meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Against the background of a chaotic eurozone investors must feel that a quarter which has seen little overall change in international equity markets represents a reasonable result. We have seen volatility, not unexpected, but the undertone has been remarkably firm and we see that outcome as a correct assessment by investors. Top quality sovereign bonds have performed well but we see no value there. There have been some strange currency movements and there is speculation that this could have been caused by the actions of the Swiss National Bank which we discuss during this review.

The tables below detail relevant movements in markets:

International Equities 30.04.12 - 31.07.12

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-1.7	+3.0	-0.6	+6.8
Finland	-8.5	-11.7	-14.8	-8.5
France	+4.4	+0.7	-2.8	+4.4
Germany	+0.2	-3.4	-6.8	+0.2
Hong Kong, China	-4.1	-0.6	-4.1	+3.1
Italy	-1.7	-5.2	-8.5	-1.7
Japan	-8.4	-3.0	-6.4	+0.6
Netherlands	+7.1	+3.3	-0.3	+7.1
Spain	+1.3	-2.3	-5.8	+1.3
Switzerland	+4.6	+0.9	-2.7	+4.6
UK	-0.8	-0.8	-4.3	+2.9
USA	-0.9	+2.7	-0.9	+6.5
Europe ex UK	+2.7	-0.4	-3.9	+3.3
Asia Pacific ex Japan	-2.3	+1.0	-2.6	+4.7
Asia Pacific	-4.9	-0.7	-4.2	+3.0
Latin America	-3.7	-5.5	-8.8	-2.0
All World All Emerging	-2.5	-2.3	-5.7	+1.3
The World	-1.3	+0.7	-2.8	+4.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +5.4%

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

Currency	30.04.12	31.07.12
Sterling	2.10	1.47
US Dollar	1.92	1.49
Yen	0.89	0.80
Germany (Euro)	1.67	1.30

Sterling's performance during the quarter ending 31.07.12 (%)

Currency	Quarter Ending 31.07.12
US Dollar	-3.5
Canadian Dollar	-2.0
Yen	-5.5
Euro	+3.8
Swiss Franc	+3.7
Australian dollar	-3.7

Other currency movements during the quarter ending 31.07.12 (%)

Currency	Quarter Ending 31.07.12
US Dollar/Canadian Dollar	+1.5
US Dollar/Yen	-2.1
US Dollar/Euro	+7.5
Swiss Franc/Euro	N/C
Euro/Yen	-8.9

Significant Commodities (US dollar terms) 30.04.12 - 31.07.12 (%)

Currency	Quarter Ending 31.07.12
Oil	-12.0
Gold	-2.5

Markets

Overall, international equity markets have shown little change over the quarter. In total return terms, The FTSE World Index returned -1.3% in local currency terms, +0.7% in sterling terms, -2.8% in US dollar terms and +4.5% in euro terms. Looking at local currency movements first, Japan has been the weakest performer with the FTSE Japan Index returning -8.4%. On the positive side, the FTSE Europe ex UK Index returned 2.7%. Within that, the FTSE Switzerland Index performed well with a total return of 4.6% and the FTSE Netherlands Index with one of 7.1%, whilst Finland was disappointing with the FTSE Finland Index returning -8.5%. There was some weakness in Latin America with the FTSE Latin American Index returning -3.7%. Some quite significant currency movements changed the position in sterling terms. Strength in the US dollar meant that a negative return on the FTSE USA Index in local currency terms became a satisfactory positive return of 2.7% in sterling terms. Strength in the yen reduced the underperformance of the FTSE Japan Index in sterling terms to -3.0%.

The weakness of the euro and Swiss Franc meant that the positive return of 2.7%, noted above, in the FTSE Europe ex UK index in local currency terms became -0.4% in sterling adjusted terms. Strength in the Australian dollar meant that a negative return in local currency terms in the FTSE Australia Index of 1.7% became a satisfactory positive return of 3.0% in sterling terms. Currency weakness in Latin America exacerbated the negative local currency return on the FTSE Latin American Index from -3.7% to -5.5% in sterling terms. On the other hand, a negative return of 2.3% in the local currency return on the FTSE Asia Pacific ex Japan Index became a positive 1.0% in sterling terms. The UK market slightly underperformed with the FTSE UK Index returning -0.8% over the quarter.

High quality international sovereign bond markets reflected the enormous distortions caused by the eurozone's sovereign debt crisis. We will talk about this in our review but, for the moment, we should note some extraordinary declines in gross redemption yields in benchmark ten year government bonds. In the UK, there was fall of 63 basis points to 1.47%, in the USA one of 43 basis points to 1.49%, in Japan one of 9 basis points to 0.80% and in Germany one of 37 basis points to 1.30%.

