting monetary policy action is always a possibility. We see the balance of probability as favourable that the world economy and stock markets can withstand the difficulties in the credit markets and related securities.

One of the current topics and, for us, an intriguing one for world stock markets is the emergence of vast Sovereign Wealth Funds. "Emergence" is not exactly the right word. Many of them have been around for a long time and have been very large. Now they are enormous and growing and are capturing the attention of governments and investors. China is to dedicate part of its vast foreign exchange reserves, US$200 billion, to achieving higher returns than on its conventional investment of its foreign exchange reserves, and the Middle Eastern oil and gas producers also are accumulating enormous funds as a result of the rise in energy prices. They are keen to make long term investments which, in the case of the Gulf States, will enable them to diversify their energy dependent economies. Equities and property are obvious assets that fit the requirement. The UK, which, to its credit, remains one of the most open economies, has seen a number of public companies acquired by foreign investors or seen substantial stakes acquired as well as significant property assets. Because equities and property are likely to provide higher returns than bonds or cash, they are likely to see significant sums invested in them. In so far as money is diverted from bonds it may not be so good for the latter but, for international equity markets which are open to foreign investors, benefits should be seen. Unfortunately, in the USA and parts of Europe, this brings out protectionist sentiments. In so far as there is any justification for these, it is that reciprocal investment is not possible or welcome in countries which have Sovereign Wealth Funds or that, having privatised many companies, it is not logical to allow them back into state owned foreign hands. But whilst western countries work on this issue with the relevant countries, it is not sensible to put up the barriers. With countries like the US and UK running substantial current account deficits, foreign inflows of capital are needed to prevent significant currency depreciation. Protectionism is our greatest fear for the world economy and stock markets and Sovereign Wealth Funds are the latest target of the protectionists.

We mentioned that the IMF, in its updated World Economic Outlook projections from those made in April, had raised its forecast for international economic growth for this year and next from 4.9% to 5.2%. Within that overall figure, there is a very minor upward revision to growth forecasts for the advanced economies to 2.6% for this year and 2.8% for next year, in both cases an increase of 0.1%. Within the advanced economies, the IMF has slightly reduced its forecast for US economic growth this year to 2.0% from 2.2% but left it unchanged at 2.8% for next year. The euro area has seen quite a significant increase in forecast growth from 2.3% to 2.6% this

year and from 2.3% to 2.5% next year. Within the eurozone, the most striking forecast is for Germany where the growth projection for this year has been raised by 0.8% to 2.6% and by 0.5% for 2008 to 2.4%. The IMF is also more optimistic on Japan, raising its forecast for this year by 0.3% to 2.6% and shading it up slightly next year by 0.1% to 2.0%. Elsewhere, the forecasts for newly industrialised Asian economies have been modestly raised by 0.2% this year and next to 4.8% each year. The category of "other emerging markets and developing countries" has seen its forecasts raised significantly by 0.5% this year and next to 8.0% and 7.6% respectively. The forecast for Russia has been significantly increased by 0.6% this year to 7.0% and by 0.9% next year to 6.8%. We mentioned earlier the influence of China and India in helping to drive forward the world economy at a time when there might be relative weakness in, say, the USA. The IMF now sees growth in China at 11.2% this year, 1.2% higher than its April forecast and 10.5% next year, 1.0% above its April forecast. India, too, has seen an upgrade with growth this year and next seen 0.6% higher than forecast in April at 9.0% and 8.4% respectively. Its forecasts for inflation are slightly higher, too. In the advanced economies, it sees inflation at 2.0% this year against its earlier forecast of 1.8% although it makes no change to its forecast of 2.1% for next year. In its category of "other emerging markets and developing countries", its forecast for inflation this year is 5.7% compared with 5.4% in April and 5.0% next year compared with 4.9% in its earlier forecast.

