meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

It has been an eventful quarter in financial markets but the overall result has been that most conventional equity portfolios will end the quarter little changed, whilst high quality bonds will have yielded positive returns. The calendar year to date will, therefore, still be showing most equity investors a satisfactory return, rather better than on bonds.

The tables below detail relevant movements in markets:

International Equities 29.06.07 – 28.09.07

Total Return Performances (%)

Country	Local Currency	£	US$	€
Australia	+6.4	+9.3	+11.0	+5.4
Finland	+16.4	+20.7	+22.5	+16.4
France	-5.4	-1.9	-0.4	-5.4
Germany	-1.4	+2.3	+3.8	-1.4
Hong Kong, China	+26.9	+25.7	+27.7	+21.2
Italy	-4.2	-0.7	+0.9	-0.7
Japan	-8.3	-3.1	-1.6	-6.5
Netherlands	-0.6	+3.1	+4.7	-0.6
Spain	-1.1	+2.5	+4.1	-1.1
Switzerland	-3.3	N/C	+1.5	-3.6
UK	-1.3	-1.3	+0.2	-4.8
USA	+2.1	+0.6	+2.1	-3.0
Europe ex UK	-2.8	+0.8	+2.4	-2.8
Asia Pacific ex Japan	+11.4	+12.0	+13.8	+8.0
Asia Pacific	+0.5	+3.9	+5.5	+0.2
Latin America	+7.5	+8.4	+10.1	+4.6
All World All Emerging	+11.4	+11.6	+13.3	+7.6
The World	+0.6	+1.5	+3.0	-2.2

Source FTS E World Indices

FT Government Securities Index All Stocks (total return): +4.1%

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

Currency	29.06.07	28.09.07
Sterling	5.46	5.06
US Dollar	5.04	4.55
Yen	1.87	1.68
Germany (Euro)	4.56	4.34

Sterling's performance during the quarter ending 28.09.07 (%)

Currency	Quarter Ending 28.09.07
US Dollar	+1.5
Canadian Dollar	-5.1
Yen	-5.4
Euro	-3.6
Swiss Franc	-3.2

Other currency movements during the quarter ending 28.09.07 (%)

Other Currency	Quarter Ending 28.09.07
US Dollar/Canadian Dollar	-6.6
US Dollar/Yen	-6.9
US Dollar/Euro	-5.0
Swiss Franc/Euro	-0.4
Euro/Yen	-1.9

Significant Commodities (US dollar terms) 29.06.07 – 28.09.07 (%)

Significant Commodities	29.06.07 – 28.09.07
Oil	+12.5
Gold	+14.3

Markets

Although there has been volatility in equity markets over the quarter, they have generally consolidated the progress noted in the first half of the year. In local currency terms, the FTSE World Index has shown a total return of 0.6%, in sterling terms 1.5%, in US dollar terms 3.0% and only in euro terms has there been a negative return, -2.2%. Looking at relevant FTSE World indices, the USA has returned 2.1% whilst Europe ex UK has returned -2.8%, Japan -8.3% and the UK -1.3%. Australia has been a positive feature with a return of 6.4%, but, as so often in recent times, the outstanding performers have been Asia Pacific ex Japan with a return of 11.4%, Latin America 7.5% and emerging markets 11.4%. Within the European section, Finland's performance has stood out with a return of 16.4% as a result of Nokia's strength during the quarter. If we look at sterling adjusted returns, Europe ex UK moves to a positive return of 0.8% whilst the USA's positive return is reduced to 0.6%. Japan's negative return is reduced to -3.1%. Australia's return moves up to 9.3%. Returns in Asia Pacific ex Japan, Latin America and emerging markets also moved higher to 12.0%, 8.4% and 11.6% respectively.

The flight to quality in credit markets was reflected in downward movements in the gross redemption yields on ten year government bonds. Those on sterling bonds fell by 40 basis pints to 5.06%, on US dollar bonds by 49 basis points to 4.55%, on yen bonds by 19 basis points to 1.68% and those on German issued euro denominated bonds to 4.34%.

The currency markets saw some significant moves with weakness in the US dollar and sterling. Against the US dollar, sterling rose by 1.5% but, elsewhere, it was weak, falling by 5.4% against the yen, 3.6% against the euro and 3.2% against the Swiss franc. One of the most remarkable recent movements in currencies has been that of the Canadian dollar which has moved to around parity with the US dollar, the first time for around thirty years. During the quarter, the US dollar fell by 6.6% against the Canadian dollar.

In the commodity markets, oil and gold both performed strongly, rising by 12.5% and 14.3% respectively, the latter movement probably reflecting fears that policy reactions to credit market turmoil could lead to a rise in inflation.

Economics

- *A time of turmoil in credit markets* ...... but quality equities and bonds hold their own.
- *Credit markets seize up* ...... but central banks, to differing degrees, take action to provide liquidity.
- *The rise in inter bank rates to a large premium over official rates is very unusual* ...... it is effectively an interest rate increase for many borrowers who are tied to inter bank rate. Savers, however, have benefited.
- *The currency markets have been affected* ...... the US dollar, in particular, and sterling have weakened.
- *The outlook for economic growth has deteriorated* ...... nevertheless, there was strong momentum coming into the credit market difficulties which should limit the impact.
- *Oil and food represent two sources of inflationary pressures* ...... OPEC agrees to raise output by 500,000 barrels a day from November and the position will remain tight.
- *Sovereign Wealth Funds are becoming an investment and political issue* ...... they raise the ire of the protectionists but they should be good news over the longer term for equity investors as the funds seek to raise their returns.
- *Ultimately, if there is a sensible re-pricing of risk, the world economy will benefit* ...... it could be argued that current problems in the credit markets started with ultra low interest rates and excess liquidity which encouraged dangerous risk taking. Ultimately these could, in some circumstances, but probably not these, lead to major economic problems. A sensible re-pricing of risk could help to obviate this.

