meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

A significant rise in international equity markets in the final quarter of 2015 meant that the gains of 2014 were consolidated. Not much changed to cause this significant recovery but it is part of a pattern we anticipated whereby, although shares would move modestly higher, there would be some poor quarters and marked volatility. We are seeing this in the early days of 2016 as markets have got off to a weak start as fears about the Chinese economy have once again risen. International bond markets, as measured by ten year government bonds, mainly drifted lower. Sterling generally weakened and commodity prices ended the year on a depressed note.

The tables below detail relevant movements in markets :

International Equities 30.09.15 - 31.12.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.4	+13.3	+10.2	+13.3
Finland	+12.5	+12.5	+9.5	+12.5
France	+4.8	+4.8	+2.0	+4.8
Germany	+10.6	+10.6	+7.7	+10.6
Hong Kong, China	+5.2	+8.1	+5.2	+8.0
Italy	+0.5	+0.5	-2.2	+0.5
Japan	+10.0	+12.5	+9.5	+12.5
Netherlands	+5.8	+5.8	+3.0	+5.8
Spain	+0.5	+0.5	-2.2	+0.5
Switzerland	+4.8	+5.1	+2.3	+5.1
UK	+3.7	+3.7	+0.9	+3.7
USA	+6.7	+9.6	+6.7	+9.6
Europe ex UK	+5.8	+6.1	+3.2	+6.1
Asia Pacific ex Japan	+4.3	+8.9	+6.0	+8.9
Asia Pacific	+7.3	+10.8	+7.8	+10.8
Latin America	-2.0	N/C	-2.7	N/C
All World All Emerging	+1.2	+3.1	+0.3	+3.1
The World	+6.0	+8.2	+5.3	+8.2

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : -1.2%

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

Currency	30.09.15	31.12.15
Sterling	1.77	1.96
US Dollar	2.06	2.27
Yen	0.35	0.27
Germany (Euro)	0.59	0.63

Sterling’s performance during the quarter ending 31.12.15 (%)

Currency	Quarter Ending 31.12.15
US Dollar	-2.6
Canadian Dollar	+0.5
Yen	-2.2
Euro	+0.2
Swiss Franc	-0.2
Australian dollar	-6.3

Other currency movements during the quarter ending 31.12.15 (%)

Currency	Quarter Ending 31.12.15
US Dollar/Canadian Dollar	+3.2
US Dollar/Yen	+0.4
US Dollar/Euro	+2.9
Swiss Franc/Euro	+0.4
Euro/Yen	-2.4

Significant Commodities (US dollar terms) 30.09.15 - 31.12.15 (%)

Currency	Quarter Ending 31.12.15
Oil	-22.5
Gold	-4.4

PERFORMANCE DURING 2015

International Equities 31.12.14 - 31.12.15

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+1.8	-4.3	-9.5	+0.8
Finland	+13.5	+7.8	+1.9	+13.5
France	+13.1	+7.4	+1.5	+13.1
Germany	+10.2	+4.7	-1.0	+10.2
Hong Kong, China	-3.7	+1.9	-3.6	+7.3
Italy	+14.7	+8.9	+3.0	+14.7
Japan	+11.5	+17.6	+11.2	+23.8
Netherlands	+12.7	+7.0	+1.2	+12.7
Spain	-6.2	-10.9	-15.8	-6.2
Switzerland	+2.4	+7.5	+1.6	+13.2
UK	-0.8	-0.8	-6.3	+4.4
USA	+1.0	+6.9	+1.0	+12.5
Europe ex UK	+8.7	+5.4	-0.4	+10.9
Asia Pacific ex Japan	-2.7	-4.4	-9.6	+0.7
Asia Pacific	+4.2	+6.5	+0.6	+12.1
Latin America	-8.3	-27.4	-31.4	-23.6
All World All Emerging	-5.8	-10.3	-15.2	-5.6
The World	+2.3	+4.3	-1.4	+9.9

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +0.6%

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

Currency	31.12.14	31.12.15
Sterling	1.76	1.96
US Dollar	2.17	2.27
Yen	0.33	0.27
Germany (Euro)	0.54	0.63

Sterling's performance during the year ending 31.12.15 (%)