Whilst the IMF has raised its forecast for economic growth this year and next it says, as it did in April, that risks to the favourable outlook remain modestly tilted to the downside. On possible negative developments, the IMF cites supply constraints and the edging up of inflation risks which may require further monetary tightening. An oil spike, naturally, is also mentioned. It also cites increased financial market risks. On the positive side, it cites lessened downside risks associated with US domestic demand. The IMF has built into its baseline projections the upside risks to growth in the euro area and emerging market countries discussed in its April World Economic Outlook. It also notes some progress towards reducing the risks of a disorderly unwinding of global imbalances. It mentions protectionism as a concern and we discussed that worry earlier. It needs watching. We discussed the issue in terms of the Sovereign Wealth Funds but the antagonism displayed towards China in the west needs restraint especially in a country like the USA with a large current account deficit and enormous foreign liabilities. Antagonising a powerful creditor like China is not clever as its large foreign exchange reserves, to give one example, can be rearranged to the embarrassment of the USA. Wise heads in the USA realise this but some members of Congress do not appear to. But, overall, the picture painted by the IMF in its update is a positive one. A footnote to this, as we discussed earlier, is the importance of China in the world economy. In raising its forecast for economic growth this year and next, the IMF said that China will become the biggest driver of global economic activity.

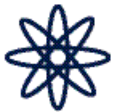
We move now to look at the different countries and regions of the world, starting with the USA. Although problems in the sub-prime loan markets have made the headlines, as we discussed earlier, there has been some good news from the US economy. The Commerce Department has reported its first estimate of second quarter US GDP growth, which is an annualised 3.4%, a higher figure than generally expected. This followed the very low growth figure of 0.6% in the first quarter. This pattern of growth falls in with the statement by Ben Bernanke to Congress in which he said that the economy was likely to expand "at a moderate pace" over the second half but that overall growth for the year would be lower than expected at between 2.25% and 2.5%. After the first quarter's low growth, growth will be skewed to the other three quarters. Ben Bernanke's chief concern remained inflation. Domestically, there is some more encouraging news on the budget deficit, although it comes with some qualifications. The White House has estimated that the US budget deficit would fall to US$205 billion by the end of September compared with its estimate of US$244 billion made in February. US$205 billion would reflect a budget deficit of 1.5% of GDP against 1.8% which US$244 billion would have represented. Whilst this level of budget deficit is quite low compared with that of many other industrialised countries, economic growth is well established and the figures would ideally be in surplus in preparation for more difficult times. The change in control of Congress has led to further upward pressure on spending requests which may lead to a Presidential

veto. The White House has now forecast an increase in the budget deficit as a percentage of GDP in fiscal 2008 to 1.8% against its earlier forecast of a fall from 1.8% to 1.6%. This reflects a return to more normal levels of tax receipts and upward pressure on spending. To put the situation into context, the present position is better than many envisaged when the Administration was running high levels of budget deficit after cutting taxes. However, politicians have an insatiable desire to spend money and it is a question of dealing with the art of the possible. The situation is worse elsewhere in Japan, the UK and some eurozone countries, for example.

We have discussed the possible effects of the problems in the sub-prime loan market earlier on but it is worth looking at the latest data from the area which has been a major contributor to the problems in the market, housing. In July, the National Association of Realtors forecast that US home sales and prices would fall further this year than previously expected. Its prediction was that national average US house prices would fall by 1.4% this year to US$218,000. The National Association of Realtors also reported that the pace of existing home sales in the USA fell in June to a 5.75 million unit annual rate. Sales fell by 3.8% to their lowest level since November 2002. On the other hand, it said that prices and sales showed signs of stabilising. The Commerce Department reported that sales of new homes fell at an annual rate of 6.6% in June and also lowered its estimate of homes sold in May. On a more positive note, housing starts rose a better than expected 2.3%. What is certain is that a full recovery can only be made when excess inventories of housing on the market are worked off and an equilibrium level reached.

As might have been expected with the economy showing signs of acceleration in the second quarter after a sluggish start to the year, a number of individual indications about the state of the US economy have been positive. The ISM survey of manufacturing activity came in with a reading of 56.0 in June compared with 55.0 in May. The ISM's index for the services sector in June was also strong, rising to 60.7 from 59.7 in May. Its employment index measure crept up from 54.9 in May to 55.0 in June. The June payrolls report was also encouraging with 132,000 new jobs added as well as an upward revision of 75,000 to the previous two months' total to keep the unemployment rate unchanged at 4.5%. Although the May trade deficit widened because of rising oil prices, exports were at a record level. The very competitive level of the US dollar is likely to be making its presence felt in export markets. There was an improvement in the Reuters / University of Michigan sentiment survey with its preliminary confidence index for July rising to 92.4 compared with a June reading of 85.3. The Conference Board's consumer confidence index rose to 112.6 in July, the highest level since August 2001. Industrial production rose by 0.5% in June after a fall of 0.1% in May and capacity utilisation was 0.3% higher in June at 81.7%. The latest three month annualised rise in production is running at 3.4%. But, whilst the balance of the news has been positive, there have, as would be expected, been some negative indicators. The Conference Board reports that chief executives are less optimistic about economic growth. The confidence index fell, in the second quarter, to 45 from 53 in the previous quarter. Retail sales were weaker than expected in June. They were lower than in May by 0.9% and, if autos were excluded, down by 0.4%. Personal spending increased by just 0.1% in June following a 0.6% rise in May. The Conference Board's index of leading indictors fell by 0.3% in June following a downwardly revised rise of 0.2%. But, overall, notwithstanding the sub-prime woes, recent news has been quite comforting. This would explain why the Federal Reserve's main item of concern is inflation rather than the dangers of economic weakness. That could, of course, change but, for the moment, inflation is the main worry.

