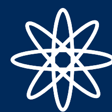
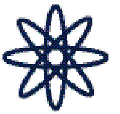


meridian

ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

It has been an encouraging quarter for international equity markets as investors sense an easing in the quantity of bad news and feel slightly less uncertain about financial and economic conditions. Conversely, high quality international bond yields as measured by ten year government bonds have trended higher as, amongst other things discussed in this review, the level of investors' risk aversion has lessened.

The tables below detail relevant movements in markets:

International Equities 30.04.09–31.07.09

Total Return Performances (%)

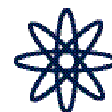
Country	Local Currency	£	US$	€
Australia	+12.6	+13.9	+27.4	+19.1
Finland	-4.0	-8.2	+2.7	-4.0
France	+11.2	+6.3	+19.0	+11.2
Germany	+11.4	+6.6	+19.2	+11.4
Hong Kong, China	+35.7	+21.3	+35.8	+26.9
Italy	+10.1	+5.3	+17.8	+10.1
Japan	+13.2	+4.6	+17.0	+9.4
Netherlands	+21.8	+16.4	+30.3	+16.4
Spain	+23.9	+18.5	+32.6	+23.9
Switzerland	+14.0	+7.8	+20.6	+12.7
UK	+9.9	+9.9	+22.9	+14.9
USA	+13.7	+1.6	+13.7	+6.3
Europe ex UK	+13.7	+8.8	+21.8	+13.8
Asia Pacific ex Japan	+21.2	+14.2	+27.8	+19.4
Asia Pacific	+17.0	+9.3	+22.3	+14.3
Latin America	+15.0	+15.2	+28.9	+20.5
All World All Emerging	+21.6	+14.6	+28.2	+19.8
The World	+14.1	+6.2	+18.8	+11.0

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -0.8%

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

Currency	30.04.09	31.07.09
Sterling	3.51	3.80
US Dollar	3.12	3.51
Yen	1.43	1.42
Germany (Euro)	3.17	3.28



Sterling's performance during the quarter ending 31.07.09 (%)

Currency	Quarter Ending 31.07.09
US Dollar	+11.9
Canadian Dollar	+1.8
Yen	+8.3
Euro	+4.6
Swiss Franc	+5.7

Other currency movements during the quarter ending 31.07.09 (%)

Other Currency	Quarter Ending 31.07.09
US Dollar/Canadian Dollar	-9.0
US Dollar/Yen	-3.2
US Dollar/Euro	-6.5
Swiss Franc/Euro	-1.1
Euro/Yen	+3.5

Significant Commodities (US dollar terms) 30.04.09–31.07.09 (%)

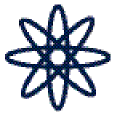
Significant Commodities	30.04.09–31.07.09
Oil	+41.1
Gold	+5.7

Markets

International equity markets have continued their recovery from their March lows and have produced satisfactory returns in the latest quarter. In local currency terms, the total return on the FTSE World Index was 14.1%, in sterling terms 6.2%, in US dollar terms 18.8% and in euro terms 11.0%. In local currency terms, the USA, Europe ex UK and Japan performed similarly with returns of 13.7%, 13.7% and 13.2% respectively. The FTSE UK Index returned 9.9%. But the stand out performances, as has often been the case recently, have been from the FTSE Asia Pacific ex Japan Index, which returned 21.2% in local currency terms, the FTSE All World All Emerging Market Index, which returned 21.6% and the FTSE Latin America Index which returned 15.0%. Elsewhere, Australia returned a very creditable 12.6% in local currency terms. Within Europe ex UK, there were exceptionally good performances from Spain with a 23.9% return and the Netherlands with one of 21.8%. Finland was disappointing with a negative return of 4.0%. With sterling being generally stronger, only Australia at 13.9% and Latin America at 15.2% saw their sterling returns higher than the local currency returns. Nevertheless, returns from the FTSE Asia Pacific ex Japan Index and the FTSE All World All Emerging Markets Index at 14.2% and 14.6% respectively, in sterling terms, were still excellent. The returns on the FTSE Europe ex UK Index, the FTSE Japanese Index and the FTSE USA Index reduced to 8.8%, 4.6% and 1.6% respectively, in sterling terms.