Currency	Year Ending 31.12.15
US Dollar	-5.4
Canadian Dollar	+12.6
Yen	-5.2
Euro	+5.3
Swiss Franc	-4.9
Australian dollar	+5.9

Other currency movements during the year ending 31.12.15 (%)

Currency	Year Ending 31.12.15
US Dollar/Canadian Dollar	+19.1
US Dollar/Yen	+0.3
US Dollar/Euro	+11.4
Swiss Franc/Euro	+10.7
Euro/Yen	-9.9

Significant Commodities (US dollar terms) 31.12.14 - 31.12.15 (%)

Currency	Year Ending 31.12.15
Oil	-34.7
Gold	-12.2

MARKETS

An uneven year for international equity markets has ended with a strong quarter. In local currency terms, the return on the FTSE World Index was 6.0%, in sterling terms it was 8.2%, in US dollar terms 5.3% and, in euro terms, 8.2%. Looking at individual markets in local currency terms, we note an above average performance from the FTSE Japan Index (+10.0%) and the FTSE USA Index (+6.7%). Individual European markets performed well such as the FTSE Finland Index (+12.5%) and the FTSE Germany Index (+10.6%). Underperforming markets included the UK, where the FTSE UK Index returned 3.7%, Latin America where the FTSE Latin American Index returned -2.0% and the FTSE All World All Emerging Markets Index which returned 1.2%. Looking at the sterling adjusted indices, the feature is the FTSE Australian Index where a good local currency performance (+6.4%) became a very good sterling adjusted return as the Australian dollar, previously weak, started to recover and lift the return on the index to 13.3%. A strong US dollar left the sterling adjusted return on the FTSE USA Index at 9.6% whilst the return on the FTSE Japan Index rose to 12.5%. Currency movements raised the return on the FTSE Asia Pacific ex Japan Index to 8.9% compared with its 4.3% local currency return. The FTSE Latin American Index broke even in sterling terms as a result of currency movements.

Looking at the gross redemption yields on benchmark ten year government bonds, we note that, with the exception of Japan, they drifted higher during the quarter. In the case of the UK, the yield rose by 19 basis points to 1.96% in the USA by 21 basis points to 2.27%, in Germany by 4 basis points to 0.63%. In Japan, however, the yield fell by 8 basis points to 0.27%.

In the currency markets, the main feature in our table is the recovery in the Australian dollar against which sterling fell by 6.3%. Sterling also fell against the US dollar by 2.6%, against the yen by 2.2% and against the Swiss Franc by 0.2%. It strengthened slightly against the Canadian dollar by 0.5% and against the euro by 0.2%.

In the commodity markets, there was again significant weakness in oil with Brent crude falling 22.5% whilst gold was modestly lower by 4.9%.

Moving on to look at the whole of 2015, we note that international equity markets mostly consolidated their 2014 gains. In local currency terms, the FTSE World Index returned 2.3%, in sterling terms 4.3%, in US dollar terms -1.4% and, in euro terms, 9.9%. Looking at local currency returns first, the stand out performers were the FTSE Japan Index which returned 11.5% and the FTSE Europe ex UK Index which returned 8.7%. On the other hand, of the main markets, the FTSE UK Index (-0.8%) and the FTSE USA Index (+1.0%) underperformed and there was marked relative weakness in the FTSE Asia Pacific ex Japan Index (-2.7%), the FTSE Latin American Index (-8.3%) and the FTSE All World All Emerging Markets Index (-5.8%). The position looks rather different in sterling adjusted terms. The return on the sterling adjusted FTSE Japan Index increased to 17.6% whilst the FTSE USA Index showed an above average performance, returning 6.9%. Despite currency weakness, the FTSE Europe ex UK Index put in an above average performance, returning 5.4%, and, within this area, it is worth noting that, because of currency strength after the peg with the euro was dismantled in January 2015, the FTSE Switzerland Index returned an above average 7.5%. The sterling adjusted returns of the local currency indices in Asia Pacific ex Japan (-4.4%), Latin America (-27.4%), emerging markets (-10.3%) and Australia (-4.3%) all worsened compared with their local currency returns.

In the bond markets, as shown in the gross redemption yields on ten year government bonds, yields drifted higher during the year. In the case of the UK, the yield rose by 20 basis points to 1.96%, in the USA by 10 basis points to 2.27%, in Germany by 9 basis points to 0.63%, whilst Japan was the exception with the yield dropping by 6 basis points to 0.27%.

