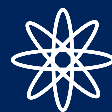

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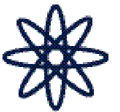
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

International equities have performed steadily over the last quarter although there have been pockets of weakness. Whilst the news background, particularly from the eurozone, has been unsettled, it has been manageable, given such low expectations. Companies' earnings reports have generally been supportive. Quality sovereign bond yields have not varied significantly. In currency markets, the feature has been the strength of sterling.

The tables below detail relevant movements in markets:

International Equities 31.01.12 - 30.04.12

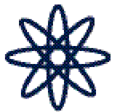
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+4.3	-0.7	+2.2	+1.0
Finland	-0.3	-2.0	+0.8	-0.3
France	-0.5	-2.3	+0.6	-0.5
Germany	+4.9	+3.1	+6.1	+4.9
Hong Kong, China	+6.3	+3.2	+6.2	+5.1
Italy	-6.9	-8.5	-5.9	-6.9
Japan	+7.7	-0.1	+2.8	+1.7
Netherlands	-1.0	-2.7	+0.1	-1.0
Spain	-17.3	-18.7	-16.4	-17.3
Switzerland	+5.4	+3.8	+6.8	+5.7
UK	+2.5	+2.5	+5.5	+4.3
USA	+7.1	+4.1	+7.1	+5.9
Europe ex UK	+1.2	-0.4	+2.5	+1.3
Asia Pacific ex Japan	+4.0	+0.6	+3.5	+2.9
Asia Pacific	+5.7	+0.4	+3.3	+2.1
Latin America	+2.8	-5.0	-2.2	-3.3
All World All Emerging	+1.9	-2.6	+0.2	-0.9
The World	+4.9	+1.9	+4.8	+3.7

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -1.8%

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

Currency	31.01.12	30.04.12
Sterling	1.97	2.10
US Dollar	1.80	1.92
Yen	0.97	0.89
Germany (Euro)	1.79	1.67



Sterling's performance during the quarter ending 30.04.12 (%)

Currency	Quarter Ending 30.04.12
US Dollar	+3.1
Canadian Dollar	+1.4
Yen	+7.9
Euro	+1.8
Swiss Franc	+1.6
Australian dollar	+4.9

Other currency movements during the quarter ending 30.04.12 (%)

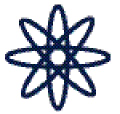
Currency	Quarter Ending 30.04.12
US Dollar/Canadian Dollar	-1.7
US Dollar/Yen	+4.6
US Dollar/Euro	-1.2
Swiss Franc/Euro	+0.2
Euro/Yen	+5.9

Significant Commodities (US dollar terms) 31.01.12 - 30.04.12 (%)

Currency	Quarter Ending 30.04.12
Oil	+7.7
Gold	-3.9

Markets

Overall, it has been a quarter of generally modest progress, although there have been exceptions, and currency movements have made a noticeable difference for sterling based investors. In local currency terms, the total return on the FTSE World Index was 4.9%, in sterling terms 1.9%, in US dollar terms 4.8% and in euro terms 3.7%. If we look at performances in local currency terms first, we see that, of the major markets, Japan and the USA performed best with respective returns in the FTSE Japan Index and FTSE USA Index of 7.7% and 7.1%. The UK and Europe ex UK were below average with their respective FTSE indices returning 2.5% and 1.2%. The FTSE Asia Pacific ex Japan Index, FTSE Latin American Index and the FTSE All World All Emerging Markets Index produced satisfactory but below average returns of 4.0%, 2.8% and 1.9% respectively. Within the Europe ex UK sector, it was noticeable that those countries in the eurozone which were under pressure saw their equity markets underperform with the FTSE Spain Index returning -17.3% and the FTSE Italy Index returning -6.9%. Within Europe, but outside the eurozone, Switzerland performed well with the FTSE Switzerland Index returning 5.4%, whilst, within the eurozone, the strongest country, Germany, returned 4.9%. However, with sterling being the strongest major currency, currency adjusted returns painted a different picture. The FTSE Japan Index sterling adjusted moved from positive to slightly negative territory, 7.7% to -0.1%, whilst the FTSE USA Index's return was reduced to a still very satisfactory 4.1%. The FTSE Europe ex UK Index moved into negative territory with a total return of -0.4%. Currency weakness against sterling in Asia Pacific ex Japan, Latin America and emerging markets reduced returns in the respective FTSE indices to 0.6%, -5.0% and -2.6%. Within the Europe ex UK section, there were still creditable performances from the sterling adjusted FTSE Switzerland Index, 3.8%, and the FTSE Germany Index, 3.1%. If we look at the well regarded sovereign credits,



