meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Overall, stock markets have held up relatively well during the last quarter with, in many cases, just a small part of the earlier quarters' gains pared. As we explain later, we think this is a rational response to events in international credit markets. Bond markets, as reflected by ten year government bonds, have benefited from events in credit markets. Currency movements have been quite sharp during the quarter.

The tables below detail relevant movements in markets:

International Equities 28.09.07 - 31.12.07

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-2.8	-1.3	-3.5	-6.2
Finland	-4.5	+0.5	-1.8	-4.5
France	-1.7	+3.5	+1.1	-1.7
Germany	+2.4	+7.8	+5.3	+2.4
Hong Kong, China	+6.0	+8.1	+5.6	+2.7
Italy	-2.2	+2.9	+0.5	-2.2
Japan	-8.3	-3.4	-5.6	-8.2
Netherlands	-5.2	-0.3	-2.6	-5.2
Spain	+4.8	+10.3	+7.8	+4.8
Switzerland	-5.2	+0.1	-2.2	-4.9
UK	+0.3	+0.3	-2.0	-4.7
USA	-3.1	-0.8	-3.1	-5.7
Europe ex UK	-1.9	+3.0	+0.7	-2.1
Asia Pacific ex Japan	-1.6	+0.1	-2.2	-4.9
Asia Pacific	-4.9	-1.6	-3.9	-6.5
Latin America	+4.7	+9.6	+7.1	+4.2
All World All Emerging	+3.2	+6.5	+4.0	+1.2
The World	-2.5	+0.4	-1.9	-4.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +4.4%

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

Currency	28.09.07	31.12.07
Sterling	5.06	4.57
US Dollar	4.55	4.04
Yen	1.68	1.51
Germany (Euro)	4.34	4.32

Sterling's performance during the quarter ending 31.12.07 (%)

Currency	Quarter Ending 30.11.07
US Dollar	-2.3
Canadian Dollar	-3.0
Yen	-5.1
Euro	-5.0
Swiss Franc	-5.3

Other currency movements during the quarter ending 31.12.07 (%)

Other Currency	Quarter Ending 30.11.07
US Dollar/Canadian Dollar	-0.7
US Dollar/Yen	-2.9
US Dollar/Euro	-2.7
Swiss Franc/Euro	+0.4
Euro/Yen	-0.1

Significant Commodities (US dollar terms) 28.09.07 - 31.12.07 (%)

Significant Commodities	31.08.07 – 30.11.07
Oil	+16.8
Gold	+12.5

Performance During 2007

International Equities 29.12.06 - 31.12.07

Total Return Performances (%)

Country	Local Currency	£	US$	€
Australia	+16.8	+28.0	+30.2	+17.4
Finland	+39.1	+51.6	+54.2	+39.1
France	+4.0	+13.4	+15.3	+4.0
Germany	+22.9	+33.9	+36.2	+22.9
Hong Kong, China	+52.9	+50.0	+52.5	+37.6
Italy	-1.9	+6.9	+8.7	-1.9
Japan	-10.7	-6.4	-4.8	-14.1
Netherlands	+6.3	+15.8	+17.8	+6.3
Spain	+10.8	+20.8	+22.9	+10.8
Switzerland	-1.7	+4.2	+6.0	-4.4
UK	+7.1	+7.1	+9.0	-1.7
USA	+6.0	+4.2	+6.0	-4.4
Europe ex UK	+6.8	+15.7	+17.7	+6.2
Asia Pacific ex Japan	+26.1	+29.4	+31.6	+18.7
Asia Pacific	+5.1	+8.9	+10.8	-0.1
Latin America	+35.5	+48.1	+50.6	+35.8
All World All Emerging	+33.1	+37.4	+39.7	+26.0
The World	+6.9	+9.5	+11.3	+0.4

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +5.6%

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

Currency	29.12.06	31.12.07
Sterling	4.74	4.57
US Dollar	4.71	4.04
Yen	1.69	1.51
Germany (Euro)	3.96	4.32

Sterling's performance during the year ending 31.12.07 (%)

Currency	Quarter Ending 30.11.07
US Dollar	+1.7
Canadian Dollar	-12.2
Yen	-4.6
Euro	-8.3
Swiss Franc	-5.7

Other currency movements during the quarter ending 31.12.07 (%)

Other Currency	Quarter Ending 30.11.07
US Dollar/Canadian Dollar	-15.2
US Dollar/Yen	-6.2
US Dollar/Euro	-9.8
Swiss Franc/Euro	-2.8
Euro/Yen	+4.0

Significant Commodities (US dollar terms) 29.12.06 - 31.12.07 (%)

Significant Commodities	29.12.06 – 31.12.07
Oil	+54.7
Gold	+31.8

Markets

In the final quarter of 2007, international equity markets drifted slightly lower although generally not for sterling based investors in international equities where the weakness of sterling raised sterling returns to leave the overall performance broadly unchanged. In local currency terms, the FTSE World Index showed a total return of -2.5%, in sterling terms +0.4%, in US dollar terms -1.9% and in euro terms -4.6%. In local currency terms, as measured by the relevant FTSE World Index, the USA returned -3.1%, Europe ex UK -1.9%, Japan -8.3%, the UK +0.3% whilst, yet again, Latin America and Emerging Markets outperformed with returns of +4.7% and +3.2% respectively. Within the Europe ex UK markets, there were positive performances from Germany +2.4% and Spain +4.8%.

However, for sterling based investors, the returns are rather different because of the currency's recent weakness. Again, as measured by the relevant FTSE World Index, the US market still shows a slight negative movement, -0.8%, as does Japan, -3.4%, but Europe ex UK moves to positive territory +3.0% whilst the returns of Latin America and emerging markets are enhanced to +9.6% and +6.5% respectively.

Reflecting the continuing problems of the credit markets, there was a move to safety which is evidenced particularly by the fall in bond yields as shown in the ten year government bond market. The gross redemption yield on sterling bonds fell by 49 basis points to 4.57%, on US dollar bonds by 51 basis points to 4.04%, on yen bonds by 17 basis points to 1.51% and on euro denominated German government bonds by just 2 basis points to 4.32%.

The main feature in currency markets during the last quarter has been the weakness of sterling which has been significant. Against the US dollar, it fell by 2.3%, against the yen by 5.1%, against the euro by 5.0% and against the Swiss franc by 5.3%. As is implied by the above, the US dollar fell against the European and Japanese currencies but by less than sterling.

