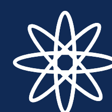

meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The setback in equity markets at the end of the quarter was not sufficient to prevent a modest rise in equities over the period. Low levels of volatility led to fears in some quarters that investors were becoming too complacent in the face of geopolitical problems whilst others, the bulls, felt that the stance of monetary policy in most areas was still likely to support equity prices. This view also gave support to bond market bulls. Currencies were relatively quiet over the quarter, whilst there was little change in the price of gold and oil.

The tables below detail relevant movements in markets :

International Equities 30.04.14 - 31.07.14

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+3.6	+4.0	+3.9	+7.7
Finland	+4.8	+1.2	+1.2	+4.8
France	-3.4	-6.8	-6.8	-3.4
Germany	-2.0	-5.4	-5.4	-2.0
Hong Kong, China	+8.7	+8.8	+8.8	+12.7
Italy	-2.9	-6.3	-6.3	-2.9
Japan	+11.3	+10.5	+10.5	+14.5
Netherlands	+0.5	-3.0	-3.0	+0.5
Spain	+5.1	+1.4	+1.4	+5.1
Switzerland	-0.3	-3.4	-3.4	+0.1
UK	+0.1	+0.1	+0.1	+3.7
USA	+3.1	+3.1	+3.1	+6.8
Europe ex UK	-0.4	-4.0	-4.0	-0.5
Asia Pacific ex Japan	+5.5	+6.1	+6.0	+9.9
Asia Pacific	+8.2	+8.2	+8.2	+12.1
Latin America	+6.4	+5.3	+5.3	+9.1
All World All Emerging	+9.8	+9.5	+9.5	+13.4
The World	+3.3	+2.6	+2.6	+6.3

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : 0.0%

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

Currency	30.04.14	31.07.14
Sterling	2.68	2.65
US Dollar	2.67	2.59
Yen	0.62	0.54
Germany (Euro)	1.48	1.19

Sterling's performance during the quarter ending 31.07.14 (%)

Currency	Quarter Ending 31.07.14
US Dollar	+0.1
Canadian Dollar	-0.4
Yen	+0.8
Euro	+3.7
Swiss Franc	+3.3
Australian dollar	-0.1

Other currency movements during the quarter ending 31.07.14 (%)

Currency	Quarter Ending 31.07.14
US Dollar/Canadian Dollar	-0.5
US Dollar/Yen	+0.7
US Dollar/Euro	+3.6
Swiss Franc/Euro	+0.3
Euro/Yen	-2.8

Significant Commodities (US dollar terms) 30.04.14 – 31.07.14 (%)

Currency	Quarter Ending 31.07.14
Oil	-2.7
Gold	-0.1

MARKETS

Despite weakness right at the end of the quarter, international equity markets trended higher during the period. In local currency terms, the FTSE World Index returned 3.3%, in sterling terms 2.6%, in US dollar terms 2.6% and in euro terms 6.3%. If we look at local currency movements first, we note that the best performance came from Japan with the FTSE Japan Index returning 11.3%. There were also good returns from Emerging Markets, Latin America and Asia Pacific ex Japan where the respective indices returned 9.8%, 6.4% and 5.5%. The return from the FTSE USA Index was closely in line with that of the FTSE World Index at 3.1%. The FTSE UK Index was an underperformer, returning just 0.1%, whilst the worst performance was seen by the FTSE Europe ex UK Index with a negative return of 0.4%. Looking at the markets in sterling terms, the FTSE Japan Index still performed very well, returning 10.5%. The returns from Emerging Markets, Latin America and Asia Pacific ex Japan remained strong in sterling terms with respective returns of 9.5%, 5.3% and 6.1%. With hardly any movement in the £/$ exchange rate, the sterling return from the FTSE USA Index was unchanged at 3.1%. With the Australian dollar recovering a little against sterling, the sterling adjusted return on the FTSE Australian Index was a healthy 4.6%. Currency weakness in Europe exacerbated the negative return in sterling terms and the FTSE Europe ex UK Index returned -4.0%.

High quality government bonds performed well during the quarter. The largest decline in gross redemption yields on ten year government bonds occurred in Japan and Germany. In the case of Japan, the yield declined by 8 basis points to 0.54% and, in the case of Germany, by 29 basis points to 1.19%. Smaller yield declines were seen in the UK where they fell by 3 basis points to 2.65% and in the USA where they fell by 8 basis points to 2.59%.

Currency markets were quieter than in some previous quarters. European currencies were the weakest. Against the euro, sterling rose by 3.7% and against the Swiss Franc by 3.3%. Elsewhere, movements were slight.

