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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equity markets have retraced some of their gains this quarter, with a recovery in July helping to limit the size of the decline. As we describe in this review, investor sentiment is fragile at present with no significant new event triggering the weakness in the earlier part of the current quarter or the subsequent recovery in July. High quality government bonds have enjoyed a good quarter whilst the yen, Swiss Franc and, to some extent, sterling, stand out for their good performances in the international currency markets.

The tables below detail relevant movements in markets:

International Equities 30.04.10 - 30.07.10

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-6.0	-10.6	-8.6	-6.7
Finland	-7.0	-11.1	-9.0	-7.1
France	-0.5	-4.8	-2.6	-0.5
Germany	-0.1	-4.4	-2.1	-0.1
Hong Kong, China	+1.2	-1.1	+1.2	+3.2
Italy	+0.2	-4.0	-1.8	-5.4
Japan	-14.1	-8.9	-6.8	-4.9
Netherlands	-3.9	-8.0	-5.9	-3.9
Spain	+3.5	-0.9	+1.4	+3.5
Switzerland	-5.3	-4.7	-2.5	-0.5
UK	-4.7	-4.7	-2.5	-0.5
USA	-7.0	-9.1	-7.0	-5.0
Europe ex UK	-1.6	-4.9	-2.7	-0.7
Asia Pacific ex Japan	-2.0	-6.8	-4.7	-2.7
Asia Pacific	-8.1	-7.8	-5.7	-3.7
Latin America	+0.4	-3.4	-1.2	+0.9
All World All Emerging	+0.2	-3.4	-1.1	+0.9
The World	-5.7	-7.4	-5.3	-3.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +3.6%

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

Currency	30.04.10	30.07.10
Sterling	3.91	3.33
US Dollar	3.66	2.91
Yen	1.29	1.07
Germany (Euro)	3.02	2.67

Sterling's performance during the quarter ending 30.07.10 (%)

Currency	Quarter Ending 30.07.10
US Dollar	+2.7
Canadian Dollar	+3.9
Yen	-5.6
Euro	+4.5
Swiss Franc	-1.0
Australian dollar	+5.3

Other currency movements during the quarter ending 30.07.10 (%)

Currency	Quarter Ending 30.07.10
US Dollar/Canadian Dollar	+1.1
US Dollar/Yen	-8.1
US Dollar/Euro	+1.7
Swiss Franc/Euro	+5.5
Euro/Yen	-9.6

Significant Commodities	(US dollar terms) 30.04.10 - 30.07.10 (%)
Oil	-5.2
Gold	+0.1

Markets

After four strong quarters international equity markets retraced some of their gains during the latest quarter although a recovery in July limited the size of the fall. In total return terms, the FTSE World Index showed a negative return of 5.7% in local currency terms, 7.4% in sterling terms, 5.3% in US dollar terms and 3.3% in euro terms. In local currency terms, in regional terms, only the FTSE All World All Emerging Markets Index (+0.2%) and the FTSE Latin American Index (+0.4%), recorded positive returns. Individual countries which showed positive returns were Hong Kong, China (+1.2%), Italy (+0.2%) and Spain (+3.5%). The Japanese market performed particularly poorly in local currency terms with the FTSE Japanese Index showing a negative return of 14.1%. Elsewhere, in local currency terms, the FTSE USA Index showed a negative return of 7.0%, the FTSE UK index 4.7% and the FTSE Europe ex UK Index 1.6%. The FTSE Asia Pacific ex Japan returned a negative 2.0%. Other than against the yen and Swiss Franc, sterling appreciated. Currency movements meant that, for sterling investors, the negative return on the FTSE USA Index exceeded that for Japan with returns of -9.1% and -8.9% respectively. The FTSE Europe ex UK Index in sterling terms showed a slightly greater negative return than the FTSE UK Index at -4.9% against -4.7%. The FTSE Asia Pacific ex Japan returned -6.8% in sterling terms, whilst the positive local currency returns for Emerging Markets and Latin American turned into negative returns of 3.4%, in sterling terms, in both cases.

Increased risk aversion due to sovereign debt concerns within the eurozone saw yields on top quality government bonds fall dramatically. The gross redemption yield on ten year government bonds fell by 58 basis points to 3.33% for sterling bonds, by 75 basis points for US dollar bonds to 2.9%, by 22 basis points to 1.07% for Japanese bonds and by 35 basis points to 2.67% for German euro denominated bonds.

In the currency markets there were mixed performances with sterling tending to strengthen as post election confidence grew in the Coalition's plan to eliminate the UK's structural deficit over the life of the current parliament. Sterling rose by 5.3% against the Australian dollar, by 4.5% against the euro, by 3.9% against the Canadian dollar and by 2.7% against the US dollar. On the other hand, sterling declined by 5.6% against the yen and 1.0% against the Swiss Franc, the latter benefiting (although the Swiss central bank would not see it that way) from flows out of the euro. Against the euro, the Swiss Franc rose by 5.5% during the quarter.

In the commodity markets, oil fell by 5.2%, whilst the gold price was virtually unchanged.

Economics

There is a division of opinion amongst economists as to whether the world economy will enter a "double dip" recession or continue to recover from last year's recession, with the balance favouring the latter proposition. This leads the market and investors to see the bottle "half full" on occasions and "half empty" on others, with poor market conditions in June being an example of the latter. What is indisputable is that the world economy is a "curate's egg", good in parts, struggling elsewhere, and that pattern looks likely to continue. It is a question of which part is the stronger influence. Based on current evidence, we favour the more optimistic construction on events. The other and related issue is whether the world moves into a deflationary environment. Although that may occur in individual countries, we do not foresee a deflationary environment overall. It is not a time to be dogmatic on these issues because each side has to admit to the possibility of being wrong. It is not a clear cut situation. Because the analysis differs, so do the solutions to the current problems, with economists locking horns on policy matters connected with deficit reduction. Should governments go hard at deficit reduction now, or proceed with caution, in order not to cause the "double dip" recession referred to above? This issue is greatly exercising the minds of politicians and economists alike.