High quality government bonds, as measured by ten year maturities, except for Japan, experienced a significant uplift in gross redemption yields in the case of sterling and US dollar bonds and a modest uplift in the case of German bonds. In the UK, the yield rose by 29 basis points to 3.8%, in the USA by 39 basis points to 3.51% and in the case of Germany by 11 basis points to 3.28%.

In the foreign exchange markets, sterling was surprisingly strong given the poor fundamentals. Against the US dollar it rose by 11.9% over the quarter, against the yen by 8.3%, against the Swiss Franc by 5.7%, against the euro by 4.6% and against the Canadian dollar by 1.8%. In the commodity markets, the price of oil rebounded strongly by 41.1%, whilst gold was 5.7% higher both in terms of a weak US dollar.



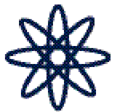
Economics

During the last quarter, we have seen the strange, but not unusual, position of international equity markets appearing to be detached from economic reality. Out in the real world, conditions remain grim, even if slightly less so than earlier in the year, but to look at the stock market you would not recognise current conditions. From its low point on 9 March 2009, the FTSE World Index has recovered 45.2% in local currency terms, 31.7% in sterling terms (from 6 March 2009), 56.2% in US dollar terms (from 9 March 2009) and 39.2% in euro terms (from 9 March 2009).

The apparent disconnection between the stock market and the real economy reflects the fact that the former looks ahead and it scents rather better times ahead or, at least, less bad ones. It seems a long time ago since last autumn but, if we cast our minds back to those days, there was real fear and uncertainty around. Fears that the banking system would collapse were real and nothing spooks investors more than uncertainty. Investors had to take a view on events but were confused by so many uncertain variables that this was very difficult to do, hence the very bad stock market conditions and the flight to perceived safety in assets such as high quality government bonds. Although we took the view that governments and central banks would have to support the banking system, as the alternative was too awful to contemplate, not everyone did, and the sheer level of uncertainty created an incredibly tense and depressed mood. But the banking system was saved and we think it is safe to say that improved stock market conditions are largely due to the removal of that uncertainty. To some extent, therefore, we can say that the recovery from last autumn's severe weakness and, then again, March's low point, reflects a relief rally. This is probably the most simple explanation of what has happened. Risk aversion has reduced and the recovery in equities and weakness in high quality bonds reflect this situation.

However, pronouncing the banking system saved is a very strong statement and we need to expand further on such a sweeping remark. It is perhaps more correct to say that governments and central banks understand how to react to problems and that this has given bank depositors more comfort, making it much less likely that there will be a run on major banks. There is enormous work to be done on restoring many banks to health and, as the recession runs its course, further businesses and customer bad debts will build up. There is also, and we appear to be seeing the start of it in the UK, the potential for conflict between the banks, which have received government money, and the governments which have provided it. The political and populist demand that banks get lending money again at reasonable interest rates to businesses and home owners is easy to understand against the background of the bailouts and the anger at what some bank managements did, but it is important that the head rules the heart. Having invested all this money on behalf of taxpayers, governments will want some return from this investment. This means that banks must restore their profitability in ways which do not make them popular, i.e. widening their margins and turning down potential borrowers who are considered too risky for the margins being considered. Similarly, for potential house purchasers, more old fashioned multiples of house value and incomes are returning. Ultimately, a return to more prudent lending will benefit both borrowers and the banks but, for the moment, it means a severe restriction on mortgage lending which keeps house prices depressed even though there are some slightly more optimistic signs in the USA and UK on this front. Banks are also being helped on the road to a return of profitability by the shape of the yield curve, with short term interest rates near zero in the USA, eurozone and UK, for example, enabling them to invest further out on the yield curve to pick up return. There is some echo of what happened in the USA after the savings and loans crisis broke. The shape of the yield curve helped some institutions to rebuild their profitability and balance sheets.

As a very broad generalisation, we can say that some stability has returned to the banking sector and that a path has been set for the restoration of profitability. Bad debts are likely to remain a problem because of the state of the economy but, in terms of depositors' concerns, authorities, internationally, appear to have worked out how to deal with financial institutions with problems. That is an important plus for investors.



It is difficult to imagine a bigger worry for investors than a collapse of the banking system. With that worry, hopefully, removed in the sense that the authorities appear to know how to deal with problems as they arise. There is less cause for pressures and more reason for an equity recovery. But there are still a myriad of other problems and we will discuss some of these in this review to see how they may impact on investors.

