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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equity prices have demonstrated a slightly weaker trend during the quarter which has been marked by sudden changes of sentiment, apparently for no good reason. The performance of good quality government bonds has been staggering, implying economic conditions which we do not foresee. Currency movements have been quite large and mixed, with weakness in the US dollar, Canadian dollar and euro, and strength in the yen and, particularly, the Swiss Franc.

The tables below detail relevant movements in markets:

International Equities 31.05.10 - 31.08.10

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+0.5	+0.8	+6.6	+3.0
Finland	-2.8	-4.9	+0.6	-2.8
France	+0.8	-1.3	+4.4	-0.8
Germany	-0.9	-3.0	+2.6	-0.9
Hong Kong, China	+9.3	+3.4	+9.4	+5.6
Italy	+2.4	+0.3	+6.1	-2.4
Japan	-8.7	-6.4	-1.0	-4.4
Netherlands	-2.0	-4.0	+1.5	-2.0
Spain	+10.9	+8.6	+14.9	+10.9
Switzerland	-1.7	+5.9	+12.0	+8.1
UK	+1.4	+1.4	+7.3	+3.6
USA	-3.3	-8.5	-3.3	-6.6
Europe ex UK	+0.8	+0.5	+6.3	+2.7
Asia Pacific ex Japan	+4.7	+1.5	+7.4	+3.7
Asia Pacific	-1.9	-2.3	+3.3	-0.3
Latin America	+2.7	-0.3	+5.5	+1.8
All World All Emerging	+4.3	-0.1	+5.7	+2.1
The World	-1.5	-4.5	+1.0	-2.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +5.9%

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

Currency	31.05.10	31.08.10
Sterling	3.57	2.83
US Dollar	3.30	2.48
Yen	1.27	0.98
Germany (Euro)	2.66	2.11

Sterling's performance during the quarter ending 31.08.10 (%)

Currency	Quarter Ending 31.08.10
US Dollar	+5.6
Canadian Dollar	+7.5
Yen	-2.6
Euro	+2.3
Swiss Franc	-7.2
Australian dollar	N/C

Other currency movements during the quarter ending 31.08.10 (%)

Currency	Quarter Ending 31.08.10
US Dollar/Canadian Dollar	+1.8
US Dollar/Yen	-7.7
US Dollar/Euro	-3.1
Swiss Franc/Euro	+10.2
Euro/Yen	-4.7

Significant Commodities	(US dollar terms) 31.05.10 - 31.08.10 (%)
Oil	N/C
Gold	+1.7

Markets

International equity markets have been in undecided mood during the last quarter and have ended slightly lower, except in US dollar terms. The total return on the FTSE World Index was -1.5% in local currency terms, -4.5% in sterling terms, +1.0% in US dollar terms and -2.5% in euro terms. In local currency terms, the Japanese market was the weakest, with the FTSE Japanese Index returning -8.7%. The FTSE USA Index returned -3.3% but the FTSE UK Index and the FTSE Europe ex UK Index showed positive returns of +1.4% and +0.8%. Within the latter index, Spain showed a sharp recovery, with the FTSE Spain Index returning +10.9%. Elsewhere, the FTSE Asia Pacific ex Japan, the FTSE All World All Emerging Markets and the FTSE Latin American indices showed returns of +4.7%, +4.3% and +2.7% respectively. During the quarter, sterling appreciated against the US dollar, the Canadian dollar and the euro by 5.6%, 7.5% and 2.3% respectively, but declined against the yen by 2.6% and by 7.2% against a very strong Swiss Franc. It was little changed against the Australian dollar. These currency movements had the effect of reducing the negative return on the Japanese market to -6.4% and turning a slightly negative Swiss market performance in local currency terms to a strong +5.9% in sterling terms. Because of the strength of the Swiss Franc, which countered some of the euro's weakness, the sterling return on the FTSE Europe ex UK Index was +0.5%. Weakness in the US dollar increased the negative return on the FTSE USA Index to -8.5%. The FTSE Asia Pacific ex Japan Index still managed a positive return in sterling terms of +1.5%, but the FTSE Latin American and All World All Emerging Markets indices moved into slightly negative territory with returns of -0.3% and -0.1% respectively.