So where are we now? The recent volatility in international equity markets suggests a great deal of uncertainty and significant mood swings. Depression in June gave way to a more confident feeling in July, yet nothing seemed to have changed. Investor sentiment can change for no apparent good reason.

However, we can, we believe, make certain statements with a reasonable degree of confidence as we look around the world. Starting with the USA, the economy looks likely to perform relatively well amongst the major industrialised economies, even if the Federal Reserve is becoming more cautious and uncertain about the outlook. The budget deficit is appalling in the USA, at around 10% of GDP. The Administration is more relaxed than most governments about the deficit and not giving top priority to reining it in. It probably feels that with the US dollar being the world's largest reserve currency and, therefore, in demand by other countries, if only by default, it can take a relatively relaxed approach to deficit reduction. It may also take comfort from the extraordinarily low level of interest rates at which the US Treasury can borrow money, approximately 0.55% for two years, 1.60% for five years, 2.91% for ten years and 3.98% for thirty years, as at the end of July. So servicing the large amounts of new debt which it is taking on is not as onerous as one might have expected. In part, the USA is benefiting from problems elsewhere. However, investors must be under no illusions. The USA has to address its fiscal profligacy, otherwise the US dollar will come under pressure and interest rates will rise. It risks losing control of the situation. The way the US political system works is not conducive to prompt action to address issues like this. The Administration has to deal with Congress which may be hostile to the Administration and the two houses of Congress may not agree with each other. It is possible that the Democrats will lose control of the House of Representatives in November's mid term elections and there is even talk that it could lose control of the Senate. The US political system, as opposed to, say, the Westminster system, suffers from being unable to make quick and decisive decisions easily. If, for example, in an economic or financial crisis, the UK government feels the need to introduce appropriate economic measures, providing it can obtain the support of its MPs, it will succeed in obtaining the necessary mandate from Parliament. The situation is much more messy in the USA. But, for the moment, the USA is growing faster than the eurozone, and the current quarter's earnings reports from US companies, being announced as this is written, are generally encouraging, with a bellwether company like General Electric starting to restore its dividend by announcing a 20% increase. At the moment, we are concentrating on the economic issues rather than the big event in the USA in the last few days, the signing by the President of the bill for new financial regulation of Wall Street. As far as the US economy is concerned, there is absolutely no room for complacency. Problems are building up, but investors' focus is elsewhere. For the moment, the USA is getting the benefit of the doubt. The latest economic forecasts from the IMF, World Bank and OECD suggest US economic growth in excess of 3% this year, much better than Europe and the UK for example. The enormous size of the US budget deficit is storing up problems for the future, but it appears not to be an immediate issue for investors.

Moving on to the eurozone, the picture is mixed. That may seem a strange statement when all we hear is doom and gloom, almost always centred around sovereign debt issues emanating from Greece but, by extension, spreading fear about what might happen in Portugal, Spain, Ireland and even Italy. What is the good news? It is that the German economy, despite the Chancellor's political woes, is doing rather well in the circumstances. The manufacturing sector is performing strongly and the profile of the German economy, with its high end manufactured goods, is well suited to provide the needs of parts of the world which are performing strongly, such as Asia, but other countries as well. The weakening of the euro has helped and some companies are taking back employees onto their payrolls and are up against capacity constraints. This is important for the eurozone because of Germany's position as its largest economy. However, this is where the good news ends for the eurozone. Germany is atypical. Most of the rest of the eurozone is struggling and a number of economies are in serious difficulty.

The bad news relates to the eurozone economies most in trouble as a result of their deficit problems, Greece, Ireland, Spain, Portugal and, perhaps, Italy, although the latter's problems are not as severe but, because of Italy's overall levels of debt, are always liable to cause problems. All of these countries, as well as other eurozone countries not on the immediate danger list, are instituting severe fiscal squeezes to reduce their budget deficits through a combination of public spending cuts and tax rises as well as reforms to the pension systems to bring an element of reality into them where they do not reflect modern day conditions and to the labour markets to make them more flexible and thus help businesses and those out of work to give them more opportunity to get into work. Spain is a good example of the latter. It has a very rigid labour market which makes it unattractive for businesses to take on staff and creates a large gulf between those in work and those out of work.

The fiscal adjustment necessary to address the large budget deficits is brutal, involving high percentage single digit figures of GDP spread over the adjustment period, but it was, of course, profligate spending which caused these countries' problems in the first place. The pace at which the adjustments are made is, as we said earlier, an issue which divides economists. The argument for spreading out the period of the adjustment is that there are no significant offsetting drivers of growth and that, therefore, to go into overkill now creates a vicious circle of economic contraction and falling tax revenues and higher government spending on entitlements such as social security. The opposite argument, the one for addressing the deficit head on now, and the one which is winning the day in the eurozone, is for action now. We believe this is the correct approach because it recognises market realities. Bond investors are not likely to tolerate a country which drags its feet on measures to curb its deficit. They want to see action, otherwise such a country will be unable to fund its deficit and interest payments will drive the country into default. There is no way in which a country like Greece can continue to pay 11.03% on three year government bonds and 10.31% on ten year government bonds, as it is doing at the end of July. A country is more likely to be able to borrow money if it is trying to put its house in order. That does not negate the economists' argument about creating a vicious spiral of contraction but, what is certain, is that no action, or what is perceived as too leisurely action, will shut a country out of the international debt markets.