whose bond yields are quoted in the table above, we note a mixed performance. The gross redemption yield on ten year sterling government bonds rose by 13 basis points to 2.10% and on US Treasuries by 12 basis points to 1.92%. On the other hand, there was a decline of 8 basis points on Japanese government ten year bond yields to 0.89%, whilst Germany, seeing inflows from some other eurozone government bond markets, experienced a 12 basis point fall in government bond yields to 1.67%.

The stand out performer in the currency markets was sterling. Against all of the currencies in our table it increased in value, most of all against a weak yen where the rise was 7.9%. It also performed strongly against the Australian dollar, up 4.9% and against the US dollar, up 3.1%. Its strength against the euro, Swiss Franc and Canadian dollar was less marked, up 1.8%, 1.6% and 1.4% respectively.

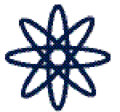
In the commodity markets, oil moved higher with Brent crude rising by 7.7%. On the other hand, gold dropped back, down 3.9%.

Economics

As has been the case for many quarters, the eurozone's woes have dominated the economic scene and it would not be a hostage to fortune to say that this will continue to be the case for as far ahead as one can see. The issue transcends the public debt problems of the USA and UK and slowing growth in China which, at other times, might be the main focus of investors' attention. We are very conscious that the eurozone has been at the forefront of these reviews for many months but a quick look at the financial pages of newspapers will show the same issue arising time and time again, so there is no avoiding the topic which will be one of the main issues informing investors' market judgement.

But each month seems to bring a new angle to the crisis and, this time, it is heightened political concerns arising from eurozone elections and referenda, actual and forthcoming, and increasing hostility in creditor as well as debtor eurozone electorates to the austerity measures which the EU is imposing on the eurozone economies. The EU has always appeared to have a democratic deficit and the eurozone sovereign debt crisis has exposed this. The rise of far right and far left politicians in a number of countries encapsulates the increasing hostility felt towards the EU and euro project. We have often stated our opinion in these reviews that the eurozone will fragment under its own economic contradictions and we have also mentioned the political angle which is becoming increasingly relevant. Whilst the eurozone countries' leaders, the eurocrats and the ECB are signed up members of the project, a new generation of politicians, not tainted by the euro's problems, are coming on to the scene and some of them will advocate their country leaving the euro and/or refusing to accept the EU's deficit edicts. At some stage, they will rise to a position where they can not only put forward their opinions but put them into practice.

When a problem of the magnitude of the eurozone sovereign debt crisis arises, one might expect the decision makers to look at the cause of the problems rather than their symptoms, as they are doing at present. But they seem to be talking to themselves and no one else. In as far as they mention the causes, the banks and the finance sector are the favourite target for some politicians, but this is a diversionary tactic. Yes, the financial sector must shoulder a lot of criticism for the financial crisis, but the fundamental contradictions of the euro and poor economic management in a number of eurozone countries are a much more deep seated problem in a monetary union. In terms of domestic public finances, some countries showed very poor discipline by persistently overspending and thereby causing large budget deficits. Related to this was an erosion of competitiveness against, say, Germany, as relative costs rose, causing current account deficits to balloon and these are becoming difficult to finance. At the outset, many within the eurozone, and some investors, too, took the view that a euro was indistinguishable whichever country was backing it. Thus, we had a period where, for example, Greek bond yields were not much higher than those of German ones and Spanish bond yields were effectively the same as those of Germany. There was hardly any differentiation of credit risk, a costly misjudgment as everyone now knows. The euro did not have the proper characteristics of a successful monetary union. Apart from the northern eurozone countries, most of