In the commodity markets, oil and gold rose significantly, by 16.8% and 12.5% respectively in US dollar terms.

If we look back at 2007 as a whole, international equity markets have performed satisfactorily although euro denominated portfolios have suffered from the currency's relative strength. In local currency terms, the FTSE World Index showed a total return of +6.9%, in sterling terms +9.5%, in US dollar terms +11.3% and in euro terms just +0.4%. Within Europe ex UK, there were particularly notable currency performances from Finland (Nokia led) +39.1% and Germany +22.9%. Italy and Switzerland were relative disappointments with total returns of -1.9% and -1.7% respectively. Japan was the major area of disappointment returning -10.7% in local currency terms. The outstanding performers, as they have often been recently, were Asia Pacific ex Japan +26.1%, Latin America +35.5% and emerging markets +33.1%.

A strong final quarter helped bond markets to achieve generally satisfactory returns in 2007. As measured by the Bloomberg / EFFAS government bond indices (maturities greater than one year), sterling bonds returned +5.2% for the year, US government bonds +9.1% and euro denominated government bonds +1.8%. Only the latter really disappointed but the return was, nevertheless, above that on equities where the strength of the euro reduced returns in euro terms.

In the currency markets, the feature was the weakness of the US dollar and sterling with the US dollar the slightly weaker of the two. Over the year, sterling rose by 1.7% against the US dollar but declined by 12.2% against a very strong commodity driven Canadian dollar, by 8.3% against the euro, by 5.7% against the Swiss franc and by 4.6% against the yen.

In the commodity markets, oil was always in the headlines, rising by 54.7% in US dollar terms whilst gold rose by 31.8% in US dollar terms. Agricultural commodities also rose strongly in price contributing with energy to cost push inflation in the international economy.

Economics

- *Problems in international credit markets continue* ...... more big write offs by some major financial institutions and money markets seize up.
- *Central banks respond* ...... by cutting interest rates like the Federal Reserve and Bank of England and providing liquidity for the banking system which has helped over the year end to bring down inter bank rates more into line with expected levels.
- *Sovereign wealth funds seize the opportunity*...... they have made or plan to make investments in major financial institutions like Citigroup, Merrill Lynch, Morgan Stanley and UBS. There is little or no protectionist opposition to these investments.
- *These sovereign wealth fund investments give comfort to investors*...... they help to steady nerves in the stock market amongst investors who worry about the possibility of a collapse of a major financial institution.
- *Equity markets hold up relatively well during the last quarter*...... investors look ahead to offsetting moves by the authorities and this means interest rate cuts or, at the very least, interest rates being lower than they would otherwise have been.
- *However, central banks remain wary about inflation*...... oil prices continue to rise as do food prices contributing to cost push inflation.
- *The latest OECD Economic Outlook (82) provides grounds for modest optimism albeit with downside risks to its forecasts*...... it sees the outcome with the highest probability involving low growth levels in the USA but no recession, a more comfortable level of inflation, a partial decoupling of euro area activity from the USA and a relatively optimistic outlook for Japan.
- *However, it highlights the downside risks*...... a worse than expected housing market, further turbulence in financial markets and further commodity price increases.
- *The OECD highlights its concern about fiscal policy in some countries*...... it has been lax in the good times with the UK a prime example. This will cause problems in more difficult economic times which the world economy now faces.
- *Overall, the OECD sees satisfactory growth amongst its members and in China, India and the Russian Federation as well*...... 2.3% this year and 2.4% in 2009 for the OECD and, in China, for example, 10.7% this year and 10.1% next year.

USA

- *The economy was moving forward strongly as it entered the fourth quarter*...... the Commerce Department confirms its previous estimate of third quarter annualised growth of 4.9%.
- *In December, the Federal Reserve makes its third reduction in interest rates in this cycle to 4.25%*...... there appears to be no great conviction about the move because it finds it difficult to discern the future.
- *The root cause of the problems in the international credit markets, the US housing market, remains weak*...... nearly all the indicators point that way.
- *The issue, as for other central banks, which makes the Federal Reserve cautious is inflation*...... the various measures of wholesale and retail price inflation which came out in December were showing quite sharp increases with food and energy the drivers.
- *But there are some encouraging pointers for the US economy*...... exports are responding to the very competitive level of the US dollar so that these are helping the current account deficit to contract.

Japan

- *Disappointingly, growth is revised downwards*...... the annualised rate of third quarter growth, which had originally been stated at 2.6%, now comes down to 1.5%.
- *The government reduces its economic growth forecast for the financial year to March 2008*...... it comes down from 2.1% to 1.3%. Tighter building regulations take an expected 0.6% off growth. The Japanese government forecasts growth of 2.0% for the financial year ending March 2009.
- *A Japanese Finance Ministry survey shows a divergence of performance between large and medium sized companies*...... large companies' profits are doing better than those of medium sized companies.
- *This may explain the paradox of low unemployment and subdued wages*...... the latter were flat in the latest survey and could explain why consumer confidence is low.
- *A mixed message from the latest Tankan survey*...... business confidence is at its lowest level since October 2005 with confidence in the business environment falling to its lowest level in three years. However, on the positive side and an important indicator, large manufacturers expect to raise capital spending by 10.5%.

Europe Ex UK

- *The ECB is the most hawkish of the major central banks*...... the turmoil in, financial markets has stopped it, for the moment, from raising interest rates above 4.0% but it may well raise them in future.
- *Inflation is a problem for the ECB*...... consumer prices in November were 3.1% higher than a year previously. The upper level of the ECB's target is just below 2.0% so prices are significantly above its comfort level. It worries about wage inflation in these circumstances.
- *Germany makes populist policy shifts*...... in a move which has been widely condemned by economists and business, the government imposes a minimum wage in the postal sector, widely regarded as a move to protect Deutsche Post from competition. The government threatens to impose more sectoral minimum wages.
- *In France, there is a lull in the conflict between the government and some public sector trade unions*...... negotiations are taking place but the outcome will be vitally important for France which has to change if it is to recover some of its competitiveness.