USA

- *The Federal Reserve acts decisively to address credit market conditions* ...... it reduced the targeted federal funds and discount rates to 4.75% and 5.25% respectively. Discount window borrowing, therefore, becomes less penal.
- *The decisive reduction in the targeted federal funds rate sparks a rally in US share prices* ...... is this a Bernanke "put" like the Greenspan "put" ?
- *However, inflation figures give some support for the Federal Reserve's action* ...... for example, the Federal Reserve's preferred inflation measure, the personal consumption expenditures index, fell 0.1% in August to give a year on year rate of 1.8%.
- *Weakness in the US dollar is now helping to improve the trade deficit* ...... although much lower than the level of imports, exports are growing much faster so that there has been quite a large fall in the trade deficit in the year to July.
- *Hopes of stabilisation of the housing market look premature* ...... recent data still suggests significant weakness.

Japan

- *Shinzo Abe resigns* ...... the LDP's political weakness will stall the pace of reform.
- *Recent growth has been disappointing* ...... second quarter economic growth is revised to a negative 1.2% on an annualised basis.
- *The Bank of Japan leaves interest rates unchanged* ...... growth and inflation figures give no comfort to those who want to move towards a more normal monetary policy.

China

- *The authorities' main concern is inflation* ...... led by food price increases, August's inflation rate rises from 5.6% to 6.5%.
- *The People's Bank of China continues to tighten monetary policy* ...... the lending rate rises to 7.9% and banks' reserve requirements are raised.

- *The government acts to control state controlled prices* ...... they are frozen.

Europe Ex UK

- *Conditions in the credit markets stay the hand of the ECB* ...... the expected increase in the interest rate from 4% fails to materialise.
- *There has been a downward revision in growth forecasts* ...... the EC and ECB reduce their forecasts slightly to growth of 2.5% this year.
- *Short term economic indicators have turned weaker* ...... the purchasing managers' indices decline (although still in positive territory) as does the EC's economic sentiment index.
- *Two non eurozone central banks raise interest rates* ...... Sweden raises rates to 3.75% and Switzerland to 2.75%, both rises of 0.25%.
- *The situation in France is very interesting* ...... President Sarkozy presses on with significant economic reforms and annoys his eurozone partners by allowing the target date for a zero deficit to slip two years to 2012.

United Kingdom

- *Northern Rock makes headline news around the world* ...... it is an embarrassment for the UK for pictures of people queuing to withdraw their deposits to be flashed around the world.
- *There is heightened speculation of an early general election* ...... from an economic perspective, this may be the most favourable time for the government to go to the country as conditions are likely to deteriorate.
- *A particular concern is the state of public finances* ...... the UK should not be running a structural deficit after a strong period of growth. It leaves little scope to provide offsetting fiscal action in the event of slower than expected economic growth, a position which looks increasingly likely.
- *The housing market is a key pillar of the UK economy* ...... the positive or negative wealth effect it can create is an important influence on the UK's economic performance. The indications are mixed but some provide evidence that conditions are weakening.
- *The Bank of England keeps interest rates unchanged* ...... conditions in the inter bank markets have imposed an interest rate increase on some borrowers and the inflation data gives the Bank of England some justification for refraining from a further interest rate increase.

Summary

- *Economic growth will be affected by conditions in the credit markets* ...... but equity investors can see some offsetting benefit from interest rates being set lower than would otherwise have been the case.
- *Notwithstanding a long period of growth in the equity markets, shares still look reasonably valued* ...... the rise in corporate earnings in recent years has been so strong as to lead to shares being downrated in some cases.
- *Most recent quarterly returns have been positive* ...... one or two negative ones must realistically be expected but long term investors should not risk the opportunity cost of selling shares only for them to continue their rise.
- *We believe that equities look better value than bonds* ...... inflation is not out of the system and food is likely to be an additional catalyst to inflationary pressures.

Without doubt, the feature of the quarter has been the turmoil in the credit markets. This has, of course, been well documented but it is still worth following the train of events to see how we got into the present position. The genesis of the problem was risky lending in the US sub-prime housing market which backfired as some house prices fell and borrowers were unable to maintain their mortgage payments. In the old days, the problems of bad loans would have stayed with the originating lender's profit and loss account and balance sheet. Now, however, loans are packaged into asset- backed securities and sold on, so no one is quite sure where they have ended up. This uncertainty made banks nervous of lending to each other and caused a severe contraction in the inter bank market where banks normally lend to each other as a matter of course. The main problems seem to have been in the one month and three month areas as banks were reluctant to lend any longer than very short periods, such as overnight, to lessen their perceived risk. The banks' reluctance to lend to each other was also caused by the possibility that they might have to take back on to their balance sheets off balance sheet structures where they had made available back up credit lines. These structures normally refinanced themselves in the commercial paper market but were no longer able to do so. A credit crunch is defined as a situation where good quality borrowers are unable to access credit markets and, at one stage, we were approaching that situation although, at the time of writing, that position is beginning to ease. One month and three month sterling inter bank rates at one stage were around 100 basis points over base rate. Whilst this was good news for savers who benefited from banks' need to retain and attract retail deposits, many private and commercial borrowers' rates are tied to inter bank rates so that, at least temporarily, these high interest rates, effectively imposed an interest rate increase on part of the UK economy.

In the UK, events came to a head at Northern Rock. The particular issue here was that it operated on a different business model to other banks in that, for its size, it had a small number of branches which enabled it to keep down costs but also made it more difficult to attract retail deposits. It relied heavily on the wholesale market for funds and, when this contracted, it faced a funding problem. Hindsight is a wonderful attribute and, although many observers are pointing out the dangers of borrowing short and lending long, it should be recognised that, prior to recent events in the money markets, which were quite extraordinary, it was a well regarded bank. We can be sure that banks will be careful about funding their assets heavily with wholesale deposits.

The global nature of financial markets meant that a bank loan originating in the USA could turn up anywhere in these asset backed securities. So German banks and some hedge funds have been hit with the effect magnified by the use of leverage. It was the unpredictable nature of the problem, together with its size, which created the uncertainty.

