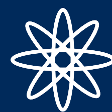

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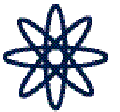
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

There has been a mixed performance in securities markets over the quarter with equities moving higher and good quality bonds retreating. In the currency markets, the feature has been the weakness of the U.S. dollar and the strength of the Swiss Franc. In the commodity markets, the rising price of oil has led to some inflationary concerns, which we will discuss, whilst rising food prices have the capacity to bring civil unrest.

The tables below detail relevant movements in markets:

International Equities 30.11.10 - 28.02.11

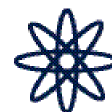
Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.4	+8.2	+13.0	+6.5
Finland	+3.6	+5.2	+9.9	+3.6
France	+13.2	+15.0	+20.2	+13.2
Germany	+9.0	+10.7	+15.6	+9.0
Hong Kong, China	-1.2	-5.6	-1.5	-7.1
Italy	+17.2	+19.1	+24.4	+17.2
Japan	+10.3	+8.0	+12.8	+6.3
Netherlands	+13.8	+15.6	+20.7	+13.8
Spain	+19.4	+21.3	+26.7	+19.4
Switzerland	+5.4	+8.2	+13.0	+6.5
UK	+9.3	+9.3	+14.1	+7.6
USA	+12.8	+8.0	+12.8	+6.3
Europe ex UK	+10.6	+13.1	+18.1	+11.3
Asia Pacific ex Japan	+3.3	+2.2	+6.8	+0.6
Asia Pacific	+6.5	+4.9	+9.6	+3.3
Latin America	+1.1	N/C	+4.5	-1.5
All World All Emerging	+1.5	-1.0	+3.4	-2.5
The World	+10.2	+8.3	+13.1	+6.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -1.3%

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

Currency	30.11.10	28.02.11
Sterling	3.23	3.69
US Dollar	2.81	3.42
Yen	1.20	1.26
Germany (Euro)	2.68	3.17



Sterling's performance during the quarter ending 28.02.11 (%)

Currency	Quarter Ending 28.02.11
US Dollar	+4.3
Canadian Dollar	-1.1
Yen	+2.1
Euro	-1.4
Swiss Franc	-3.2
Australian dollar	-1.6

Other currency movements during the quarter ending 28.02.11 (%)

Currency	Quarter Ending 28.02.11
US Dollar/Canadian Dollar	-5.2
US Dollar/Yen	-2.1
US Dollar/Euro	-5.5
Swiss Franc/Euro	+1.9
Euro/Yen	+3.5

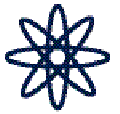
Significant Commodities (US dollar terms) 30.11.10 - 28.02.11 (%)

Significant Commodities	30.11.10 - 28.02.11
Oil	+30.1
Gold	+3.3

Markets

Despite the political turmoil in North Africa and Middle East at the end of the quarter, international equity markets have moved higher over the period. In local currency terms, the total return on the FTSE World Index was 10.2%, in sterling terms 8.3%, in US dollar terms 13.1% and in euro terms 6.6%. In local currency terms, there were above average performances from the FTSE USA Index (+12.8%), the FTSE Europe ex UK Index (+10.6%) and the FTSE Japan Index (+10.3%). The FTSE UK Index slightly underperformed (+9.3%) whilst other underperformers, unusual by recent standards, were the FTSE Asia Pacific ex Japan Index (+3.3%), the FTSE Latin American Index (+1.1%) and the FTSE All World All Emerging Markets Index (+1.5%). If we look at the relevant sterling adjusted figures, the FTSE Europe ex UK Index emerges as the strongest performer, returning 13.1%. The other two outperformers in local currency terms, Japan and the USA, both returned 8.0%, very slightly underperforming the sterling adjusted return on the FTSE World Index. The UK moved to an outperformance against the FTSE World Index because of currency movements. The FTSE All World All Emerging Markets Index actually turned in a slight negative performance in sterling terms, returning -1.0%.

High quality government bonds, as measured by ten year benchmark issues, experienced a poor quarter, although there was a modest recovery right at the end of the quarter. The gross redemption yield on ten year sterling government bonds rose by 46 basis points to 3.69%, on US dollar government bonds by 61 basis points to 3.42%, on Japanese government bonds by 6 basis points to 1.26% and on euro denominated German government bonds by 49 basis points to 3.17%.



In the currency markets, the weakness of the US dollar was the main feature. Against it, sterling rose by 4.3%. The yen also weakened, with sterling rising by 2.1%. Elsewhere, though, sterling weakened slightly, although, against a rampant Swiss Franc, it declined 3.2%.