There were significant movements in the currency markets during 2015. Against the US dollar, sterling weakened by 5.4%, against the yen by 5.2% and against the Swiss Franc by 4.9%, but against the Canadian dollar it rose by 12.6%, against the Australian dollar by 5.9% and against the euro by 5.3%.

One of the features was the fall in commodity prices and, over the year, oil, as measured by Brent crude fell by 34.7%, whilst gold fell by 12.2%.

ECONOMICS

The background for markets did not materially change during the year although some factors assumed greater prominence and a small number of new issues emerged. As we indicated at the end of 2014, there would be periods of weakness and volatility reflecting the political and economic background but we expected the stock market to grind higher, at least as far as equities were concerned. We were negative on bonds believing them to be seriously overvalued. The possible political and economic risks which we highlighted specifically were the eurozone, deflation, Russia, the UK General Election, possible sovereign defaults and a more pronounced slowdown in the Chinese economy than expected. On the positive side, we based our support for equities on continued growth in the world economy and we regarded the fall in the oil price as being generally positive. We thought that corporate earnings would rise and that cheap money would continue to support asset prices, highlighting the relative attraction of the dividend yields on shares.

Going through our list of the possible negative factors mentioned above, we were not taking many risks in suggesting that the eurozone would remain an issue because it continues to be an area with chronic problems. For a long time, Greece was the issue but some sort of deal was agreed with its creditors, although implementation of the Greek government’s promises is uneven and there remains a lack of credibility since the Greek government’s heart is not in many of the policies to be implemented. Greece does not sit comfortably in a fixed currency area and problems could erupt at any time. Perhaps more significant, given that Greece was an existing problem, is the result of the Spanish and Portuguese elections. In the case of Portugal, a left wing coalition has been formed. It remains to be seen how viable it is given inherent conflicts and an anti austerity viewpoint. The result of the Spanish election could not be more inconclusive with no obvious viable coalitions. Spain has performed well economically in 2015, albeit from a low level, having taken measures to improve the competitiveness of the economy, although there remains a lot more to do. It is the fourth largest eurozone economy and the political stalemate must be a concern. It is unlikely that the reform programme will make further progress.

We perhaps underplayed the deflation factor since it was a recurring concern for some investors in 2015. One of the features of 2015 was continuing weakness in the commodity markets. We touched obliquely on this through our mention of deflation and the benefits of the weaker oil prices but, had we known how weak commodity prices would be in 2015 (the Bloomberg commodity index fell 24.7% in US dollar terms), we would certainly have made more of it. Although we do not see a sustained period of deflation, falling energy and food prices have resulted in negative inflation rates in some countries. Deflation, in its way, is as dangerous as inflation, so those who viewed the market outlook negatively seized upon this point. The UK and Australia, whose indices contain some big dividend paying commodity stocks, experienced concerns about dividend sustainability. As far as Russia is concerned, its economy has suffered badly from lack of diversification away from energy and sanctions but, whilst it flexed its muscles militarily, it did not become a major market issue. With the UK General Election unexpectedly returning a majority government, the fears of uncertainty resulting in an indecisive result were removed so that, from May onwards, this potentially negative issue fell away from the list of concerns. Whilst there were no major sovereign defaults in 2016, the potential for trouble has not gone away. In our reasoning for having a negative view on bonds, we should, with hindsight, have made more of the potential for trouble in the high yield bond markets. Investors were chasing yield as a result of the very loose standard and non standard monetary policy being followed around the world and some of the areas, such as US energy, have proved problematic as energy prices have collapsed. Defaults are rising and the sector performed poorly in 2015. China, which we mentioned, was definitely an issue and one of the major influences on markets, particularly since August when China devalued its currency through allowing the trading band of the renminbi to widen. Growth has slowed down as the country tries to make the transition from an investment and export led economy to one more driven by consumption. In the opening days of 2016, China has dominated the markets, leading to a weak start to the year.