In the currency markets, as we have alluded to above, the feature was the strength of the yen, US dollar and Australian dollar, whilst the euro and Swiss Franc (because of Swiss National Bank intervention) weakened. Against the yen, sterling fell by 5.5%, against the US dollar by 3.5% and against the Australian dollar by 3.7%. On the other hand, it rose by 3.8% against the euro and by 3.7% against the Swiss Franc. There has been some suggestion that some of the surprising currency movements have been due to the Swiss National Bank selling some of the euros which it has been buying to diversify its currency holdings. For example, in view of the weakness in some commodity prices, it is surprising to see the Australian dollar so strong.

In the commodity markets, oil, as measured by Brent crude, fell quite sharply by 12.0%, although the price made a partial recovery towards the end of the quarter. Gold fell by 2.5%.

Economics

There remains really only one story to write about which is the eurozone's existential crisis. In normal times, we would be writing about the USA's debt problem, including the forthcoming "fiscal cliff", the UK's large budget deficit and apparent lack of growth and China's economic slowdown. We will still mention these subjects, which in normal times would be assuming headline importance, but, incredibly, given the circumstances, they pale into insignificance besides the eurozone's problems.

So many words have been written about the eurozone, it is difficult to find a new angle. The continuing and deepening crisis confirms to us our long held view that the eurozone will fragment, whatever the politicians may say. The political background is not unchanged, however. There is movement at the edges which manifests itself in different ways. In Greece, in the recent elections, we have seen the growth of extreme parties which were prepared to tear up the agreement with the troika. They did not win the election but their influence on the Greek political scene has increased and, given the hopelessness of the Greek economic situation, it is quite probable that their influence will increase. Elsewhere, in the southern eurozone, Spain's economic position is looking increasingly dire and pressure, largely arising from Spain's appalling unemployment situation, is growing on the Spanish government even though it is relatively new and has an absolute majority. Economic management of the Spanish economy, as of the other bailed out economies, is effectively in the hands of those providing the support for its banks. Because the measures forced on the bailed out countries are essentially pro cyclical, they are exacerbating a contractionary or, at least, non growth situation. To have any chance of recovering their position these countries need economic growth. It is very difficult to see where this will come from.

As this is written, it is not only the Spanish bond market which is in difficulty outside the original troubled ones, but also the Italian one, and, because Italy has the third largest amount of outstanding public debt, it is a very dangerous situation. The technocratic government of Mr Monti, a man widely lauded for his intellect and understanding of European economic matters, is beginning to run into difficulties. The structural reforms which Italy badly needs to boost its long term potential growth rate have been considerably watered down in the face of opposition from vested interests. Elections are to be held next year and anti euro feeling is developing. Italy is just too big for the eurozone to bail out.

It is not only the countries which have effectively lost their economic sovereignty which are very unhappy with what is being foisted upon them but it is also what might be termed their "bank managers". In Germany, but particularly in the Netherlands and Finland, acute resentment is growing about the size of their commitments to the bailed out eurozone countries and some politicians are exploiting this groundswell of resentment. So, from both sides of the political and economic spectrum, we are seeing a build up of resentment against the provision of bailout money or the terms on which it is accepted or proposed.

For the moment, though, the leaders and their mainstream political opponents in the eurozone go along with the euro project and all the pain which it currently entails. For the recipient countries, the leaders say that there is no alternative which is not worse than the current misery which they are enduring. Leaders of countries backing the bailout, as well as the leading eurocrats, say the solution is "more Europe". Although we try, as far as possible, in these reviews to stay away from politics, it seems very difficult to believe that, if asked, the various electorates would go along with closer integration. For what we are effectively talking about here is a fiscal transfer union, really a eurozone economic government, with economic decisions being taken centrally and individual countries formally losing their economic sovereignty. This would enable fiscal transfers to be made to eurozone states in trouble, with the money coming from the better off countries. But why would citizens of the northern eurozone countries keep wanting to support southern eurozone countries, other than very possibly for a short time? The fact is that ever since the eurozone was founded, with those in favour saying that it would lead to economic convergence, it has been diverging with relative costs of the southern eurozone countries, as well as, worryingly, France, diverging, hence the current imbalances and the resulting crises. If asked, it is unlikely that the citizens of "creditor" or "debtor" eurozone countries would want to go along with such an idea. In Germany, the Constitutional Court is a powerful block on any transfer of German sovereignty, which is incompatible with the German Constitution, and it is currently examining whether the European Stability Mechanism, which is the €500 billion permanent rescue fund for the eurozone, can go ahead. The Constitutional Court is going to make a decision in September. But, of course, markets are not going to wait, particularly whilst the Constitutional Court decides on the issue, nor will they wait for the much longer process of delivering an economic government for the eurozone, which we think would be impossible anyway.