Different countries' central banks reacted in different ways to the problem. All faced a spike in money market rates although a combination of open market operations, lender of last resort actions and, in the case of the Federal Reserve in the USA, an interest rate cut as well, have managed to control the situation which appears to be improving. The Bank of England, initially, took a much tougher approach. The Governor emphasised the danger of underwriting moral hazard and he was, of course, quite right. If lenders and borrowers feel that they will be bailed out by central bank intervention and resort to imprudent borrowing and lending practices, this raises the risks for the economy. This would be because the expected reduction in interest rates would be likely to exacerbate inflation and lead to undesirable bubbles, the bursting of which would have unpleasant economic effects. Eventually, the Bank of England relented by easing borrowing conditions in its money market operations after queues started forming at Northern Rock branches although, unlike the Federal Reserve, but like the ECB, it has not cut interest rates.

The Federal Reserve opted to cut interest rates because it was concerned about the state of the US housing market. Unlike the position in the UK, where house prices are still rising, house prices are declining in parts of the USA. The consequences of a negative wealth effect would be harmful to the US economy and the Federal Reserve will be anxious to try to prevent this happening, hence the decision to lower the target for the federal funds rate by 50 basis points rather than the more usual 25 basis points. The Federal Reserve's decision was made easier by a better trend in inflation even though it remains alert to any deterioration in the inflation outlook. Whilst the ECB did not cut interest rates, it did not raise them in September, as had almost certainly been the plan, and the Bank of England has not raised interest rates to 6% as was a possibility and still may be at some stage. So what we can say is that interest rates in the USA, eurozone and UK are lower than they would otherwise have been as a result of the turmoil in the credit markets.

Sterling and the US dollar have also suffered, probably as a result of the fall out from the credit market woes. The sight of queues of depositors waiting to withdraw their savings from a hitherto well regarded British bank will have resonated throughout the world and will have reduced confidence in the UK's system of financial regulation. The pound, in any case, is overvalued and this just may be the catalyst for a re-evaluation of its level. Apart from against the US dollar where it is little changed over the quarter, it has weakened against all major currencies. As far as the USA is concerned, the dollar will have felt the effects of lower interest rates. One of the most remarkable moves in the currency markets has been in the Canadian dollar which has moved to around parity with the US dollar, the first time this has happened for around thirty years. Investors have been attracted by its natural resources.

Whilst there has been grief in the credit markets and amongst some financial institutions and hedge funds, shares, overall, have held their levels since the end of June and good quality bonds have performed well as they have benefited from a flight to quality in the credit markets. Media headlines always emphasise bad times in financial markets. Thus, when the stock market has a particularly bad day, it may make one of the lead stories in the news or the press ; when it has a particularly good day, it is hardly ever mentioned because good news does not sell like bad news. Investors may therefore be surprised that equity markets are little changed over the quarter and perhaps a little puzzled. After all, is what has happened in credit markets not likely to cause damage to economic growth prospects? The answer is "yes" but that does not mean it will necessarily harm share prices. Firstly, we must distinguish between some of the artificially constructed structures which have got into trouble and good quality shares representing companies which provide goods and services which are needed every day. The former may hold some delinquent assets or be over leveraged or, as in the case of some quantitative hedge funds, which are computer driven, unexpected moves in asset prices occurred, which the model did not predict, causing poor performance. In circumstances such as we have seen, many investors have come to appreciate the simple and inexpensive concept of investing in a business which provides a product or service that is required and pays a dividend. Around that, they can factor in the economic outlook and valuation issues. By retaining money in the portfolio which would otherwise be paid out in fees, they have that money working for them in the portfolio to provide future growth. Although shares have performed well over many years, they do, of course, have times of weakness but, during that time, most of those shares will continue to pay dividends and, over time, most will recover and move up beyond their starting point.

The economic consequences of what has happened will be that international economic growth will be trimmed. Just prior to the problems in the credit markets, the IMF had raised its forecast for international growth from 4.9% to 5.2% for both 2007 and 2008. Whilst the problems of Northern Rock, for example, may colour the thinking of people in the UK about economic prospects, out in the east growth remains very strong and this is an important catalyst for world economic growth. Investors always need to try to anticipate what the authorities will do, especially when an unexpected development occurs, such as we have seen in credit markets. The obvious response, if things look serious, is to ease monetary policy and, in the case of the threat of a credit crunch, to use the facilities, such as use of the discount window, which are available to central banks. Ultimately, such measures should stabilise the position and lower interest rates should help to bolster growth. For shares, provided they are not too highly rated, which we do not think they are at present, that is good news. That is broadly where we are now.

However, beyond the immediate future and the necessity of restoring normality in the money markets, which central banks are presently on the way to doing, they do face difficult issues. For the moment, at least, inflation appears to be behaving itself in the USA and eurozone and, on the government's inflation measure, the consumer price index, in the UK. Japan would like to have a little inflation so that it can raise interest rates and move towards a more normal monetary policy. The real worry on inflation is in China at present where, because of rising food prices, inflation has risen sharply. But, with the exception of the Bank of Japan, central banks are concerned about potential inflationary problems and, when things get back to normal, we may still see further interest rate rises in the eurozone and even the UK and, possibly, a reversal of the recent cut in the USA. There are inflationary pressures in the commodities markets and food prices are on an upward trend. The gold price gives some indication of investors' concern about inflation. We cannot assume, with the inflation which we now see in China, that low cost Chinese exports will continue to restrain inflation in industrialised countries as they have done in the recent past.

If the world economy can emerge relatively unscathed from what has happened in the credit markets, some good may come out of it. It is said that fear and greed drive markets. For a long time leading up to recent events, apart from short periods like May / June 2006 and February 2007, there was very little volatility in financial markets and complacency ensued, leading some investors to take higher risks which were underpriced. If, out of all this, a re-pricing of risk occurs, it will give a better foundation to the world economy because it will reduce the chances of unexpected financial problems hurting it.

The activity in the credit markets has dominated the economic news over the last quarter but much has been going on in individual countries. We should perhaps just mention two potential sources of inflationary pressure : oil (and this is not to ignore other commodities which have been rising in price) and food. Fast international economic growth and sharply rising demand from countries like China and India have raised the demand for oil considerably whilst refinery capacity has not kept pace. Meanwhile, OPEC has steadily raised its sights for target oil prices with the world economy better able to absorb price rises when it is expanding. From November, OPEC will be raising its production levels by 500,000 barrels a day. The International Energy Authority has forecast that oil consumption will rise by 2 million barrels a day between the third and fourth quarters so the position may well remain tight. Connected with attempts to diversify sources of energy, has been the growth of bio-fuels but this has led to food price inflation caused by a tightening of supply. As we have noted, food price inflation is a particular problem in China, leading to a sharp rise in the overall rate of inflation. There have been many warnings from food manufacturers about the inflationary pressures they face and this will be a continuing problem.