It may seem tedious to keep repeating comments in previous reviews about the price which these countries are paying for being in a monetary union, but it is important to reflect on the results of this. The catalyst for some offsetting growth to combat public expenditure cuts is private sector growth. In a position of freely floating exchange rates, countries such as those struggling eurozone countries mentioned above, which have lost significant competitiveness against Germany, for example, would be expected to have experienced exchange rate depreciation. Exports could be expected to have risen and some import substitution to have taken place which would have increased economic activity in the private sector. As the public sector contracted, the private sector could make up some or, even, all of the leeway. But, of course, this cannot happen in the eurozone with the exchange rate being fixed. Therefore, the only way to restore competitiveness against members of the eurozone which have increased their relative competitiveness is to deflate and reduce costs. This may be done through pay cuts across the economies in question, but it is difficult to imagine the population standing for this, and social unrest would surely follow in most of the affected countries.

We mentioned earlier that Germany was benefiting from the weakening of the euro as it made its goods more competitive in export markets. This will also help countries like Greece, in tourism for example, in attracting visitors from outside the eurozone from countries whose currency had appreciated against the euro. However, being bound into a fixed exchange rate through monetary union does not improve a country like Greece's relative position within the eurozone. On the other hand, if Greece had its own currency, depreciation of that currency against the euro or, say, Deutschemark, if one was looking at legacy currencies, would improve exports or create import substitution activity. For this to be the case, however, Greece must have goods and services which eurozone countries want to buy. Tourism is such an example. At present, whilst countries like Greece remain in the eurozone, there is no escape hatch. Although we will not dwell on it as an issue this month, we maintain our view that the eurozone cannot continue in its present form and will fragment, whether by the stronger countries leaving it or, more likely, the weaker ones, because the populations will not stand for the years of austerity necessary to regain their countries' competitiveness. Whatever happens, it is going to be very messy.

For the moment, however, sentiment towards the eurozone has slightly improved in recent weeks, evidenced by some recovery in the euro. As this is written, the results of the Committee of European Banking Supervisors' stress tests have been announced with only 7 of all the 91 tested failing it, giving a capital shortfall of just €3.5 billion. 5 of the 7 failures were in the cajas of Spain, as expected. There was one German failure and one Greek failure.

Although immediate market action has been fairly subdued, the issue of the European and, in particular, the eurozone banks will not go away. The issue of sovereign debt is paramount. In the stress tests, there was no allowance for sovereign debt default, although "haircuts", discounts on the value of European sovereign debt held, were factored in at various levels. Also, only bonds on the banks' trading books were considered.

Is this realistic? The levels of yields on Greek bonds, referred to earlier in this review, certainly do not suggest any expectation of full debt repayments. The "haircut" for Greek sovereign debt factored in by the CEBS was 26%. As we can see from the yield premiums of the most lowly rated eurozone government debt, compared with the highest rated, Germany, investors are concerned about the risks. If we look at the 10 year government bonds as a yardstick compared with the relevant German government bond, we see yield premiums as follows: Greece (764 basis points), Portugal (264 basis points), Ireland (241 basis points), Spain (159 basis points) and Italy (130 basis points), all at the end of July. Greece, of course, is in a league of its own, but these yield premiums, apart from possibly Italy, do not inspire a great deal of confidence.

Confidence is what it is all about. Taking Eurostat's figures for 2009, Greece was estimated to have an annual government deficit as a percentage of GDP of 13.6% and a level of government debt as a percentage of GDP of 115.1%. The relevant figures for Portugal were 9.4% and 76.8%, for Ireland 14.3% and 64.0%, for Spain 11.2% and 53.2% and Italy 5.3% and 115.8%. Each of these countries has a problem or problems but they differ.

For Greece and, to a lesser extent, Portugal, the problems relate to both the size of the current deficit and that of the overall level of debt outstanding in relation to GDP. It is useful to remember that the Maastricht limit for the latter was 60%. For Ireland and Spain, the main problem is the size of the current budget deficit, but, so large are they in both countries, that they could spill over into concerns about the overall level of public debt in relation to GDP, and, in any case, Ireland is over the Maastricht limit. For Italy, the problem is that whilst the current budget deficit does not look too bad in relative terms, although again it is over the Maastricht limit of 3%, the overall level of public debt in relation to GDP is very high. Countries with high levels of public debt in relation to GDP are in a vulnerable position, should interest rates rise, because of an across the board increase or because of a relative increase or because of both. The more regular refinancing of debt implied by high overall levels of debt could be a problem in markets like we have at present.

Economic growth is one way to improve public finances. It should be helpful in raising tax revenues and in restraining government expenditure on items like social security payments related to unemployment. One driver for growth would be devaluation, which gives a short term impetus to exports and import substitution, although providing longer term problems in the form of additional inflationary pressures. In the absence of a relative devaluation against more competitive eurozone partners and only an absolute devaluation against non euro currencies, it will be difficult to rekindle economic growth in the worst affected eurozone economies. Although it is essential that the public finances of the worst eurozone offenders are tackled, the risk, as the argument amongst economists to which we referred earlier shows, is that the affected countries will go into a vicious spiral of economic contraction and that the debt problem will become worse.

The issue which will worry eurozone leaders and the ECB is that a large amount of eurozone government debt is held by eurozone banks and, as we mentioned above, the stress tests for European banks did not build in the possibility of a sovereign debt default. Figures from the Bank for International Settlements show that in December 2009 exposure to Greece, amongst European banks, amounted to €188.8 billion, to Portugal €240.7, to Ireland €638.3 billion and to Spain €856.0 billion. Of these amounts, French banks' exposure was €399.8 billion and German banks' exposure was €514.2 billion. That of UK banks was €341.0 billion, with over half of that to Ireland. Notwithstanding the stress tests, if any sovereign debt default occurred, it would be a serious problem for the eurozone and, so, there is absolutely no room for complacency. This is why, notwithstanding very serious debt issues in the USA, the latter is relatively better placed than the eurozone.