As this is written, Spanish and Italian government bond yields continue to show distress. We are witnessing ten year government bond yields in the two countries of approximately 6.9% and 6.1% respectively, and they have been higher in recent days, and these are unsustainable, especially against the background of economic contraction. These two important eurozone countries, no. 3 (Italy) and no. 4 (Spain) are effectively being shut out of the market. An estimate from the Financial Times, derived from IMF data, indicates, for 2013, refinancing needs of €232 billion for Spain comprising the budget deficit and maturing debt, whilst, for Italy, the country with the third largest amount of outstanding debt, the figure is €380 billion. In the case of Italy, which runs a primary budget surplus (i.e. before interest payments), the financing requirement is largely for maturing debt, whereas, in Spain, it is likely that over a quarter of the financing requirement relates to the budget deficit and, given current circumstances, this may yet get worse. Whilst, in normal times, maturing debt might be rolled over into new debt, foreign investors, especially, might refuse to reinvest redemption proceeds in the relevant country's debt. If and when the European Stability Mechanism (ESM) becomes operative and, as mentioned earlier, the German Constitutional Court will not opine until September, there will be an additional €500 billion available as rescue funds but, in the context of the figures mentioned above and not including existing bailed out countries' continuing needs and funds for Spanish banks to be disbursed, the eurozone does not have the financial firepower to fight a full blown eurozone sovereign debt crisis, which is where events are inexorably leading.

It is to be hoped that decision makers in the eurozone have a plan. Emphasising that the euro is for ever and that "more Europe" is the answer, will not make the problem go away. The damage to the system is so great, and getting worse, that it cannot be repaired. Confidence once lost is always very difficult to regain and the problem with the euro is magnified by the number of losers. In the bond market, private investors have seen their interests in Greece subjugated to those of official lenders. The damage has been done. Foreign investors are fleeing the bond markets of eurozone countries perceived to be at risk. They will not return and their absence will wreck the relevant countries' funding possibilities. Those eurozone economies in trouble have been forced to accept what is, effectively, external management of their economies. The economic medicine is pro cyclical as it magnifies the downturn and leads to shockingly high unemployment levels. This will not be forgotten and means that hostility to the common currency is likely to increase. The same goes for the creditor countries. For Germany and the Netherlands, the threat of a downgrade from Moody's will be a shock and will sour opinion on the euro.

The hope must be that those who carry the influence at the top within the eurozone are working on a plan to dismantle the eurozone. This is why, whatever the politicians, eurocrats and central bankers say, denials that the eurozone could break up must be treated with caution. They have to say that to stop a further loss of confidence. What cripples all of the struggling countries is the lack of a flexible exchange rate. One that is more competitive gives the opportunity for the relevant countries to grow. At the moment, there is absolutely no catalyst for growth anywhere and the social challenges arising from very high levels of unemployment will find themselves reflected in the ballot boxes. A break up of the euro will be very messy and cause immense problems but at least there will be light at the end of the tunnel for these countries which will be able to manage their own monetary policy and not be strangled by a fixed exchange rate. It is likely to be a less bad outcome than continuing with the present doomed policy of applying sticking plaster to the problem without addressing its cause. Trying to hold together a non optimal currency area is an impossible task and the idea of having one economic country called "eurozone" is a non starter politically if the electorates were asked which they would have to be in this case.

One of the problems of decision making by a large committee, which is what the eurozone is, is that it is very difficult. Typically, there will be a summit, an agreed statement and course of action and then back peddling as the politicians return home to satisfy a different audience who may not have been pleased with what they heard.

So where does the power lie to do anything meaningful about the current position? As we have said before, it is the ECB. At the moment, it is putting up a strong fight to preserve its financial integrity and the limits of its mandate, but we do not see that any other body has any power to stabilise the position even temporarily. Long term stabilisation of the eurozone as presently constituted is, in our view, impossible. Hardliners in the ECB, from countries like Germany, resist any move from monetary orthodoxy. The nuclear situation for the ECB is to create money to buy unlimited amounts of troubled eurozone bonds to try to hold down yields in the hope that ECB's action can create enough certainty in the market to encourage buyers back in. The ECB is not allowed to finance countries directly but, in the case of extreme emergency, might it not do so? Going back to our earlier discussion of Spanish and Italian financing needs next year, one has to wonder how they are going to refinance themselves, especially with the countries' economies likely to be contracting. If the ECB did buy unlimited quantities of troubled eurozone sovereign bonds, it would effectively be a money printing exercise, threatening inflation and, if the sovereigns defaulted, heavy losses for the ECB's eurozone shareholders. If the countries in question left the eurozone, then the position would be worsened by currency losses. Under the Securities Market Programme, the ECB had been purchasing the bonds of troubled eurozone countries, but it has not activated the programme recently and it currently holds around €211 billion of eurozone sovereign debt. One of the reasons why the Securities Market Programme was halted was because the ECB activated its Long Term Refinancing Operation (LTRO), providing three year money to banks which were finding it hard to attract deposits. Relying on a central bank to fund a bank's business is not a sustainable long term course of action, but the action undoubtedly calmed nerves in the first quarter of the year and contributed to a positive stock market performance. With ECB financing made available at 1%, and longer term yields in the troubled countries much higher, some eurozone banks were able to play the yield curve and seemingly make a turn. However, weakness in Spanish and Italian bond markets has rendered this tactic dangerous as the fall in bond prices has caused the banks to face some unrealised losses, so the link between the sovereign and the banks has not been broken, rather it has been strengthened. In the recent bailout of Spanish banks, the attempt by Spain to make the support for banks independent of the sovereign failed. They are inextricably linked.