Of most concern to us is the level of debt which governments are accumulating relating to the sudden onset of recession and the cost of bailing out the banks. An indication of the broad levels and what might be termed budget deficits was given by the OECD in its interim report at the end of March, shown in the table below.

General government financial balance

surplus / deficit as a % of nominal GDP

	2009	2010
USA	-10.2	-11.9
Japan	-6.8	-8.4
Germany	-4.5	-6.8
France	-6.6	-8.3
Italy	-4.7	-5.9
UK	-9.3	-10.5
Canada	-4.4	-6.2
Euro area	-5.4	-7.0
Total OECD	-7.2	-8.7

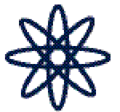
Source: OECD

Even if they are only broadly correct, and there is some expectation that some of them may be worse, they are astonishing figures and, for some countries such as the UK, they present very real economic and financial dangers. The reasons are very clear but it does no harm to spell them out.

Firstly, the deficits have to be financed. Other things being equal, an increase in net borrowings each year raises the interest bill and, therefore, the level of government spending. A government cannot borrow indefinitely to finance the interest costs on its debt because the compounding effect is horrendous. Taxes will either have to be increased or public expenditure cut to pay for increased debt servicing costs. The more a government has to borrow, the greater the danger to its credit rating and the higher the relative cost of its borrowings against those of countries with a higher credit rating. Furthermore, in the present economic situation, interest rates have been abnormally low. Were they to revert to historically more normal levels, the debt servicing burden would start to rise even more quickly. The ultimate sanction on a profligate government is a refusal by investors to buy a country's debt because the risk of default is considered to be too great. If we take the UK, approximately one third of the gilt market is estimated to be owned by foreign holders. Because of the danger that foreign creditors might take fright, such an exposure places a country's currency at risk if they sell or if a country does not have the capital inflows to support a currency. If a country is unable to finance its deficit, it risks monetising its debt with the resultant inflation risk. The more a country borrows, the more it puts itself in the hands of its creditors.

It might be argued that nearly every country is having to borrow money to finance its deficit. This is true, but some countries are in a better position than others. They may have a low overall level of debt or their budget deficit may be relatively low. The relative position matters and those countries which are perceived to be relatively badly placed could be very vulnerable.

Politics often clouds the situation. At a time when these deficits are in serious need of addressing or of setting a timetable set out for reducing them, the fear of taking unpopular measures can deter politicians from setting out before an electorate what needs to be done. A prime example is the UK where the deficit size is particularly serious.



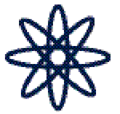
Avoiding the word "cuts" at a time when most economists recommend dramatic cuts in public expenditure and some tax rises, threatens to destabilise the pound and the funding of the present deficit should foreign investors believe that the present or next government is not serious about tackling the problem. The looming election is stifling proper debate and the setting out of an action plan to bring public finances under control.

As the OECD table shows, the size of the US deficit is also alarmingly large. The USA does have an important advantage over the UK in that the US dollar is the major reserve currency and much trade is circulated in US dollars. For a major holder of US dollars to effect an important shift in the composition of its reserves risks an own goal if it weakens the US dollar. This risk to holders of US dollar reserves gives some reassurance to the US authorities at a time when the budget is spilling red ink in unprecedented quantities.

Although inflation is generally at very low levels, or even negative, our view remains that current government bond yields are very inadequate for the risks involved. As investors' level of risk aversion lessens and they lean more towards equities, so we are likely to see the continual upward pressure on bond yields, as governments everywhere have to raise vast sums of money in the bond markets. Whilst a moderate rise in bond yields may be seen as healthy in that it reflects a return to more normal conditions and equities can rise, too, in those circumstances, a very sharp rise would be damaging to not only equities but also the international economy. The trick, generally, will be to reduce budget deficits at a rate which is acceptable to the bond markets and at a rate which is not so dramatic that it threatens a continuation of the recession. For countries where the current deficit is relatively modest in relation to GDP, although high in actual terms, and overall levels of public debt in relation to GDP manageable, the process can be more gradual and, therefore, less threatening to growth. For countries, like the UK, which are running exceptionally high deficit levels, the need for action is greater but run with it the risk of damage to growth prospects.