Not that inflation is bad at the moment - it is just a worry where it might get to when there are obvious inflationary pressures around in the areas of energy and food. The June producer price index fell by 0.2% but the core rate rose by 0.3%. Headline producer prices were up by 3.3% over the year whilst the core producer price index was up 1.8%. The consumer price index was up 2.7% on the year previously whilst the core rate was up 2.2%. Encouragingly, the Federal Reserve's preferred inflation indicator, the core personal consumption expenditures index, which excludes food and energy prices, has been moving in the right direction. It rose by just 0.1% in June and by 1.9% for the year, within the Federal Reserve's target range. The headline index was up 2.3%.



Whilst we are not at the end of the corporate earnings reporting season in the USA, results so far have been generally satisfactory. What is of help to the large capitalisation US stocks in that they often have substantial overseas business or are large exporters. The weakness of the US dollar helps on both counts. Translated earnings increase in value and exports are more competitive and profitable depending upon the pricing policy used. Furthermore, as we saw from the sluggish first quarter growth in the US economy and IMF forecasts indicating faster growth outside the USA, overseas markets and economies are likely to be the main drivers of profits growth in the USA. So more lowly rated large capitalisation US stocks have an advantage in the current environment. Whilst the weakness of the US housing market has detracted from overall economic growth, we believe that the effects can be contained because of buoyant international economic growth.

In Japan, the main item of interest is the heavy defeat of the LDP in the recent elections for the upper house of the Japanese Parliament. Whilst not as important as the lower house of the Japanese Parliament, the defeat will make life more difficult for the LDP and in terms of slowing down much needed macro and structural reforms to the Japanese economy, it would be bad news. We have to see how the situation unfolds.

Economic conditions remain benign for Japanese companies which are significant exporters. The absence of inflation and a very competitive currency are excellent factors for them. We see some very buoyant results from Japanese exporting companies. Whilst fundamentals in terms of a large current account surplus would normally be considered a supportive factor for the currency, previously deflationary conditions and, now, effectively flat prices, mean that any significant nominal interest rate would also be a significant real interest rate, something that is not appropriate to the Japanese economy. With interest rates rising in a number of other major countries, the interest rate differential has encouraged the "carry trade" which has depressed the yen. But, as we have often pointed out, it is a very risky strategy and, in recent days, the yen has bounced bank sharply against currencies which have received attention from the other side of the "carry trade" such as the Australian and New Zealand dollars. The August meeting of the Bank of Japan will be interesting. Its last meeting in July voted by 8-1 to leave interest rates unchanged but many in the Bank of Japan would like to see a more normal monetary policy. However, with flat prices, it is difficult to justify tightening monetary policy and, unusually, the weak yen has not caused inflation to occur, let alone to rise. In fact, the latest inflation figures show that year on year Japanese consumer prices fell for the fifth month in a row. The core consumer price index is 0.1% lower than a year ago. A further factor inhibiting the Bank of Japan from raising interest rates is the fall in average earnings which were 1.1% lower in the year to June.

In early July, the Tankan survey showed the large manufacturers' diffusion index remaining unchanged at +23, quite a positive figure with a high degree of confidence well spread between manufacturers and non manufacturers. Significantly less positive readings came from small and medium sized manufacturers which are not so exposed to export markets. At the end of the month, there was good news on industrial output which rose by 1.2% in June, the first increase for four months. Unemployment continues to fall, being down to 3.7% in June. The overall economic outlook for Japan looks relatively good. China remains a positive feature for the Japanese economy as it is an important market for its exports, and Chinese economic growth looks as if it will continue strongly. As we noted at the beginning of this review, the IMF has modestly upgraded its growth projections for this year and next for the Japanese economy.