United Kingdom

- *The effects of excessive personal and government borrowing are beginning to be felt*...... a weaker economy will make these problems worse.
- *The Northern Rock affair is a major embarrassment for the UK because of the importance of the finance sector*...... worldwide pictures of the queues outside Northern Rock branches and, now, the possibility that it may be nationalised damage the UK's reputation.
- *The housing market has taken a turn for the worse*...... the evidence is no longer ambiguous - it nearly all points to a downturn.
- *The government's finances deteriorate badly*...... we have long been concerned about the growth rate of public expenditure which has led to excessive government borrowing. The level of government borrowing is totally inappropriate for this stage of the economic cycle and there is now no leeway to offset the economic slowdown which is coming.
- *An alarming revision to the third quarter's current account deficit*...... it is raised to £20 billion from the earlier estimate of £13.7 billion, representing 5.7% of GDP, worse than the USA's current account deficit.
- *Sterling declines sharply*...... we have long felt it is overvalued and the poor news emanating from the UK makes it likely that the fall will continue.
- *Difficulties in the commercial property market increase*...... the switchover of rental yields against the cost of money was ignored for a while - now it is not being ignored and prices are falling.
- *There are large differences in the measures of inflation*...... the official measure, the consumer price index, shows a year on year increase of 2.1%, just above the official target but the Retail Price Index, regarded by many as more realistic, was up 4.3%. Energy and food prices and, now, a weaker pound will keep the Bank of England fully on alert after worsening economic conditions forced it to cut interest rates by 0.25% to 5.5%.

CHINA

- *Rapid growth is almost certain to continue*...... the OECD projects 10.7% for 2008.
- *The authorities' main concern is inflation*...... food price increases and the inflationary consequences of a build up of liquidity in the economy arising from the very large current account surplus are to blame.
- *There has been a continuing tightening of monetary policy*...... interest rates were raised in December for the sixth time this year and bank reserve requirements have regularly been raised.
- *China takes further measures to allow individuals to invest overseas*...... it plans to extend the conduits from Hong Kong to include as well the UK and USA.
- *Booming tax revenues give scope for tax cuts*...... individuals' tax free thresholds are to be raised.

Summary

- *Moderate economic growth in 2008 should support equities*...... corporate earnings should show modest growth thus giving support to quite low share ratings in the main industrialised countries.
- *We still remain cautious about bonds*...... the threat of inflation remains and yields do not accommodate that threat.
- *Although there are plenty of economic problems at present, it is important to look ahead*...... monetary policy should be supportive to markets as central banks react to an economic slowdown.

The performance of the international equity markets over the year has been satisfactory yet behind this performance lies serious turmoil in international credit markets. Anybody who had been out of touch with news for calendar 2007 and had returned to look at their portfolio, assuming it was a representative one, would have been quite pleased with what they found and would have had no inkling of the dramatic events in the second half of the year. Is this paradoxical? We think not for reasons which we will go into later.

The turmoil in the credit markets is undoubtedly the big story for investors in 2007. Its origins lay in the US sub-prime mortgage market. Aggressive lending to people with poor credit records did not seem such a bad idea whilst house prices were rising. After all, if the borrower could not keep up with the payments, the property, if repossessed, could be sold and the borrowings repaid. Imprudent lending practices could not withstand falling property prices, which is what has happened in many cases, and a flood of re-possessed properties on the market creates a vicious downward spiral. Even that would not be so bad if investors knew where the problems lay. That would normally have been the case in the past. A loan would stay on the books of the originating lender and, if it had made particularly poor lending decisions, investors would know and react accordingly. But not now. Many of these loans and other receivables have been packaged up into asset backed securities and sold on so that a sub-prime mortgage in the USA could end up in, say, Europe, as part of an asset backed package held by a financial institution. By using structured investment vehicles, banks could keep the business off their books. However, these vehicles mismatched their assets and liabilities, borrowing short and lending long. A lot of hindsight has been brought into action since the credit market problems began and those who borrowed short and lent long would say that they could not have expected the credit market to have seized up as it did. Nevertheless, what might have seemed a theoretical risk turned into an actual risk as these vehicles found themselves shut out of the credit markets. A number of banks have taken these vehicles back on to their balance sheets but this stifles their ability to expand their lending. The need to hoard cash and fear of lending in the inter bank market to other banks led to a seizing up of liquidity with the undesirable result that inter bank rates soared well above base rates, effectively introducing an undesired tightening of monetary policy. As we ended the year, the situation was eased by co-ordinated central bank action to provide banks with liquidity over the year end and beyond. As a result, inter bank rates have fallen back. The situation, however, remains far from normal.

Well known international banks have had to take serious write offs on assets on their balance sheet, thereby weakening their capital base. But help has been to hand in the form of sovereign wealth funds. For some time, we have been writing about the potential importance of these for long term equity investors but, at the time, we had no idea that this would be apparent so early. Vast accumulations of wealth have been built up in the Middle East and Far East but also elsewhere in energy rich countries like Norway and Canada, for example. Initially, we mainly concentrated on China, the country with the world's largest foreign exchange reserves, which planned to set aside, initially, US$200 billion in a fund to aim to make a higher return than it would normally on its reserves, traditionally invested in deposits, bills and bonds, for example. The concern we had was that protectionist noises would arise in the USA and Europe. About two years earlier, we had seen the ugly rejection in the USA of the purchase by Dubai, as part of its acquisition of P & O, of some east coast ports. Dubai had to sell them. Protectionism was cloaked in security issues. However, changing circumstances have seen different reactions as Abu Dhabi, for example, plans to inject US$7.5 billion into Citigroup. There has been no adverse reaction in the USA this time as the injection has been positively welcomed. Other countries like China and Singapore are planning to put money into financial institutions which have suffered write offs and need to replenish their capital base. So, in a way which was not planned, sovereign wealth funds have been able to put significant funds into foreign banks at prices which, in time, will most probably be seen to have been favourable. Although these investments have not developed in the way which anyone could have foreseen, the circumstances in which they have been made do not detract from our previous view that these investments, likely to go into equities, private equity and property, for example, will be significant influences on securities markets in future. This phenomenon might not be such good news for bonds as money is likely to be diverted from them to equities as far as the investment of cash flow is concerned. The activities of sovereign wealth funds represent a recycling of the current account surpluses of these countries, past and present, into countries, some of which, like the USA and UK, are running significant current account deficits. In the short term, the activities of the sovereign wealth funds are likely to provide reassurance to stock markets, something they need in the fragile atmosphere which has prevailed in the second half of the year. By accident, it seems, sovereign wealth funds have got their foot in the door in a way which seems acceptable to most. However, a word of caution is in order as sovereign wealth funds are viewed with suspicion in some quarters, Germany being a good example.