To stabilise the position and prevent a recession growing into a depression, governments and central banks everywhere have been following exceptionally loose fiscal and monetary policy, evidenced by huge budget deficits and extraordinarily low interest rates. But, apart from the financing threat, touched upon earlier, if the deficits are not addressed, there is also the threat of inflation developing from such policies. Apart from anything else, it is important that interest rates do start to move towards more normal levels. The balance between savers and borrowers has become seriously distorted and this could spread to other asset markets, such as bonds, as investors move along the yield curve into what we consider risky territory.

Investors will also be concerned to know how deficit reduction plans will be enacted, because, for them, as opposed to the politicians, there are less and more desirable ways to do this. In practice, in most countries, the policy will comprise a mixture of tax increases and public expenditure reductions. It might seem as if the mixture does not matter as long as it reduces the deficits. But we do not agree that this is the case. If tax increases act as a disincentive for the productive part of the economy, i.e. the private sector, then future growth will be adversely affected and with it the tax revenues which the companies and individuals employed bring. Like tax increases, cuts in public expenditure will have a negative short term effect on the economy but they will have more of a continuing effect than tax increases in restraining the budget deficit. By way of example, let us consider the possible effect of the forthcoming rise in the top rate of income tax in the UK to 50% from 40%. The increase has evoked fierce criticism in certain quarters, largely based on the increasing mobility of individuals and entrepreneurs. Let us suppose that the critics are right and a business moves abroad, perhaps a Mayfair based hedge fund management group. We accept straight away that this industry has few defenders at present but, let us ignore this, and look at the economic consequences. The loss of business and personal tax from those employed would be permanent if the business left the UK. The spending generated by the businesses and the individuals employed would disappear, leading to job losses and business closures for those affected. The tax paying base would be permanently affected as would job opportunities in the businesses affected. The loss of incentive associated with the private sector would be a disadvantage for the UK economy. This is a very simple and very generalised example but it serves to make the point. By extension, it is better for investors for the private sector to be flourishing which means that the stock market should perform better. How governments tackle the deficit reduction issue will be important for the stock market.



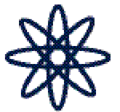
One of the extreme measures taken in the UK, USA, and now the eurozone, in different forms, is quantitative easing, a rather polite and modern day way of saying "printing money". It involves the relevant central bank buying assets such as bonds from the financial sector and, at a stroke of the keyboard, creating a deposit for them which will hopefully have a significant money multiplier effect, boosting the money supply, and, at the same time, bring down bond yields to make it easier for corporate borrowers. It is a highly dangerous game and, unless reversed carefully in due course, likely to be inflationary. Those who disagree with this view point to the output gap in the world economy, the difference between actual output and potential output. With the former being well below the latter, the argument goes that pricing power will be weak. But, in time, a larger amount of money chasing a limited supply of goods and services will bid up prices and inflation will develop. This is why there is so much attention, particularly in the USA at present, to mapping out an exit strategy from the policy of quantitative easing. Whilst some areas now have negative inflation, we do not see this as a persistent problem, given extremely loose monetary and fiscal policy. Some signs of "green shoots", which we will indicate later, give comfort to the view that a period of deflation, as opposed to a short period of falling prices in certain countries, is unlikely. One might ask why one should be worried about the possibility of falling prices. Surely, that is better than rising prices which most of us have been used to. For those who are not borrowers, that may be so. Their purchasing power increases but, in the general economy, it would be bad news as it could cause a recession to lead to a depression. Non essential purchases would be held back, damaging manufacturers, probably some service providers, and borrowers who would see the real value of their liabilities increase, whereas, in the past, they would be used to seeing them being whittled away by inflation, at the same time as their houses, against which they might be borrowing, were rising in value. However, one senses that fears of deflation are receding, a view with which we concur.

Whilst we have highlighted the dangers of deflation, this is not in any way to imply that inflation is a good thing. At a very modest rate, say 2%, it can be argued to be beneficial. The expectation of rising prices does not hold back expenditure and helps economic growth, completely the opposite of what occurs in a deflationary environment. At the same time, it only modestly eats away at savings and, in normal times, when interest rates are positive in real terms, it is not a serious problem. A high rate of inflation destroys savings and, if higher than the rate of inflation amongst competitor countries, will cause a loss of competitiveness, perhaps leading to currency weakness and still greater inflation.