As we mentioned earlier, the IMF has upgraded its forecasts for eurozone growth this year and next, reflecting the quite buoyant conditions which presently obtain. However, in the short term, perhaps the most interesting issue is the political one which has arisen since the election of President Sarkozy in France. He has made no secret of his wish to have more political influence on the ECB in terms of exchange rate and interest rate policy and to make it more pro growth orientated. In particular, he wishes to stimulate the French economy by tax cuts which would break France's undertakings on fiscal discipline. Italy would also like more flexibility but, predictably, this has met with Germany's ire, as it regards the ECB's independence as sacrosanct. Germany's will is likely to prevail

but it does underline all the potential conflicts which exist within a monetary union which is not optimal. As one might expect, the ECB has weighed in on this issue. The President of the ECB said its governing council noted "with concern" pressure in some eurozone countries "to relax previous fiscal consolidation targets". He said that it was "imperative" that, in good times, all governments complied with the EU's fiscal rules.

At its latest meeting, the ECB kept its interest rate unchanged but there remain expectations of a further increase in the autumn. Mr Trichet told the European Parliament that the ECB remains ready to take "firm and timely action". At present, inflation is within the ECB's target range of close to but below 2%. For four successive months it has remained at 1.9% but the ECB has indicated previously that it expected it to move higher later this year. Producer price inflation in May fell to an annual rate of 2.3% compared with 2.4% in April.

As might be expected with the economic growth upgrades for the eurozone, the balance of short term economic news has been favourable. First quarter GDP growth has been revised upwards to 0.7% compared with the previous estimate of 0.5%. The NTC/RBS purchasing managers index for the manufacturing sector rose to 55.6 in June compared with 55.0 in May. The equivalent survey for the services sector was 55.8 in June compared with 55.6 in May. The flash estimate for both manufacturing and services sector for July shows a slight decline but both are still strong readings. In the construction sector, the CIPS purchasing managers survey showed an index level of 60.1 in June compared with 58.0 in May. Eurozone unemployment in May fell to a new low of 7.0% in May compared with 7.1% in April. Industrial production in the eurozone rose by 0.9% in May compared with April when it had declined by 0.7%. Industrial new orders also showed an encouraging picture in May, rising by 1.7% to give a 9.1% rise over the year.

An important reason why the eurozone economy is performing well is because of the relative strength of the German economy. In the first quarter, it grew by 0.5% compared with the previous quarter and the Bundesbank thinks it grew by slightly less in the second quarter. Indicators of strength in the German economy are a rise of 3.2% in manufacturing orders in May, comprising a rise of 2.2% in domestic orders and 4.4% in overseas orders. Industrial production rose by 1.9% in May to give an annual rate of increase of 4.6%. The trade surplus rose still further in May to €6.7 billion from €5.8 billion for April reflecting the strong demand for German exports. Unemployment continues to fall, down by a seasonally adjusted 45,000 in July to 9%. The VDMA federation of machine makers reported orders up 19% in the first half. One negative survey coming out recently from Germany was the ZEW Institute survey of investor confidence which fell to 10.4 in July from 20.3 in June. Reasons given for the decline in the reading were the euro's strength and rising oil prices. But this was an isolated negative indicator and it is also worth noting in the context of our discussion of eurozone interest rates and the ECB's caution on inflation that, according to preliminary statistics, German inflation rose to 2.2% in July compared with 2.0% in June.

Within the eurozone, there was some good news from Italy which is a weak link in the eurozone because of its very high level of public debt, standing at over 100% of GDP. Agreement has been reached between the government and trade unions on pension reform, one of the most serious issues facing the Italian economy. The agreement involves raising the retirement age from 57 to 61 between 2008 and 2013.

So, overall, conditions in the eurozone remain good, providing solid support for markets which, because of the large rise in corporate earnings in recent years, still seem reasonably valued.

Because of the size of its economy, its rapid economic growth and its influence on the world economy, China increasingly dominates economic discussion whether it be because of its own remarkable economic performance or because of the resentment felt towards it by protectionist tendencies in the west.