In commodities, oil rose by 30.1% on political fears and we will discuss this issue at some length in this review. Gold was just 3.3% higher.

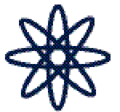
Economics

Political events, albeit with economic consequences, have dramatically taken centre stage so far this year, with the uprising in Tunisia spreading to Egypt and, as this is written, Libya, with demonstrations taking place in other Arab states such as Yemen and Bahrain. Together with the natural disasters in Australia and, now, New Zealand, the world has become more unpredictable than ever in so many ways. Events in North Africa and the Middle East have temporarily pushed the sovereign debt crisis to the sidelines although, in the absence of events in North Africa and the Middle East taking an even worse turn, probably involving unrest spreading to Saudi Arabia, the sovereign debt crisis looks likely to remain one of the main issues for this year for investors to consider. One obvious consequence of political unrest and natural disasters has been heightened concern about inflation which is now starting to exercise central bankers' minds and become another economic issue.

Let us work backwards from the inflation issue, a function, in part, of recent political events and natural disasters. Until recently, many feared that, in the aftermath of the financial and economic crisis of 2009 and 2010, deflation, rather than inflation, would be the issue, citing the size of the output gap, the difference between potential and actual output as the rationale for the view. To us, this was not a credible view because inflationary forces could be seen in the system. In the UK, whilst not expecting deflation, the Bank of England was quite sanguine about inflation prospects even though inflationary pressures seemed to be building particularly strongly in the UK in the aftermath of the 2008 devaluation of sterling. One can sense a change of tone emerging from the Bank of England's Monetary Policy Committee.

The main catalysts of inflation for many people in the world are food and energy costs, yet core measures of inflation sometimes exclude these costs with, in current circumstances, core inflation levels being below the general level which includes these volatile items. But we do not see this distinction as being very valid at present. Anchoring inflationary expectations to core levels of inflation, rather than actual levels which people experience, seems unrealistically optimistic. In the UK, for example, the Consumer Price Index for January was 4.0% higher than a year ago but the core figure was 3.0% and the previous measure, the Retail Price Index, was 5.1% higher. In the context of an inflation target of 2.0%, the difference is significant. In the USA, the relevant figures are 1.6% and 1.0%, a big difference, albeit at a much lower absolute level. The implications for wage bargaining are negative for inflation if people's inflationary expectations become anchored around the All Items Consumer Price Index, rather than the core level. Of course, energy price increases, such as we are seeing at the moment, feed through to businesses' general costs and provide a catalyst for inflation, so it is increasingly difficult to justify policy decision making on the basis of the level of core inflation.

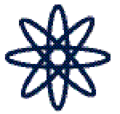
If we look at commodity prices in general, not just agricultural commodities, and energy, it is difficult to see anything but an upward trend in prices (not a straight line, of course) and that does not taken into account political upheaval in oil producing countries, which is pushing up the oil price now, or natural catastrophes, such as those in Queensland, which have devastated agricultural crops. As populations grow and food tastes change with increasing affluence, food prices are likely to continue to rise although, in theory, higher prices should stimulate more production. Rising energy use can also be expected due to rapid growth in Asia and some emerging markets. Just one example shows why demand for commodities is likely to remain strong. China has announced that it plans to build 45 airports in the next five years, an example of why demand for iron ore is likely to remain strong, this being just one example.



After a steady start to the year, markets have, at least temporarily, been unsettled by the recent events in Libya. Libya is the world's twelfth largest oil producer but its daily production levels are well below the level of spare capacity in Saudi Arabia, which has indicated its willingness to make up for Libya's output shortfall even though its oil is of a different quality. It is not in Saudi Arabia's interest for there to be an oil price induced economic recession and instability. The nightmare scenario would be for unrest to spread to Saudi Arabia, holder of the world's largest oil reserves, so, understandably, investors are nervous. A supply shock, such as occurred in the 1970s after the Arab Israeli conflict, would be far more damaging than a demand induced price rise. Of course, there might be a happy outcome in Libya whereby a new government with popular support is formed if Gaddafi is overthrown and stability results. This is not obviously something which can occur overnight because there are no democratic institutions in place in a country which has been under a dictatorship for so long. An even more optimistic scenario would be for the unrest to spread to Iran and for a government with some popular authority and less extreme views to take the place of the current regime. There has been unrest in Iran and a positive outcome in Libya could have repercussions there.