The fall in yields on high quality government bonds has been staggering and we will discuss this issue in our review. Taking ten year government bonds as a benchmark, the gross redemption yield on sterling bonds fell by 74 basis points to 2.83%, on US dollar bonds by 82 basis points to 2.48%, on Japanese bonds by 29 basis points to 0.98% and on German bonds by 55 basis points to 2.11%.

In the currency markets, there were some significant movements. Sterling rose by 5.6% against the US dollar, by 7.5% against the Canadian dollar and by 2.3% against the euro. On the other hand, it fell by 2.6% against the yen and by 7.2% against an exceptionally strong Swiss Franc.

In the commodity markets, oil was unchanged in US dollar terms, whilst gold was slightly higher, rising by 1.7%.

Economics

Economists are as deeply divided as investors about the path of the economy, whether it be globally, in individual regions or particular economies. The pessimists say that a double dip recession will occur in certain countries, whilst optimists say that a slowdown within an economic recovery is occurring. Understandably, many investors find the world economy a confusing place and, by extension, the course of securities' markets. Investors' and economists' views are made more uncertain by the appearance of good and bad economic news in the world economy. If the news was all one way, it might be easier for investors to gather their thoughts, but it is not. Conflicting signals are being given out all over the place and contradictions abound.

The negative signals are fairly obvious. There is a large public and private debt overhang which has to be worked off. For individuals, this involves deleveraging by paying off debt and we see evidence of this in rising savings ratios. This deleveraging involves buying fewer goods and services, thus depressing economic activity where this is occurring. For overborrowed governments, of which there are many, deficit reduction will involve reduced public sector demand for goods and services and, perhaps, payments or benefits to individuals or companies thereby affecting their spending ability as well. This is the economic hangover from excessive public and private consumption financed by borrowing. Some economies seem "borrowed out".

Then, there are individual countries whose public finances are in a critical state. The pain of adjustment will be very severe and the measures being taken risk turning a recession into a depression for the countries concerned. The main problems here lie within the eurozone with Greece being the most noticeable example. The yields on Greek government bonds show that investors do not expect to have the debt repaid in full. Ireland, Spain, Portugal and, perhaps, Italy also have serious problems with those of Ireland most severe because of the size of the Irish banking problem in relation to GDP. As members of the eurozone, none of these countries can adopt one of the policies that would help to provide economic growth, namely currency devaluation. Yet within the eurozone, Germany, as we shall see later, is showing a stellar performance. This is one of the contradictions in the present economic background.

The USA and UK also, of course, suffer from serious budget deficit problems but they have one priceless advantage over their eurozone deficit counterparts, and that is having their own currency. They can, therefore, determine their own interest rates and, if necessary, print their own currency in the sense of currency creation. It is important to remember this because of the negative mood prevalent in both countries. It is to the UK's credit (as evidenced by the fall in gilt edged yields since the General Election) that it is taking decisive action to eliminate the structural deficit by the end of the current parliament, if it runs for its full five years. In doing so, it is going to have every vested interest and lobby group pointing out how badly they are going to be affected. The news background will be dominated by these negative stories and it is important that the country does not talk itself into a recession. This can happen, because negative talk does affect consumer and business confidence and can become self fulfilling. Whilst the USA has not announced such dramatic measures to deal with its structural deficit (the USA's political system makes it difficult to do so in the way that the UK's can), there is plenty of negative sentiment there, perhaps dominated by the weak housing market, with its attendant consequences, and the high level of unemployment.