One consequence of the strong oil price has been a huge build up of wealth in the Middle East and into Sovereign Wealth Funds, not only there, but elsewhere with China a particular case in point. As economic power has shifted east, the growth of these vehicles will be an increasing economic, political and investment issue. The political issue is protectionism. This has been one of our greatest concerns in relation to the long term prosperity of the world economy. Certain political factions in the USA and Europe have shown regrettable protectionist tendencies which, if they come to fruition, threaten economic growth and inflation as well as rising unemployment. If these protectionist leanings can be neutralised, investors in various asset classes should see a long term benefit from the investment policies of Sovereign Wealth Funds. Traditionally, the governments have invested their foreign exchange reserves in low risk assets such as US Treasury bills and bonds. As their reserves have grown and they have a significant margin over any buffer they might need for financial or economic troubles, so they are looking to increase their returns. Obvious asset classes are equities, private equity and property, and countries, like the UK, which, quite rightly, have a liberal outlook to foreign investment, have benefited. Very generally, a move towards potentially more rewarding investments, means a movement away from lower returning assets such as bonds. It is more likely to be a diversion of cash flows but, other things being equal, it will mean relatively higher bond yields. In some cases, it might mean takeovers of whole companies, P & O, for example, by Dubai Ports, or in other new investments, China and Singapore, for example, in Barclays. As a broad generalisation, such moves can expect to benefit equity investors.

At the time of writing, we appear to have passed the worst of the storm in credit markets in terms of the drying up of liquidity but there will be further victims and they will turn up in unexpected places. It is difficult to know what the extent of the negative effect on world economic growth will be although we should draw comfort from the strong growth in the lead up to the credit market problems. In September, the OECD published an interim assessment of the outlook. For G7 members, it reduced very slightly by 0.1% to 2.2% its forecast for growth this year compared with its forecast last May. With the G7 members, it reduced its forecast for growth this year in the USA to 1.9% from 2.1%. It kept its forecast for Japan unchanged at 2.4%. It reduced very slightly its forecast for the euro area from 2.7% to 2.6%, with Germany down from 2.9% to 2.6%, France from 2.2% to 1.8% and Italy from 2.0% to 1.8%. The forecast for the United Kingdom was raised from 2.7% to 3.1% and, for Canada, from 2.5% to 2.7%. These forecasts are based on less data than its main forecasts and cannot build in the full effect of the financial market turbulence but, nevertheless, they provide a useful guide for evaluating prospects. The OECD makes the point that these figures, reflecting year end averages, reflect the influence of strong past momentum and that prospects going forward look less buoyant and are more uncertain. However, the OECD makes the point that there is not much slack in the world economy, either in the case of spare capacity or employment levels, and it expresses some concern about inflationary pressures, except in Japan, and it refers to the inflationary pressures of oil and food which we mentioned earlier. The update was written before the Federal Reserve cut its target for the federal funds rate and it suggested that there was a case for doing this but it also suggested that it might be necessary for the ECB to raise eurozone interest rates once the present credit market situation has quietened down. The OECD also refers to an issue we have mentioned in past reviews which is the absence of action in certain countries to take advantage of buoyant economic conditions to tackle their budget deficits. Certain countries, like the UK and France, for example, are running excessive structural deficits which give them little room to take offsetting fiscal action, should the economic weather deteriorate. It refers to the USA and Germany as countries which have shown faster than expected budget consolidation as a result of unexpectedly large revenue growth.

In its latest Global Financial Stability Report, the IMF states that "although the dislocations, especially to short term funding markets, have been large, and in some cases unexpected, the event hit during a period of above average global growth. Our assessment is that credit losses and the liquidity constrictions experienced to date will nevertheless likely slow the global expansion". The IMF's next forecast for world growth will be on 17 October. The IMF made some specific observations about how the tighter monetary and credit conditions could reduce economic activity. Firstly, a tightening of the supply of credit to weaker household borrowers could exacerbate the downturn in the US housing market. Secondly, falling equity prices could reduce spending through the wealth effect and a weakening of consumer sentiment. We should note, though, at this stage, that equity prices have not fallen. Thirdly, the IMF suggested that capital spending could also be curtailed owing to a higher cost of capital for the corporate sector. Fourthly, it suggested that the dislocations in credit and funding markets could slow the overall provision and channelling of credit.

The IMF also went on to discuss the position in emerging markets. It is a very interesting fact that emerging markets have been remarkably unscathed by recent events. In the past, one might have expected them to be badly hit but not this time as shares in these markets have performed well. The IMF puts this down to strong global growth and improved domestic macro economic policy making. It went on to refer to lower sovereign risks and improving balance sheets supported by strong fundamentals, but balanced these against rising risks in some economies experiencing rapid credit growth, particularly where banks are using capital markets to finance credit growth. It also added that some private sector borrowers in certain emerging markets are adopting relatively risky strategies to raise financing. Certainly, the solidity of international equity markets generally, and not only those of emerging markets, is an encouraging feature of recent events and, from the position as we see it, the correct one.