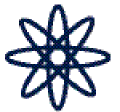


the other eurozone members, and this includes France, did not have the same economic and financial disciplines or culture as Germany and, therefore, the "one size fits all" monetary policy was totally unsuitable, with interest rates too low for the profligate members of the eurozone or those with higher inbuilt inflation. For example, had the central banks of Spain and Ireland been able to set their own interest rates, the housing boom and bust in those countries might not have been so extreme.

We now have a situation where the treaty agreed last December, excluding the UK and Czech Republic, relating to financial targets for budget deficits and public finances, is unravelling. One of the AAA rated (for the moment) "creditor" countries, the Netherlands, has seen its government fall, after Geert Wilders, the eurosceptic, was not prepared to go along with the economic measures required to meet the Netherlands' treaty obligations. In France, the newly elected Mr Hollande wants to add to December's agreement measures to promote growth. Spain went back on its deficit reduction commitment, citing its decision as a "sovereign" one, and eventually agreed on a compromise with the European Commission. The election in Greece has raised the representation of the extreme left and right parties at the expense of the traditional governing parties, Pasok and New Democracy, which could well make the execution of the pledges made to the troika more difficult, if not impossible, to achieve. At some stage, the other technocratically run eurozone country, Italy, will have to have an election. At the moment, the pressure on eurozone countries is to get their public finances in order through an austerity programme and those which are in receipt of bailed out funds are bound by specific programmes. The one good result of the troika's instructions to these bail out countries is the demand for structural reforms to improve the efficiency and long term growth prospects. There are severe structural rigidities in the labour and product markets in the southern eurozone economies, in particular, as well as France, which have limited economic growth and ensured some very severe unemployment, especially for the young. In Spain, for example, about half of young people are unemployed because labour market rigidities protect those in work at the expense of those out of work. It goes without saying that the social consequences are very severe. The economic problem is that, vital as it is to make these troubled countries creditworthy again, these austerity measures condemn them to a spiral of economic decline. There are no catalysts for growth.

For some, the answer is for Germany to reflate its economy to encourage more consumer spending and to allow inflation to rise in order to start reversing the relative loss of competitiveness suffered by southern eurozone economies. For Germany, this is a non starter. Although it was an early culprit in ignoring the Stability and Growth Pact's budgetary disciplines, it generally adheres to a very disciplined approach to inflation and public finances. Another answer for some is for Germany, as the largest and strongest eurozone country, to sanction transfers to weaker economies and assist in underwriting a eurozone eurobond. If this were to be proposed, it would almost certainly be rejected by Germany. The German electorate is becoming increasingly hostile to the idea of supporting other eurozone countries which are in financial trouble. Apart from this, Germany's credit rating would bound to be affected and the whole idea seems to be a non starter. It would be addressing the symptoms but not the causes of the problem and, as such, would provide no solution.

What could reignite growth in the eurozone countries which are struggling? The traditional method would be a devaluation of the currency to provide increased competitiveness for exports and to encourage import substitution. This would be a standard IMF remedy for a country in need of assistance, combined with measures to suppress the inflationary implications of devaluation such as pay restraint. But, of course, this cannot happen in a monetary union with a single currency and the internal devaluations, i.e. pay cuts etc, which are being imposed on the troubled countries, depress rather than stimulate demand. So, apart from all the other issues with the euro, none of the measures being taken can spur economic growth. When a country has public debt problems, the best way to improve finances is through economic growth so that tax revenues can benefit and government spending be restrained on items like unemployment pay as more people come back into the labour market.