Then there is talk of deflation. Certainly, the extraordinarily low level of top quality government bond yields can only be justified if those countries were going to enter a period of deflation. Talk of deflation conjures up a Japanese type position whereby expectations of constantly falling price levels deter consumers from buying "nice to have" goods rather than "must have" ones, thereby entrenching weak demand in the system. It also raises debt default fears as the real value of debt rises. All in all, it is a very undesirable position to be in but we do not think it likely to occur on a widespread basis. Why do we believe this? Firstly, as we shall discuss shortly, by no means all of the world is in the unfortunate position of much of the west. Other parts are growing and with it their demand for raw materials, the cost of which, of course, enters the international price chain. Another reason, and the UK is an example, is that indirect taxes are likely to be on an upward trend as governments struggle with their budget deficits also putting upward pressure on prices. The trend towards "green taxes" is a complementary catalyst. If deflation were to take hold on a widespread basis, it would be serious for equity investors because, whilst costs, notably labour costs, would be likely to be sticky downwards, revenue would fall in many cases because of price reductions, thus having a disproportionate effect on profitability.

Then, there is the housing market in the USA, the initial source of the financial crisis. There is a glut of houses available for sale, many resulting from foreclosures. A weak housing market, for those affected, gives a negative wealth effect. The size of the overhang is such that it casts a depressing shadow on that part of the US economy and we can see from stock market moves in relation to the different sets of data which are provided for the housing market that it casts an important influence.

But there are positive factors for the world economy. Over in the west we tend to be influenced by the predicament of countries around us. However, the rapid economic growth of the BRIC countries (Brazil, Russia, India and China), not to mention other Asian economies, some in the Middle East and other emerging markets, provides an offsetting balance to the world economy. Their rapid growth should help to stave off deflation as their demand for commodities helps to sustain prices. Their demand for industrial goods, which cannot yet be met from local industries, assists economies in the west and Japan. For example, Germany's current excellent growth rate is fuelled by the demand for its exports. So, whilst the west struggles to restore some order to its public finances, some help is at hand to fill the gap left by reduced domestic demand as a result of the fiscal squeeze. This depends upon the relevant economy producing goods and services required by fast growing economies. For example, within the eurozone, Germany does produce such goods, but Greece really does not, so Germany is much more likely to solve its debt problem which, in any case, is not a major one compared to Greece. The latter will have much more difficulty. In one way, a world economy which is not synchronised has one benefit which might not appear very obvious when a number of investors and economists are worried about the possibility of deflation. The benefit is that it acts as a restraint on inflation. If the whole world were growing rapidly, it would significantly raise the chances of inflation as buyers chased up the prices of commodities and production bottlenecks started to appear giving manufacturers greater pricing power. This, in turn, would push up wages and an inflationary spiral would appear to be dealt with, amongst other policies, by much higher interest rates which would not be good for securities markets.

That leads to a further positive factor for the world economy at present although the welcome needs a heavy qualification. Because fiscal policy in the form of tax increases and public spending cuts is so tight in many heavily indebted countries, monetary policy is likely to remain exceptionally loose. Interest rates in the USA, UK, eurozone and Japan are likely to remain very low in the foreseeable future, thus providing some help to businesses and individuals with borrowings. We should not, however, forget the plight of savers in these circumstances whose purchasing power has been adversely affected by the virtual disappearance of their interest income. In addition to the likely continuation of very low interest rates, it is quite possible that another monetary tool, quantitative easing, may be extended as a way of trying to stimulate sluggish economies. In the USA, UK, eurozone and Japan, conventional monetary policy has lost its power to influence economic activity because it is not possible to reduce interest rates meaningfully from present exceptionally low levels. That being the case, money creation may help but the policy is fraught with danger later on. If UK style quantitative easing is undertaken, with the Bank of England buying bonds (it has been almost totally centred on purchasing government stock) from the private sector and creating a deposit electronically for the seller, it does two things. Firstly, the buying of bonds should keep yields below what they would otherwise be. That may (depending if margins over gilts remain unchanged) lower the cost of borrowing for business and thereby indirectly help economic activity in an economy. Secondly, the liquidity created by the bond sale may find its way into the economy, say for a bank by increased lending, and have an economic multiplier effect that way. It all sounds very easy but, of course, it is not. If we could just print money and spend it, problems would disappear, but the threat is of inflation being resurrected. That may not seem very likely at present, as some people worry about deflation, but, if more money chases a relatively inelastic supply of goods, then prices will rise. So, there has to be an exit strategy from quantitative easing so that the additional money which has temporarily been created can be withdrawn from the relevant economies. That will not be so easy, especially if the economic background is subdued. If, in the above example in the UK, the process is reversed and the gilts purchased are sold back to the private sector, it would threaten a rise in yields in the bond markets. Having a large seller of stock in the market at a time when the government is still borrowing heavily could push interest rates higher, thus making life more difficult for the corporate sector. But, for the moment, it is a possibility that can be viewed positively for the economies affected as it is one further weapon in economic policymakers' armoury to stave off recession.