Moving now to individual countries and regions of the world, we start with the USA, unwittingly the source of recent turmoil in international credit markets through problems in the sub-prime credit market. These events, of course, forced the hand of the Federal Reserve on interest rates. Although they had been unchanged since June 2006 and had probably, but not certainly, peaked, the Federal Reserve kept reminding everyone about its concern on inflation even though recent trends had been more encouraging. The problem in the credit markets made it a question of by how much interest rates would be reduced, the usual 25 basis points or the more eye catching 50 basis points. In the event, it went for the decisive 50 basis points reduction to a targeted federal funds rate of 4.75% and the reaction in the stock market was immediately positive. It had, earlier in the credit market crisis when the inter bank market was contracting, reduced its discount rate by 0.5% to give it a margin of 50 basis points over the target federal funds rate and, therefore, to make the cost of borrowing less penal. Four high profile banks, which did not need funds, publicly borrowed what, for them, was a nominal amount, to reduce the stigma any other borrowers might have felt for borrowing from the Federal Reserve in its lender of the last resort role. When it cut the target rate for federal funds rates on 18 September, it again reduced the discount rate by 50 basis points to retain the 50 basis point margin. In its statement accompanying the interest rate reduction, the Federal Reserve said that its move was to "help forestall some of the adverse effects on the broader economy that might otherwise arise from disruptions in financial markets". It also referred to the effect which credit tightening could have on the housing market and, with it, the economy generally. It continued to give itself flexibility to act as necessary in pursuit of its dual objectives of stable prices and sustainable economic growth. There was a change in tone on inflation in response to more recently encouraging figures. The Federal Reserve statement said that inflation had "improved modestly this year" although it qualified its remarks with the usual caution about inflation. Earlier in September, the Federal Reserve's Beige Book had noted that "outside of real estate, reports that the turmoil in financial markets had affected economic activity during the survey period were limited". Events have shown that the Federal Reserve is prepared to act quickly to try to ensure that credit market problems have limited effect on economic growth prospects. Inevitably, there is now talk of a Bernanke "put" just like there was of a Greenspan "put" when the Federal Reserve, under the latter's Chairmanship, was prepared to drive down interest rates to keep the US economy moving forward.

The Federal Reserve indicated, in its background thinking supporting an interest rate cut, that the inflation trend was better and recent figures tend to support this view. August's producer price figures showed a 1.4% fall compared with July whilst the year on year rate was up 2.2%. Falling energy costs were helpful here. August's consumer price index fell by 0.1% compared with July, with core prices up by 0.2%. Annual underlying inflation was at a seventeen month low of 2.1% compared with 2.2% the previous month. The Federal Reserve's preferred inflation measure, the personal consumption expenditure index, fell 0.1% in August to give a year on year rate of 1.8%, just within the Federal Reserve's comfort level.

As we can see from the table at the beginning of this review, the U.S. dollar has weakened over the quarter, not by very much against sterling but by a significant level against the euro, Swiss franc and yen. Very often those who are concerned about the weakness of a currency forget the advantages which a weak currency can bring to companies in those countries. Exports become more competitive and import substitution more possible. It also increases the value of overseas earnings. These are factors which might cause the relevant country's stock market to perform well. At the macro economic level, after the initial deterioration in the trade account as imports become more expensive and exports take time to adjust to their increased competitiveness, the trade positions should start to improve. It is what economists call the "J curve", for obvious reasons. Very gradually, in the USA, the deficit has started to improve. US companies are very competitive and have an advantage over companies in harder currency countries. A prime example is Boeing and Airbus. Although both businesses have been winning large orders because of the boom in the civil aircraft industry, Airbus is feeling the pain of the high value of the euro as its hedges run out and is having to embark on a severe cost cutting exercise. So far this year, up to the end of July, the US trade deficit is running at an annual rate of US$711 billion compared with US$ 758.5

billion in 2006. Although there is a very large gap between the value of US exports and imports, the fact that it is narrowing in cash terms shows that volumes of exports are rising far more quickly than the volume of imports. So, although there is a long way to go, this is good news for the USA.

The US housing market was at the root cause of the problem which has spread worldwide and it is the prospects for this sector which will have an important bearing on the short and medium term outcome for the US economy. Various indicators are published each month. The National Association of Realtors reported that signed purchase agreements for existing homes fell by 6.5% in August, the lowest level since records began in 2001, and 22% lower than a year ago. The National Association of Homebuilders reported that builder confidence had fallen to its record lowest level in January 1991. Applications for building permits fell to a twelve year low. Housing starts fell to the lowest level since June 1995, down by 2.6%. The inventory of unsold existing single family homes rose to ten months' supply at current volumes compared with 9.5 months in August. There are mixed indicators as to where the price of houses currently stand compared with a year ago. According to the National Association of Realtors, the average price of a house sold in August was roughly the same as a year ago although there are questions about the sales mix of houses. The Standard & Poors / Case - Shiller index reports a 3.9% decline across twenty big city markets.

Not surprisingly, the bias of individual news over the last month has been to the negative in the USA. The ISM's index of factory activity fell to 52.9 in August from 53.8 in July, still in positive territory, however. Construction spending fell by 0.4% in July. The employment numbers for August were disappointing. Non-farm payrolls fell by 4,000, the first decline for four years, and previous months' figures were revised down. We have just heard with September's figures that August's figures have been revised to a gain. The Commerce Department reported that sales growth slowed to 0.3% from 0.5%. The Conference Board's index of consumer confidence fell from 105.6 in August to 99.8 in September. Durable goods orders fell by 4.9% in August following a 6.1% rise in July. The ISM's services index was slightly down at 54.8 (55.8) in September and that for manufacturing slightly down at 52.0 (52.9). Consumer spending has also held up well. In August, spending in real terms was up by 0.6% compared with 0.3% in July. This period covered perhaps the worst of the news on the credit market problems so could be considered encouraging. Whilst further bad news on the housing market could point one way for consumer spending, the interest rate cut in September could point in a more positive direction.

In Japan, politics have made the headlines following the resignation of the Prime Minister, Shinzo Abe, in September but there has been plenty happening, on the economic front. As we saw from the currency movement tables at the beginning of this review, the yen has made a significant recovery over the quarter although it is nowhere near realistic levels, still being significantly undervalued. One of the areas of speculation we have often referred to in these reviews has been the "carry trade" whereby investors borrow low cost yen and, to a lesser extent, the Swiss franc and invest in higher yielding currencies. This, as we have often pointed out, is a high risk strategy and, when problems in the financial markets started, the yen moved sharply higher as carry trades were unwound. The yen has weakened somewhat after its recovery suggesting that the strategy is still being pursued but it is a high risk strategy. For foreign investors, the strength of the yen over the quarter has reduced the effect of the stock market's underperformance but it still performed poorly compared with the major markets. Political uncertainty, which started when the LDP performed so badly in the upper house elections, has continued with the resignation of Shinzo Abe and the formation of a new cabinet under Mr Fukuda. Continuing economic reform, which is what Japan needs, becomes more difficult under the present situation of a weak government which does not control the upper house.