Notwithstanding the Middle Eastern conflict, oil, as measured by Brent crude, fell by 2.7% and gold was little changed over the quarter.

ECONOMICS

International equity markets up to the end of July have broadly maintained their slightly higher levels compared with the start of the year, even with the setback at the end of the quarter. This is despite serious political tension in the Middle East and Ukraine, the destruction of a Malaysian Airlines plane and also a downgrade by the IMF of its forecast for world economic growth. In our view, shares continue to be supported by the very loose orthodox and unorthodox monetary policies being followed around the world and the same goes for bonds, the asset class which we think is clearly overvalued. As we have said a number of times, corporate earnings' growth needs to accelerate to validate the extent of last year's rise in share prices and this requirement means a reasonable level of economic growth in most areas.

In this respect, the downgrade from the IMF, whilst not ideal, does not detract from the case for equities but it does heighten the need to be watchful for trends which could undermine markets. The IMF now expects world output to increase by 3.4% this year, down from its April forecast of 3.7%. It has left its 2015 forecast of 4.0% unchanged. The main reason for this year's growth downgrade

is a 0.4% reduction in the forecast for advanced economies where growth is now estimated to be 1.8% for this year, although next year's forecast has been fractionally increased to 2.4%. Within the forecast for advanced economies, the main cause of the quite significant downgrade is the USA where a very bad weather related first quarter has pulled back the IMF's estimate of growth to 1.7% this year, down from its April estimate of 2.8%. There is a very slight increase in next year's forecast to 3.0% from 2.9%. Elsewhere, the IMF has left its eurozone growth forecast unchanged at 1.1% for this year and raised its very slightly to 1.5% next year. But, within that unchanged forecast, there are some significant underlying changes which reflect the differing fortunes of the four biggest eurozone economies. The forecasts for this year for Germany (the number one eurozone economy) and Spain (number four) have been increased by 0.2% and 0.3% respectively to 1.9% and 1.2%, whilst those for France (number two) and Italy (number three) have been reduced by 0.3% in both cases to 0.7% and 0.3%. We will revert to the eurozone later, suffice it to say that the economic position of both France and Italy gives cause for concern. For next year, amongst the eurozone's big four countries, the IMF's main adjustment concerns Spain where the forecast has been upgraded by 0.6% to 1.6%. Japan sees a meaningful uplift in the IMF's forecast for this year by 0.3% to 1.6% as a result of a strong first quarter and a fractional uplift next year to 1.1%. However, the star of the show is the UK where the IMF has raised its forecast for growth this year by 0.4% to 3.2% and by 0.2% for next year to 2.7%. This gives the UK by far the highest forecast growth rate this year, a full 1% higher than the next highest forecast which is Canada at 2.2%. If we look at its forecast for Emerging Markets and Developing Economies, the IMF has downgraded its forecast by 0.2% this year to 4.6% and by 0.1% next year to 5.2%. For China, its forecasts for 2014 and 2015 have been downgraded by 0.2% each year to 7.4% and 7.1% respectively. For Russia, for obvious reasons, the downgrade has been severe, by 1.1% and 1.3% respectively to 0.2% and 1.0%, and these forecasts must be subject to a high degree of uncertainty, given what is happening at the moment. For India, a particularly interesting country at present, given the recent political change which has increased investors' interest in the country, the IMF has left its forecasts unchanged at 5.4% for this year and 6.4% for next year. Brazil, which has produced a disappointing economic performance, has seen its growth forecasts sharply reduced by 0.6% for both 2014 and 2015 to 1.3% and 2.0% respectively.

Investors can draw some comfort from the fact that the US economy which, in the first quarter contracted at an annualised rate of 2.1%, will bounce back. Very poor weather in January and February plus a high level of inventories going into 2014, were the main reasons for this apparently very poor performance, but the US economy should bounce back from now onwards. Certainly, if we look at the performance of Wall Street, it does not appear that investors are unduly worried by the temporary contraction in the US economy in the first quarter. They have also drawn encouragement from measures taken by the Chinese authorities to stimulate the economy. The strong recovery of Chinese "H" shares in Hong Kong suggests better sentiment in the region. The main problem area remains the eurozone. Although the IMF sees a return to growth in the region this year and next year, at 1.1% and 1.5% respectively, following a contraction of 0.7% in 2012 and 0.4% in 2013, this level of growth is insufficient to deal with the worsening debt dynamics of the region. We will be talking about this area in more detail shortly.