This is all complete speculation but, just mentioning it, does serve to remind investors that what is currently a dangerous situation could have positive as well as negative outcomes. We just cannot tell at present but we have to bear both scenarios in mind. The danger of taking the negative view is that, apart from it being costly if it is wrong, eventually economies adapt to a new situation. So, one reason why a high oil price is less dangerous now that it was in the 1970s is that, in industrialised countries, energy efficiency is far higher with a much lower level of energy input needed to produce the same level of output as in the 1970s, roughly one half. That is not the position in developing economies where energy usage remains highly intensive. An oil price spike, whilst reducing growth, should not be as negative for the world economy as in the 1970s.

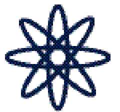
Let us, therefore, move back to where we started this review with the inflation issue. Although it is commanding much more attention now because of the rise in food prices, other commodity prices and energy, we believe, particularly in the UK and, possibly the eurozone as well, where inflation is rising, that it will move to centre stage in economic policy. The reason is that, in the aftermath of the financial and economic crisis, orthodox and unorthodox monetary policy was used to prevent a temporary recession becoming a depression. It was, however, an emergency policy and not one which was sustainable in the medium and long term. With fiscal policy tightening significantly in many countries, with no better example than in the UK, very loose monetary policy provides some offset. However, ultra loose monetary policy, which is how we can describe the position currently being followed in the USA, UK and eurozone, is potentially very dangerous from an inflation perspective. Quantitative easing, which has been practised in the USA and UK and a different version in the eurozone, has to be withdrawn at some stage. At its simplest, just printing money in the context of a finite amount of goods and services available will eventually drive up inflation. As an emergency measure in the extraordinary circumstances of 2008 and 2009, it could be justified, but it will have to be withdrawn at some stage. That was the unorthodox part of monetary policy. The orthodox part of monetary policy, although right at the outer limits, was the negligible official interest rate applied in many countries, mainly those affected by the financial and economic crisis. In some countries, which were less affected by the crisis, interest rates have been moving up for some time, examples being, amongst others, Australia, Canada, China, India, other Asian countries and non-eurozone EU members like Sweden. But in the USA, UK, Japan and eurozone, official rates have not yet been raised from crisis levels with the result that, in many countries, official interest rates are below inflation. For many borrowers, because of the margin over base rate which they pay, they may be paying a real, inflation adjusted interest rate, but the point remains that official interest rates of between 0% and 1% would, until the crisis erupted in 2008, have been considered incredible, except in Japan, which has a long experience of deflation. The issue is most starkly seen in the UK where, even on the more favourable Consumer Price Index, currently standing at 4%, the real official interest rate can be said to -3.5%. If an economist were to arrive from Mars, and had not been aware of why this rate had been set so low in the first place, he or she would blink in disbelief. Having negative real interest rates



would normally be considered highly dangerous because it could stoke inflation or cause undesirable bubbles in securities and/or property markets. In the same way as the unorthodox monetary policy measure of quantitative easing has to be reversed as soon as it is considered safely possible, so, too, have ultra low official interest rates.

Timing is a difficult policy decision, and a perfect example of the dilemmas faced by central bank policy makers comes from the four way split of opinion amongst the members of the Bank of England's Monetary Policy Committee. The latest decision is to keep the official interest rate unchanged at 0.5%, but that hides a complicated story. At the dovish end, one member, besides voting to keep interest rates unchanged, wanted a further £50 billion of quantitative easing, whilst, at the other end of the spectrum, another member wanted a 0.5% increase in the official rate. Two members wanted a 0.25% rise, whilst the rest voted to keep interest rates unchanged, although there was increasing unease about inflation. The momentum is towards the interest rate hawks, although "hawks" is a relative term with interest rates at this level. As we mentioned earlier, the Bank of England has consistently proved over optimistic on inflation and, to many an outsider, its optimism was puzzling. Intuitively, it did not seem correct, especially with sterling having been so weak in 2008 and the usual time lags before a devaluation make its presence felt through the supply chain. As we said, an important reason for its optimism was the size of the output gap, with a large gap implying that producers' pricing power was muted until full capacity was reached. Now, there is an increasing belief that the amount of potential capacity lost during the recession meant that the UK economy may be bumping up against capacity constraints earlier than expected, implying that previous inflation forecasts may prove to be too optimistic. Once the inflationary genie is released from the bottle, it is very difficult to put it back in. The four way split in the Monetary Policy Committee is symptomatic of the problems faced by policy makers in circumstances as difficult as they are now. The doves on the MPC, whom we would class as the member wanting more quantitative easing and those who voted for maintaining the status quo on quantitative easing and interest rates, would argue that the enormous fiscal squeeze scheduled for the lifetime of this parliament will so weaken the economy that a very loose offsetting monetary policy must be in place to stop the economy moving back into recession as it did in 2009. Those favouring an interest rate increase of 0.25% or 0.5% would want to start to see a return to a more normal interest rate level because of the danger that inflation would move out of control. If it did, the pound would be likely to suffer and interest rates eventually move higher than would otherwise be the case, thus weakening the economy further. In another context, the examples of Ireland and Spain within the eurozone are instructive. The inability of those countries to set an appropriate interest rate because they renounced control of domestic monetary policy by joining the euro led to the property bubble and subsequent crash.