On the economic front, it was disappointing to note that second quarter economic growth was revised downwards to a negative 1.2% on an annualised basis. The first estimate had been for growth at an annualised 0.5%. On a quarter on quarter basis, the economy contracted by 0.3%. A reduction in capital spending was blamed for the decline in GDP. As a result of this, it was no surprise that the September meeting of the Bank of Japan voted to keep interest rates unchanged, much as the Bank of Japan would like to normalise monetary policy. The capital spending figures, which were to blame for the decline in second quarter GDP, fell 4.9% compared with the same period a year earlier. The non manufacturing sector was responsible for this situation. Somewhat surprisingly, in view of previous growth in the economy and the low unemployment levels, cash payments to employees in July were 1.9% below the level of a year earlier. It is difficult for domestic spending to be robust in these circumstances. One example of this is car sales which were 3.3% lower in July than a year previously.

We look now at Europe ex UK where, in the eurozone, the ECB has been operating in the money markets to provide liquidity. It has also refrained from raising interest rates which it surely would have done had there not been the problems in the credit markets. At the time, in early September, when the "no change" decision was announced, the ECB President, Mr. Trichet, said it was "appropriate to gather additional information and to examine new data before drawing conclusions for monetary policy".

Economic forecasts have been revised downwards to reflect recent events in financial markets. The European Commission has reduced this year's economic growth forecast slightly from its estimate of 2.6% last May to 2.5% now. The ECB has also revised downwards its forecast to around 2.5% for this year. Next year's forecast of 2.3% remains unchanged with expectations of inflation at 2% this year and next, although the President of the ECB said that inflation risks were on the upside. Eurozone finance ministers, meeting in September, were reasonably sanguine about growth but recognised that risks had grown and the ECB's monthly bulletin in September expressed caution about the effects of the financial markets' turbulence on the real economy. Modest optimism came from the OECD in its brief Economic Outlook projections. It felt the eurozone was in a better position to withstand the effects of what was happening in the USA.

Not surprisingly, in view of the background in the credit markets, short term indicators in the eurozone have been negative. The purchasing managers' index for September showed a significant drop although it was still in positive territory, i.e. over 50. The composite index, covering both the manufacturing and services sector, declined from 57.4 in August to 54.5 in September. This reflected the largest fall since October 2001 and was more pronounced in the services sector than the manufacturing sector. The European Commission's economic sentiment index fell from 109.9 in August to 107.1 in September and represents the fourth consecutive month of decline although the absolute level of the index is still quite strong.

Against this background of probable or possible changes in intention on interest rates by the Federal Reserve, ECB and the Bank of England, it is interesting to note that two European central banks have raised their interest rates in the last month. On 7 September, the Swedish central bank raised interest rates by 0.25% to 3.75% and indicated a probable further interest rate rise to 4% by the end of the year. It put forward the standard reasons for raising interest rates to head off inflationary pressure. These were: strong second quarter growth (3.6% annualised), a tighter than expected labour market, rising cost pressures and inflationary expectations, rising lending and rapidly rising house prices. The second central bank to raise interest rates was the Swiss one on 13 September. The three month interest rate was raised by 0.25% to 2.75%. The reasons did not seem as pressing as those in Sweden, with the bank citing the strong domestic economy.

Given that the ECB is responsible for setting interest rates for thirteen countries and these are two non eurozone members with only their countries' interest rates to consider, it should be easier for them to set an appropriate monetary policy. As we have noted before, the eurozone economies are not converging so setting interest rates at an appropriate level is not easy and the ECB's "play safe" policy of refraining from raising interest rates in September, even when it might have felt it inappropriate in other circumstances, is understandable against the background of unsettled financial markets. There might have been unpleasant and unexpected consequences from raising interest rates in the eurozone in September.

Although Germany has benefited form the profile of international economic growth, which has meant strong demand for Germany's high value exports, things have been less buoyant domestically and recent economic news has tended towards the negative. July showed only a small increase in industrial production, a rise of just 0.1%, following a rise of 0.2% in June. Not surprisingly, investor confidence has suffered. The ZEW Institute's monthly index, measuring investors' expectations for the next six months, fell to -18.1 in September compared with -6.9 in August and +10.4 in July. The German retailers' association gave a gloomy forecast of retail sales for this year, suggesting that price adjusted retail turnover would fall 0.5%. It blamed the 3% VAT rise on 1 January 2007 for this. Retail sales fell by 1.4% in August. Ifo reported that its business climate index fell from 105.8 in August to 104.2 in July, the fourth consecutive monthly fall. Various points were made with the survey figures. Employment growth was expected to continue. At the end of September, it was announced that the adjusted number of job seekers fell by 50,000 in September, a much larger fall than expected. German businesses' assessment of current business conditions was the gloomiest for a year.

In many ways, France is the most interesting country in the eurozone from an economic point of view. President Sarkozy emphasised in his election campaign, and since, that France needs to change if it is to restore its competitiveness. In recent times, its performance has clearly lagged behind that of Germany on economic measures such as growth and the balance of payments. An over large public sector, excessive taxation and regulation and an inflexible employment market, exemplified by the 35 hour week, are all causing France to lose economic ground. With a strong mandate behind him and his government, there will never be a better time than now to push forward with the necessary reforms. It seems that public opinion is broadly behind him on this. Change is never easy in France and confrontations with public sector trade unions may be inevitable but a lot is at stake and, if the necessary changes are not made in the immediate future, it is doubtful that they will be made. The French Prime Minister, Mr. Fillion, has given dire warnings about the state of France's public finances, saying that they are in a "critical state".