When the financial crisis hit the world economy, companies battened down the hatches immediately by cutting spending wherever possible and running down stocks. The result is that many companies are in a very lean position with strong balance sheets. Many companies' profits are improving and dividends are starting to be increased. We are also witnessing the re-emergence of significant merger and acquisition activity. Lord Keynes referred to "animal spirits" which, in this case, reflects a mood change amongst companies to a more optimistic frame of mind. At the moment, "animal spirits" are working positively and with many large companies having significant cash fire power, we can expect M & A activity to gather pace.

Market indicators point to confusion amongst investors, as evidenced by day to day random movements which are difficult to relate to any particular piece of news. Significant movements are rationalised retrospectively. On a bad day, the rationale might be concerns about economic growth or a slowdown in China yet, on a good day, the rationale could be a more optimistic outlook for the world economy and optimism about Chinese economic growth helping to sustain the world economy. Movements are hard to gauge.

Yet there is certainly some mispricing in the securities markets. The question is where. The ten year government bond yields which we show at the beginning of this review, are extraordinary. The first thing to say is that the countries' bonds quoted are from well regarded borrowers. This is a relative term. Of the four countries shown in the table, only Germany's finances can be said to be in reasonable order, but it shows how badly many countries have allowed their public finances to deteriorate that the three other countries, the USA, UK and Japan, are considered a 'good' risk. A simple explanation could be that bond investors, having to have bond exposure, have drifted to these countries' bonds by default. The most instructive data comes from the eurozone bond market. Those advocating the formation of a monetary union in Europe paraded the economic convergence advantages without considering whether it had the attributes of an optimal currency area. Observers without a political axe to grind in favour of monetary union could see that the "one size fits all" interest rate policy implied by monetary union would be unlikely to work. What has happened is that the structural flaws in monetary union have accelerated economic divergences, and the loss of currency sovereignty, as far as the members are concerned, has exacerbated the situation. The eurozone countries which are struggling cannot use one of the traditional aids to economic recovery, namely devaluation.

One of the alternative ways of restoring competitiveness with, say, Germany, for the struggling countries, is savage deflation. Holders of these eurozone members' bonds are indicating their doubts about whether these countries will be able to escape from their debt trap. The redemption yield on Greek three year government bonds, currently 12.0%, and on ten year government bonds, currently 11.56%, tells us that debt reorganisation is all but inevitable. Greece cannot possibly afford to pay these levels of interest rate on new borrowings. Whilst not in the same league as Greece, ten year Irish government bond yields of 5.76%, and those of Portugal at 5.53%, indicate the scale of problems within the eurozone. For countries trapped in the eurozone, both absolutely and relatively to the more successful eurozone members, the lack of an economic stimulus, which could be expected from devaluation, means that efforts to reduce budget deficits could lead to a vicious circle of economic confrontation, thus making budget deficit reduction difficult, if not impossible. As we said earlier, one advantage which the USA, UK and Japan have is that they are not trapped in a monetary union, thus giving them a better chance of addressing their debt problems. Against this background, a flight to the bonds of countries deemed unlikely to default, in the case of Germany because of its financial strength and in the case of the above three because they have their own currency, has taken place. That is an over simplistic statement because there are other factors such as the favourable impression the new UK government has made with its plan to eliminate the structural deficit by the end of the current parliament, but it makes the point. We can say that serious concern about the creditworthiness of some countries is driving down yields to unrealistic levels in countries which are considered "safe". This, we believe, is causing a serious mispricing in the bond market. Only if we move into a deflationary environment, not just for one or two quarters but for much longer and, therefore, have a significantly higher real rate of interest rather than the nominal one, do we feel that yields on US, UK and German government bonds could be justified. Similarly, if the world went into an economic depression with serious consequences for company profitability and, therefore, dividend paying power, the yields would look relatively attractive. In the more realistic scenario which is likely to prevail, we think they offer very poor value.