As the eurozone crisis deepens one keeps feeling that the end game is round the corner but, just as we approach the moment of no return, events move off towards another dead end, postponing the moment of reckoning. The scale of the financing needs of Italy and Spain, detailed above, will surely move us to that time. They are effectively shut out of the market. Bank deposits in the weaker eurozone countries move to the larger ones and the money is recycled back by the ECB, but, all the time, the amount of eligible collateral declines. Even if electorates supported a fiscal union, which is highly unlikely, it would take years to put in place, whereas the time scale of the crisis is days, weeks, but no more than months.

Over many months, we have maintained that, although it goes against everything it has ever stood for, the ECB will step in to buy bonds of the troubled countries and, perhaps, finance the countries itself, even though it is prohibited from doing so. Needs must in a crisis. One way round the problem would be to grant a banking licence to the ESM so that it could gear up the fund, but Germany is opposed to this and, as said before, it faces the restrictions of the decisions of the Constitutional Court. All of these plans are effectively debt mutualisation, which weakens the creditworthiness of the stronger members of the eurozone. One notes the criticism, in Germany, of Moody's understandable decision to put Germany on negative credit watch but, if they and the two other countries put on negative credit watch alongside Germany, namely the Netherlands and Luxembourg, do eventually suffer a credit rating downgrade, it may be a game changer in terms of attitude. In non eurozone eurosceptic countries like the UK, where the economic theory aspects of a currency union inform the criticism of the euro, it is easy to underestimate the political drive behind monetary union which leads to increasing puzzlement as to why the eurozone members persist with a currency union which is doing untold damage to the fabric of certain countries, the bailout countries and Spain to be precise. The leaders have boxed themselves into a corner and are in a state of denial.

How do investors respond to this situation? We can see that the current economic policy mix, not only in the eurozone but also in the USA, UK and Japan, has led to extraordinary market distortions, not least arising from a very loose monetary policy, orthodox and non orthodox (i.e. quantitative easing). At a time when fiscal policy is tightening in many countries, monetary policy has been used as an offset to boost confidence after the financial crisis of 2008. Had the eurozone not been formed, the exchange rate would have worked as a discipline in those countries whose costs had moved out of line, whilst its central bank (Ireland and Spain would have been good examples) would have raised interest rates to a level suitable to local circumstances and, in the course of doing so, dampened the speculation in the property markets. Money would have flowed into strong currencies, like the Deutschemark, and some sort of equilibrium would have been reached as a result of market forces working. Monetary union, as well as bearing a heavy responsibility for the eurozone's current crisis, has caused immense distortions in markets. If we look at the eurozone bond market's strong credits, we see Germany's two year bond yields showing a negative redemption yield of 0.05%, whilst outside the eurozone, but reflecting troubles within the eurozone, we see Denmark's November 2014 bond with a negative redemption yield of 0.27% and Switzerland's January 2014 bond with a negative redemption yield of 0.37%. The modern jargon for describing this state of affairs is that investors are no longer worried about "return on capital" but, rather, "return of capital". Investing, knowing that one will lose money, shows the level of fear prevailing about the eurozone. The second reason for investing for a seemingly negative return is that one might actually make some money if one's base country is one of the weaker members of the eurozone. Thus, someone in Greece, who moved their money out of a Greek bank and bought a German government bond in the belief that it was the safest possible investment, might consider the possibility of a currency gain. This could come about if Greece left the euro so that it would provide a hedge against what would be a much weaker currency or if, as some think might be a better outcome for the eurozone, Germany left the euro with the new Deutschemark floating upwards. But this is a fairly extreme investment stance. Our opinion is that, whilst one may understand investors' reasons for being prepared to buy paper with negative or very low yields, it does not make them good investments. We think that the chances of losing money on eurozone government bonds in countries viewed as being in distress are high for all the reasons we have given earlier about the future of the eurozone.