What further measures might the governments or central bank in the eurozone take to mitigate the serious debt problems and to stimulate the eurozone economy as a whole, notwithstanding that Germany is doing quite well at present? Interest rates are likely to remain very low whilst fiscal policy is being significantly tightened. But might the ECB go further? Whilst the UK and USA have engaged in quantitative easing, i.e. the modern version of printing money, the ECB has not. Its bond purchasing programme, aimed at keeping down yields on the issues of the most troubled eurozone economies was sterilised, i.e. the purchases were funded by raising money not creating balances in the sellers' bank accounts. Although it would be more difficult in a monetary union comprising different countries, quantitative easing could occur and, much as it would go against the grain for the ECB to sanction it, it may have to approve such a move as a last resort to try to keep the eurozone economies moving.

The actions of the new coalition government in the UK have, so far, been well received in international markets, as evidenced by the move upwards in the value of the pound and the decline in gilt edged yields. Unlike the USA, which has not shown the same enthusiasm for tackling its budget deficit as the UK, and it has not had to for the reasons we have given earlier, and the eurozone which has not gone as far as the UK, the new government set out in its June budget to eliminate the structural deficit over the lifetime of the current parliament. On the Eurostat figures, to which we referred earlier, the UK came behind only Ireland and Greece in the level of government deficits as a percentage of GDP in 2009 with a level of 11.5%. As a percentage of GDP, public debt stood at 66.1% but rising fast given the level of government deficits being accumulated each year.

The Chancellor announced his intention to eliminate the structural element of the budget deficit by 2014/5, which will take the UK up to the end of the current parliament, if it lasts the full five years. The overall level of public sector net debt as a percentage of GDP is forecast to peak at 70.3% in 2013/4. Setting out targets is easy, achieving them is more difficult, especially with the savage adjustment needed to restore UK public finances onto a proper footing. At the end of the day, as the Chancellor has often repeated, the maintenance of the UK's AAA credit rating is of paramount importance and the new government has make a good start on this score. But it is the lull before the storm in the UK, and the autumn spending review, which will be, and has to be, brutal, will bring home how serious matters have become for the UK. The political will of the coalition government will be tested to the limit and significant industrial unrest is likely, but it is taking the right course of action to rectify a position into which UK public finances should never have been allowed to deteriorate. The UK has one big advantage over the eurozone in that it retained its own currency. Although the pound has made some recovery after the substantial fall in 2008, the UK has gained some competitive advantage which one would expect it to be able to exploit, albeit that it is hindered by the weak state of the European market, its largest export destination.

The most indebted country of all is Japan, with public debt as a percentage of GDP approaching 200% at the end of 2009. Although it is obviously an issue of which investors are aware, Japan's indebtedness is way down everyone's list of concerns at present. Most of Japan's debt is held internally, about 90%, and Japan's famously low interest rates make the cost of servicing the debt manageable. It is, however, becoming more of an issue in Japan, as the contentious issue of raising consumption tax is aired. The issue will have to be addressed. The latest OECD Economic Outlook forecasts a fiscal deficit of 7.6% of GDP this year and 8.3% next year. As with the US deficit, this is not the top of investors' worries at present, as the level of the yen and Japanese bond yields shows.

Looking at the good part of the world economy, Asia ex Japan, parts of Latin America and some emerging markets, circumstances are altogether different. Strong growth, even accompanied by inflationary worries in countries like China and India, is evident, and the strength of these economies is helpful to the west and Japan where conditions are more difficult. In China, the authorities, who acted decisively in 2009 to prevent the economy from contracting in the face of the financial and economic crisis, are now trying to dampen down the inflation in house prices to stop inflation spreading to the wider economy.

Three sets of economic forecasts from the IMF, OECD and the World Bank, published in April, May and June, respectively, illustrate the general comments which we have made so far about the different areas of the world economy. At the bottom end of the growth forecasts, not surprisingly, is the eurozone and, at the top end, the so called BRIC economies, Brazil, Russia, India and China. As always with forecasts, the magnitude may be wrong, but the profile is not likely to be, and the satisfactory (in the circumstances) overall level of growth expected this year is due to these economic powerhouses. For those worried about deflation, the insatiable desire for natural resources by these economies is likely to keep demand for commodities buoyant, and with it, prices. Excerpts from these three economic forecasts are shown below:

IMF Projections (world output year over year % change)		
	2010 (estimate) %	**2011** (estimate) %
World output	4.2	3.3
USA	3.1	2.6
Euro Area	1.0	1.5
Germany	1.2	1.7
France	1.5	1.8
Italy	0.8	1.2
Spain	(0.4)	0.9
Japan	1.9	2.0
United Kingdom	1.3	2.5
Canada	3.1	3.2
Newly Industrialised Asian Economies	5.2	4.9
Russia	4.0	3.3
China	10.0	9.9
India	8.8	8.4
Middle East & North Africa	4.5	4.8
Brazil	5.5	4.1

Source: IMF World Economic Outlook Update - April 2010 (excerpts)

Real GDP Growth		
	2010 (estimate) %	**2011** (estimate) %
USA	3.2	3.2
Japan	3.0	2.0
Euro Area	1.2	1.8
Germany	1.9	2.1
France	1.7	2.1
Italy	1.1	1.5
Spain	(0.2)	0.9
United Kingdom	1.3	2.5
Canada	3.6	3.2

Accession and Enhanced Engagement Economies		
	2010 (estimate) %	**2011** (estimate) %
Brazil	6.5	5.0
China	11.1	9.7
India	8.3	8.5
Russia	5.5	5.1

Source: OECD Economic Outlook - May 2010 (excerpts)

The latest of the three forecasts detailed in this review comes from the World Bank and an excerpt from their forecasts for economic growth is shown below :