As we noted earlier, China is growing extremely rapidly. In the year to the second quarter of 2007, growth stood at 11.9% compared with the same period in 2006. Even though China needs rapid growth to absorb those coming into urban areas from rural ones, the danger of overheating and asset bubbles is one to which the authorities

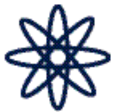
are very much alive. Inflation has been rising as it reached 4.4% in June. The authorities have reacted in a number of ways to try to cool down growth. There has been a series of interest rate increases as well as increased reserve requirements placed on banks. In July, as well as raising interest rates, the authorities announced that they would cut the tax on bank deposit interest with the aim of making saving more attractive.

China's trade surplus reached an all time high of US$26.9 billion in June and, for the first half of the year, the surplus reached US$13 billion. It is this magnitude of surplus which causes resentment in the West with China being accused of keeping its currency artificially low. But, even if the currency were revalued significantly, import substitution would be very difficult in many countries since they no longer make the goods and prices of imports would simply be higher. As a result of the large trade surplus and inward flows of investment, foreign exchange reserves stood at US$1.33 trillion at the end of June. Between January and June, the foreign exchange reserves rose by US$266.3 billion. Part of these, about US$200 billion, will be earmarked for investment in potentially higher yielding investments, an issue we discussed earlier on in the context of Sovereign Wealth Funds. Partly to take the pressure off the rapidly growing domestic economy and to offer a wider opportunity to increase investment returns, Chinese insurance companies are to be allowed to invest more overseas. They will now be allowed to increase their overseas investments to 15% of assets from 5%. Chinese insurance companies have £161 billion in assets, and growing quickly, so the sums and effect could be significant. Together with sums to be available for the China Investment Corporation, as discussed above, China will be an increasing influence on the world's securities markets.

Of course, Asia, generally, is growing strongly. The Asian Development Bank, in its recent report, has raised its economic growth forecast for the region for this year from 7%, the forecast made last December, to 8.1%. In a generally positive review, the ADB warned that East Asia's financial markets are vulnerable to a sudden unwinding of yen carry trades and withdrawal of capital. It said relevant countries must be ready for a reversal of flows and it made various recommendations to improve the economic framework. But, notwithstanding these very relevant words of caution, the region is in a strong position which has been reflected in a generally pleasing stock market performance.

July has seen a further increase in UK interest rates as the Monetary Policy Committee of the Bank of England voted by 6 - 3 to raise interest rates to 5.75%. Reasons given with the announcement were : strong growth, limited spare capacity and indications of increased pricing power by businesses. It warned, as previously, that the balance of risks to inflation lay on the upside. When the minutes of the meeting were published later in July, the different interpretations of the state of the economy, as evident from the split vote, became clear. The doves were "not clear that the economy as a whole was operating substantially above its non inflationary capacity". They did not feel that the full effect of the previous interest rate rises had been felt, referring to the delayed effect on mortgages when interest rates were reset. There were also differing interpretations of the state of the labour market. The hawks, who prevailed at the meeting, cited strong money supply growth, buoyant corporate activity and the likelihood that import prices were rising as reasons to raise interest rates again.

What, therefore, is the latest picture on inflation? Producer prices - i.e. the cost of goods leaving the factories, rose by 0.2% in June compared with May. Annual producer price inflation remained at 2.4% for the third consecutive month. At the input level, prices rose by 0.6% in June to give an annual rate of 2.1% compared with 1.3% the previous month. So there is some evidence of cost push inflation from import prices, not surprisingly, given the increase in the oil price. The latest consumer price index for June showed a year on year rise of 2.4%, slightly lower than the previous month's 2.5%. At the core level, the increase was 2.0%, the highest level for ten years. On the more realistic (for many people) measure of inflation, the Retail Price Index, it increased to 4.4% in June compared with 4.3% in May. The Bank of England also monitors anecdotal evidence on inflation, with respected surveys a useful source of evidence. The RBS / CIPS purchasing managers' survey for the manufacturing sector, published at the beginning of July, showed that import costs rose to a nine year high in June with output prices

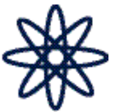


falling a little compared with May but still close to May's high. The CIPS / NTC index of prices for the services sector rose to 53.3 in June from 52.5 in May but, in absolute terms, does not signify significant upward pricing pressure. A CBI survey of the manufacturing sector actually showed some diminution in pricing pressures as it reported the balance of manufacturers expecting to increase prices in the next three months at +11% compared with +16% in June and +25% in May. In terms of pay pressure, there is little sign of cost push inflation. Average earnings growth, including bonuses, was 3.5% year on year in May compared with a rise of 4.1% to April. That was the lowest level of increase for eighteen months according to the ONS. We can say from the above selection of indicators that there is support for both the hawks and the doves on the Monetary Policy Committee and that the evidence is inconclusive.