We also need to be on our guard about over complacency. Markets have experienced a very low level of volatility, considering the extent of the economic and political problems, causing some to worry about how markets will react if something which is not currently foreseen occurs. This might seem a statement of the obvious but, to misquote Donald Rumsfeld, the market can accommodate "known knowns" but not "unknown unknowns". However bad the "known knowns" are, and they are bad, for example the Middle Eastern conflict, the Ukraine and, on the economic front, the eurozone's economic and debt problems, investors can take them into account. Bears worry that something

totally unexpected will hit the market badly and that investors are over complacent at present. It is certainly true that markets have been remarkably unaffected by the recent serious political events which have occurred. For the moment, the lack of significant volatility is an observation, not a reason to be bearish. It does not mean complacency about an "unknown unknown" occurring. However, notwithstanding the extent of known political problems, which must mean that economic forecasts are likely to be more prone than usual to revision, the level of economic growth as evidenced in the IMF's forecasts and those of others does seem to be improving and we think it is the direction of travel which is important at the moment.

What we would hope to see as a result of the steadiness of international equity markets at these higher levels is evidence of "animal spirits" appearing. In some respects, we are seeing this. M & A activity in the USA is much in evidence at present. When company directors are feeling more confident they may be more inclined to take a risk by trying to buy other companies. M & A activity excites investors and buoys share prices. However, the "animal spirits" which economists would prefer to see include increased business investment. This has been notably absent in recent years as companies have preferred to build up cash balances due to uncertainty about the economic outlook. Companies have engaged in shareholder friendly actions such as share buy backs or increased dividends but, ultimately, if an economy's long term potential growth rate is to be secured, there must be capital investment. Fortunately, at least in the USA and UK, there are some signs of this and such an upturn would contribute to good quality economic growth.

One of the most puzzling aspects of markets' behaviour this year has been the strength of bond and equity markets, on the face of it a contradictory combination. The very low level of bond yields suggests recession and/or deflation, whilst the level of the international equity markets suggests that the economic outlook is promising. They cannot both be right. What we do know, of course, is that bond yields have been artificially suppressed by the extreme monetary policy followed by many countries. Central banks' bond purchases have driven down yields as a way of helping borrowers and stimulating the economies. Money printing ultimately threatens inflation, although it may not seem like it at present, and there are two reasons why this has not yet happened. The printed money has not circulated round the economies and there is still an output gap in most countries. This means that the level of output in an economy has not come up against its potential output level and, until that happens, inflation is not likely to become a problem as companies do not have to bid up wages to attract employees nor to pay up for inputs like raw materials. However, once that output ceiling is reached, inflationary pressures will begin to be felt as companies have to bid up for employees and inputs like raw materials. Unit costs begin to accelerate and inflation ensues. If the flood of cheap money starts to circulate as businesses and consumers become more confident, the output ceiling will be reached earlier and the prospect of an inflationary problem brought forward. When one is in a period of high or low inflation, it is always tempting to believe that this state of affairs will continue indefinitely but it is a temptation which should be avoided.

However, there is one area experiencing very low inflation, the eurozone, and this is largely due to a highly specific reason, the euro. At present, inflation is running at 0.4%, lower than any other major region, and there are fears of deflation with some members of the eurozone already experiencing it. If one is dismissive of deflation being a general problem in the world economy why should one make a possible exception of the eurozone? It is worth considering why deflation is an unwelcome economic phenomenon, sometimes just as malign as inflation. If consumers and businesses expect prices to fall, it is rational to defer expenditure which can wait in the hope of saving money. Such a pattern of economic behaviour can lead to recession or depression as demand collapses. In inflationary times, borrowers gain at the expense of lenders as the real value of their