But it would, in our view, be wrong to ignore eurozone equities as an option. Many of them provide the hedge one needs against the area's woes because of their spread of international business. Conditions may be difficult in their domestic markets but those with business in the faster growing areas of the world have a buffer. There are many world class companies based in the eurozone and, besides their spread of business, they will have been taking what precautions they can against a break up of the single currency. The area's troubles have left European equities very lowly rated and with some attractive dividend yields. As with Japan, given its importance to the world economy, it would be an unbalanced international portfolio which did not have exposure to these areas and eurozone equities remain our preferred means of investing in the area, notwithstanding their recent disappointing performance relative to a number of other markets.

An area of concern in the eurozone, besides the obvious ones, is France. A change in administration in the recent elections has led to the formation of what appears, by its early policy decisions, to be a very ideologically driven government. The issue for France is that it has steadily been losing competitiveness against Germany and this is reflected in a deteriorating trade account as its costs have moved out of line. The French President, Mr Hollande, has emphasised growth as a way out of the eurozone's problems but it is not obvious that the government's early measures will promote this. Emphasis on increased taxes for large companies and the wealthy, a roll back of the previous government's pension reforms, which has reduced the retirement age for some back to 60 from 62, threats of action against companies which want to restructure and efforts to dismantle Mr Sarkozy's relaxation of the ruinous 35 hour week by taxing overtime work and bringing in social security contributions on these earnings, are not obvious incentives to make companies invest and hire more people. Added to this, the Industry Minister's attack on Peugeot for announcing a plant closure in France because of overcapacity and one has a very unhelpful environment for business. The concern is that, before the recent elections, very few politicians were willing to talk about the economic issues facing France, particularly the need for hard spending decisions in an economy where the public sector accounts for 56% of GDP. The recent report from the national auditor, the Cour des Comptes, has brought home the severity of the situation regarding France's public finances. France's commitment is to reduce its budget deficit as a percentage of GDP to 3% in 2013 and eliminate it by 2017. The national auditor, as well as stressing the severity of the position of France's public finances, also emphasised, as mentioned above, the need to address France's deteriorating competitive position. The auditor said that outstanding public debt could reach 90% of GDP this year, a level which many economists believe acts as a permanent restraint on a country's growth potential. The auditor estimated that savings of €33 billion will be needed to meet next year's deficit target and that estimate was based on 1% economic growth which, at this stage, looks a fairly optimistic projection. Furthermore, this projection takes no account of spending pledges by the new government - it plans to take on extra teachers, for example. There were a whole host of warnings about the problems France faces but perhaps the starkest and most obvious is that France needs to cut public spending. The 56% level means a "crowding out" of the private sector and this needs addressing.

Although the Franco-German axis has been the linchpin of the EU and the eurozone, the divergence in economic fortunes means that if the eurozone splits in one of the ways which some people believe to be possible, with the stronger countries staying in the euro and the others peeling off, it is by no means certain that France would automatically join the top tier. From what we have seen so far, there are no obvious drivers of growth in France coming through. The warning from the Cour des Comptes shows that France, too, could become immersed in the eurozone's problems if remedial action to its public finances is not taken. The fact that the politicians, prior to the recent French elections, did not spell out to the electorate the severity of the problem relating to French public finances is likely to make implementation of the inevitable public spending cuts difficult.

As this is written stock markets and the bond prices of Spain and Italy have rallied after Mr Draghi said that the ECB would do what was necessary to save the euro (this is paraphrasing what he said). As we have said, we think the ECB has the power to salvage the situation in the short term by buying in distressed sovereign debt in the secondary market and even financing countries directly. It must be emphasised that this is well outside its brief but it can monetise debt, albeit at a terrible cost in the medium and long term in terms of currency debasement and inflation. Faced with an existential crisis, there are few options. Once the ECB moves on this fact (if we are right) we would expect equity markets to experience a relief rally. There would be strong opposition to this move, particularly from Germany, the Netherlands and Finland, which could derail the plan, in which case the fragmentation of the eurozone will be brought closer. The plan being hatched to give the ECB cover seems to be that Spain and Italy, if it becomes involved, will have to request a bailout and therefore be subject to conditions being imposed upon their economies. Once those conditions have been accepted, the ECB could resume bond purchases.

There is increasing exasperation with the eurozone in the rest of the world because of the effect which the crisis is having on the international economy. President Obama is exasperated because it indirectly affects his re-election prospects. David Cameron's hope that economic recovery will come in time for the next General Election, due in 2015, has been dashed and China is finding that its exports to the eurozone are suffering. All areas of the world are affected to some extent. This eurozone effect is borne out by the latest IMF World Economic Outlook update published on 16 July.