World Bank Forecasts for Economic Growth		
	2010 (estimate) %	**2011** (estimate) %
USA	3.3	2.9
Japan	2.5	2.1
Euro Area	0.7	1.3
Germany	1.3	1.5
France	1.1	1.5
Italy	0.6	1.0
Spain	(0.8)	0.8
United Kingdom	1.2	2.2
Canada	3.4	3.0
Brazil	6.4	4.5
China	9.5	8.5
India	8.2	8.7
Russia	4.5	4.8

Source: World Bank - Global Economic Prospects - June 2010 (excerpts)

The variations in economic performances between regions and countries will influence the mix of economic policy. In regions and countries like much of Asia, Australia and Canada, which are performing well, monetary policy can be expected to be tightened, enhanced by interest rate rises which we have been seeing for a while in countries like Australia, one of the first to start tightening last year, as well as India and Brazil amongst others. China has also been tightening policy by raising the banks' reserve ratios. It is desirable that those countries should be following a more conventional monetary policy. They had no need to introduce extreme monetary policy measures like quantitative easing. The relative robustness of their banking systems meant that they did not experience the level of economic fallout of countries where there was a financial crash. The conventional wisdom is that if interest rates are set too low, say, for example, below the rate of inflation, inflationary pressures will develop because of extra demand for credit at possibly negative real interest rates or no more than very low real interest rates. In these circumstances, asset prices could rise, leading to an inflationary fallout in the economy. A distortion of the financial markets caused by artificially low interest rates which drives money into other assets for yield, risks inflation, so these countries, which are performing relatively well, are keen to return to a more normal position on interest rates.

On the other hand, in heavily indebted countries which are experiencing severe deficits in their public finances and facing a fiscal squeeze which will have a deflationary impact on their economies, monetary policy might have exhausted its potential to give the relevant economy a further stimulus. If official interest rates are near zero, there is no room for them to fall. Furthermore, if an economy is experiencing a period of deflation, even zero interest rates mean a positive real rate of interest. With conventional monetary tools being exhausted, unorthodox measures like quantitative easing, i.e. the effective printing of money, may find further uses. So it is not out of the question that we will see more quantitative easing from the USA and UK end and perhaps its adoption in the eurozone as an extreme method to stimulate their economies and provide a further boost to asset prices which might stimulate a positive wealth effect. This course of action is a risky one. Money cannot be printed without running serious inflationary risks down the line. It is an easier policy to institute rather than to reverse. The money "printed", to put it at its most basic, has to be withdrawn at some stage. Thus, if quantitative easing is evidenced by a central bank purchasing bonds from the private sector and creating bank deposits for the seller of the bonds, that process has to be reversed at some stage, say, by the central bank selling the bonds back to the private sector, thereby cancelling out the originally created money. Other things being equal, that may be expected to raise interest rates as a big seller of bonds enters the market at a time when the relevant government is borrowing heavily. Exiting quantitative easing is tricky, but a further instalment of it may be necessary to prevent economic recession or a period of very low growth.

Looking at the world economy, there is some, but not total, agreement on what needs to be done. The USA, although the market is not yet pressurising the Administration for action, must address its deficit problem or the markets will force it to take action. The US President is seen in the "tax and spend" camp, whereas it is felt that the instincts of many Americans are against accumulating ever increasing amounts of debt. It seems quite likely, on the evidence of current opinion polls, that the mid term verdict of the voters will give a boost to those in Congress who are seriously concerned about the trajectory of US government debt. So the situation is not without hope in the USA that a serious strategy to tackle the mounting deficits might emerge from the mid term elections onwards.

In the UK, as we mentioned earlier, the boldest measures to tackle the serious deficit problem have been announced by the Coalition and its plans have been well received, as evidenced by the movements in gilts and the pound. But there is going to be serious opposition to the details of the measures when the spending review is published in the autumn. It is difficult to know how this is going to play out in the UK. Before May's General Election, none of the political parties really spelled out to the electorate the extent of the adjustment which had to take place in the UK economy in order to restore confidence in the UK and maintain the UK's AAA credit rating. In one sense, the Coalition has been fortunate. No sooner had the election results come in than the Greek debt crisis attracted the full attention of the markets. It gave the Liberal Democrats the chance to reverse their "no early cuts" policy because it was able to draw attention to the crisis in the financial markets caused by contagion from the Greek debt woes. Already, we see the lobbyists coming out against public expenditure cuts, citing the danger they will do to their particular areas of involvement. There are bound to be major industrial relations problems and the scene is set for a difficult autumn and winter. The Coalition has a big public relations exercise to conduct to convince the electorate that the economic sacrifices are necessary to restore credibility to the UK's public finances. In this, it is not likely to receive any help from the Opposition, which will focus on the effects of the spending cuts rather than deficit reduction. However, sometimes it is easier to stay with tough decisions when there is no alternative course of action. The frightening level of the UK's budget deficit would mean that any backsliding would be likely to be heavily punished by markets, with the strong possibility of a credit downgrade for the UK which is something no government would surely wish to contemplate. So, it will be a battle for the hearts and minds of the electorate. As few will emerge unscathed from the effects of the austerity measures, will the electorate blame the previous government for presiding over such an alarming deterioration in the UK's public finances or blame the Coalition for imposing such savage austerity measures? The other issue is whether the Coalition can hold together. The coming together of two political parties with such disparate views is a modern day experiment for the UK political system. We already see evidence of unease on both partners' back benches and this is inevitable even in good times. With the probable extent of the political unpopularity which the Coalition is going to endure, loyalty to the Coalition will be tested to the core. The desire at the top of both parties for the agreement to endure for the period of a full parliament appears strong but the Coalition will be at the mercy of some unpredictable events. This will be highly relevant for the UK stock market. The best scenario would be for a successful programme of structural deficit elimination over the five year parliamentary term, as outlined in the recent budget. If that "crowds in" the private sector as a result, that will be a highly desirable result. On the other hand, if, for any reason, the deficit elimination goal appears in danger, the markets are likely to punish the pound and the gilt edged market. We can sum up the situation for the UK as "so far so good". Markets have taken a lot on trust and there is plenty of room for disappointment if the deficit elimination plans are derailed but, looking around the world at countries where budget deficits and public debt levels are a serious concern, the UK looks to have made the most impressive start, showing the value of maintaining control of a country's actions rather than cede control to outside bodies because markets are no longer prepared to give countries the benefit of the doubt and finance their deficit at reasonable rates of interest, or not be prepared to finance it at all.