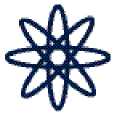


The contradictions behind the single currency make its demise inevitable, in our opinion, and we would hope that, behind the scenes, but inevitably in great secrecy, plans are being made to deal with the departure of one or more members of the eurozone and for its ultimate complete fragmentation. The public voice of all those connected with the euro does not even mention the possibility. One would hope that they understand why the currency cannot work and that their denial is brought about by the necessity to stop confidence ebbing away whilst they make plans for departures from the currency union.

As we have said before, there is going to be no happy ending to the eurozone crisis. If the monetary union breaks up, it will be very messy and will bring very serious financial problems for companies (financial and non financial) and individuals, not to mention governments and central banks. With the new currencies of weaker eurozone members heavily devalued, there would be the chance to start again with a freely floating exchange rate. If it sounds easy, it is not, but at least it provides some way forward. What appears to be the current thinking is to persevere with the euro, applying sticking plaster to the ever increasing number of problems and hope for the best. Whilst one can see that this is the easier option for politicians, it condemns a number of the eurozone members to many years of austerity and financial hardship and, in our view, is a worse course of action than the first one. As we are seeing at present, it is also stoking up political unrest which is another major threat to the euro project.

So, against this background, what should investors make of this outlook? In the short term, we believe that the ECB will again have to come to the rescue because there are no other realistic means of shoring up the situation. It has used two weapons to stem the crisis temporarily, firstly the securities market programme whereby it purchased the government bonds of troubled eurozone members in the secondary market and, secondly, the Long Term Refinancing Operation whereby it has provided over €1 trillion in loans to banks to tide them over refinancing problems with the three year period giving time for banks to undertake remedial work on their balance sheets. These are emphatically not solutions for the eurozone's debt problem, they are just short term expedients to stop the crisis from getting even worse. If the Spanish and Italian bond markets signalled even more distress, the securities market programme would be likely to be resumed, effectively being financed, if it moved out of control, by money printing if the purchases could not be sterilised.

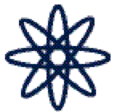
As an investor or an investment manager, in a situation which has not been experienced before, one might be struggling to think of a suitable investment strategy, but it is worth considering each of the main asset classes. Cash in the major currencies is offering negligible returns so, in real terms, would be bound to decline in value on any realistic assessment of the inflation outlook. There would be opportunities to make foreign exchange gains (and losses). If the world economy were to sink into depression, one might expect to see falls in prices so that very low nominal interest rates could turn into positive real returns. But currencies are threatening to be debased by quantitative easing which, in different forms, has taken place in all the main advanced countries and regions. Countries cannot continue to print money without serious inflationary consequences developing. In extreme circumstances, cash could be the least bad investment because not all currencies can go down against each other but, with all advanced economies having economic problems of different magnitudes, the major currencies could all come under attack at one time or another. Although, intuitively, one might think that the euro was the worst placed because of the enormity of its problems, that might not be the case depending upon how it fragmented and what was left. Because of all these uncertainties, portfolios with a substantial percentage of cash held carry risks and, at the very least, a decline in value in real terms. For bonds, the risks are worse, in our view. Whereas cash will hold its value in nominal terms, although a breakup of the euro could leave some depositors holding a different and devalued currency, bond holders could see their holdings depreciate significantly in value, not only because of possible defaults, but also, which will be the most common cause, because of a sharp fall in the price of bonds. The gross redemption yield on bonds shown at the beginning of this review are at levels we believe to be completely unrealistic. Quantitative easing, very loose monetary policy and flights to quality have pushed yields down to levels we believe offer no value at all. When sentiment turns, as it will do at some stage, and yields move to much higher and realistic levels, the drop in capital values will be sharp. For lesser quality eurozone