We believe that it is correct to try to eliminate the structural deficit over the lifetime of the current parliament, assuming it runs its full course, because, not do so, risks markets taking matters out of the hands of the government and central bank because of a sterling crisis and/or a funding crisis, with attendant very high interest rates. But there is also a risk connected with the inflationary implications of having negative real official short term interest rates and that lies in the bond market. The table at the beginning of this review shows that the gross redemption yield on the ten year UK gilt is below the inflation rate as measured by the Consumer Price Index and, especially, by the Retail Price Index (often used in wage negotiations). In our view, this difference makes UK gilts and other bonds very expensive. If investors feel that UK monetary policy is dangerously loose, yields will be pushed up to much higher levels, thus exerting a contractionary influence on the UK economy. We have often said in these reviews that we regard bond yields, notwithstanding their recent rise, as being in dangerously low territory and we believe that they are likely to perform better if monetary policy is being seen to move towards a more orthodox state. In other words, we believe that the views of the "hawks" on the Monetary Policy Committee, which seem to be gaining ground, are correct and that, gradually, short term interest rates should be seen to be moving upwards.

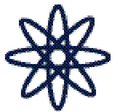


Given the dire state of the UK's public finances, it is possible to construct a negative case for every action or inaction on the part of the fiscal and monetary policy makers. However, the growing elephant in the room, inflation, cannot be ignored and so we believe that the current fiscal policy aimed at stabilising the UK's public finances, combined with a gradual tightening of monetary policy, is the best option. Failure to recognise either the fiscal or inflationary threat risks making a bad situation even worse, with matters taken out of the UK's hands, as has happened, for example, to Greece and Ireland within the eurozone.

We have spent some time discussing the UK in the context of its current inflationary problem and also because the split within the Monetary Policy Committee of the Bank of England makes the different policy options and views very vivid. But we could be discussing the eurozone and perhaps, to a lesser extent in the context of inflation where it is not currently such a problem, the USA. Notwithstanding its current dire public finances, the UK does at least have a plan to restore some semblance of order to them, whereas the eurozone's plans are more limited and those of the USA practically non existent.

Whilst the eurozone's inflation problem is not as bad as that of the UK, its problems are, in many ways, more intractable by virtue of it being a currency area which, in economic terms, is not an optimal one. Eurozone inflation has risen above the target level of close to but below 2% and the official interest rate is 1%. Like sterling, it has also been a weak currency. For example, in 2010, it was the only major currency against which sterling strengthened. This situation has been a boon to Germany, for example. In recent years, it has maintained a strict lid on costs. The euro has made German goods very competitive and the profile of its exports has been very favourable to meet the demands of fast growing economies like those of China. One can see, however, that the recent success of the German economy is going to lead to wage pressures and the ECB will be very wary of such a trend in the eurozone's largest economy. Probably more than any other central bank, the ECB can be relied upon to counter potential inflationary problems through interest rate rises. In one sense this is good because it may hold down medium and long term interest rates which are susceptible to inflationary concerns but rising shorter term interest rates could cause problems for those eurozone countries like Greece, Ireland Portugal which are struggling with their public finances and are having to tighten fiscal policy fiercely. If, for any reason, the ECB was considered to be tardy in raising interest rates and thereby cause the inflationary risks to rise with a resultant negative effect on medium and long dated bond yields, solvency risks within certain eurozone countries would rise as they become less able to service their debt.

The politicians are becoming desperate to save the euro project but are increasingly tying themselves into knots as they try to avoid facing reality. It is difficult to see how it can have a happy ending. The trouble is that the politicians cannot face reality. The eurozone was never an optimal area. It was a political idea, without the necessary economic underpinnings in terms of fiscal union and the latter is something that the eurozone's electorates would surely not have stomached, even though they were not asked about the euro. So sticking plaster is being attached or suggested for a problem which we believe to be intractable without an economic superstate. In the context of the eurozone's sovereign debt crisis, the message from the Irish electorate at the general election just held in unequivocal. Ireland's traditional ruling party was decimated and the Irish electorate is very angry. The grave state of the Irish economy partly has its roots in a domestic policy error which Ireland could have controlled, namely allowing the banks to grow to a size in terms of their balance sheet which was out of proportion to the size of the Irish economy. An earlier political mistake was taking Ireland into the euro but, once inside the currency zone, the central bank lost control of the economy, for an independent central bank would surely have raised interest rates to stem the property bubble. Now, Ireland is faced not only with the crippling cost of its debt and bailout, but increased unemployment, falling real incomes and emigration again because of the lack of job opportunities in Ireland. The yield on Irish government debt, 9.07% on five year government bonds and 9.37% on ten year government bonds, tells us that investors give Ireland almost no chance of repaying its debt