Although a number of international banks have had to write down in value significant sums, it is probably in the UK that the biggest embarrassment has occurred as a result of the Northern Rock affair. Again, substantial amounts of hindsight have been brought to bear in the situation. It was the best performing bank share in 2006 and one look at Bloomberg, for example, shows that some analysts were quite effusive about the stock earlier in the year. There did not seem to be widespread doubts about its business model. We now know that its dependence on the wholesale market for funds was its undoing. When that market seized up, it could not easily finance its assets. The worldwide pictures of Northern Rock depositors queuing to get their money out has done serious damage to the UK's financial reputation, more important than usual given the size of the UK financial sector.

Why, at the time of writing, have equity markets held up well when the financial background has been so unsettled? As always, it is a question of looking ahead to see what might be the action of the authorities, particularly the central banks, since governments can do relatively little, though we should come back to Northern Rock shortly. Monetary policy is normally more quick acting than fiscal policy. There are nuances, however. The Federal Reserve has more latitude. It can look at the whole economic picture and, although it had been concerned about inflation (and still is), it is no coincidence that it was the Federal Reserve which took the most decisive and immediate action, cutting the target for the federal funds rate by 50 basis points and then by a further 25 basis points. Rather later, the Bank of England trimmed interest rates by 25 basis points although it, too, remains concerned about inflation. The Bank of England and the ECB have inflation targets to meet and are, therefore, more restricted in the action they can take particularly when inflation is above target, substantially so in the case of the eurozone. This explains why the ECB's latest language is hawkish even though it did not raise interest rates. With inflation around 3% in the eurozone and the benchmark rate 4%, it will consider the real rate too low. For the ECB, the turmoil in financial markets has had the effect of staying its hand in raising interest rates.

However, a second part of central banks' responsibilities is to try to ensure orderly money markets and, as we saw from the gap between the inter bank rate and base rate in the UK (the same applies to the USA and eurozone), there has been extreme stress, itself representing a tightening of monetary policy for those whose borrowing is tied to inter bank rates. Their action has been likened to helicopters dropping notes on to the market and, through massive money market operations, particularly by the ECB, it does seem to be having its desired effect.

It is now possible, but by no means certain, that interest rates will fall further in the USA and UK but more doubtful that they will fall in the eurozone. The economic implications of what has happened are not good. Business and consumer confidence has been affected, banks will be much more cautious in their lending policy for the foreseeable future and many borrowers will find themselves paying a higher margin over base or inter bank rate than they would have paid before. After September 11, 2001, we saw central banks, particularly the Federal Reserve, cutting interest rates extraordinarily aggressively to prevent serious economic damage. It is difficult to see interest rates being cut so aggressively this time (partly because those cuts are being blamed for the easy money policy which has led to imprudent lending causing the present difficulties) but they may be cut enough to prevent a recession and then laying the base for accelerated growth thereafter. Lower short term interest rates should be helpful to equities but not necessarily to bonds (they may be affected by fears that an over stimulative monetary policy will raise inflation and, therefore, we may see a more normally shaped yield curve). Equities may be looking forward to this now so investors may be being rational. We think that this is the case.

Central banks are still, however, quite rightly concerned about inflation. Although it is manageable at present, oil prices remain high with the OPEC cartel having been successful in holding production at a level which has caused these high prices. Food price inflation looks here to stay. Strong demand from the east and the turning over of land to produce crops for bio fuels mean that food price inflation is likely to remain elevated. Whilst, in other circumstances, restrictive monetary policy might be expected to bear down on inflation, it might not be as successful against this background. This makes it a very difficult job for central banks to pitch their monetary policy correctly.

In its Economic Outlook 82, just published, the OECD paints a not unpromising picture for the world economy albeit with downside risks to its forecasts. Growth forecasts have, of course, been revised downwards almost everywhere but against a background, going into the credit turmoil, of some good economic momentum, the damage should be limited. The OECD suggests that the outcome with the highest probability, i.e. a manageable one for the world economy, involves low growth levels in the USA, but not a recession, and a more comfortable level of inflation, a partial decoupling of euro area activity from the USA and a relatively optimistic outlook for Japan albeit with weakened expansion of which we have seen some evidence with the recent GDP figures. Downside risks to this forecast reflect a worse than expected housing market situation, further turbulence in financial markets and further increases in commodity prices. Quite rightly, the OECD remains concerned about the lack of fiscal consolidation in many countries in the good times which could leave them exposed in bad times. We think this situation particularly applies in the UK where public finances are a major concern. The OECD reiterates its concern about protectionist pressures, whether in investment (it makes reference to sovereign wealth funds) or trade and this has been a repeated concern of ours as one of the main threats to economic growth and hence, the stock market.

The following table, with data from its statistical section, reflects the economic projections from OECD Economic Outlook 82.

Real GDP growth (%)

	2007	2008	2009
USA	2.2	2.0	2.2
Japan	1.9	1.6	1.8
Euro area	2.6	1.9	2.0
Germany	2.6	1.8	1.6
France	1.9	1.8	2.0
UK	3.1	2.0	2.4
Total OECD	2.7	2.3	2.4
China	10.7	10.1	
India	8.8	8.6	8.4
Russia Federation	7.3	6.5	6.0

None of the growth projections for OECD countries look startlingly bad and the overall forecast for OECD members for real GDP growth of 2.3% in 2008 against an expected 2.7% in 2007 must be considered satisfactory in the light of recent events. Of course, some or all of the risks to its projections which the OECD mentions may render these projections too optimistic but it reflects the outcome which the OECD feels has the highest probability.

The inflation forecasts are benign and, within the OECD membership, the OECD expects inflation to fall slightly in 2008 to 2.1% from 2.3% in 2007 and its forecast for 2009 is also 2.1%. It forecasts a continuation of deflation for Japan in 2008 (-0.3%) but a return to inflation in 2009 (0.3%). Its projections also suggest a stable unemployment rate within its members at 5.4% in 2008 (5.3% in 2009) compared with 5.4% in 2007.

The current account balance for the OECD is projected to remain unchanged at -1.4% of GDP with a slight improvement in the USA's position from -5.6% of GDP in 2007 to 5.4% in 2008 and -5.3% in 2009. Cyclically adjusted fiscal balances within the OECD, a source of concern to it, are not expected to change greatly, -2.0% in 2007, -2.2% in 2008 and 2.1% in 2009.