bonds, the "haircuts" taken by private bondholders in the Greek debt restructuring should serve as a warning as to what can happen to holders of certain other countries' eurozone bonds in the probable event of their debt restructuring. Official creditors insisted on preference which sends out a bad signal to bond markets and private sector investors. The problem for traditional bond investors is twofold. For the best AAA rated sovereign debt, the gross redemption yields have been driven down to unrealistically low levels by a combination of risk aversion and quantitative easing. These two reasons do not form a sound basis for the current levels of yield and bond investors have to be aware of how much money it is possible to lose in bond markets. If the yield level shifts upwards, as is very likely to happen, and stays there, the resulting fall in prices may take a long time to recover and then only because of the pull to redemption, but the loss in real terms will be significant. Whilst the yield margins against corporate bonds may vary, good quality corporate bonds will still sell off their sovereign. If shares fall because of market movements, they are likely in time to recover and move ahead much more quickly. Traditionally, bonds have generally been considered a more stable investment but the convulsions in the eurozone bond market have shown that this is anything but the case and, with the yields of the perceived highest credits at extraordinarily low levels, the likelihood of significant volatility in the market increases because of the prospect of these bond yields moving to more realistic levels.

A partial, or total, break up of the monetary union would lead to hugely unpleasant and difficult consequences and multiple defaults. It would not be an issue confined to the eurozone alone, so that staying out of eurozone investments would not protect an investor from the consequences of a break up, so interlinked are business and debt relationships. Whilst it may seem counterintuitive, we think that large multinational companies would be as well placed as any organisation to deal with the consequences. They operate in many markets and are used to managing currency exposure. They would presumably try to match their assets and liabilities as far as possible in each country where they operate. Such characteristics should be valuable in such a dangerous position and for investors to have exposure to real assets at a time like this should be a benefit.

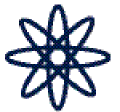
France holds a pivotal position in the eurozone crisis because of a change of tack likely to be pursued by Mr Hollande. His present position is that, whilst he does not want to unpick the treaty agreed in principle last December, he wants to add growth aspects to it and that, because the French parliament has to ratify the treaty, he will not put the treaty to a vote without getting what he wants. This will put him on a collision course with Germany with Mrs Merkel saying that the treaty is non-negotiable. The point is that, whilst economic growth is the best way to start tackling the debt crisis, it just does not happen like that. What those backing Mr Hollande's line have in mind is some type of increased public spending or relaxation of the deficit reduction targets, perhaps so that the funds can be spent on, for example, infrastructure projects. But, of course, all this debt has to be financed and markets are not likely to look favourably on such backdoor moves to relax the moves towards improving the eurozone's public finances. There is strong internal opposition in Germany to any moves to increase further Germany's liabilities in respect of eurozone bailouts, which loosening the purse strings would almost certainly entail. The consequences of an early fall out between Germany and France would be bad but that is the way it looks at present. But besides the broader picture, we need to think what a victory for Mr Hollande might mean for the French economy and the way it is viewed abroad - very important because foreigners hold 59% of French debt. Whilst Mr Hollande seeks wider measures to provide growth within the eurozone, it is difficult to see any likely French domestic economic policy which will promote growth. Raising taxes on large companies and the wealthy and increasing numbers in the public sector, which accounts for about 55% of the French economy, does not obviously stimulate economic growth, which should be the French aim with its economic policy. The public sector is so large in France that it "crowds out" the private sector and a sustainable increase in France's long term growth potential is not going to be possible until this imbalance is addressed. In all the other eurozone countries which have a debt problem, the emphasis is not only on raising taxes but on cutting spending and on introducing supply side reforms to improve their economies' long term growth potential. In France, this is an almost impossible task so foreign reaction to the course of French economic policy is going to be very important.