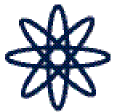
in full (respective yields for the best eurozone credit, Germany, are 2.39% and 3.17%). During the election campaign, the largest party now, Fine Gael, said that it would try to renegotiate the bailout package, particularly with respect to the interest rate of about 6% on the eurozone's portion of the package. Such a renegotiation is opposed by other members of the eurozone. Fine Gael also wants senior bank bondholders to take a haircut on their loans. Paradoxically, Ireland may have some unexpected clout in this matter because such a threat, if implemented, could bring the house down and it could be considered cheaper to make concessions to Ireland. With cross holdings of bank bonds across the eurozone, eurozone politicians and bankers would dread possible contagion. Given how bleak is the position of Ireland, the new government might try to punch above its weight in the renegotiations. Having raised the issue of renegotiation before the election, it would not want to start its period of office with a climb down.

Greece started the crisis, and its ten year bond yield of 11.8% suggests no hope of a full repayment of creditors, whilst Portugal's ten year bond yield of 7.62% suggests serious doubts. Unless the political situation in North Africa and the Middle East turns even more threatening, the eurozone's problems are likely to remain at the centre of attention.

Because of what is going on with respect to the eurozone's sovereign debt, the USA has, so far, escaped lightly. The very serious state of some eurozone countries' public finances has forced them to address the problem in a way which they never would have done before. The same cannot be said of the USA where the budget deficit is forecast to be almost 10% of GDP this financial year, an unsustainable level. With decision making deadlocked because of the Republicans capture of the House of Representatives in last November's mid term elections, it is difficult to see any meaningful progress on the increasingly urgent need to rein in the deficit. As we have often said, the USA enjoys the advantage of its major reserve currency status and the US dollar is the medium of exchange for many goods and commodities, but this status cannot protect it indefinitely from a day of reckoning if it does not act decisively to try to tackle the crisis in its public finances.

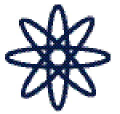
In this respect, China is important, as the holder of the world's largest foreign exchange reserves. The tension between the USA and China over the belief of many in the USA that China was gaining an unfair trade advantage because its currency was artificially depressed seems to have eased but not gone away. Protectionist forces in the USA are strong and, if they were to gain any traction by putting tariffs or quotas in place for a range of Chinese goods, this would be a dangerous development. For the moment, however, China is occupied by inflation, particularly food price inflation, and, as in many countries, rising food prices are dangerous for ruling parties. Food price inflation, of course, can be caused by a range of issues not connected with an overheated economy, such as those we mentioned earlier, notably, in the short term, weather and, in the longer term, factors like increased affluence leading to changes in eating habits. Through interest rate increases and increasing bank reserve requirements, China is trying to contain inflationary pressures and, with regard to the food price problem, important parts of the country are raising minimum wages sharply. Importers of Chinese goods report that prices are rising and this, to some extent, meets the complaints of politicians in countries like the USA which are very vocal in their condemnation of the Chinese exchange rate policy. It is only a start and, of course, many industrialised countries no longer produce the goods which China makes in volume. Within Asia, there is also an effect. Some manufacturers are moving from China to cheaper Asian manufacturing centres.

The spectre of rising inflation is likely to mean an early rise in interest rates in the UK, almost certainly the eurozone and, later on, in the USA. Other countries which have started to raise interest rates may continue to do so. Japan may be an exception. Because of the distortions in the market which ultra low interest rates have caused, it is desirable that they start to move back to normal levels and, whilst they are doing that, we do not expect this to impact negatively on equity markets.