In this context, it is quite possible that the sheer viciousness of the downturn and collapse in demand has changed companies' and individuals' behaviour and attitudes. It has increased the flexibility of business models. Pay reductions, time off and reduced working hours have been more widely accepted than in previous recessions as a way of reducing the level of redundancies. This has the economic advantage of reducing costs when a business upturn occurs and saving some redundancy costs in the short term. A higher level of skills is likely to be retained. Pay is regularly considered to be what economists call "sticky" on the downside. If it is more flexible on the downside, it is ultimately likely to be more beneficial for everyone in terms of maintaining a higher level of jobs, keeping businesses more competitive and enabling economies to recover more quickly from recession.

So far, this is almost exclusively a private sector phenomenon. Desperate circumstances require desperate measures. The public sector, where the view is prevalent that these disciplines do not apply, is likely to face pressure to adopt similar attitudes as governments seek to cut spending around the world to address excessive budget deficits. This will be very difficult to achieve but the threat to many countries' financial stability, caused by very high levels of borrowing, might just achieve the same attitude change as in the private sector. If that saves jobs, that is an economic as well as an obvious social benefit. Economies and labour markets which are more flexible and without economic rigidities are much better placed to withstand the present economic difficulties and bounce back.

In recent reviews, since the financial crisis became the dominant issue, we have made our reviews more philosophical in nature trying to reflect on how events will turn out and, by extension, how that would inform investment policy. With the banking crisis having been addressed, as we discussed earlier, there is more stability in the world economy, albeit at a very depressed level, and therefore economic data and forecasts are becoming more relevant than they were.



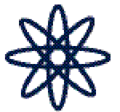
At the height of the crisis, economic data was being rendered irrelevant, so fast were events moving. By no means are we anywhere near normality now but economic data and forecasts are becoming more relevant so we now start to bring them into our reviews as we used to, albeit in a more limited way until events truly get back to normal.

To put matters into perspective, the International Monetary Fund's latest update, in July, of its World Economic Outlook paints a slightly better view of economic prospects in 2010 than it did last April. It sees world output contracting by 1.4% this year, a fractionally worse outcome than it indicated then but it has raised its forecast for 2010 by 0.6% to 2.5% growth. Its forecast for the USA is upgraded for both years by 0.2% and 0.8% respectively to growth of -2.6% in 2009 and +0.8% in 2010. Its forecasts for the eurozone show how badly it has been affected with its forecast for 2009 showing growth of -4.8%, a reduction of 0.6% over its April forecast, whilst its 2010 forecast has been improved by just 0.1% to -0.3%. The forecast for Germany is particularly dire at -6.2% for 2009 and -0.6% for 2010. Although the forecast for Japan is also very gloomy for 2009 at -6.0% (very slightly less gloomy than its April forecast) it has increased its forecast for 2010 quite significantly, by 1.2% to growth of 1.7%. It has very slightly downgraded its forecast for the UK to -4.2% this year but has upgraded it by 0.6% for 2010 to forecast growth of 0.2%. The so called BRIC economies (Brazil, Russia, India and China) are, of course, very important in the context of the world economy and, apart from Russia, which is showing a sharp contraction this year with the IMF forecasting growth of -6.5%, and Brazil to a lesser extent (forecasting growth of -1.3% this year), they are performing relatively well. The IMF sees growth for China of 7.5% this year (up 1.0% from its April forecast) and 9.5% next year (also up from 1.0%). For India, its growth forecasts have been raised by 0.9% in 2009 and 2010 to 5.4% and 6.5% respectively. After growing by -1.3% this year, unchanged on its April forecast, Brazil is forecast to grow by 2.5%, 0.3% higher than forecast in April.

So, whilst the forecast for world output to grow by 2.5% is not spectacular (this is less than half the level achieved in 2007, 5.1%), it is riches compared with the 1.4% contraction forecast for this year. Therein lies a clue for the rationale in the recent recovery in international equity prices. Markets look ahead and they are anticipating better economic times. The severe measures needed to improve public finances in many countries mean that growth is likely to be steady rather than spectacular, but an economic recovery which is underpinned by improving trends in public finances is likely to be more sustainable.

The IMF is also reasonably sanguine about inflationary prospects or, rather, the absence of deflation. In the advanced economies, it sees inflation as measured by consumer prices, rising just 0.1% this year and 0.9% next year and for emerging and developing economies the relevant figures are 5.3% and 4.6%.