The ONS's initial estimate of second quarter GDP growth is 0.8% compared with 0.7% in the first quarter. Compared with the second quarter of 2006, the rise is 3.0%. Manufacturing, although now a relatively small part of the economy, was a driver of growth, and production industries showed a rise of 0.6% in the second quarter compared with the first quarter. The service sector showed quarter on quarter growth of 0.8%.

One of the indicators that is most closely watched by the Monetary Policy Committee is the housing market. One important reason for the series of interest rate increases has been an attempt to put a brake on the rate of inflation in the housing market which threatens wider inflation and unbalancing the economy. The ideal situation the Bank of England would like to engineer is a slowdown to a very modest level of inflation in the housing market, perhaps to the level of inflation generally obtaining in the economy. Runaway house price inflation is likely to lead to a bust in the economy with all the unpleasant consequences which that would entail. An example to avoid would be the problems in the US housing market. House prices have not crashed in the USA but they are generally stable and the damage has been caused by the rise in interest rates. Because of the importance of the housing market in the UK economy, the Bank of England will be keen to strike a careful balance in its monetary policy in as far as it affects the housing market.

The early evidence is that the series of interest rate increases is beginning to have some effect although it is too early to say that it is conclusive. In terms of the evidence on house prices, there are a number of reports which come out each month. Hometrack reported that house prices rose by 0.3% in June compared with 0.6% in May to bring the annual rate of inflation down to 6.4% compared with 6.7% in May. The Halifax reported house price inflation of 0.4% in June after a rise of 0.2% in May. The annual rate of house price inflation according to Halifax's figures was 10.7%. The RICS reported that house price inflation in June was less than half the level of May. The FT House Price index showed a rise in the price of the average house of 0.7% in June compared with 0.5% in May, to give an annual increase of 9% in June compared with 8.7% in May. The Nationwide reported a 0.1% rise in house prices in July to take the annual increase down to 9.9% compared with 11.1% in June. The Department for Communities and Local Government reported annual house price inflation at 10.9% in May, down from 11.3% in May. The Land Registry reported that house prices rose by 0.4% in June compared with 0.6% in May to give a year on year increase of 9.1%, up from 8.8%. In terms of forecasts and statistics from the lenders, it is interesting to note the forecast from the Director General of the Council of Mortgage Lenders that there will be a crunch in the property market next year. He forecast a rise in prices of 2% to 3% in 2008. The British Bankers Association reported a slight decline in mortgage approvals in June, 75,300 against 77,400 in May with the number being 11% lower than a year ago. The overall figure for approvals given by the Bank of England suggested a slightly stronger picture with the figure of 114,000 unchanged from May and the actual figure lent in June was higher than in May. It would be a fair summation of the evidence above that a slowdown in probably occurring but that several months' more evidence is needed for this to be a conclusive assessment. As before, everyone is agreed that London is a different market, reflecting the fact that it can be considered an economy of its own. Whilst prices in some parts of the country are falling, they are still rising strongly in London.



The balance of economic indicators appearing over the last month point to a fairly positive position for the UK economy supporting the evidence provided by the first estimate of second quarter growth from the ONS. One cloud on the horizon for the manufacturing sector is the strength of the pound. A number of exporters have made this point in reporting their recent results. If the pound continues to remain strong (it appears overvalued) then UK manufacturing companies are likely to diversify further their manufacturing activities.

As we always emphasise during a period of volatility, long term investors should stay with the fundamentals rather than be intimidated by markets into taking investment actions which they could later regret in terms of opportunity costs. The lessons of May and June 2006, and to a lesser extent, February this year, are instructive. Markets soon recovered in the face of good fundamentals for shares. Our view is that, on balance, the evidence from the world economy continues to favour equities as an asset class. Bonds, we still believe, are rather expensive and we would stay with cash or the shorter end of the market for portfolios or those parts of portfolios which are normally allocated to bonds.

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