With regard to the factors which we thought would be positive for equities in 2015, we cited continued growth in the world economy which would benefit corporate earnings and we thought that the fall in the oil price would help growth. As mentioned above, we still believe that to be the case and it will probably show through in 2016 but, in 2015, consumers tended to save the windfall of lower energy prices in order to reduce their indebtedness. This is one reason why the world economy did not grow as much as expected. As the year went on, growth forecasts tended to be pared back. Nevertheless, there was still growth. Partly allied to this, we were too optimistic on corporate earnings, particularly in the USA where the strength of the US dollar provided currency headwinds for companies with overseas earnings. We said that cheap money would also continue to support asset prices and make dividend yields relatively attractive. That is still the case.

In summary, our closing 2014 economic review, where we outlined what we thought would be the influences on markets in 2015, did touch upon the main issues but, inevitably, gave too much weight to some and not enough to others. The equity markets have provided the approximate level of return we expected and in the manner expected with some bad periods during the year with the level of volatility higher than we had anticipated at times, although we felt it would be an issue in certain quarters. High quality bond returns have been small and less than on equities but still better than we had thought likely.

What it is important to remember is that, with inflation at around zero, even a small nominal return gives a real positive return and that the long term investment objective, at least in equity orientated portfolios where income requirements may be secondary to capital growth, is to increase the real value purchasing power of a portfolio. A 1% total return when inflation is zero is better than a 1% return when inflation is 2%. Over the years, there have been some very high nominal returns, interspersed with some poor years with the tech bubble and the financial crisis. Even though corporate earnings have increased, there have been positive returns in international equity markets over the last four years at a time when inflation has been subdued. It cannot be taken for granted that equities will rise every year, especially at a time of very modest economic growth which will find its reflection in the level of earnings growth and on to dividend growth.

So what might we expect in 2016? We have had recent economic projections from the IMF and OECD. For 2015, the IMF projected world economic growth would be 3.1%, slightly lower than 2014's 3.4%. For 2016, it projects that growth will recover to 3.6%. Those latest projections were made in October. The OECD Economic Outlook, in November, suggested that growth in 2015 would turn out to be 2.9% and its projection for 2016 was 3.3%. So, on the latest forecasts, accelerating growth on 2015's pared back forecasts is expected at this stage but these forecasts represent only modest growth, but growth nevertheless. A feature of 2015 has been the narrowing of the growth gap between developed countries and developing countries. Developing countries' growth rates usually exceed those of developed countries but weak commodity prices and specific country problems (for example, Brazil and Russia) have narrowed the gap. So, for example, the IMF projects growth in Advanced Economies in 2015 of 2.0% against 1.8% in 2014, whilst growth in Emerging Markets and Developing Economies is projected to be 4.0% in 2015 against 4.6% in 2014. The gap therefore reduces from 2.8% to 2.0%. The OECD sees its members' growth rate at 2.0% in 2015 against 1.9% in 2014, whilst it sees non OECD countries' growth rate at 3.7% in 2015 against 4.7% in 2014. The gap therefore narrows from 2.8% in 2014 to 1.7% in 2015. Both organisations see the gap widening again in 2016, it is worth noting, to 2.3% in the case of the IMF and 2.0% in the case of the OECD.

Looking at the outturn for 2015 within the Advanced Economies category as projected by the IMF, the three best performing economies are expected to have been Spain (3.1% growth), the USA (2.6%) and the UK (2.5%) with Japan (0.6%), Italy (0.8%) and France (1.2%) at the other end of the scale. It is much the same story with the OECD where the November projections showed Spain (3.2%), the USA (2.4%) and the UK (2.4%). At the other end of the scale it, too, had Japan (0.6%), Italy (0.8%) and France (1.1%). If we look at forecasts for Emerging Markets and Developing Economies and taking China, India, Brazil and Russia, we see an enormous disparity in performance. The IMF sees Chinese growth in 2015 at 6.8% and the OECD at the same level whilst the IMF sees Indian growth at 7.3% and the OECD at 7.2%. On the other hand, the IMF sees Brazil's growth rate at -3.0% in 2015 and the OECD sees -3.1%. The IMF sees Russian growth at -4.0% in 2015 and the OECD at -3.8%. The deterioration in the performance of Brazil and Russia is very significant. In 2014, Brazil had marginal growth of 0.1% and Russia 0.6%, both very poor figures themselves but, as shown above, 2015 will have been much worse.