An obvious comparison is against equities. After their depressed levels last year, dividends are starting to rise again almost everywhere and it is common, but not always the case, for dividend yields to be well in excess of, say, ten year government bond yields at present. Taking Bloomberg estimates for this year, the FTSE 100 Index dividend yield of 3.55% is about 70 basis points higher than the ten year gilt's gross redemption yield. If we take Germany, the DAX is forecast to yield 3.61%, a full 150 basis points more than the ten year bond. In France, on the CAC 40 index, the difference is approximately 169 basis points, in the Netherlands, on the AEX index, it is approximately 121 basis points and in Switzerland, on the Swiss Market index, it is approximately 215 basis points. In Japan, on the Nikkei 225 index, it is approximately 86 basis points. The main exception is the USA, where the estimated dividend yield on the S & P 500 Index is about 52 basis points below on the ten year US Treasury bond. The yield on the less representative Dow Jones Industrial Index is slightly higher than on the bond and neither of these take into account share buybacks. The expectation is, at this stage, that next year's dividends will be higher still. Then, if we look at price/earnings ratios, we see, on Bloomberg estimates, current year levels of only just in double figures in Europe and about 13 for the S & P 500 Index. At present, the estimates for next year are for a further recovery in earnings and, therefore, a fall in price/earnings ratios, taking most European markets into single figures and the S & P 500 Index to about 11.3. These ratings are low.

In the UK, it was in the 1950s when gilt edged yields rose above those on equities. Until that time, it was thought that equities should yield more than gilts because they were riskier and higher yields were necessary to compensate for this perception. The thinking after that, as the cult of the equity took over, was that the growth in share prices would make up for lower yields on shares. Of course, it is true that economic growth should bring with it profits growth which, in turn, would bring dividend growth. So, provided dividends were growing, lower equity yields had some justification. Shares were also considered as a hedge against inflation. Now, as a result of the volatility of equities during this last decade and pressure to match assets with liabilities, there has been a move back towards bond investments and during this volatile period high quality bonds have performed better than equities. But this does not mean that the crossover in yields in the UK in the 1950s was wrong and being influenced by recent relative movements is not necessarily right. It may or may not be.

We would say that one has to be very negative about the outlook for the world economy to believe that bonds are a better investment than equities at present. We have discussed the deflation argument for bonds and, as we have said, we do not buy the deflation argument. One only has to note recent concerns about the world's food supply to note the factors which could raise inflation levels. The lead news in the Financial Times of 3 September was headed "Fears grow over food supply", with three bullet points above it, namely "Russia extends grain export ban", "Riots in Africa" and "Wheat prices soar". On the macro economic side, we see enough drivers of economic growth in the world economy to believe that the likelihood of economic depression is very low, and the likelihood of a double dip recession, a shorter term issue, is low. Indicators such as an increase in demand for air travel and the World Trade Organisation's September report of a 25% increase in the value of world trade in the first six months of 2010, compared with the same period in 2009 and 7% up in the second quarter of 2010 against the first quarter of 2010, suggest economic recovery is underway on a worldwide basis, although with significant variations between countries and regions. This recovery is, of course, from a very depressed base, but there are some encouraging signs. Even in the very troubled eurozone, it is believed that only Greece failed to grow in the second quarter. The point about these indicators is that, if the world economy is recovering overall, we may expect overall profits and dividends to rise. If that is the case, dividend yields in many markets in excess of ten year government bond yields, to use a benchmark, make little sense. It suggests good value in shares. It could be argued that share valuations are broadly correct and that bond valuations are unduly inflated and, on fundamentals, we believe the latter supposition is correct, but it remains likely, for reasons mentioned earlier, that, because fiscal policy will remain so tight in many countries, monetary policy will remain correspondingly loose, perhaps enhanced by further quantitative easing in some countries. That means that bond yields may rise only gradually. The paradox is that, if the world economy does continue to recover and investors feel less jittery and therefore "risk off" days become more frequent, the chances of a sudden bursting of the bond bubble increase, with some nasty losses ensuing. The increase in very short term or high frequency trading seems to exacerbate mood swings in markets but fundamentals appear to point to a serious overvaluation of bonds and an undervaluation of equities. By their nature, "black swan" events cannot be foreseen but, as this is written, against a still sombre economic background, it is difficult to see what can shock investors and, therefore, not be in prices. However, this is always the way. Whilst the problems of the banking system have not been resolved, individual banks are performing well and their profitability has increased dramatically. The authorities around the world appear to have worked out how to deal with problem banks and no longer do investors and depositors worry about the security of the banking system. The tightening up of financial regulation is aimed at reducing risk taking. It will be more difficult for banks to make money and increased capital requirements will mean that profitability will increase more slowly. But growth should be of a better quality and, if the risk of a systemic failure of the banking system is reduced, the risks to the international economy will be reduced. After what it has been through, that must be an improvement.