But, as our table of international equity market performances over the last quarter shows, the very turbulent and uncertain background largely brought on by the eurozone's sovereign debt crisis has not adversely affected equity markets overall in the quarter. If anything, markets have drifted higher. We discussed at some length earlier on why equities as a class were our favoured asset if the worst happened in the eurozone and, with low short term interest rates and bond yields also being very important. This is certainly the case in the USA, but the health of the corporate sector is an important reason. Whilst corporate earnings are facing some difficult headwinds and comparisons with the first quarter of 2011, the robust state of many large companies' balance sheets has enabled healthy dividends to be paid, with increases still being announced (just one example of a very large company is the 21.3% increase in Exxon Mobil's quarterly dividend). The importance of buying shares in companies to spread geographical exposure indirectly has been underlined by the statements of many multinational companies wherever they are based. Some of their developing and emerging market exposure has given an impetus to their profits growth.

In April, the IMF published its latest World Economic Outlook. Whilst many things can happen to render forecasts obsolete very quickly, it is, nevertheless, worth noting that the IMF has raised its forecast for world economic growth since its previous projection in January. For 2012, it is now projecting world output to grow by 3.5% in 2012, a 0.2% increase on its earlier projection and, for 2013, it now sees growth of 4.1%, an increase of 0.1% over its previous projection. For advanced economies overall, it sees growth of 1.4% this year and 2.0% next year. These are not dramatic growth rates but, in this troubled environment, they provide some perspective on the steady performance of international equities because, overall, they should provide some underpinning for company profits. As we have noted in the table of equity performances over this quarter at the front of this review, the USA has been performing well and part of the reason for this must surely be its relatively superior growth rate against most of its peers. The IMF has raised its economic growth projections for the USA for 2013 to 2.1% and 2.4%, increases over its previous projections of 0.2% and 0.1% respectively. For the euro area, it projects a 0.3% contraction in 2012, followed by growth of 0.9% in 2013, an increase of 0.2% and 0.1% respectively on its January projection. This may seem counterintuitive given the eurozone's woes and, in truth, one would feel that any forecasts for this area are particularly subject to change because of uncertainties about how the crisis will play out. Of the big four eurozone economies, Germany, France, Italy and Spain, two, Germany and France, are forecast to show modest growth of 0.6% and 0.5% respectively, whilst, not surprisingly, Italy and Spain are expected to contract by 1.9% and 1.8% respectively. At this stage, the IMF is projecting growth of 1.5% and 1.0% respectively for Germany and France in 2013, whilst Italy is forecast to contract again by 0.3% and Spain to grow by just 0.1%. For Japan, the prospects are considered better with growth of 2.0% projected for this year and 1.7% next year. However, this year's figure is a function of some catch up from last year's tragic natural disasters which badly disrupted the Japanese economy. Not surprisingly, the UK economy is projected to show only very modest growth this year, just 0.8%, and 2.0% next year. Elsewhere, and this is one reason why many multinational companies' profits are holding up well, the picture is better. The Newly Industrialised Asian Economies' growth rate is projected at 3.4% this year and 4.2% next year, whilst the growth rate for Emerging and Developing Economies is forecast to be 5.7% this year and 6.0% next year. Within the latter area, China is projected to grow by 8.2% this year and 8.8% next year, very little different from its January projection. The outlook reflects the position as the IMF sees it at the moment and there are an unusually large amount of variables at present so the forecasts will undoubtedly have to be adjusted. The point we would like to make and the reason we have quoted these figures is that the multi speed economies offer hope of growth from which investors whose home base is economically depressed can hope to benefit.

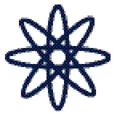
We turn now to look at the main areas of the world economy, starting with the USA, where the first estimate of first quarter 2012 GDP growth was an annualised growth rate of 2.2%, a little lower than expected and, as always, there will probably be subsequent revisions to these figures. Contributing to the lower than expected growth rate (subject to the caveat just mentioned) was a 2.1% decline in business investment. With many large



companies, not only in the USA, having very strong balance sheets, governments would love them to release the purse strings to increase capital investment. To do that, they have to have a business case, and low confidence levels do not arouse Lord Keynes' "animal spirits". These strong balance sheets have supported dividend growth but, understandably, many companies are taking a cautious attitude to capital investment. Most indicators point to a modest improvement in the US economy or at least to stability at a low level in the case of the housing market. Just one example of the latter is the latest S & P/Case Shiller composite index of 20 metropolitan areas which showed that house prices rose by 0.2% in February, the first time that house prices have risen since April 2011. The closely watched ISM index of factory activity rose to 54.8 in April from 53.4 in March. So, although it is still relatively early in the year, there is enough evidence to support the view that, as the IMF suggests in its latest World Economic Outlook, the US will record modest growth this year even if it does not reach the 3% figure cited by some optimists at the beginning of the year.