As we look ahead to 2016, both the IMF and OECD see some improvement, although growth is still expected to be modest. The IMF sees world growth at 3.6% and the OECD at 3.3%. Not surprisingly, in view of what we know about the world economy now, the leaders in 2015 are also expected to be the leaders in 2016. The IMF sees growth in the USA, UK and Spain at 2.8%, 2.2% and 2.5% respectively, whilst the projections by the OECD are 2.5%, 2.4% and 2.7% respectively. The laggards are the same, albeit that they are expected to show an improved rate of growth compared with 2015. In Emerging Markets and Developing Economies, the IMF sees a further slowing in the Chinese economy, projecting growth down to 6.3% and so, too, does the OECD which projects growth of 6.5%. Both organisations see a modest increase in India's economic growth rate in 2016, in the case of the IMF to 7.5% and the OECD to 7.3%. As mentioned above, both organisations see a reduction in the level of contraction of the Brazilian and Russian economies in 2016. The IMF sees the Brazilian economy contracting by 1.0% in 2016 whilst the OECD sees a 1.2% contraction. In the case of Russia, the respective levels of contraction are seen as 0.6% and 0.4%. Because of the number of variables for both economies, particularly commodity prices and political issues in Brazil, these projections must be considered quite tentative at the moment.

All of these projections must, as a year ago, be made against a background full of uncertainties as the world economy remains in uncharted territory as far as monetary policy is concerned, and we will come back to this later as we review the main countries and areas, starting with the USA where, after a period of seven years at an unchanged level of 0.00% to 0.25%, the Federal Reserve raised its federal funds target level on 16th December from 0.25% to 0.50%, this being one of a series of small rises expected to be made in 2016, perhaps ending 2016 in a range of 1.25% to 1.5%. The FOMC, in making its decision to raise interest rates, said "economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate". Such is the sensitivity about the potential effect of an increase in US interest rates that the Federal Reserve stayed its hand in September after the repercussions on markets of the Chinese interest rate move in August. Many had expected it to raise interest rates at that time. With concerns about the Chinese economy having diminished since then and with modest growth in the US economy, there was no reason for the Federal Reserve to delay any longer. From an economic perspective, it is highly desirable that the Federal Reserve starts to move towards a more normal monetary policy, this for several reasons. Firstly, although consumer price inflation is very low at 0.5% year on year, interest rates are very low even against this rate of inflation. Quantitative easing has not been reversed and monetary policy remains very loose. This risks a rise in inflation and, at some stage, the favourable year on year consumer prices comparison will drop out given that the benefit of falling energy prices will fall out of the index. As the US economy moves to full capacity by closing the output gap, the risks to inflation rise, although the recent increase in the federal funds rate was symbolic and will therefore have little tangible effect on the economy other than through a signalling exercise. With interest rates so low, monetary policy loses its power to influence an economy. If interest rates return to more normal levels by historical standards, then central banks can reduce interest rates if an economy needs stimulus and monetary policy can be effective in influencing an economy. The danger with present very low interest rates is that, if there is another period of economic weakness, monetary policy cannot do much to effect a change. There could be more quantitative easing but the effects of this are increasingly milder and printing money is not a good solution to any other than an immediate crisis. Negative interest rates carry obvious practical difficulties, even though they are being widely seen in Europe. So, a gradual move towards normality in US and UK interest rates, in particular, is highly desirable for both of these reasons, potential inflation implications and the effectiveness of future monetary policy.

If the IMF's and OECD's economic projections for the USA in 2016 turn out to be reasonably accurate, it may be that politics will be the more important influence on markets as we approach the November Presidential and Congressional elections. The campaigns, particularly for the Republican nomination, have thrown up some surprises so far. Whilst Hillary Clinton is the overwhelming favourite to gain the Democratic nomination, the Republican nomination is more uncertain. Whilst ideologically driven candidates might appeal to activists, they are unlikely to appeal to a wider electorate, so we may see the situation where the Presidency and Congress are controlled by different parties. As we are seeing at present, where this split control now exists, there is a fairly benign effect on economic movement since contentious issues tend to be marginalised. We now see a less confrontational mood in Congress, where both Houses are controlled by Republicans, and evidence is the recent agreed budget deal for 2016, involving give and take between both parties. The end result is another US$1.1 trillion in spending and another US$700 billion of tax reductions. The USA has major budget problems for the future arising from entitlement issues but, for the moment, the US budget is not a major market issues. Any surprising developments of a political nature might be, though.