To put these conflicting influences into some sort of perspective, we show below excerpts from the IMF's updated projections for the world economy made in July. The following excerpts are from its projection for economic growth this year and next compared with the outturn for 2009.

IMF Projections (world output year over year % change)

	2009 (actual) %	2010 (estimate) %	2011 (estimate) %
World output	(0.6)	4.6	4.3
Advanced economies	(3.2)	2.6	2.4
USA	(2.4)	3.3	2.9
Eurozone	(4.1)	1.0	1.3
Germany	(4.9)	1.4	1.6
France	(2.5)	1.4	1.6
Italy	(5.0)	0.9	1.2
Spain	(3.6)	(0.4)	0.6
Japan	(5.2)	2.4	1.8
UK	(4.9)	1.2	2.1
Canada	(2.5)	3.6	2.8
Newly industrialised Asian economies	(0.9)	6.7	4.7
Emerging & developing economies	2.5	6.8	6.4
Russia	(7.9)	4.3	4.1
China	9.1	10.5	9.6
India	5.7	9.4	8.4
Brazil	(0.2)	7.1	4.2

Other significant economies straddling the above definition

	2009 (actual) %	2010 (estimate) %	2011 (estimate) %
Australia	1.3	3.0	3.5
Hong Kong SAR	(2.8)	6.0	4.4
Korea	0.2	5.7	5.0
Singapore	(1.3)	9.9	4.9
Taiwan Province of China	(1.9)	7.7	4.3
ASEAN - 5			
Indonesia	4.5	6.0	6.2
Malaysia	(1.7)	6.7	5.3
Philippines	1.1	6.0	4.0
Thailand	(2.2)	7.0	4.5
Vietnam	5.3	6.5	6.8

Consumer Prices			
	2009 (actual) %	**2010** (estimate) %	**2011** (estimate) %
Advanced economies	0.1	1.4	1.3
Emerging & developing economies	5.2	6.3	5.0

Source IMF World Economic Outlook Update - July 2010 (excerpt)

The reduction in world output in 2009 will have been more than made up by the end of the year. Within that expectation, there are, however, many divergences of performance. Overall, advanced economies, if the IMF projections are correct, will take two years to make up for last year's decline in output but, within that category, the USA, Canada and especially the Newly Industrialised Asian economies will significantly outperform the eurozone, which is forecast not to have made up the decline in output in 2009 even by the end of 2011. Japan and the UK are in the same category as the eurozone. If we look at the BRICs (Brazil, Russia, India and China) we see that they are all expected to power ahead this year and next and only Russia, which suffered very badly in 2009 (output down 7.9%), will be struggling to recover its position by 2011. China and India powered ahead in 2009 and are expected to continue to do so this year (certain) and next year. We have added a list of other significant economies which are expected to show strong growth this year and next, Australia, Hong Kong SAR, Korea, Singapore, Taiwan Province of China, Indonesia, Malaysia, Philippines, Thailand and Vietnam.

Interestingly, in the light of concerns about deflation, the IMF expects some modest inflation in advanced economies (1.4% this year and 1.3% next year) and much stronger inflation in emerging and developing economies (6.3% and 5.0%).