As can be seen from the tables, although growth is projected to slow slightly in China, India and the Russian Federation, it is still at a very high level and growth from these countries and others will continue to be a leading force driving the world economy. In terms of high profile policy actions, China's measures to control inflation are high on the things for investors to watch. As measured by the consumer price index, the OECD sees inflation in China dropping from an average of 4.5% in 2007 (the year on year rate is higher) to 4.0% in 2008 and 3.9% in 2009. The reasons for its forecast of declining inflation is weaker food prices offsetting accelerating non-agricultural prices. This is important for investors because the extent of measures taken by the Chinese authorities to dampen inflation could have an impact on stock markets.

The OECD's economic projections therefore provide investors with a degree of comfort going into 2008 for they provide a background where overall corporate earnings can be expected to increase modestly. For equities, given mostly moderate ratings, this situation should be supportive. However, we have to watch closely for developments which could undermine the projections.

We turn now to look at individual areas of the world economy, starting with the USA where momentum going into the fourth quarter was strong. In late December, the Commerce Department confirmed its November estimate of third quarter annualised growth of 4.9%. That, of course, did not reflect the problems in the third quarter in international financial markets but it was pleasing that one of the drivers of this good growth figure was exports.

During December, the Federal Reserve made its third cut in the target rate for federal funds, this time by a further 0.25% to 4.25% making 100 basis points of easing since it has changed its policy. In many ways, the announcement lacked conviction because it is very difficult for the Federal Reserve to tell which way things are going to go. As a reason for cutting interest rates further, it obviously cited developments in the financial markets and the effects which they may have on economic growth. It sat on the fence on inflation by not indicating whether what had happened in the markets had changed the balance of risk between inflation and economic growth. It kept the door completely open to the course of future interest rate movements. Whilst it had previously signalled that information it received suggested economic growth was slowing and the housing situation becoming worse, a new factor entered the equation which was "some softening in business and consumer spending". This is probably all it can say because conditions change in markets week by week. We sense that conditions have settled somewhat as the willingness of sovereign wealth funds to invest in blue chip US companies becomes more apparent. The real scare was probably that a major US financial institution would fail but that now looks less likely. Whilst the situation in financial markets is still reflecting considerable stress, we think that the central banks' action in the money markets, which has reduced the difference between what might be called the base rate and the inter bank rate, has also been helpful.

The housing market, the source of the present economic problems in the USA, continues to report disappointing news. The US construction sector reported spending falling by 0.8% in October due to the decline in private house building. US home foreclosures rose from 1.4% of home loans in the second quarter to 1.69% in the third quarter. The Mortgage Bankers Association predicts worse to come. The Commerce Department reported a fall in the construction of new homes and apartments of 3.7% in November. This represented the lowest level in more than sixteen years. According to the Standard & Poors / Case Shiller house price index, the value of single family homes fell by 6.7% in October compared with a year earlier. However, there was slightly better news from the National Association of Realtors which reported that pending sales of existing US homes rose by 0.6% in October. The year on year fall was the third largest on record but at least this is slightly better news to offset the gloomy statistics elsewhere in the sector. Sales of existing homes rose slightly to a 5 million annual rate in November also, according to the National Association of Realtors, but the median price of a house was lower than a year ago. The Commerce Department reported separately that October sales of new homes dropped by 9% in November on an annual basis compared with October.

Whilst one of the downside risks to the US economy, which may influence the Federal Reserve's interest rate decisions, is the housing market, the opposite factor which could cause monetary policy to stay on hold, or even to cause the Federal Reserve to raise interest rates, is inflation. US producer prices rose by 3.2% in November, the biggest increase for 34 years as a result of a sharp rise in petrol prices. The year on year rise in the producer price index is 7.2%. The producer price index, excluding food and energy prices, rose by 0.4% over the month to give a year on year figure of 2.0%. The consumer price index had a sharp 0.8% rise over the month and the core index, excluding food and energy, was up 0.3%. This gives respective year on year figures of 4.3% and 2.3%. The core personal consumption expenditure index, which the Federal Reserve monitors closely, showed a month on month rise in November of 0.2% with a year on year rise of 2.2%, above its comfort level which is 2% at a maximum. So one can see from these figures that the Federal Reserve is right to be concerned about inflation although it certainly does not seem to be getting out of hand at the moment. These conflicting indicators from housing and inflation show just how difficult it is for the Federal Reserve to feel confident about interest rate policy from one month to the next.

Most, but not all, of the short term news has tended towards the negative. Personal consumption was unchanged in November and there was a decline in real incomes. The latter fell by 0.1% in November and as personal consumption is an important driver of the US economy, accounting for about two thirds of it, this has implications for future growth. So, in setting interest rate policy, this would be a factor for the Federal Reserve. The two ISM surveys for manufacturing and services were slightly negative in December. There was a very slight decline in the manufacturing index to 50.8 in November compared with 50.9 in October. This is not disastrous and the reading over 50 indicates expansion but it is very close. The equivalent services index showed a decline in November to 54.1 from 55.8 in October, a larger fall but more comfortably in positive territory as far as growth is concerned.

But it is important not to be too negative about the US economy since it is still growing and there are positive features. In November, non farm payroll data showed that the number of employed people rose by 94,000 to keep the unemployment rate at a low 4.7%. Retail sales were quite strong in November, rising by 1.2% over October, and represented the biggest increase for six months. Encouragingly, the US economy is responding to the weaker dollar and the Commerce Department reported that the current account deficit in the third quarter narrowed to US$178.5 billion from US$188.9 billion in the second quarter to equal 5.1% of GDP, down from 5.5% in the second quarter and the lowest level of deficit relative to GDP since the first quarter of 2004. We noted that improved net exports had been a driver of growth and this is about the best quality driver that there is. If we look at October's trade deficit, the rising price of oil caused the deficit to widen slightly but, if the oil is excluded, the trade deficit was running at its lowest level since March 2004.

As it has shown before, the US economy is a very resilient one and it is wrong to overdo the gloom. It looks unlikely to go into recession and its powers of recovery are formidable. The improvement in the trade deficit, excluding oil, is particularly encouraging and US companies, assuming no significant deterioration in the economic outlook, appear likely to increase their earnings again in 2008. The market is not highly rated, in our view, and the US remains an important part of our international equity portfolio. US companies remain an effective way to take low risk exposure to faster growing areas of the world. Significant growth rates in Latin America, Asia and emerging markets should be very beneficial for those US companies operating in these areas. It is apparent from company announcements that many of them are already benefiting from this trend.