liabilities falls. In a deflationary environment, borrowers face increasing real liabilities which may cause bankruptcies and problems for the banking sector. The nature of the monetary union and the policies which it follows make deflation a possibility for the eurozone as a whole as opposed to in specific countries although not, in our view, a probability at this stage. That such a possibility exists is because, by definition, there is inflexibility of exchange rates within a monetary union. With unit costs of production having diverged within the eurozone rather than having converged as they were supposed to do, the way chosen by the EU, ECB and IMF, the troika, for those recalcitrant countries is an internal devaluation. It is the fact that divergence of unit costs of production has bad side effects which causes the problem. It is likely to damage a country's balance of payments and its internal budgetary situation. In normal circumstances, if a country becomes uncompetitive, it would devalue. Whilst only a short term palliative, it could help if other appropriate internal economic measures were taken. What the troika of the ECB, EU and IMF has imposed on the affected eurozone members is an internal devaluation, meaning that domestic costs must be cut in order that these countries move to restore their competitiveness. This includes wage cuts which means that domestic demand will be weakened, thus leading to a downward spiral of demand and economic activity. With wage costs falling and demand weak, the climate is conducive to falling prices and that is where the fear lies. Furthermore, at the macro level, it gets even worse for it damages a country's debt dynamics. It happens in the following way with a very simple example. If a country has a given level of outstanding public debt and nominal GDP declines because of deflation and assuming the budget is balanced, then the mere fact of deflation will cause the outstanding level of public debt in relation to GDP to rise, the so called denominator effect. This, of course, is a grossly over simplified example but it makes the point. It also fits an environment of low growth and budget deficits, both of which are features of the troubled eurozone countries as they find economic growth elusive. It will be recalled that one of the rules of the club was that outstanding public debt as a percentage of GDP was supposed to be limited to 60%. At the end of last year, we see levels of 175.1% in Greece, 132.6% in Italy, 129.0% in Portugal, 123.7% in Ireland, 93.9% in Spain and 91.8% in France. These levels of debt are generally deteriorating and threaten economic growth as servicing costs eventually overwhelm the budget. If interest rates return to more normal levels, the problem will become acute.

The ECB has taken further measures to try to kick start the eurozone. In June, it cut its benchmark interest rate by 0.15% to 0.1%, said that it would pay a negative interest rate on banks' balances with the ECB (-0.1%) and said that it would offer up to €400 billion of cheap long term loans to banks to stimulate lending to small businesses. Whilst these measures will no doubt help at the margin, the structural rigidities which are hardwired into a number of eurozone countries and which they are being asked to address are the real problem together with the euro. Job destroying employment law measures make firms reluctant to expand, yet meaningful reform is beyond these countries' ability to enact it. Where there has been some progress on this front, Spain, for example, the situation, although bad, does look a little better. There seems little prospect of the troubled eurozone countries growing quickly enough to stabilise their debt profiles and, at some stage, there will almost certainly be another eurozone debt crisis. France and Italy are concerns. They both need decisive action to improve the supply side of their economies but it is hard to see how this will come about and their problems pose a threat to the eurozone. Both countries are trying to make modest reforms to help business but something much more dramatic is needed.

We now turn to look at various areas of the world economy, starting with the USA where second quarter GDP figures reflected a marked recovery from the weather and inventory level depressed first quarter which showed an annualised decline of 2.1%, the reason why, as mentioned earlier, the IMF has downgraded its forecast growth level for the USA this year. The first estimate of a second

quarter growth is 4.0% and there were upward revisions to third quarter growth to 4.5% (4.1%) and fourth quarter growth to 3.5% (2.6%). As evidenced by the stock market performance, investors do not appear to be too concerned about the first quarter's contraction in GDP, regarding it as an explicable aberration. They will be more concerned if the rest of the year does not meet expectations. The latest purchasing managers' indices present a reasonably good picture. The data from these is regarded as important and high value in ascertaining the state of a given economy. The manufacturing PMI for July stood at 57.1 and for non manufacturing at 56.0 in June. With 50 marking the boundary between expansion and contraction, both these readings are quite healthy. The latest industrial production figures showed a month on month rise of 0.2% in June, down from May's rise of 0.6%, to give a year on year increase of 4.3%. The Conference Board's leading indicators showed a rise of 0.3% in June following a rise of 0.5% in May. Retail sales crept up by 0.2% month on month in June and house prices continue to rise, if not quite at the rate previously. For example, the latest S & P/Case-Shiller Composite Index for 20 US cities house prices showed a year on year increase in prices of 9.3% in May, down from 10.8% in April. The unemployment figures, another key guide to the state of the US economy, have given a positive surprise. The unemployment rate in July was 6.2%, up from 6.1% in June, but the participation rate increased. Encouragingly, in the context of better quality growth, business investment in the second quarter rose by 5.5%, up from the first quarter's increase of 1.6%.