Of course, forecasters can be wrong but, from what we know at present, the projections look realistic. It is likely to take some incident, which we cannot presently foresee, to prevent growth from continuing next year. It is growth in the high achieving parts of the world economy that will provide some help to those countries which will be facing domestic contractionary forces as a result of their need to put their public finances in order. Overall, the IMF does not paint an unpromising picture and it is not one, we believe, which should fill investors with despondency.

As one would expect from these forecasts, some items of good news have been appearing. The balance of news has gone from being universally bad towards the end of 2008 and early 2009 to being less bad and, now, to having just a moderately negative bias. It is the trend and not the actual balance between bad and good news which is important and the trend is more encouraging.

As we have been doing in recent reviews, we will highlight some of the more encouraging news from various areas of the world. This is not to give a bullish spin on news to try to make a positive case for markets but to give some balance to the sometimes very negative headlines. However, these items of news are given against a background of economic data which is still, on balance, negative.

In the USA, the ISM said that its US services sector index rose to 54.3 in July from 53.8 in June. Industrial output in the USA rose by 1% in July from a revised 0.1% in June and these figures were better than expected. Orders in the US for big ticket items rose in July by 0.3% to US$193 billion. Official data showed that US consumer spending rose by 0.4% in July, which was a slightly better figure than expected. In the eurozone, notwithstanding the sovereign debt problems, there have been a number of encouraging items. The Markit purchasing managers index for the eurozone services sector rose to 55.8 in July compared with 55.5 in June. Whilst keeping eurozone interest rates at 1%, the President of the ECB said that the economy was looking better than expected in the third quarter. Although the initial reading of the composite purchasing managers index in the eurozone for services and manufacturing sectors fell from 56.7 to 56.1, it was still quite a strong reading, being well above 50. Eurozone industrial orders rose in June by 2.5% month on month for a 22.6% annual gain. The ECB reported that bank lending to the eurozone private sector rose by 0.9% in July. In Germany, there have been some particularly encouraging items of news. The Bundesbank gave an optimistic forecast for growth this year of 3%, up from its 2% forecast in June, and this, it will be noted, is significantly in excess of the IMF's forecast made in July. The German services sector expanded at its fastest rate for three years in August with the Markit purchasing managers index rising to 58.5 from 56.5 in July. German GDP grew at a rate of 2.2% in the second quarter, which is the fastest rate since German unification. Business confidence is rising in Germany. The Ifo Research Institute business confidence index rose to 106.7 in August compared with 106.2 in July. The GfK Institute's German confidence index rose to 4.1 in August from 4.0 in July. In the UK, a Bank of England report showed that UK factories are hiring staff at the fastest rate in thirteen years and the report also showed that exports were beginning to recover. In July, high street sales rose faster than expected, rising by 1.1% during the month, to be 1.3% higher, year on year. Although only reflecting one month, government borrowing fell to £3.8 billion in July compared with £6.1 billion in July 2009. This should, however, be put into the context of a £5.3 billion net repayment in July 2008. The CBI's industrial trend survey showed that the gauge of new orders rose to its highest level in almost two years, rising from -16 to -14. The CBI's gauge of high street sales rose to 35 in August compared with 33 in July and was the best reading since April 2007. In the second quarter, the economy grew slightly faster than previously estimated, with GDP growth being revised upwards from 1.1% between April and June to 1.2% to take the annual pace of growth to 1.7% up from 1.6%. The GfK NOP gauge of consumer sentiment rose to -18 in August compared with -22 in July. This was the first rise since February.

With conditions in markets quite febrile on occasions, it is worth taking a step backwards and asking oneself if the yields currently being shown on good quality government bonds really reflect what might happen. They are telling us of an ugly situation coming up where minuscule bond yields offer the best value in the securities' markets because of deflation and/or economic depression. Their relative relation with equity yields foretells a serious outlook for company profits and significant dividend cuts. We do not believe that the evidence is strong for this view and therefore that bonds are very dear and equities offer good value. Although this is being written as sentiment has once again improved, further setbacks are possible giving opportunity for judicious purchases, but we expect the underlying trend to improve.