Its overall estimate is that world output will grow by 3.5% this year and 3.9% in 2013, reductions of 0.1% and 0.2% respectively from its April forecast. Overall, for advanced economies, it has kept its 2012 forecast unchanged at 1.4% but reduced it by 0.2% in 2013 to 1.9%. The forecast for the USA has been trimmed by 0.1% each year to 2.0% and 2.3% respectively. For the eurozone, it maintains its forecast of an economic contraction of 0.3% this year but has reduced its forecast by 0.2% for next year to growth of 0.7%. It has actually increased its growth forecast for Japan this year by 0.4% to 2.4% but reduced it by 0.2% for 2013 to 1.5%. The downgrades for the UK are sharp, 0.6% each year to 0.2% and 1.4% respectively. Canada remains a relatively bright spot with forecasts of growth this year of 2.1%, up 0.1% on its April forecast and 2.2% next year. The catalyst for world economic growth remains the emerging and developing economies. If we look at the BRIC economies, namely Brazil, Russia, India and China, we see a downgrade for Brazil this year with the growth forecast of 2.5% being 0.6% lower than the IMF's April forecast, although it has raised its forecast by 0.5% next year to 4.6%. For Russia, there has been no change for 2012 with its forecast remaining at 4.0% and its 2013 forecast only 0.1% lower at 3.9%. India has been a disappointment as a result of the political paralysis which seems to be gripping the government. The IMF has reduced its growth estimates by 0.7% for 2012 and 2013 to 6.1% respectively. For the largest BRIC member of all, China, forecasts have been reduced by 0.2% for 2012 to 8.0% and by 0.3% for 2013 to 8.5%.

At the best of times, making forecasts is an uncertain business but, at the present, it is even more difficult with so many variables, so these forecasts will undoubtedly be modified. With all the problems besetting the eurozone, one would feel that further downgrades to economic forecasts are more likely than upgrades.

As the performance of the US stock market shows, investors appear not to be worried about the approaching "fiscal cliff" which, on the most pessimistic estimates, could amount to 5% of US GDP. Instead, they are attracted by the USA's safe haven status plus the solid earnings of US companies. As the second quarter figures come through, it is evident that companies are finding life tougher but it is at what might be described a high level. Companies' earnings visibility is becoming more difficult because of what is going on elsewhere and second quarter's earnings from US companies, just coming through, show revenues under pressure. However, in the current environment, where investors' return ambitions have been curtailed by the crisis, the security of a dividend and a yield relatively much more attractive than on an US Treasury, seems very appealing. The US has many such companies with a good international breadth to their businesses and, in this environment, this is something which investors value, not only in the USA, but in other countries also.

As the IMF's latest economic forecasts show, US economic growth this year is likely to be modest but at a rate at which the eurozone and UK would clearly like to have achieved. Although it may be modified later, the first estimate of US second quarter economic growth was at an annualised rate of 1.5%. That rate of growth, if it is not significantly revised, chimes in with the testimony of Ben Bernanke to Congress in June. He said that it was unclear whether the recent slowdown in the US economy was enduring but he warned that reducing the 8.2% unemployment rate would be "frustratingly slow". Mr Bernanke listed options which were open to the Federal Reserve, such as different types of asset purchase which could be Treasuries or mortgage backed securities. Another option would be to lend via the Federal Reserve's discount window, a further one would be to communicate the Federal Reserve's future policy and yet another would be to cut the rate of interest paid to the banks on their excess reserves. Quite rightly, he criticised Congress for not addressing the USA's pressing fiscal problems and said that this issue, together with the eurozone's crisis, were the main risks to the US economy. In summary, it is very difficult for the Federal Reserve to know how matters are going to work out for the US economy. It is a relative beacon of health compared with the eurozone and the UK but, in absolute terms, growth is disappointing. So, at this stage, all Mr Bernanke can really do is to lay out the options open to the Federal Reserve if it needs to act further. With the fiscal issue seemingly incapable of being addressed because of the USA's political impasse, it falls, for the time being, on monetary policy to do the heavy lifting but monetary policy is so loose at the moment that the effectiveness of further loosening by non standard methods is likely to tail off. This very loose monetary policy threatens to unleash inflation later on but, for the moment, because output is below capacity, inflationary pressures are muted. The consumer price index is up 1.7% year on year but, still, real interest rates, measured by short term interest rates and ten year Treasuries, are negative. Printing money may seem a painless way to try to stimulate economic activity but the process will have to be reversed at some stage and it must, in the USA, as elsewhere, be seen as an extreme measure to be implemented in exceptional circumstances. The IMF, in its report on the US economy, emphasised its concern about the "fiscal cliff" and also urged the USA to raise its debt ceiling to avoid last year's dangerous situation, where the stand off threatened a US default, arising again. As 1 January approaches, and if no action appears forthcoming, there could be a loss of confidence amongst businesses and consumers, with negative consequences for the US economy. The checks and balances built into the US system of government at present exert a negative effect on economic management when, as at present, there is split control of Congress. If current opinion polls are correct, the two Presidential candidates are neck and neck with perhaps a slight advantage for the President. It is possible that the Republicans will gain the Senate, as well as holding the House of Representatives, so the stalemate could continue. If the Presidency and Congress are held by the same party, at least it makes decision making easier even if the decisions are the wrong ones. The USA has important advantages over the eurozone, namely its own currency and the US dollar's status as the world's largest reserve currency, which means it has to be held in other countries' foreign exchange reserves. It can, therefore, take more liberties with its economic policy and it is certainly doing that at present. In The Economist's table of forecasts, this year's budget deficit is forecast at 7.8% of GDP, which is why it is essential to start establishing a credible plan to address the very serious problems which US government finances face, with increasing liabilities for entitlements. The good performance of the US stock market this year suggests that investors are sanguine about the outcome of the fiscal stand off but it is undoubtedly the largest issue facing the USA at present. A disintegration of the eurozone on top of this would be something that the US economy could well do without. Although US Treasury yields look terrible value, the performance of the US equity market this year suggests that investors find reassurance in the county's equity market. Although, as usual, more highly valued than UK and European equity markets, investors are happy to invest in the big names where dividends at the very least are likely to be maintained and probably increased modestly. In this very difficult environment, investors are scaling back their ambitions and, certainly, the US equity market looks far better value than its bond market.