Just looking at some of the current economic data from the USA, one can see that most of it confirms the prospect of modest growth again in 2016. If we look at the purchasing managers indices for December, a high value piece of economic data, we see quite a weak picture for manufacturing, with the reading at 48.2 below the 50 marker of expansion or contraction. The non manufacturing purchasing managers index stood at 55.3 in December, a much stronger reading, although slightly down on that of November. Manufacturing is around 12% of GDP in the USA, whilst services are around 78%, so the latter has much greater weighting. The unemployment rate has fallen from 5.7% in January to 5.0% in December, although the Labour Force participation rate remains disappointingly low at 62.6%, which takes some of the gloss over the falling unemployment percentages. However, the December payroll numbers were very strong with growth of 292,000 positions. Average hourly earnings growth in the private sector is running 2.5% higher than a year previously. There is no evidence of meaningful upward pressure on pay, again, in line with the evidence of a modestly improving economy. Obviously, there are some areas of weakness, notably in the energy industry, where employment has been affected by the collapse in energy prices, but one would expect that lower oil prices will give a boost to the economy in 2016. In terms of where the greatest risks lie in 2016, the USA looks to be one of the lowest risk countries, notwithstanding the November elections.

The same cannot be said of the eurozone. Despite the feeling in some quarters that the worst of the crisis has passed, we think that this is an optimistic assessment of the situation. The fundamental flaw in the euro's construction cannot be wished away and the combination of countries tied together by one exchange rate is unstable given the widely differing economic circumstances of the eurozone's membership. Change is likely to be bottom up rather than top down. Eurozone politicians and eurocrats resolutely refuse to accept that the euro was a mistake and that is quite natural from their point of view but the voters are starting to notice. The euro bred complacency in some countries, Greece being a good example, that profligate spending would not be punished but, of course, it would eventually. The constraints of the Stability and Growth Pact on budgets and the eurozone's insistence that budget deficits should be curbed have led to the rise of anti austerity parties. Greece was the first country to be governed by an anti austerity party but because of its relatively small size eventually had to succumb to the demands of its creditors, albeit very reluctantly and with no certainty that it will see through its agreed programme of actions. Being part of the eurozone has caused immense damage to Greece. It is and always was fanciful to expect that Greece could share a common currency with Germany and it is difficult to see Greece's long term future in the eurozone. But it is not only Greece where revolt is occurring. Portugal and Spain have both seen centre right parties lose ground in recent general elections with anti austerity parties performing well. There is a potentially unstable coalition of left wing parties in Portugal and the Spanish election was about as indecisive as one could imagine. In the recent local elections in France, although there were obviously other issues, the FN made much of its anti euro credentials and gained a significant minority of support. With no end in sight to the austerity policies in a number of eurozone countries, one must expect the dam to burst at some stage with anti austerity parties in some of the larger eurozone countries gaining a foothold on power. If the disciplines of the rules on public finances fall by the wayside, sovereign credit ratings will be downgraded. At the moment, the ECB's programme of extensive quantitative easing is suppressing yields but this programme cannot last indefinitely. The euro area as a whole is likely to run a budget deficit of about 2.1% of GDP in 2015 but this figure is flattered by Germany being in surplus and, as Germany is the eurozone's largest economy, this exerts a disproportionate effect. France, for instance, is likely to record a budget deficit of over 4% of GDP in 2015. With most countries in the eurozone (Germany is a relative exception) having little flexibility to use fiscal policy to stimulate their economies, the burden has fallen on monetary policy to try to stimulate growth but with an extensive and extended QE programme and, with little room to reduce further negative interest rates, many eurozone countries are in a serious bind. What is generally lacking is the will to undertake structural reform, particularly in the labour markets, in order to increase the long term potential growth rate of the eurozone economy. Where some steps have been taken, for example in Spain, there has been some success in making inroads into unemployment, currently 21.6%, and stimulating growth. The President of the ECB has been making the point about the need for structural reform since monetary policy alone cannot solve the eurozone's problems. The EU in general is fighting problems on all sorts of fronts at present but the eurozone part of the EU could give problems at any time during 2016.