Looking ahead, there is a positive development for the USA over the coming years on the energy front because of the increased amount of oil production coming from "tight" oil which is accompanying the astonishing development of the shale gas bonanza. It is suggested that, over the next decade, the USA might once again become the world's largest oil producer. If everything goes according to plan, this development will have profound economic significance, amongst other things, for the US dollar as the USA's current account position should improve relative to other energy poor areas like much of Europe and parts of Asia. Investors and commentators are beginning to take note of this potential bounty for the US economy. But before all of this kicks in, the USA has to face an election in November. At present, the US political system is showing up all of its disadvantages insofar as they affect decision making on the economic front. There is none, and nothing is likely to be done in front of the election. After last year's drama on the lifting of the US debt ceiling, things seem to have gone rather quiet on this front, but all things are relative, and this is because the eurozone sovereign debt crisis has swamped the news. The USA's debt position is extremely bad and demographic developments will make it worse but, as in nearly every other debt troubled country, most politicians dare not spell out the implications of these deteriorating trends. As we have said before, the USA has the invaluable advantage of controlling its own currency and, if necessary, it can print its own money. Furthermore, as the world's largest reserve currency, it benefits from the absence of convincing alternatives for other countries' reserves by virtue of its size. US politics has increasingly been captured by the party extremes and the centre ground seems to have been all but vacated. When Congress and the Administration are split, there is a good chance of stalemate. So we have, at present, a Democrat in the White House and a Democrat controlled Senate but a Republican controlled House of Representatives. There is such ill will between the parties that a bipartisan policy towards tackling such a serious problem as the budget deficit seems out of the question. The Simpson Bowles report, arising from the National Commission on Fiscal Responsibility and Reform, which made recommendations, was simply ignored. Although November is a long way off, one likely scenario now, although this could change, is that is that President Obama retains the White House but that the Republicans gain the Senate as well as holding the House of Representatives. That outcome does not bode well for progress on the deficit reduction front for, as it is, the Bush era tax cuts will expire at the end of the year as will payroll tax cuts and unemployment benefit help and automatic budget cuts kick in. These could, if not extended, amount to a 3½ - 4% tightening in relation to GDP. So, the US could be facing some self induced headwinds next year. The trick will be to keep tightening as much as it is possible to do without putting the economy into recession, a very difficult balancing act. Yet for all of its problems, the eurozone can only look on with relative envy at the USA.

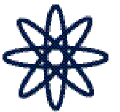
Moving on to Japan, its debt position is daunting, with an outstanding public debt as a percentage of GDP at over 200%. The vast majority of government debt is held internally so it is less at the mercy of foreign investors who may withdraw their money. Nevertheless, problems loom with a worrying demographic outlook and a deteriorating current account outlook caused by the need to import more fossil fuels following the shutdown of most of the country's nuclear capacity following last year's earthquake and tsunami. Japan would not want to be



dependent upon foreign inflows of capital. As we can see from the table at the beginning of this review, Japanese interest rates are negligible, so that financing such a vast debt is not too difficult at these levels. However, should interest rates rise significantly, then Japan would have a problem. It remains essential that Japan tackles its budget deficit so that it stops adding to its outstanding public debt. Progress is proving very difficult. In the short term, the Bank of Japan is engaging in a programme of further quantitative easing which has driven down the value of the yen, something which will be helpful to hard pressed Japanese manufacturing businesses suffering from the strong yen.