On the face of it, the IMF's forecast of economic growth for Japan this year of 2.4% looks relatively good but it reflects the distortion caused by last year's terrible natural disaster, the earthquake and resulting tsunami. The after effects caused the Japanese economy to contract by 0.7% last year so this year's forecast reflects some recovery from that contraction. Life for many Japanese manufacturing companies is made very difficult by the strength of the yen which, as our table at the beginning of this review shows, was quite pronounced in the last quarter. Whilst Japan remains home to many world class companies, the exchange rate has remained a serious problem and many of them have moved manufacturing to cheaper locations. It is now the third largest economy and has the second largest foreign exchange reserves after China, which is a source of strength but it also has significant problems. Its level of outstanding public debt at around 230% of the gross level cannot be tolerated indefinitely, particularly with some troublesome demographic problems. Given its history of stable prices and, sometimes, deflation, it cannot inflate away its debt. Its current budgetary position is awful. According to The Economist's estimates, its budget deficit will be 9.3% of GDP this year. It has been able to finance its deficits at very low levels of interest rates and largely through domestic savings as foreign investors own only around 7% of outstanding public debt. But times are changing. Partly because a large part of its nuclear power industry shut down as a result of last year's disaster, Japan has to increase its energy imports and its trade account, though not yet as its current account, is moving into deficit. Its current account surplus is now quite modest and, if it were to move into deficit, financing might not be so easy, although the size of its foreign exchange reserves helps. For Japan, as for the USA, although for different reasons, finding the political consensus to act decisively is very difficult. But there is some glimmer of hope which is that, in two stages, it has been agreed to raise consumption tax, currently a low rate of 5% to 10%. Japan needs major supply side reforms to improve the country's long term potential growth rate, just as the eurozone does. Agreement on the consumption tax increase might just be the sign that foreign investors in the Japanese stock market are looking for, namely action to address the country's deep seated economic problems. At its recent meeting, the Bank of Japan did not increase the amount of its monetary easing as some had hoped. With interest rates so low, as we have said in other countries' contexts, monetary policy loses its power to be effective. A high value for the yen and sharp competition from elsewhere in Asia is forcing radical action on a number of large Japanese manufacturing companies. The latest Tankan survey showed that business conditions for large Japanese manufacturers were, on balance, negative, although they were positive for non manufacturers.

Given the difficulties of the western economies, the eurozone and the UK, in particular, China, the second largest economy after the USA, assumes more importance than ever. A certain amount of alarm has been raised because of evidence that the Chinese economy has been slowing down. In the second quarter, the annual rate of growth slipped to 7.6% from 8.1% in the first quarter, rates of which the industrialised countries can only dream but, nevertheless, low by recent Chinese standards. Other evidence is China's manufacturing purchasing managers index which fell to 50.1 in July from 50.2 in June and an HSBC purchasing managers index which showed a reading of 49.3 in July, actually up from 48.2 in June but still a weak figure. It does not help that some of its export markets are weak but China can act more quickly than most to stimulate or cool down its economy, as recent reductions in interest rates and bank reserve requirements have shown. China has to perform a delicate balancing act between keeping a lid on inflation and stopping the economy from falling into a growth rate which is not sufficient to absorb all those coming on to the labour market. At the moment, it is trying to stimulate growth but it will also be aware that recent abnormal weather patterns will pose a threat to food prices in due course. This is an aspect of inflation which, for obvious reasons, is difficult to control but which has the possibility of causing political difficulties for the Chinese leadership. China remains an important driver for the world economy and its economic fortunes will be watched closely by investors.