Given the current very difficult conditions in the world economy, one might wonder why a significant turnround might be seen next year, albeit from negative growth to modest growth. Firstly, the stock cycle explains some of the recovery. When the world economy juddered to a standstill, and worse, after the financial storms last autumn, companies drew on stocks to some degree to satisfy demand. In that way, risk was reduced because the outlook was so uncertain and working capital was released, something which was important given the reluctance of banks to lend. But this process cannot go on indefinitely without posing risks to a business arising from not being able to satisfy customers' orders. So, it is a self correcting mechanism and when stocks can be drawn down no longer, manufacturing activity increases. The stock cycle is important in explaining economic cycles. This, combined with extremely loose fiscal and monetary policy, will act as a stimulus. But, as explained earlier, extremely loose economic policy has to be reversed at some stage, otherwise an inflationary crisis will develop. As well as gradually returning short term interest rates to more normal levels, the quantitative easing policy will have to be reversed to avoid inflationary problems. That will mean central banks selling back bonds to the private sector to withdraw cash from the relevant economies and, at a time when governments will still be borrowing very heavily in the bond markets, the operation will have to be handled very carefully. It will be all too easy to do nothing and political pressure will always be in the background but the creation of money, to add to existing supplies chasing a limited number of goods and services, is the route to inflation and currency debasement. This is why, even though equity markets are currently buoyant, because they can scent some recovery, the economic road to recovery is fraught with danger.

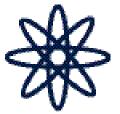


We have noted in a number of previous reviews, when the economic news has been almost 100% bad, that the road to better times in the stock market depended upon the progression of economic news from less bad, to stable to better. Whilst the majority of news is still bad, we can say that a majority of news is in the less bad to stable category and that was all markets needed to know to move off their worst levels. Against this background, we move towards the end of this review by detailing some items of news which broadly fit into the latter category.

Looking at the individual items of news from the USA, perhaps some of the most encouraging data comes from the housing sector, a crucial part of the economic system and where the financial crisis started with subprime mortgages. Again, it is important to emphasise that the news is not exciting but it does indicate a position in the less bad to stable zone of economic news. At the beginning of July, data came out showing that prices fell by 1% in April in ten US metropolitan areas and this was the slowest rate of decline for ten months. The S&P/Case Shiller composite 20 index, giving a wider reading, fell by 0.9%. Pending home sales rose by 0.1% in May, the fourth consecutive monthly rise. The NAHB/Wells Fargo housing market index, in July, was its highest level since September 2008. It stood at 17 in July, compared with 15 in June. Again, this is well in negative territory, given that any reading below 50 indicates that more builders take a pessimistic view than optimistic view but, in common with a number of other indicators, it reflects the situation becoming less bad. In June, the number of new houses started rose by 3.6% and permits to build new homes rose by 8.7%, which was the highest level since December 2008. The National Association of Realtors reported that sales in June rose by 3.6% and this was the third month in a row in which home sales rose. The Commerce Department reported that sales of newly built homes rose by 11% in June with May's figure also revised upwardly. According to the S&P/Case Shiller house price index for twenty metropolitan areas, prices rose by 0.5% in May, the first time they had risen for three years. This meant that the rate of annual decline decreased from 18.1% in April to 17.1% in May. An item of less discouraging news outside the housing sector included the ISM's US manufacturing activity index which, in June, rose to 44.8 which was the best level since August 2008. The ISM's reading for the service sector moved up to 47 in June from 44 in May. The USA's trade deficit fell to its lowest level for nine years in May with the gap narrowing to US$26 billion, 9.8% lower than the figure for April. The Conference Board's leading economic indicator rose by 0.7 in June, the third monthly increase. Finally, the Federal Reserve forecasts that, because of an expected rebound in the US economy in the second half of 2009, the fall in GDP will be limited to between 1.0% and 1.5%. It raised its growth forecast for 2010 to between 2.1% and 3.3%, compared with an April forecast of 2.0% to 3.0%. Its estimate for growth for 2011 was between 3.8% and 4.6%.