As well as supply side tax cuts to try to stimulate economic growth and thereby bringing France into conflict with its eurozone partners because of the implications for the budget deficit, there will be measures to contain the social security deficit involving tax increases on early retirement packages and increases in certain charges. France's budget deficits are of a structural nature. Public debt now runs at 64.3% of GDP and it is over thirty years since France ran a balanced budget. The proposed budget for 2008 allows for €9 billion of tax cuts with the biggest item being €5.1 billion for the exemption of overtime from tax and social charges. Whilst this move is expensive, it is a smart way of dismantling the 35 hour week which has been so damaging to the French economy. It makes it very difficult to oppose. In terms of the undertakings which France gave to its partners on the budget deficit, a zero deficit has now been pushed back by two years to 2012 and, even this, is dependent upon the French economy growing by at least 2.5% a year, a tall order.

France also continues to annoy its eurozone partners by attempts to exert more political control on the ECB. President Sarkozy would like it to resemble more closely the Federal Reserve in the USA which takes into account a wide range of factors in setting US interest rates. Specifically, he would like it to be more active on the exchange rate, as well as interest rates. The high value of the euro is affecting European companies' competitiveness, Airbus being a case in point. Such pressure is frowned upon by Germany, in particular, which gave up the Deutschemark on the understanding that monetary policy, set by the ECB, would resemble the model established by the Bundesbank. The ECB's focus on inflation alone is not to France's taste.

The disadvantages of monetary union, pointed out by sceptical observers at the outset of the project, seem likely to come to the fore quite soon. Besides the problem with French public finances, there remain difficulties for Italy with its very high level of public debt and its political difficulties, caused by coalition politics, of dealing with the issue. For Spain, an economy with an impressive growth record, but heavily dependent upon the construction industry, lower interest rates fairly soon may well be deemed necessary by the central bank to help alleviate problems of weakness in the construction industry and over indebted individuals. A strong fiscal position does give some room for manoeuvre. A testing time is ahead for the euro project.

The strong rise in the domestic Chinese stock market is symptomatic of bubble conditions developing there. While inflation has risen strongly, the Chinese authorities are taking increasingly aggressive measures to try to get on top of the situation. The August inflation rate of 6.5%, up from 5.6% in July, was largely driven by rising food prices which were up 18.7% on the year whilst non food prices rose by only 0.9%. September saw a further rise in deposits which banks must place with the central bank, the eighth time this year this has happened. On 14 September, the People's Bank of China raised interest rates for the second time in a month to give a lending rate of 7.9%. Bank lending, which it wants to rein in, has continued to grow very rapidly. In the first eight months of 2007, new loans of the equivalent of US$409 billion represented 97% of the total for the whole of 2006. So far this year to the end of August, the trade surplus has reached US$162 billion which is 71% ahead of the figure a year earlier.

As a sign of the concern felt in China about inflation, all government controlled prices are to be frozen. The authorities would be concerned about inflation causing social unrest, hence action on the monetary front and, now, the administrative front.

But, for many, interest in China currently revolves about the potential for Chinese portfolio investment overseas, whether it be from part of the country's burgeoning foreign exchange reserves or from individual portfolio investment which is gradually being liberalised. A question asked is often about good ways of benefiting from the rapid rate of growth in China and, one way its presence may be felt, is through its effect on overseas stock markets, either because, over time, of its investment in them directly or in stock markets which may benefit from booming Chinese demand.

Looking at the UK, events have been dominated by Northern Rock, whilst, on the political front, there is speculation about an early election, the timing of which might be determined by the economic outlook. As so often, economics and politics are closely linked. Problems in the financial markets have a particular relevance for the UK because of the importance of financial services and the earnings of the City of London to the UK economy. Excesses always create their own problems and banks and financial services are now pulling back from areas where they have been hit and are taking financial punishment. We are already seeing the start of lay offs. For the government, this is bad news and why, from a purely economic point of view, there is a strong argument for an early election, since the economic news is very likely to get worse from now on. Slower growth, reduced tax revenues, against the level expected from the financial services sector, and larger than expected government borrowing, will be unwelcome developments. As we mentioned before, the UK is running an unhealthy structural deficit and this is after a period of strong growth. Public sector borrowing in August was £9.1 billion compared with £6.8 billion the same with a year ago. This was the biggest ever deficit. If economic growth were to deteriorate, the government would not have many options at its disposal to rectify the situation and none of them palatable to the electorate. One would have thought, though no politician would say it, that economic conditions and prospects might make the government call an election well before it had to. Whilst the internal deficit is too high, the overseas deficit remains a problem with August's trade deficit of £4.4 billion, the highest in eleven months. Gone are the days when Prime Ministers were influenced by the trade figures on the timing of calling an election because people do not take nearly as much notice of them as they used to. But the UK's current account deficit is a sign of imbalances within the economy which could affect sterling, a currency that looks overvalued, and prolonged weakness in the currency could lead to increased inflation and higher interest rates. In the tables at the beginning of this review, we noted that, apart from against the US dollar, sterling had been quite weak over the quarter.

Given what has happened in financial markets recently, backward looking data has less relevance than normal. But, and it is relevant to the poor state of government finances at this stage of the cycle, it should be noted that there was a slight upward revision in UK growth figures for earlier this year. First quarter GDP growth was revised upwards by 0.1% to 0.8% which meant that annualised growth in the second quarter of the year was estimated at 3.1% rather than 3.0%. Factors contributing to the slight data revision were higher than estimated growth in the services sector, a downward revision in the estimate for the growth of government expenditure in the second quarter and an increase in the positive contribution of net trade as the deficit in the second quarter narrowed slightly from the first quarter.

Looking ahead, things are almost certainly going to become more difficult. The OECD has recently pointed out, in its latest comments on the UK economy, some of the issues we have discussed above. They were the housing market and reduced profitability in the City hitting tax revenues and affecting government borrowing levels.

Indeed, housing is one of the key pillars of the UK economy which is capable of having a striking positive or negative wealth effect. So far, in recent times, it has been positive but, now, the dangers are tipping to the negative after the series of interest rate increases which have taken place. Various measures of the movement in house prices are produced each month and they do not always tell the same story. Halifax estimated that house prices rose by 0.4% in August to give an annual increase of 11.4%. But there was a marked slowdown on the most recent evidence with the three monthly increase down to 1.6%. The FT house price index also shows a slowdown in the pace of price increases. Its index showed house prices rising by 0.5% in August against July. It says that monthly price rises are about half of the level of a year earlier. Its measure of the annual house price increase was running at 9.3%. The Department for Communities and Local Government showed quite a high increase on its measurement, 12.4% in July against 12.1% in June. A much more negative picture was given by the RICS. It said that 1.8% more surveyors reported a fall in prices than a rise and reported a sharp fall in the number of enquiries by new buyers. The Nationwide reported a 0.7% increase in house prices in September but the rate of increase in house prices was declining. It saw house prices increasing by 1.6% over the third quarter as a whole compared with a 2.2% rise in the second quarter.