We cannot yet be sure what the full implication of the political unrest in the oil producing countries is at the moment but, prior to the Libyan unrest, the IMF had produced its latest projections and forecast an increase in world output in 2011 of 4.4%, rising slightly to 4.5% in 2012. Within that overall picture, growth in advanced economies for both years, was projected to be 2.5%. Within the latter total, it had raised its forecast for US economic growth to 3.0% this year because of the stimulus given to the US economy by the end of the year agreement between the President and Congress. This will store up trouble for the budget deficit in future but, in the short term, can be expected to act as a stimulus. The euro area, as one might expect, was forecast to show subdued growth in both years, 1.5% and 1.7% respectively, although Germany, the largest eurozone economy, having grown 3.6% in 2010 was expected to grow a relatively satisfactory 2.2% this year and 2.0% next year in the context of much lower growth in other major eurozone economies. Following its rapid growth in 2010 of 4.3%, the Japanese economy was projected to grow just 1.6% this year and 1.8% next year. For the UK, the relevant figures are 2.0% and 2.3%. Amongst Newly Industrialised Asian Economies, 8.2% growth in 2010 was expected to give way to more modest, but still satisfactory, growth of 4.7% this year and 4.3% next year. Emerging and developing economies, as would be expected, are forecast to grow much more rapidly, with the 7.1% growth in 2010 giving way to a projected 6.5% in 2011 and 6.5% in 2012 and, within that total, China is expected to grow 9.6% this year and 9.5% next year, whilst growth in India is forecast at 8.4% and 8.0%. A rise in the price of oil is a transfer of purchasing power from consumers to oil producers and therefore, if the current price of oil continues at over US$100 a barrel, we may expect some modest trimming of those forecasts. However, at this stage, the oil price is not at a level which we might consider to be significant in terms of having a major impact on growth. Supporting the view that the world economy started the year quite strongly is a global purchasing managers index compiled by JP Morgan and Markit Economics which rose to 57.2 in January against 55.6 in December, this composite index referring to the manufacturing sector. Purchasing managers indices for individual countries are watched quite closely because they give a good indicator of economic activity and this one was certainly positive. It did, however, point to cost pressures supporting the view that deflation is certainly not going to be a problem in most countries, rather that inflation is going to be the issue.

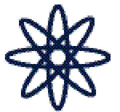
Although fourth quarter annualised GDP growth was reduced in the USA from an initial estimate of 3.2% to 2.8%, the economy appears to be performing reasonably well. The minutes from the January meeting of the Federal Reserve's FOMC meeting show that the Federal Reserve has upgraded its forecast for economic growth this year to a range of 3.4% to 3.9% compared with its previous forecast of 3.0% to 3.6%. This is higher than the IMF forecast referred to above. The reason for the upgrade is stronger consumer spending, business investment and exports. The Federal Reserve decided to maintain its US$600 billion Treasury bond purchase scheme, although it appears some members have doubts. The FOMC's view on inflation was also quite sanguine. It said that measures of underlying inflation remain "subdued" and that longer run inflation expectations were stable despite the rise in commodity prices. However, for those who were not wholly convinced about this, the data for January's core wholesale prices showed that they rose by 0.5%. This was the fastest monthly rise since October 2008. The US economy is a relatively closed one, i.e. international trade is relatively low compared to the size of the economy, and the USA is not as affected as a country like the UK, for example, by rising import prices. The two ISM indices for manufacturing and service sector activity both rose quite strongly in February to 61.4, in the case of manufacturing, from 60.8 in January, and to 59.7 in February from 59.4 in January, as far as non manufacturing activity is concerned. Furthermore, consumer confidence appeared to be very strong in February, with its index rising to 70.4 from 64.8. This is the highest level the index has achieved for three years. But, of course, there are many problems in the USA. Unemployment remains very high, at around 9%, and the housing market, despite a few pieces of positive data, remains in difficulties. Furthermore, behind all this is the problem of the dire state of public finances. Many US states are in a desperate way and they are having to take measures to address the weakness in their public finances which, at some stage in the future, will have to be taken



by the federal government.

We have talked at length about the eurozone where the sovereign debt issue dominates the area. As we see from the IMF forecast, growth is expected to be quite subdued this year and this is not surprising given the severe measures which countries are taking to address their public finances. Germany continues to be the most robust economy, even though it is not likely to grow as quickly as last year. According to Eurostat, the eurozone grew at 0.3% in the final quarter of 2010 and by 1.7% for the year. Nevertheless, some of the news from the eurozone has been surprisingly good, although it is necessary to keep this in context. The purchasing managers index for the services sector in February rose from 55.9 in January to 56.8, and for the manufacturing sector, from 57.3 to 59.0, to leave the composite index at 58.2 at its highest level since July 2006, up from 57.0 in January. In Germany, the Ifo Institute's business confidence index reached its highest level ever since the reunification of Germany. Consumer confidence also rose. However, in early March, the ECB signalled that interest rates would almost certainly rise in April, reflecting the more hawkish attitude taken by the ECB towards inflation. The ECB takes its inflation remit very seriously and is much less willing than the Federal Reserve in the USA and the Bank of England to risk inflationary pressures developing by keeping interest rates at levels which would normally be considered dangerously low against the rate of inflation.