Given the economic woes in the west, it is natural that investors look to China, in particular, to provide a counter to the slow growth/no growth situation prevailing in the west. As we know, China has a growth rate of which the west can only dream, but the first quarter's data pointed to a slowdown in an annualised rate of growth to 8.1%. This is not surprising given the slowdown in China' export markets. In response, China is loosening its monetary policy by rolling back some of the banks' reserve requirements which were progressively raised as it tried to restrain the rise in property prices. It has also stopped, for the moment, the appreciation of the renminbi which had been rising against the US dollar. The much highlighted events at the top of Chinese politics will have investors watching for change later this year but, for the moment in the economic sphere, the government will want to raise consumption at the expense of investment and to try to prevent social unrest coming from the most likely source, strong food price inflation. Large increases in minimum wages in many areas of the country have been announced. China is becoming a more expensive country from which to source goods, and second order effects are being seen as some low value manufacturing is transferred to cheaper production countries, like Vietnam, and some "reshoring" takes place in advanced industrialised countries like the USA. For its part, China will move up the value added chain, aircraft manufacturing being one high profile example. The fear in the west is that, with many economies struggling, the last thing which is needed is for one big source of demand, China, to slow down dramatically. The Chinese have been quite adept at managing the economy and we would back them again to do this successfully. The stakes are very high for the Chinese leaders. Growth has to remain robust to avoid social unrest caused by lack of job opportunities.

For the UK coalition government, things do not get any easier, with the inevitable political unpopularity being seen in the local election results. With the first estimate of first quarter growth a negative 0.2%, the pressure on the Chancellor has increased. Coalitions are never easy, particularly, as in the case of the UK, when it involves two parties quite far apart in the political spectrum. In former times, Budget leaks were a resigning matter but this year's Budget negotiations were played out in front of the nation and the whole spectacle has been hugely damaging to the government. At a time when the austerity pressure is going to rise, the government must give the impression of competence, in which case it may be able to carry the electorate along with it. To give the impression of incompetence at the same time as fiscal policy is being tightened significantly will weaken support for the government's attempt to restore some order to the UK's public finances. For investors, the danger is that the government's resolve will weaken, or that it will espouse populist anti-business policies to try to regain support as it showed signs of doing not so long ago. That would be disastrous. Markets will be in no mood to indulge the UK if it departs from its chosen path of trying to restore the UK's public finances to some sort of order. At the moment, as the table of international ten year government bond yields shows, the UK is receiving strong international support with foreign buyers lapping up UK government bonds. The markets will probably understand the reasons for the slippage of the programme towards the elimination of the structural deficit, namely the weak international environment, particularly in the eurozone which, after all, has nothing to do with the UK, it having declined to join the single currency. What it would not do is stomach a U turn on the structural deficit elimination programme. We think this is unlikely because a U turn would wreck the government's credibility. In many ways, the UK equity market has some advantages, such as modest ratings, attractive dividend yields and very substantial international exposure through its major companies. The UK continues, in our view, to deserve the benefit of the doubt.



In summary, our view on the markets remains unchanged. We are living in dangerous economic times, with a combination of economic and financial events which are unprecedented. We face the possible disintegration of a monetary union and we have extraordinarily low interest rates and money being freely printed in certain countries. Bond yields are often below inflation and, although one understands the reasons why they are where they are, they are far removed from reality, which makes them very risky, not in a qualitative sense, but in a price sense in some countries. They are qualitatively risky in other countries. Equity market investors understand that the economic background in certain countries and areas is very bad and equity markets will undoubtedly react to even worse news, which is almost inevitable from parts of the eurozone. We think that, in these circumstances, provided investors can accept the volatility of share prices, and, as we say, even worse economic news is likely to trigger this, shares in companies which, through their operations, can diversify the risk, offer the best prospects for returns. Against such a dreadful economic news background, the resilience of equities has been impressive.

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