Is Japan likely to be problematic in 2016? Probably not, but this does not imply that there are no issues. In fact, there are plenty. The country's fiscal position is awful. The budget deficit is expected to be nearly 7% of GDP in 2015 and outstanding public debt stands at around 240% of GDP. Growth has been disappointing despite the efforts of Abenomics. The monetary and fiscal arrows of Abenomics have been fired but there has been disappointing progress on the third arrow, structural reform. As in the eurozone, if efforts to free up an economy by increasing flexibility and reducing rigidities are not made, the benefits of an active fiscal and monetary policy are much reduced and the long term increase in a country's growth potential is compromised. Most of Japan's outstanding government debt is held internally so it is unlikely to face a run on the currency and loss of investor confidence. Japan's problem is unusual in that, although it is struggling to meet the Bank of Japan's inflation target like other countries, it is, in a way, more important for Japan to do so. The reason is Japan's history of deflation which has induced a cautious mind set in consumers. After all, if one expects prices to fall, a rational consumer will hold off unessential purchases. To get growth, the Japanese government wants to encourage consumption. The 2014 sales tax increase has worked itself out of the system, although there is a second part to it due in April 2017. However, the fall in energy prices, whilst helpful to Japan as a large importer, has not helped to achieve the Bank of Japan's 2% inflation target, with prices currently up just 0.3% year on year. The Prime Minister is exhorting companies to raise wages but many companies are very cautious. There have been moves by the authorities to get public bodies to raise their equity holdings and this may well account for the good performance of Japanese equities in 2015. Although the world's third largest economy, and therefore problematical if there were a crisis, its domestic problems do not seem likely to set of concerns for investors in 2016.

China, however, will remain a very important influence for stock markets in 2016 as we are seeing early in 2016. Its size, as the second largest economy, will ensure that but also because its growth rate, although lower than the double digit levels of the past, will be watched closely for signs of it slowing down more than expected. The aim of the Chinese government's economic policy is to engineer a transition in the economy away from fixed asset investment and exports towards consumption with the latter being a more reliable driver of growth and therefore of higher quality. So, although growth will be less than the double digit level of recent years, it will be of higher quality. That is the aim. What happens in China has international ramifications for markets. Weakness in the price of some commodities like iron ore is due to the fall in demand for steel in China. The apparent devaluation of the Chinese renminbi in August set off a bad reaction in stock markets. The thinking was that China was sufficiently concerned about its falling growth rate to try to stimulate the economy by devaluing. That set off jitters in other emerging markets that there would be competitive devaluations and a flight out of emerging market currencies. In fact, the reason may have been more prosaic. China wanted, and has since gained, entry of its currency into the IMF's Special Drawing rights. By increasing the flexibility and the market orientation of the currency with a widening of the trading bands, it hoped to convince the IMF that the currency's value was becoming more market determined and in this it succeeded. During a year in which the US dollar's trade weighted index has risen by approximately 11%, the rise of the US dollar against the renminbi has been approximately 4% so China cannot be accused of competitive devaluations. There is little doubt that China will be one of the major market factors in 2016. Investors will be watching carefully the data coming out of China and for evidence that big local government spending increases in 2015 are working through the system.

The UK economy has been performing relatively well in 2015 and, as the projections of the IMF and OECD show, this relatively good performance is expected to continue in 2016. A year ago, a political issue, the forthcoming UK General Election, was highlighted as one of the market issues, given the gulf in policies between the two main parties and what looked as if there could be an indecisive result. In the event, of course, that did not happen, but, as we enter 2016, another political event, the EU referendum, looms, either in 2016 or 2017 at the latest. Markets do not like uncertainty and, without making a statement as to whether the UK will be better off inside or outside the EU, one can see the uncertainty affecting sterling, Whilst the UK's economic performance is relatively good, like every economy, it has its vulnerabilities. In the case of the UK, it is the twin deficits, the current account and the budget deficit. In 2014, the UK's current account deficit was 5.5% of GDP, a dangerously high figure. It has been on a declining trend in 2015, running at 5.2% in the first quarter of 2015 and 3.6% in the second quarter and estimates for the year run at 4.5%, according to The Economist. These deficits have to be financed. Whilst confidence in an economy is high, this should not be an issue, and that has been the case so far for the UK but, if foreign investors, rightly or wrongly, feel that there is a risk of the UK leaving the EU and that, if it does, it will make the UK a less attractive investment destination, then sterling could be vulnerable. The Chancellor has outlined his plans to eliminate the budget deficit over the course of this parliament but, if it looks as if his plan is in trouble, that may increase the costs of financing the deficit. We now raise the EU referendum as a political risk, different from the one faced a year ago, and one of which sterling based investors should be aware. Whilst it is important to note the relatively favourable position of the UK economy, certainly against that of the eurozone, it is right to point out the unbalanced state of the UK economy which could render sterling vulnerable to concerns about the EU referendum vote.