In the UK, the second estimate of fourth quarter 2010 GDP growth was revised down slightly to show that GDP fell by 0.6%, not the previously estimated 0.5%. It is estimated that almost all the fall was weather related but it does not seem that the economy grew, even taking that into account. Quarterly data, or monthly data, in isolation, must always be treated with caution because it may not be representative of a trend. The GDP data was seized upon by those who argue for a less aggressive approach towards eliminating the structural deficit in the UK but, as we said earlier, we think this is a highly risky policy because, if the UK's creditors take fright at the UK's economic policy, there is nothing that the UK government can do about. A sharp fall in the pound or very sharp rise in interest rates, or probably both, could see matters move out of the control of the UK government. There is no doubt that the path to correcting the appalling fiscal deficit in the UK is going to be very difficult as tax rises bite and people and businesses are affected by a lowering of the rate of increase of public spending. It is important to emphasise that overall spending is not going to be cut. It is just the rate of increase that is going to slow down. What the government is hoping for is that improving public finances will reduce the risk of "crowding out" the private sector which it will look to in order to try to offset the shrinkage in the public sector. This is why the government has to do all it can to help the private sector to grow. There is no money available, obviously, but supply side measures, which cost nothing but make it easier for business to operate, are important and it is to be hoped that these will be taken. What Lord Keynes has called "animal spirits" will be important in this respect and, if business can gain confidence from a clear trend towards improvement in the UK's public finances, it may be more confident to invest. There have been some good figures from the UK which might be a straw in the wind but, again, they need to be treated with caution unless they form part of the trend. For the manufacturing sector, which has been performing well but only represents about 13% of the UK economy, the purchasing managers index in February rose to 62.0 from 58.7 in January. The equivalent index for the services sector rose from 49.7 to 54.5. Encouragingly, although with the major caveat about not treating one month's figures as indicative of the situation, the Treasury ran a budget surplus of £3.73 billion in January against a £1.26 billion deficit in 2010. January is normally a good month and the increase in VAT came into effect so the future trend of monthly figures will be very important. The latest Bank of England Quarterly Inflation Report was very interesting for those who have not felt confident about the UK's inflation prospects. As we mentioned earlier, the Bank of England has consistently underestimated the level of inflation and, to many outsiders, this seems strange because there were inflationary pressures around, arising, for example, from the devaluation of sterling in 2008. Those who were concerned about deflation or, at least, not concerned about inflation, have cited the output gap which we described earlier. The Bank of England's Quarterly Inflation Report suggested that the trade off between inflation and the output gap was perhaps not quite what had been anticipated earlier. It suggested that,

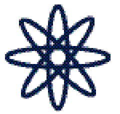


if the UK wants to avoid rising inflation, it will have to get used to slower growth. The MPC gives four reasons why the trade off may have deteriorated. The first is that it thinks that UK companies selling goods and services are likely to raise profit margins in the wake of sterling's fall and higher import prices. The second reason is that the MPC thinks that the financial crisis and lack of investment has reduced potential output and, therefore, that the degree of spare capacity is less than earlier thought. The MPC has also built in a small effect from increasing inflation expectations as companies raise prices and wages faster in anticipation of higher inflation. We talked about the importance of inflation expectations earlier. Finally, it expects employees to try to offset the effects of the squeeze on living standards by demanding higher pay increases. We discussed the four way split in the Monetary Policy Committee earlier and if, as seems likely, the ECB raises interest rates shortly, it surely cannot be long after that the Bank of England starts the same process.

Turning to China, it is significant that, in US dollar terms, China has replaced Japan as the world's second largest economy. Japanese officials said that Japan's nominal GDP was worth US$5,474 billion in 2010 compared with China's US$5,879 billion. In purchasing power parity terms, China has been the world's largest second economy for a long time. China's current problem is, as we mentioned earlier, inflation, and, in February, the People's Bank of China announced a further interest rate increase for one year deposits and loans respectively to 3.0% and 6.06%. The latest Chinese consumer price index showed a 4.9% increase, year on year, well above the target rate of 4.0%. The latest data for the Chinese property market, which the authorities are trying to subdue, showed that in January in most Chinese cities, prices continued to rise. The importance of controlling inflation was discussed earlier and is the top priority for the Chinese authorities. If they cannot control it then, through measures like increases in minimum wages, they are trying to address the issue in order to avoid any social unrest.