If we turn to the eurozone, eurozone industrial production rose by 0.5% in May. Indicators of an improving situation were that the Markit eurozone manufacturing purchasers managers index rose to 42.6 in June compared with 40.7 in May. This was its highest level since September 2008. Markit's eurozone flash services purchasing managers index for July rose to 45.6 compared with 44.7 in June with the manufacturing index at 46.0, compared with 42.6 in June. The European Commission's economic sentiment indicator rose to 76.0 in July from 73.2 in June. This compares with March's trend of 64.6. Within the eurozone, there were a number of more encouraging indicators from Germany. Strengthening demand in orders from home and abroad caused orders for German manufacturers to increase by 4.4%, which is the biggest increase for two years and the third consecutive monthly gain. German industrial production rose by 3.7% in May following a 2.6% increase in April. This was the fastest rate of increase for sixteen years. Industrial orders rose 4.4% in May. In Germany, the Ifo's business optimism index rose in July to 87.3 from 85.9 in June, the highest level since last October. GFK's gauge of consumer optimism rose to 3.5 compared with 3.0 in July. In France, high street sales rose at their fastest rate since last January in June, with the consumption of manufacturing goods rising by 1.4% following a 0.2% decline in May.

Turning to Asia, we note that the second quarter showed an acceleration in growth in China from an annual rate of 6.1% in the first quarter to 7.9% in the second quarter. Production in China rose at an annual rate of 10.7% in June compared with 8.9% in May. In Japan, industrial output rose by 2.4% in June, the fourth monthly rise.



Looking at the UK, as in the USA, the housing market is a crucial indicator of economic health. Plummeting house prices reduced consumer confidence and had a significantly negative impact on the economy, so any signs of improvement or stabilisation in this sector are helpful indicators for future recovery. It looks as if matters in the housing market in the UK are not getting significantly worse and may be stabilising, or even slightly improving. A number of indicators over the last month support this view. May saw the third consecutive month of increasing numbers of mortgages approved. There was an increase of 4% compared with April. The Council of Mortgage Lenders reported that gross mortgage lending rose by £12.3 billion in June, its highest level this year. The British Bankers Association reported that the number of new mortgages approved in June was at the highest level since March. The Land Registry reported that prices paid for houses in England and Wales rose by 0.1% in June, the first rise, on its data, for eighteen months. There was a slight increase in home loans approved during June to 47,584 compared with 44,169 in May. To put these figures into prospective, the long term average is 93,000 approvals per month. Gross mortgage lending by building societies rose in June to its highest level since last December but again this was 40% lower than a year ago. The Nationwide Building Society reported an increase of 1.3% in house prices in July following a 0.9% rise in June. Estate agents, too, are feeling slightly more confident. More estate agents expect house prices to rise than fall, according to the RICS. Also making them happier is the fact that the number of sales per branch rose to 12.7 on average in the three months to June compared with 11.7 in the three months to May. Outside the housing sector, there was a slight increase in the CIPS/Markit purchasing managers index to 47 in June from 45.4 in May and the gauge of manufacturing output increased to 52.1, which was the first increase in output in fifteen months. The CIPS/Markit purchasing managers index for the services sector showed its headline activity index slightly lower in June at 51.6 compared with 51.7 but in excess of 50 which indicates growth. The Nationwide Building Society, which runs a consumer sentiment index poll, reported an increase in its reading to 58 in June compared with 54 in May. The British Retail Consortium reported a 1.4% increase in sales in June, with food sales particularly strong. A Lloyds TSB survey shows improving sentiment among UK businesses with its bi-annual gauge of confidence rising to -3 in July from -32 in February. A small balance, 1%, expects a rise in sales compared with -28 six months ago.

All in all, we can see signs of a slightly more encouraging picture developing albeit from a low base. Data earlier in this review show the extent to which international equity markets have recovered from their March lows. With hindsight, we may conclude that markets fell too far but it was harder to take a view at that time, given the number of uncertainties about. Now, those uncertainties are fewer. On fundamentals, shares in most countries do not look dear with dividend yields quite attractive, certainly in relation to cash deposits and we would argue top quality bonds yields also. Forward price/earnings ratios also look reasonable on the view that the world economy will improve modestly in 2010 and thereafter. Altogether, international equity markets look to be nearer the bottom of their cycle than the top. We reiterate our caution on bonds for the reasons given. The international economic situation remains fraught with danger, but equity market movements reflect a situation that is not as bad as it was.

July 2009

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