The Japanese economy is something of an enigma at the moment. One feels that it should be doing better than it is. Third quarter GDP growth, which had originally been shown as 2.6% annualised, was revised downwards in December to 1.5%. The government has now reduced its forecast for economic growth in the current financial year which ends in March 2008. It now suggests that real GDP would be up just 1.3% compared with its previous forecast of 2.1%. Part of the reason for the reduction in the growth forecast was down to tighter building regulations which caused the industry to experience a sharp drop in housing starts and these regulations are expected to take 0.6% off the growth rate. The government has expressed its regret at this. Forecast growth for the year ending 31 March 2009 is 2%. The government forecasts that the GDP deflator will rise for the first time in eleven years from next April. The lower than expected growth in the current financial year plus the absence of inflation makes it very hard for the Bank of Japan to revert to a more normal monetary policy and, in late December, it warned that "downside risks" were growing for Japan. Minutes of the Bank of Japan's November meeting showed some division on the course of inflation in the Japanese economy. The latest consumer price index shows a fairly flat situation. Consumer prices for November overall rose by 0.6% year on year but without food and energy prices the consumer price index would have fallen 0.1% year on year. One of the enigmas of the Japanese economy is the divergence in performance between larger companies and medium sized companies. The Japanese Finance Ministry's survey, published in early October, showed that profits for Japan's medium sized companies fell sharply in the third quarter by 17%. A Finance Ministry survey showed that pre tax profits at large companies were up 1.3% on a year ago, but because of the drag of medium sized companies, all industry profits were down 0.7%, the first drop since the three months to June 2002. The rate of reduction in capital investment slowed down to 1.2% in the third quarter compared with 4.9% in the previous quarter. The differential performance between large and mid sized companies is probably the cause of very subdued wage figures. Wages were flat in the latest survey and, taking out overtime and bonuses, they were down 0.3%. This is probably one reason why Japanese consumer confidence is low. The latest Cabinet Office sentiment index fell by three points to 39.8 in November compared with 42.8 in October. The government said that rising energy and grocery prices were to blame. The Tankan Survey showed a reduction in business confidence to its lowest point since October 2005. The index fell to 19 in December from 23 in September and the index measuring confidence in the business environment to next March fell to its worst level for three years. However, auguring well for the future, large manufacturers expect to raise their capital spending by 10.5%. Sentiment in Japan appears to worsen whenever the yen rises. Given the lack of inflation in the economy, Japan has gained strongly in competitiveness as its currency has weakened without the unpleasant side effects of rising inflation. One would have thought that Japanese companies could withstand a recovery in the yen given how competitive most Japanese companies are in their export markets. China remains a very important influence for Japan and some nervousness about China's growth prospects has rubbed off onto Japanese business. Nevertheless, the Chinese connection is a very important and positive one for the Japanese economy. Although some investors, in the generally buoyant market conditions which we have enjoyed, have become disillusioned with Japan, it still has enough positive features for it to command some exposure in international portfolios with an array of world class companies.

As we noted earlier in this review, the OECD considered there could be some decoupling of the euro area activity from that of the USA. Overall, the economy appears reasonably robust but with some difficulties ahead, notably on inflation. By far the most hawkish central bank is the ECB and it has good reason to be given the inflation numbers in the eurozone. For example, producer prices rose by 3.3% in October, the highest reading since December 2006. Consumer prices in the eurozone hit a six year high point of 3.1% in November. This was up from 2.6% in October. Although the ECB described the rise as a "hump" which will ease off next year, the President of the ECB is not happy about it. The concern is that this high inflation rate, well above its upper target of just below 2%, will exacerbate inflation through bigger wage claims. Currently, the ECB is forecasting that eurozone inflation will return it to its target in 2009. The core rate of inflation, which excludes food and unprocessed food prices, rose from 2.1% in October to 2.3% in November. The President of the ECB, Mr. Trichet, said in late December that other central banks are in a different position to the ECB. In a very hawkish statement, he says that the ECB will not allow second round effects from the current high level of inflation to happen and that can only mean higher interest rates if the situation demands it. Detailed updated forecasts from the ECB show that, before it reaches the forecast of 1.8% in 2008, it will rise to a mid point of 2.5%. So, if conditions in financial markets return to some semblance of normality and the eurozone continues to grow at a reasonable rate, ugly inflation figures could well cause the ECB to raise interest rates as it had planned to do before the credit turmoil occurred. In the short term, the news from the eurozone has been mixed. October's unemployment level fell to 7.2% from 7.3% in October. The RBS / NTC eurozone purchasing managers index for manufacturing rose to 52.8 in November compared with 51.5 in October. In the equivalent survey for the services sector, there was a fall to 53.1 in November from 55.1 in October, a level that still indicates growth. Industrial production in October was 0.4% higher than in September and was 3.8% up over the year. Consumer confidence remains fragile with retail sales falling by 0.7% in October to show a level 0.2% higher than a year earlier. Whilst exports are strong in some countries like Germany, growth is unbalanced while domestic demand is subdued.

Turning specifically to Germany, there has been widespread condemnation of the government's decision to impose a sectoral minimum wage in the postal industry. This populist measure seems targeted at helping Deutsche Post's entrenched position in the market and making life more difficult for its competitors, one of which has already laid off 1,000 people as a result of this. The government threatens to widen the imposition of sectoral minimum wages and this can only be considered as a measure which is likely to have damaging economic consequences. It throws into doubt the free market credentials of the Christian Democrats and there has been strong opposition from within the party. The President of the ECB has warned that Germany's move to create what he calls "unnecessary minimum wages" in the services sector will act as a "brake on employment". The economic news from Germany is mixed. October showed a pleasing rise in industrial orders of 4%, driven by exports. The DIHK National Chambers of Commerce says in its latest survey of the service sector that 200,000 new jobs are expected to be created in 2008. Bigger companies are more optimistic than smaller ones. Another survey by the BDI Business Association of 930 companies in the Mittelstand showed that managers expected conditions to gradually worsen because of higher energy costs, with labour shortages and high non wage labour costs also a potential problem. On the negative side, the German ZEW business sentiment indicator fell to -37.2 in December compared with -32.5 in November. In this case, the strength of the euro was cited as a problem in eroding competitiveness. The Ifo Institute's business climate index for Germany fell to 103.0 in December from 104.2 in December. Although it has been falling since April, it is at quite a high level and, encouragingly, the component which covers expectations for the next six months fell hardly at all from 98.3 in November to 98.2 in December. The index covering perceptions of the current business climate fell from 110.3 in November to 108.1 in December.