Investor focus will inevitably remain on emerging markets in 2016. Because they reflect a relatively low weighting in international equity indices (about 9%), there is often a tendency to underestimate their importance in the world economy. If we look at the share of world GDP on a purchasing power parity basis (i.e. equalising the purchasing power of currencies to take into account cost of living and inflation differences), that of developed economies has fallen to 43% in 2014 compared with 54% in 2004. Many of the emerging markets have experienced problems in 2015, often caused by the weakness in commodity prices. Concerns over the effect on their economies of the associated currency weakness and their ability to service and repay foreign currency debt (many companies have US dollar debt) have been widespread. In the context of a gradual rise in US interest rates and resulting currency outflows into the US dollar, the concerns have increased. We mentioned earlier the market weakness after China adjusted its currency bands, last August, in the context of the country trying to accelerate economic growth through currency devaluation and the danger of competitive devaluations spreading. Emerging markets stand at a significant discount to developed markets but there is a danger that investors will not appreciate the mismatch between their economic weight and their stock market weight and will get caught when sentiment turns, as it will at some stage. Emerging markets are likely to be at the forefront of investors' attention in 2016. Contrarians will be watching for an opportunity to increase their weightings.

One issue about which we have been concerned for a long time is potential for instability in the bond markets as a result of the distortions arising from extreme standard and non standard monetary policy, in particular quantitative easing where it has been applied. The search for yield has led, amongst other consequences, to the purchase of more speculative assets such as high yielding bonds where the risks are obviously greater. As mentioned earlier, energy related corporate issues in the USA are sometimes having difficulty because of the fall in energy prices and defaults are starting to rise. In high quality government bonds, we have the extraordinary position where a large number of European countries' bonds are standing on negative gross redemption yields. For two year bonds, those of Switzerland, Denmark, Sweden, Czech Republic, Netherlands, Germany, Belgium, Finland, France, Austria, Latvia, Ireland and Spain are in this category. At the five year maturity dates, those of Switzerland, Czech Republic, Slovakia, Germany, Netherlands and Austria are also showing negative gross redemption yields and, at the ten year level, Swiss government bonds are also on negative gross redemption yields. One understands why this is happening but, unless one believes that the world is entering a period of more permanent deflation, it is a very dangerous phenomenon. One has to be of a very pessimistic frame of mind to be satisfied with investing for a negative return. Whilst quantitative easing by the ECB is suppressing yields in the eurozone, it cannot continue this policy indefinitely without taking enormous risks and a reversion to anything like normal yields will imply a large fall in bond prices. The danger is that open ended funds will face large redemptions causing them to sell some of their underlying holdings. Liquidity is being limited by the capital constraints placed on market participants and, particularly at the lower quality end of the spectrum, price movements could be very sharp. The recent poor performance of some high yield corporate bonds is a warning signal. Two US funds were forced to suspend redemptions in high yielding funds because of market conditions at the end of 2015. The overvaluation of the bond market and the consequences arising from this could be one of the issues of 2015.

So, as we move into 2016, on current evidence we expect much of the same as in 2015. Modest economic growth at very low inflation levels will mean modest nominal rises in companies' revenues, profits and dividends, but even low nominal returns for investors can translate into real returns, the objective of most investors. But the political and economic background remains troubled in many areas and, as at the start of 2016, we must, as in 2015, expect this to translate into share price volatility so that, although we believe, on what we know at the moment, that share prices will end higher, they will endure some negative periods. Shares' yield attractions against bonds and cash are likely to remain supportive to prices. Bonds remain dangerously overpriced, in our view.