This leads us logically on to the eurozone, where a number of countries have effectively lost control of independent action, although to varying degrees, with Greece the most obvious eurozone member to have austerity measures imposed on it. Action has been forced upon most other eurozone members, ranging from measures taken from a position of strength, Germany for example, or weakness, in the case of southern European eurozone members and Ireland. Whilst the UK has the priceless advantage of a freely floating currency and independent monetary policy, eurozone politicians have no such advantages, and the political situation in a number of important countries in the eurozone is very difficult for incumbent governments. Opposition parties can be expected to make mischief for party political advantage, although, sometimes, they have been complicit in the deficit problems, Greece being a notable example. The sovereign debt crisis in the eurozone started when the new Greek government announced that the deficit figures were far worse than had been admitted by the previous government. In Germany, Angela Merkel and the coalition government have become extremely unpopular, in France the government and President Sarkozy are very unpopular, and that is generally the case in the weakest eurozone countries as well. The danger for the eurozone is that populist opposition parties will attempt to derail the difficult austerity measures being taken and/or the possibility that social unrest will bring down incumbent governments. Such possibilities raise the level of risk in the eurozone for sovereign debt holders and any backsliding on measures to address various countries' debt problems will catch the attention of the debt rating agencies. So, whilst sentiment is slightly better towards the euro now, as evidenced by the partial recovery of the euro against the US dollar, the position in the eurozone remains fraught with danger. It is quite likely, and we are seeing some evidence of this now, that there will be political and social unrest in some eurozone countries, particularly the southern European ones, as well as France. Ireland may be an exception. There seems to be a reluctant acceptance of the very tough measures which have and are being taken. We maintain the view that there is a strong possibility that the eurozone will fragment. Membership is likely to prove too painful for a number of members, with the inability to adjust relative exchange rates against stronger members being a major hindrance to rebalancing their economies.

However, as we move east, excluding Japan from this comment, the world looks a different place. Through prudent management of their economies (the Asian financial crises of the late 1990s left a marked impression on policy makers), the region has emerged relatively unscathed from the financial crisis both because its banks did not go in for the type of financial activities which created such havoc in the west and because the domestic finances of countries in the region were in generally good order. Economic growth in the region is quite strong with China, of course, the powerhouse and India also growing very strongly, although the latter has more issues to deal with such as the size of the budget deficit, inflation, inflexible labour markets and often infrastructure which needs upgrading. However, it is showing an economic growth rate which the west can only envy. Away from Asia, Brazil, too, has managed its economy well, is growing rapidly and is an economic powerhouse.

Russia, too, after a difficult 2009 is set to grow strongly this year. The growing economic power of the BRICs is of major importance for investors, not only for their investments in these countries and elsewhere in Asia, but for the positive influence which they have on the world economy. It is no coincidence that the new British government has led a high powered political, business and sporting delegation to India so early in its term of office, whilst the Chancellor was a very early visitor to China. It is instructive that the new Coalition government in the UK is putting a heavy emphasis on "marketing" the UK in fast growing areas of the world because, notwithstanding the UK's precarious economic situation, many of its companies, often for historical reasons, are well placed to benefit from rapid expansion in these areas. So the "curate's egg" state of the world economy, to which we referred earlier in this review, is not as bad as it might be for investors in weaker economies because they can invest directly, and indirectly, to benefit from these relative economic trends, which are set to continue as far ahead as one can see.

Japan, as we touched upon earlier, has a very serious level of public debt in relation to GDP, helped, however, by the substantial domestic demand for and holdings of government debt and consistently low levels of interest rates at which this debt has been serviced. However, changes in demographics are bringing down Japan's historically high savings rate, bringing potential problems for future funding so, as with the USA, the problem is not one which can be ignored indefinitely. For the moment, however, the yen is seen as a safe haven for investors. So far this year it has risen against every major currency, which does not make life easy for Japanese exporters. It is, of course, a country which benefits significantly from the Chinese economy's rapid growth rate, but longer term problems are there for all to see, hence the discussion in Japan about raising the level of consumption tax.

Another economy which has benefited from the Chinese connection is Australia, which weathered the financial crisis well because of its commodity bias and the strength of its banking system which did not get embroiled in toxic assets. A recent "own goal" by the former Prime Minister, Kevin Rudd, was his proposal for a mining super tax, which could have been immensely dangerous, both in its effect on the mining industry and potential future investment but also for Australia's image of stability. He lost his job as a result but crass actions like that, introduced without any consideration and surely done for populist electioneering purposes, cannot be put entirely out of mind by a policy reversal. Under the new Prime Minister, an election has been called and because of splits in the government's ranks, the result is in doubt. Overall, however, Australia's financial and economic position is relatively strong, notwithstanding this unnecessary danger to its reputation caused by recent events surrounding mining taxation.