In terms of economics forecasts, the Ifo Institute has cut its forecast for growth in 2007 to 2.5% from 2.6% and for 2008 from 2.2% to 1.8% with a forecast of 1.5% growth in 2009. The Bundesbank has cut its forecast for 2008 to 1.6% compared to the figure of just below 2% which it had previously expected. Nevertheless, the Bundesbank still considers the German economy to be in "robust shape". Inflation has been a concern in Germany as it has approached 3.0% but the Finance Minister is currently forecasting that it will drop below 2.0% in 2008. If this is correct, it would be helpful for inflation rates given the hawkishness of the ECB which we have noted earlier on in this review.

As far as France is concerned, we are really waiting to hear how the confrontation between the government and certain public sector unions turns out. At the time of writing, there is a truce for negotiations but there is really only one opportunity for President Sarkozy to implement his reforms and that is when the momentum is with him and that time is now, shortly after an election victory. How this plays out will be very important for France's economic prospects since it is generally agreed that the country suffers from excessive taxation and regulation and an over large public sector.

The situation does not look as good in the UK as in the eurozone where its current problems can broadly be put down to excessive borrowing whether by the government or individuals and the bills are now coming in. The Northern Rock affair is perhaps the greatest embarrassment and, in fairness and as we discussed earlier, a lot of hindsight has been used but its business model has now been found to be wanting in a time of extreme stress in financial markets. The possibility that Northern Rock may have to be nationalised is a remarkable situation but action has to be taken quickly. Apart from anything else, any government guarantee for depositors distorts the market and creates an unlevel playing field for other companies in the sector and the EU will have to become involved if it goes on much longer because of state aid rules. The effect on confidence whether it be to business or consumers is significant given that the Northern Rock affair reflected the first run on a bank in the UK for a long time and has not been repeated elsewhere in any major country in the current financial problems. The more general issue is excessive expansion of lending in the housing market on aggressive terms and, now that the housing market has started to falter, a potentially dangerous position emerges for those who have overextended themselves and to the economy as well because of the effect of falling confidence and a negative wealth effect.

There is little doubt now that the housing market has turned. The Halifax reported that average house prices fell by 1.1% in November and this has reduced the annual rate of house price inflation to 6.3% compared with 8.9% in October and a peak of 11.4% last August. The Halifax has predicted that house prices will be flat in 2008 and the number of property transactions will decline by 15%. The latest Financial Times house price index reports annual house price inflation of 9.1% compared with its peak last summer of 10.2%. The Department for Communities and Local Government said that prices were flat in October although the year on year figure was 11.3% higher. According to the RICS, house prices fell in November at their fastest rate since May 2005. Its house price balance fell to -40.6 from -23.4 in October with a number of agreed sales falling for the fifth month in a row in November. According to Hometrack, house prices fell by 0.3% in December compared with November and the average time to sell a house was 8.3 weeks which is the longest since its survey began in 2001. On its measure, house prices rose by just 3% for the year as a whole with nearly all of the rise coming in the first half. Hometrack is forecasting a house price rise of just 1% in 2008. At the end of December, the Nationwide reported, on its measure, a fall in house prices of 0.5% in December compared with November with annual house price growth down to 4.8% in December compared with 6.9% in November. The Council of Mortgage Lenders reported that gross mortgage lending in November fell to £30.7 billion compared with £33.5 billion in October and £33.2 billion in November last year, reflecting the first year on year fall since July 2005. It attributed the fall primarily to a lack of available funding. Net mortgage lending in November was the lowest for over two years, rising by £4.3 billion compared with October's figure of £4.8 billion and a six month average of £5.5 billion. There was also a sharp fall in the number of mortgages approved by banks during November. According to the British Bankers Association, the number was 43% down on a year earlier.

It is not only households which are heavily indebted and which may struggle during the coming year. The government is also, and this is an issue that we have mentioned many times before but it now seems to be coming to the fore as a result of a conjunction of unfavourable circumstances. The prime culprit is the excessive rise in public expenditure because, during a period of economic growth, it is normally sensible for governments to try to run a surplus or at least to balance the books and the OECD, as we mentioned earlier, makes reference to the fact that governments have not used the benign circumstances of recent years to improve their finances. In fact, the situation in the UK has been becoming worse and now there is no leeway. It is noticeable that their Treasury is trying to find new or increased sources of revenue, one of which is small businesses. Given that this sector should be one of the engines of growth, it is quite clearly wrong that it should be seeking to raise taxation at this time but it is a measure of the problems with government finances that short term solutions are being examined. The longer term consequences are almost certainly going to be bad but the Treasury needs to shore up government finances in the short term. It is unlikely to be successful without either raising taxes, which would be difficult politically, or by cutting government expenditure, an equally difficult task. Something, however, has to happen. Public sector net borrowing stood at £11.2 billion in November, which is the largest sum since records began in

1993 and compares with a deficit of £9.1 billion a year earlier. The public sector net cash requirement recorded a deficit of £9 billion in November compared with £7.4 billion a year earlier. The Treasury has consistently underestimated government borrowing requirements and, according to the Financial Times, the situation is set to worsen as asset sales prove difficult.

Excessive borrowing and consumption is one reason why the external situation of the UK is also poor. In late December, the ONS revealed startling figures on the current account deficit with a revision to a deficit of £20 billion in the third quarter compared with £13.7 billion announced earlier, this being equivalent to 5.7% of GDP. This reflects the largest current account deficit in the G7 countries, worse than that of the USA which is normally held up to be a bad example. The revision was largely caused by a revaluation of the figure for foreign investment income.

It is no wonder that the pound has started to fall. We have said in previous reviews that it is overvalued but it is always difficult to tell when a change in trend may occur. The pound has been uncompetitive but, recently, it has started to fall quite sharply and with weakened confidence in the UK because of what is going on in financial markets, Northern Rock, deteriorating public finances and an alarming current account deficit, we would expect this trend to continue. The government has to make some very difficult decisions in 2008 and the increasing onset of problems is not favourable in terms of the electoral cycle. Sudden decisions, which have not been subject to rigorous analysis, such as the increase in taxation on small companies, an increase in the capital gains tax rate on business and proposals for non domiciled residents, threaten to have unpleasant and unintended consequences.