There is also some sign of a softening in the mortgage market. The Council of Mortgage Lenders said that July's mortgage lending was the lowest for three months and the British Bankers Association said that, although net mortgage lending rose in August, mortgage approvals were down 14% from a year earlier. Put together, these various pieces of data do suggest quite strongly a reduction in the rate of increase in house prices which will be welcome to the Bank of England. Excessively fast house price inflation risks creating inflationary pressures elsewhere in the economy whilst also increasing the risk of a house price crash. A negative wealth effect from falling house prices risks putting the economy into recession. So it is a very delicate balance that the Bank of England has to tread on interest rates.

Linked to all this is inflation which, as in the case of the Federal Reserve and the ECB, has been a potential source of worry for the Bank of England. At least temporarily, the pressures seemed to have eased a little. There was a slight fall in the consumer price index in August to 1.8% compared with 1.9% in July. The Retail Price Index, which used to be the official measure of inflation, rose to 4.1% from 3.8% in July because of the rise in mortgage interest rates, and the RPIX, which excludes mortgage interest payments, remained at 2.7%. One of the measures which the Bank of England looks at when considering the current trend of interest rates is people's expectations on inflation. Its latest quarterly survey of public expectations on inflation show median expectations on inflation of 2.7% for the next year and people's perception of the current inflation rate is 2.8%. The clue to these differences is likely to lie in the change in the accepted measure of inflation from the RPI to the CPI. As the above figures show, there is a significant difference between the two measures and, for many, the CPI is not representative of their own inflation experiences. These expectations are important in setting pay increase aspirations and the RPI is still in wage negotiators' minds, so, whilst the Bank of England may be disappointed by this survey, it is hardly surprising. In terms of sources of inflation, input prices were benign in August, falling

0.5%, whilst output inflation was 2.4%. Average earnings growth increased slightly in July compared with June, up 3.6% against 3.5%, with the impetus coming from the public sector. In the manufacturing sector, now only a modest part of the economy, the latest CIPS/NTC index suggested some easing of pricing pressures whilst the experience of the equivalent services sector survey was the opposite. Those optimistic about inflation will cite the sharp fall in the CPI from its peak of 3.1% last May ; those who are cautious, and this will still include the Bank of England, will look at the RPI (even though it is not the target measure of inflation) and the public's inflation expectations. Even though the standstill in UK interest rates in September could be justified by the fall in the CPI to below its target level, conditions in financial markets were obviously the clinching matter. There is, however, still no cause for complacency and, were sterling to decline, inflation worries would increase.

So, how cautious should we be about the UK? It is very odd that there is the current level of speculation about an election less than half way through the maximum life of this Parliament when the government has a working majority. If there is to be an election, the prospective economic situation is bound to come into the equation for the Prime Minister. Whilst nothing is certain in economics, the strong likelihood is that the present time is going to be the most favourable one for the foreseeable future and there are significant economic risks ahead. The main one, as we see it, is the state of public finances. Should economic growth slow down, as is likely, the deterioration in public finances could be quite significant and tax increases would almost certainly be necessary which would be difficult to sell to the electorate. There is some risk to sterling from the situation. The perception of the UK has understandably been weakened by the Northern Rock affair and, this, together with the imbalances in the economy could contribute to weakness in sterling.

The Australian economy remains very vibrant. In the second quarter, it expanded 4.3% compared with the previous year. This represented the fastest rate of growth since 2004 and is faster than growth in any major industrialised country. As in other countries, the central bank had to act in September to ease conditions in the money markets. The rapid rate in Australian growth makes Australia, where interest rates are high by international standards, a candidate for a further interest rate increase in order to restrain inflation. Perhaps the most interesting issue for investors is the forthcoming election in Australia where the opposition leads the government in the opinion polls. Given the success of the Australian economy over many years, investors will need to take careful note of the opposition's election manifesto in economic areas.

We saw from the performance table on the first page of this review that Asia Pacific ex Japan, Latin America and emerging markets continue to perform very strongly and it is a testament as to how investors' attitudes towards these markets have changed that they have performed so strongly at a time of turbulence in the credit markets. Investors have been impressed by growth that rates from satisfactory to exceptional, economic profiles which are often favourable in current circumstances (i.e. commodity based economies) and international and external financial positions which are strong and in a good position to withstand unfavourable external factors. After such a strong run, it would be unreasonable to expect the same rate of share price increases. Indeed, it would be undesirable because it could cause "bubble" effects, and there may be a period of underperformance, but long term portfolios need to take account of changing economic circumstances and there is no doubt that economic power is shifting to many of the countries which comprise these markets.

We have made the point for some time that we believe shares overall to be reasonably valued. In most cases, earnings yields are well in excess of dividend yields. Notwithstanding the fact that recent problems in the credit markets will have some negative effect on economic growth, the probability is that, at the very least, there will be modest growth in the world economy next year which should be reflected in higher corporate earnings. Although shares have moved up strongly over the past four and a half years from their depressed levels at that time, corporate earnings have often risen even faster. We are not too concerned about the longevity of this bull market for that reason. Although, after such an extended run, it would be realistic to expect the occasional negative quarter, shares look well supported. For a while, one of the catalysts for market strength, the flow of takeovers, is likely to be more subdued, especially from potential private equity purchasers and some companies may be more cautious about buying back their shares but we think that valuations still give comfort for equity investors. We believe equities to be more attractive than bonds where we believe yields do not discount sufficiently potential inflationary risks to the world economy. Although, at the time of writing, volatility has died down somewhat, it could return at any time and the key, in those circumstances, is to concentrate on fundamental issues rather than be intimidated by short term market movements into making investment decisions which could prove costly later on.