As we have seen from the change in short term sentiment between June and July, investors are in an uncertain mood, notwithstanding the major increase in stock market indices since March 2009. With hindsight, it is clear that shares were seriously oversold then but investors can be forgiven for having been very cautious then given the uncertainty over the state of the banking system. The big rise in share prices since then has made some investors nervous about the market levels and they can rationalise their feelings by pointing to the number of economic problems which exist, the sovereign debt crisis being one, which was not an issue at the time of the original banking crisis. Even though recent economic and financial events are extraordinary, nothing is ever 100% bad or 100% good in the world economic scene and it is always possible to place a different construction on events in order to define an investment policy which is in place at the time.

Negative factors for markets at present include the sovereign debt problems of the eurozone, severe fiscal deficits in Western Europe, the USA and Japan and the effect which a severe tightening of fiscal policy will have on economic activity in the affected countries. Concerns about some banks still exist. On the positive side is the fast economic growth of the BRIC countries and some other Asian and emerging markets which will help economic activity to grow this year and next from last year's depressed base. Although interest rates are likely to move up to more normal levels in countries which are moving towards more traditional growth rates, monetary policy is likely to remain very loose in the USA, eurozone, Japan and the UK and will act as a counter to fiscal tightening where it is taking place. Further quantitative easing may take place and, although a desperate measure, it has helped and may continue to help to support a rise in asset prices.

What does this mean for bonds and equities? If we look at the high quality government issues, as shown in the table at the beginning of this review, it is very difficult to see value in such low yields. It is true that this would not necessarily be the case if the relevant countries moved into a period of deflation, but we do not think that is likely to happen. There may be odd quarters of deflation but that is not likely to lead to a sustained trend. The paltry levels of yields available on, say, ten year UK, USA, German and Japanese bonds do not look appealing. As for lower grade eurozone government bonds, the yields are telling us that there are some risks and these self evidently surround their ability to borrow and take the necessary measures to restore fiscal stability to their country, not to mention any problems which may have to be addressed by their banks if there are any sovereign debt defaults in the eurozone. The hard work to put certain eurozone countries on the road to fiscal rectitude is strewn with problems surrounding the willingness of their populations to accept the necessary measures. Any major hints of problems would be likely to be very badly received by the markets. We remain cautious of bonds issued by governments in the eurozone where debt problems are apparent and, for top grade bonds everywhere, we just do not see value. One would hope to do better in equities over any realistic period bearing in mind that the short term is difficult to forecast.

What makes us feel that equities are a better proposition is valuation levels. Looking at the forecasts on Bloomberg for current year dividend estimates, we see dividend yields which look quite attractive in their own right and very attractive compared with bonds and even more so against cash deposits in most places. If we take the Bloomberg dividend forecasts for the current year for the UK, we see a forecast yield of 3.43% which, if it is accurate, is about 14 basis points above that for the ten year gilt. In Germany, the expected current year yields of 3.47% is 177 basis points above the yield on the ten year government bond. In France, the forecast dividend yield on the market of 4.12% is 114 basis points above that on a ten year French government bond. In Japan, where the bond market is somewhat of a law unto itself, the expected dividend yield for the current year is 1.83%, 77 basis points above the yield on a ten year Japanese government bond. This, however, is not the case in the USA where the forecast yield on the S&P 500 Index at 2.03% is 93 basis points below the yield on the ten year Treasury bond. In terms of price/earnings ratios, according to current year estimates from Bloomberg, the S&P 500 Index is on a p/e of about 13.5, falling to about 11.7 on next year's forecasts. For most of Europe, including the UK, forecast price/earnings ratios for this year are not far into double figures, falling into single figures in most cases for next year, if forecasts are accurate. At a time of considerable economic uncertainty, the modest rating of shares and relative yield attractions give some comfort and provide a fundamental reason for staying with good quality shares. It is encouraging to see companies start to increase their dividends again as their confidence grows. When the financial storm hit the world economy towards the end of 2008, companies battened down the hatches to conserve cash. Now they are releasing the purse strings modestly as trading conditions improve.

As the economic and news background has started to improve, we have begun to reintroduce into our reviews economic data which has been reported, usually within the previous month, which points towards a more positive outlook. The starting point for this is the acceptance that the majority of the news in the west and Japan is negative. However, whereas in late 2008 and in 2009, it was almost universally bad, there are now some items of good news and in Asia, outside Japan, parts of the Middle East, Brazil and some emerging markets, the overall picture is much brighter.

Before we detail some of the more positive economic data to emerge, we should touch upon one trend which is disturbing and needs monitoring as far as investors are concerned and that is the potentially damaging actions of some politicians. Whilst bankers have not covered themselves in glory in recent times, nor have many politicians. Their profligate spending, sometimes in search of short term electoral gain, has contributed to the sovereign debt crisis. Politicians' time horizons are generally quite short, perhaps only to the next election and diverting attention from their own shortcomings or unpopular measures which they are taking is a standard policy. In this respect, the popular pastime of "bank bashing" has proved an irresistible temptations for politicians in the USA, UK and Europe. Sometimes it has led to an absurd situation with the UK being a good example. All sorts of threats are being made by politicians whom one would hope would know better. Banks are being told that they must lend more, although it is not clear that businesses want to borrow more, and at the same time to strengthen their balance sheets. The two requirements are contradictory. If politicians are trying to force them to make loans against their commercial judgement, then we are in danger of going back to the type of issue which caused problems in the banking sector. For an economy like the UK, which specialises in financial services, it is madness to threaten banks and other financial institutions with legislative action of many kinds, which may have the effect of driving some businesses away from the UK, never to return. Proper regulation to ensure that no repeat of what caused the financial meltdown occurs is one thing, grandstanding, threatening the banks and trying to court populist opinion with additional levies and taxes, is another. One must never underestimate the potential for politicians to cause economic damage. Economies often have good healing powers and do not need political interference which could be counterproductive. Investors must watch the politicians.

With that important caveat, we now turn to some items of positive or, at least, mildly positive news.