In mentioning that Japan has lost its place as the second largest economy, measured in US dollar terms, to China, the problems elsewhere in the world have tended to obscure the fact that the Japanese economy performed well last year. It grew faster than other major countries, although growth was from a low level, having contracted by 1.2% in 2008 and 6.3% in 2009. In fact, although the year was good for Japan, GDP fell by 0.3%, quarter on quarter, between October and December, which was the first contraction since the middle of 2009. The latest evidence suggests that Japanese exports to the USA are recovering and it is still benefiting from rapid Chinese growth. The problem for Japan further out is an horrendous level of public debt to GDP, over 200% at the gross level, which will have to be addressed in due course. Because most of the government's deficit is financed internally, it has not so far been a problem and, of course, interest rates have remained very low but, in due course, the situation will have to be addressed as it is unsustainable. So, as in the USA, the state of its public finances is going to have to be addressed in the future, otherwise the markets will rebel.

So where does all this leave markets? We would say that the easiest call is the bond market. Given that we believe that inflation is more of a risk than deflation, the sterling bond market looks poor value, despite the significant increase in yields over the last quarter. If we take the ten year gilt edged security, at present one would be investing for a negative real return. If one took the thirty year gilt, the return is slightly positive in real terms measured against the Consumer Price Index but negative as measured against the Retail Price Index. The authorities will have to continue issuing vast quantities of new gilts, notwithstanding the plan to tackle the deficit over the lifetime of this parliament so there will be a plentiful supply of new stock. Unless one is a forced buyer of gilts, like banks or pension funds, for example, what can be the attraction of investing for such poor returns? It would have to be a negative reason, namely that everything else looked so unattractive and that would have to be a situation borne out of fear, such as we saw in the immediate aftermath of the banking crisis when government securities were purchased irrespective of their returns because of the fear of losing money placed in bank deposits, for example. However, on the assumption that such crises are not going to be a recurring feature of the economic landscape, it is not a sound policy to have one's investment policy predicated on a background of perpetual crisis. Usually, it is wrong, and the long term performance of equities shows as much. Furthermore, if there is a steep



change in interest rates, say because of inflation, the damage to investment performance may be permanent whereas equities are likely to recover more quickly. During the UK's economic crisis in the 1970s, when inflation at one stage reached about 25% at its worst point, the highest coupon on a new issue of government stock was 15½%, roughly 10 points higher than the level a decade earlier. The change in yield levels inflicted severe losses in nominal and real terms on holders of sterling bonds. Whilst the equity market also collapsed in the wake of the oil crisis and also because of government measures which were damaging to businesses like price, wage and dividend controls, it did recover very sharply, so that those who maintained their position fared much better eventually than sterling bond holders. Whilst we are not expecting inflation at anything like the levels seen in the 1970s, it is difficult to see any value in sterling bonds at present and there is a lot of room for disappointment. The dangers of very loose monetary policy, whether orthodox, through very low official rates, or unorthodox, through quantitative easing or money printing, are that these measures will unleash inflation. Quantitative easing will have to be reversed at some stage. The Bank of England will need to sell back the bonds it has bought from the private sector and the combination of a seller of existing stock and the issuance of new gilts will be a challenge for the markets irrespective of additional inflation concerns. From an inflation perspective, the position for other AAA rated sovereign borrowers, like the USA and Germany, is not as bad, taking ten year government bond yields measured against inflation but, in absolute terms, the yields shown at the beginning of this review in the table cannot be considered attractive and the risks are obvious. In the case of the USA, they revolve around the dire state of public finances which will, sooner or later, be reflected in bond markets if convincing efforts are not made to deal with the problem. In the case of Germany, where public finances, whilst stretched, are not in nearly as bad a condition of those of the USA, UK and Japan, the issue, besides a resurgence of inflation, is a possible weakening of Germany's credit arising from problems elsewhere in the eurozone and the extent to which Germany gives assistance. Cash, of course, yields hardly anything at present, although the prospect is for gradual rises in short term interest rates in the eurozone, UK and USA, in that order. It is interesting only for the highly risk averse or for those awaiting an opportunity to enter equity and/or bond markets at a lower level. That leaves equities and commodities and we are here talking about exposure to the latter being taken through the former. If we make a working assumption that the political troubles in North Africa and the Middle East can be contained and do not lead to a very sharp increase in the oil price from this level, then the economic background is supportive to equities. With dividends on the rise as a result of an improvement in corporate earnings, reasonable dividend yields and earnings multiplies in many markets, equities are the preferred asset class at present. It must be emphasised that with so many problematical issues in the background, it is likely to be an uneven ride and "black swan" events seem to occur more often. Although 2010 was a profitable year for international equity investors, markets did suffer a poor second quarter before recovery set in again and 2011 may show a similar pattern.

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