Problems are also apparent in the commercial property market with prices falling and pressure on some open-ended funds which invest in property. Again, the warning signs were there when the cost of money exceeded the yields on properties but, in a bullish environment, people believe that this difference can be covered by rising prices. This will not go on forever and, when it reverses, the consequences are unpleasant. According to Investment Property Databank, capital values fell by 1.9% in October which was the worst fall for seventeen years.

Changed conditions in the economy seem to have made the Bank of England's decision to cut interest rates by 0.25% in December fairly easy, notwithstanding earlier hawkish noises on inflation. The decision to cut rates was unanimous and, in the statement accompanying the cut, the emphasis was placed on the negative factors for the UK economy which informed their decision. The minutes showed the MPC to be concerned about the availability of credit in the turbulent conditions obtaining in the financial markets. There was also recognition that there were problems in the housing market, lower growth worldwide and the fact that its agents reported tighter credit conditions for companies. The MPC was certainly not complacent about inflation which remains its main concern. On the inflation front, the Producer Price Index rose by 0.5% in November to show a 4.5% rise year on year. As well as energy prices, food prices are a catalyst for higher inflation. The consumer price index rose by 0.3% in November compared with October to give a year on year rate unchanged at 2.1%. This is just above the Bank of England's target. Excluding energy and food prices, the core inflation rate fell from 1.5% to 1.4% year on year. However, the measure of inflation that many people will recognise, the Retail Price Index, rose to 4.3% in November year on year compared with 4.2% in October and the same measure which excludes mortgage interest payments showed a year on year increase of 3.2% against 3.1%. Again, one should note that food prices are 5% higher than a year ago and the expectation is that there is more in the pipeline which makes complacency on inflation unwise. Anecdotal evidence from the CBI in its monthly survey of industrial trends shows that manufacturers intend to increase prices over the next three months. The Bank of England survey of inflation expectations shows that these were at their highest since the series began in 1999. Again, this is something that the Bank of England notes since perceptions of inflation are important for wage negotiations and thus to inflation.

In its review of the UK with the Economic Outlook, the OECD warned that the UK is particularly vulnerable to the turmoil in the financial markets and its housing market is at a greater risk of a downturn. The large size of the financial sector is also a vulnerability to the UK and it also points out that, as well as the USA, it is one of the few countries to have a mortgage sub-prime sector.

Currencies are notoriously difficult to forecast but we would assess the likelihood that there has been a turn in sentiment towards sterling which could decline quite sharply. Many British companies have substantial overseas operations and, as in the USA with the weak currency, they will stand to benefit either because exports will become more profitable or, if they are not big exporters, their overseas profits translated back into sterling will be expanded. These companies provide a good insurance against weakness in sterling as well as portfolios which have overseas assets. Certainly, we never buy equities for currency exposure but this is a by-product of our view of what is likely to happen for sterling in what we think will be a particularly difficult year for the UK economy in 2008.

As the OECD projections suggest, China will continue to grow at a very rapid rate in 2008 and 2009 albeit possibly a little more slowly than the forecast growth of 11.4% in 2007. China's main problem at the moment is inflation caused mainly by rapidly rising food prices but also because of significant liquidity in the economy arising from the very large external surplus which China is earning and which is the cause of protectionist noises abroad.

China's year on year inflation rate as measured by the Consumer Price Index stands at 6.9% in November, up from its 6.5% in October, and an eleven year high. The authorities have said that they will move towards a "tight" monetary policy from what had been called a "prudent" stance. The authorities plan to try to control inflation by restricting bank lending, raising bank reserve requirements and raising interest rates. In December, interest rates were raised for the sixth time this year. One year benchmark deposit rates rose by 27 basis points to 4.14% and one year lending rates by 18 basis points to 7.47%.

China is also trying to take a constructive way of addressing the problems by allowing more overseas investment by Chinese private investors. At present, the Chinese can make overseas investments through Hong Kong in certain prescribed circumstances and the plan is to extend this to the UK and the USA. The China Banking Regulatory Commission has made an agreement with British regulators and it is in the course of doing the same with US regulators. At the end of September, twenty one commercial banks had approved quotas totalling US$15.1 billion although they have not as yet been fully used. As well as the increased impact of China in world markets through the disposition of assets in its sovereign wealth fund, individual Chinese investors will also make their mark. This is something that should provide encouragement for international equity investors over the years given the potential sums involved. The boom in the Chinese economy also leaves the authorities with a pleasant task as tax revenues have risen by about 30% this year. Amongst other measures under consideration is a plan to raise the individual tax threshold.

As an economic and investment force China becomes more interesting by the month whether it is because of its official investments in overseas companies or because of its liberalisation of the rules for individual foreign investment. China will continue to resist pressure from abroad to change its economic policy, for instance on the exchange rate which it is likely to allow to rise modestly in its own good time although the central bank did make some encouraging moves at the end of December about allowing a faster appreciation of the currency. As we have said before, we regard the Chinese influence on world markets as good notwithstanding that there are, of course, some losers. As Chinese inflation rises and the currency perhaps creeps upwards, the era of low cost Chinese imports to the industrialised world will begin to draw to an end. China is also going upmarket in terms of value added goods and high technology items and will become a formidable competitor there as well. For investors, the Chinese influence is everywhere.

The centre of power is moving eastwards whether it is to the Middle East, India or the Far East. Growth rates are likely to continue to exceed by a long way those in the West. This growth will help to sustain the world economy overall and, notwithstanding headwinds in the form of high energy prices and the current financial problems, we would expect the world economy to weather the current storm with the OECD projections looking realistic at this stage.

Looking forward to 2008, our best estimate, on the evidence currently available is that equity markets might show a similar performance to that in 2007. Assuming modest growth in the world economy, overall corporate earnings should increase although only at a moderate rate, but still good enough to provide support for shares which, in the major industrialised economies, look quite cheap. Earnings yields are significantly higher than the bond yields and the overall short term interest rate environment should be helpful. We do, however, remain cautious of bonds because, for reasons given earlier, we do not think the inflationary threat has passed. There are certainly plenty of problems in the world economy and we have mentioned many of them but it is important to look ahead for clues as to how the stock market might progress and these will largely be governed by economic action, particularly in the sphere of monetary policy. There is enough evidence, in the absence of events we cannot presently foresee, to believe that 2008 will be a satisfactory year.