In the USA, the balance of news has tended to indicate some slowdown, as was evidenced by the first estimate of second quarter growth which showed it slowing to an annual rate of 2.4% compared with 3.7% in the first quarter. Nevertheless, there are still some positive features in the recent economic data released. The purchasing managers index for US manufacturing fell to 56.2 in June compared with 59.7 in May, but still well above the 50 mark which indicates the border between expansion and contraction. The index for non manufacturing activity fell to 53.8 in June compared with 55.4 in May and the same comment applies here. There was a slight increase in production at US factories, mines and utilities in June, just 0.1% compared with 1.3% in May. Although most of the housing data has been rather negative, the S&P/Case-Shiller index of twenty cities showed US house prices to be rising 0.5% in May following 0.6% increase in April. In the eurozone, Markit's purchasing managers index for the eurozone service sector stood at 55.5 in June, down from 56.2 in May, but still quite a strong figure. Eurozone industrial production rose in May by 0.9%, month on month, to give an annual rise of 9.4%. The purchasing managers index for services and manufacturing in the eurozone stood at 56.7 in July, compared with 56 in June. This is quite a strong figure. The European Commission's index of eurozone consumer sentiment also improved to -14.1 in July from -17.3 in June. The Conference Board's leading economic index rose by 0.5% to 111.2 in June. This is 16.4% higher than the trough hit in March 2009. The European Commission's indicator of economic sentiment stood at a twenty three month high of 101.3 in July compared with 99.0 in June. In individual country news within the eurozone, German unemployment fell by 21,000 to 3.23 million in June, which is its lowest level since December 2008. Industrial production in May was up 2.6% compared with the previous month and above forecasts. The GfK Institute said that its indicator of German consumer confidence rose to 3.9 in August compared with 3.6 in July, this being the highest level since last November. In Ireland, which has suffered so badly from the financial and economic crisis, there was some good news on growth, with the Irish Central Statistics Office reporting that GDP had grown by 2.7% in the first quarter, which is the first such rise since the last quarter of 2007. In Spain, there were some slight signs of encouragement in the housing market, with housing sales rising for a fifth straight month. House sales were up 11.9% in May compared with a year earlier and were 10.1% higher than in April, according to the Statistical Institute. In Japan, consumer sentiment improved, with the index measuring general households' sentiment standing at 43.5 in June compared with 42.8 in May, this being the highest level for nearly three years. Figures showed that Japanese all industry activity rose by a better than expected 0.2% in May. The Bank of Japan, whilst keeping interest rates at 0.1%, lifted its growth forecast for the year to March 2011 to 2.6% from 1.8%. Exports by Japanese companies were 27% higher, year on year, although the rate of increase, as measured by the performance each month, is declining. In China, the annual rate of growth of the Chinese economy in the second quarter was 10.3%, compared with 11.9% in the first quarter, but probably closer to the rate of expansion with which the Chinese authorities are happy, given their concerns about inflation. Such a rate of growth is still positive for the world economy. In the UK, the Markit / CIPS manufacturing index was slightly lower in June, at 57.5, compared with 58 in May, but still a quite strongly positive figure, even though the indicator for export orders fell quite sharply. The Markit/CIPS construction purchasing managers index stood at 58.4 in June, a fraction lower than 58.5 in May, but still quite a positive reading and well above 50, which separates growth from contraction. The Markit/CIPS services purchasing managers index stood at 54.4 in June compared with 55.4 in May. Although down slightly, it was still a reasonably positive figure. A KPMG/REC report reported a balance of companies taking on permanent staff in June at 60.7 compared with 61.3 in May, still a positive signal, given that it was over 50. The British Retail Consortium reported that high street sales rose by 1.2% in June, following a 0.8% increase in May. In the housing market, government data showed house prices rising by 0.7% in May to be up 11% year on year. The Land Registry reported house prices to be 0.1% up in June to be 8.4% higher than a year ago. Official figures showed retail sales volumes to be up 0.7% in June, compared with a 0.8% increase in May. The CBI's gauge of high street sales rose strongly in July to 33 from -5 in June, the best reading since April 2007, with retailers' optimism about future sales being at their highest for six years, standing at 45 compared with 11. The first estimate of GDP growth for the second quarter is for a rise of 1.1% compared with the first quarter, with construction driving the gain, rising by 6.6%. This figure was higher than expected and may well be revised in future estimates.

As this is written, international equity markets stand at roughly the level they were at the start of the year if we look at the return on the FTSE World Index in local currency and sterling terms. A good first calendar quarter was followed by a poor second quarter, followed by a recovery in July. That really shows up the mixture of emotions through which investors are passing at present. Some days investors see the bottle as half empty, on other occasions, as half full. We fall into the latter category, based upon the expectations of the continuation of modest international economic growth into 2011, rising corporate earnings and dividends resulting in modestly rated equities in most countries. We do not expect to see deflation as the norm, and very low good quality bond yields to us reflect the fears about lower quality sovereign debt. In their own right, absent deflation, they look dear. The consolidation of last year's recovery in international equity markets so far this year, albeit with the volatility described above, does not suggest the fairly extreme level of risk aversion that current AAA rated government bond yields suggest. In this review, we have emphasised the negative features of the world economy, the ones which are causing some investors to view the bottle as half full, and these relate to the size of government deficits and the effect on the various economies of measures to correct them, as well as the effect of any eurozone sovereign debt defaults on mainly eurozone banking. Even those taking a negative view of markets should recognise that there are still some weapons left in the armoury of central banks and governments, notably further quantitative easing, which could support and enhance asset values, whilst interest rates remain at historically low levels. Against this background, we continue to view equities as the most attractive asset class in the current environment. It is impossible to forecast short term movements, such is the mercurial mood of many investors at present, but, for medium and long term investors, equity valuations look attractive and bond valuations (of the quality of bonds we would consider) unattractive.

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