Economic statistics for the UK have been and will be distorted by the Diamond Jubilee celebrations and the Olympic Games and there are puzzling discrepancies between the GDP figures and labour market statistics but, nevertheless, there is no doubt that the economy is flat, which poses a significant problem for the Chancellor who needs the UK economy to grow to help with his plan to eliminate the structural deficit. He has already had to put back by two years the date when it is supposed to be eliminated and further delays would not be surprising given the lack of growth in the eurozone.

The siren voices which are urging the Chancellor to slow down his plans for structural deficit elimination and, by doing so, to create the growth necessary to reduce and then eliminate the deficit, are, we believe, mistaken. The UK's top credit rating is on negative watch and the UK cannot afford to risk a downgrade. It may well be that the UK, along with a number of other top rated sovereign credits, may be downgraded because of the way the world economy is developing, or not developing, in terms of economic growth, but that is quite different from deliberately slowing down the pace of deficit reduction when a country has a debt problem as serious as that of the UK. If we refer again to The Economist's forecasts, it is suggesting a budget balance of -8.2% this year which is worse than some of the eurozone countries in trouble. It is true that the USA has, so far, withstood its credit downgrade but its circumstances are quite different from those of the UK. The US dollar is the world's largest reserve currency and that gives it a significant advantage over sterling, which accounts for around 4% of the world's foreign exchange reserves. If the UK, with its appalling public finances, was seen to be compromising its deficit elimination on plans which have been well received by investors, it would be likely to be severely punished by the markets. The UK, as our table at the beginning of this review show, has the benefit of being able to borrow at interest rates which, until recently, would have been considered the stuff of fantasy. Partly this is due to the depression of interest rates through the Bank of England's policy of quantitative easing, but it is also due to confidence in the UK's economic programme. Once that confidence is lost, it will be virtually impossible to recover. In those circumstances, although the UK fortunately has retained its own currency, the Bank of England might have to monetise the deficit further, leading to currency debasement. In those countries trapped within the eurozone, and which are in trouble, current interest rates mean that the countries will enter a debt spiral from which recovery would be virtually impossible without default. The UK's situation would be less bad but not at the ugly end of the spectrum.

The first estimate of UK second quarter GDP was a negative 0.7%, worse than expected. Nobody thinks that the economy is doing well, it obviously is not, but there are doubts as to whether it is doing that badly. The jobs figure is the puzzle. The latest unemployment figures show that unemployment fell to a nine month low of 2.58 million in the three months to May. It was the fourth successive month in which unemployment has fallen and now stands at 8.1%. Very often GDP figures are revised, quite often going back a long time and it is possible that this may happen again.

With no money available for a fiscal expansion, the best way forward would be significant supply side reforms which encourage businesses to expand and take on staff. But whilst the coalition can agree on the big issue of tackling the deficit, some meaningful supply side measures seem too difficult to touch because of disagreements. It is for this reason that business has become increasingly critical of the government.

Perhaps because the UK is not in the eurozone and has, therefore, not experienced the level of crisis it might have done had it been a member and therefore not had a flexible exchange rate and the ability to print its own money, the stock market has held up well, as has sterling ; indeed the strength of the pound against the euro will have been unhelpful to companies doing business in the eurozone. Whatever the travails of the UK economy, it does have some excellent companies whose earnings and dividends are holding up well (indeed the progression of dividends has been surprisingly good), whose business is significant in faster growing markets and whose shares are not excessively rated even in this gloomy economic environment. As with the eurozone, it is important to distinguish between the sovereign and the companies domiciled in them.

In conclusion, our message for our investors remains unchanged, in that the seemingly paradoxical situation of equities being the most attractive asset class in a particularly difficult and uncertain environment, which includes the possibility of a currency union breaking up, still holds. Equity ratings, even in a very bad environment, can be justified unlike those of good quality sovereign debt which at some stage are going to cause some very painful losses for investors when yields return to a realistic level. Companies which are preparing contingency plans in case the euro fragments are better placed than many governments to deal with the fallout from a disintegration of the eurozone. As this is written, sentiment is better in the markets but nothing has been done to address the fundamental problem of the euro and, so, investors must expect an uneven ride against a background of an uptrend in equities.