With the economic figures generally encouraging, the Federal Reserve has seen no reason to stop its tapering programme and, by October, the Federal Reserve should have stopped printing money to buy bonds. The next issue for monetary policy will be the timing of an interest rate rise. With inflation beginning to creep up, the consumer price index was up 2.1% year on year in June, real interest rates, as measured by the Fed funds rate, are significantly negative and, as measured by the ten year Treasury bond, only slightly positive in real terms, so monetary policy will remain very loose. The big concern for investors would be how equity markets would react to a tightening of monetary policy. We saw two bouts of "taper tantrums" last year when tapering became a more realistic prospect but, now, markets, at least in the USA, seem to have come to terms with a tightening of monetary policy, albeit one which remains very loose by any standards. It is right that it should do so for two reasons. The first is that any signs of a gradual return to normality in the economy should be welcomed. The second is that, whilst cheap and printed money has boosted asset prices, it has seriously distorted investment and economic decisions. An example of the former is the demand for bonds at yield levels that we would never previously have considered possible and certainly not sensible. An example of the latter is companies borrowing very cheap money on the bond market to repurchase some of their equity rather than invest. Whilst that has no doubt helped to boost share prices by enhancing earnings per share, it is not good for long term economic prospects, as we discussed earlier, because the long term productive potential growth of an economy is adversely affected by lack of business investment. The Federal Reserve's decision on interest rates will be heavily influenced by the FOMC's view on the size of the output gap in the economy, that is the difference between the economy's current output and its potential output, as we discussed earlier. Those who think the gap remains quite large will take a more dovish view on interest rates, whilst a more hawkish attitude on the need to raise interest rates sooner rather than later will be held by those who think the level of spare capacity in the economy is nearly exhausted. The increased rate of business investment, noted above, is encouraging in this respect.

Besides concerns about the advent of tapering, other recent negative influences on Wall Street from time to time have been the political stand offs between the Administration and Congress, notably over the budget and debt ceiling. Although this has not gone away in the sense that, even though they have improved in the short term, the long term trajectory of public finances has to be addressed, it

is not an issue at present. It may sound cynical but sometimes the less politicians do, the better it is for an economy. Congressional elections in November may hand control of the Senate to the Republicans who already control the House of Representatives, in which case the deadlock would be even more intractable. That is not a bad background for the stock market given that the US economy seems to be moving along quite well after the setback in the first quarter caused by special factors.

Given that Wall Street regained all time highs during the quarter, although off them at present, the elevated rating of the market means that it is important that company earnings' growth does not disappoint. At present, the rate of increase of corporate earnings is expected to accelerate quarter by quarter and the market is also buoyed by the high level of M & A activity. Our view is that, whilst share price growth will be more modest from here after last year's spectacular performance and there may be some setbacks along the way, it remains one of the more attractive markets in which to be invested.

Moving on to the eurozone, we have discussed the big picture and the severe problems which the area faces. It is likely to remain a drag on world economic growth for the foreseeable future with a very sub par growth performance. Whilst there are some more encouraging signs from countries such as Spain, which have suffered badly, and Germany continues to be the economic powerhouse, weakness in France and Italy, as the IMF forecasts suggest, is a real concern and problem for the future of the euro as pressures from these countries to ease back on the austerity programme grow. Recent overall purchasing managers indices for the eurozone have not been too bad. The latest composite index for July gave a reading of 53.8 which is quite encouraging. Within that figure, the dominant services sector gave a reading of 54.2, manufacturing 51.8 and construction 43.3 (June). The latest purchasing managers' indices figures we have for July from Germany and France give an example of the divergence in performance between these two economies. The composite PMI for Germany for July was 55.9 (manufacturing at 52.9 and services at 56.6) whilst the composite index for France was 49.4 (manufacturing 47.6 and services 50.4). Both composite figures are better than those for June but the absolute level of the index for July suggests economic growth for Germany and contraction for France. The French economy failed to grow in the first quarter whilst the German economy grew by 0.8% quarter on quarter. Year on year to the end of the first quarter of 2014, the German economy grew by 2.3% whilst the French economy grew by 0.7%. If we look at the latest industrial production figures for May, Germany's level is 1.3% higher than a year earlier, those for France 3.7% lower. The number three eurozone economy, Italy, showed a year on year decline of 4.9% while the number four economy, Spain, so badly hit by the crisis but showing slight signs of recovery, showed an increase of 0.4%. France is expected to show a budget deficit of around 4.0% this year and Italy 5.5%, whilst Germany's surplus is expected to be around 0.5%, according to The Economist's estimates. Declining competitiveness reflects itself in a country's current account and, whilst the eurozone as a whole is in healthy surplus, France is in deficit (estimate 1.3% of GDP this year, again The Economist's estimate) and Germany's surplus an enormous 7.0%. The latest eurozone unemployment rate is 11.5% with the figures for Italy and France at 12.3% and 10.3% respectively, whilst that for Germany is 6.7%.

The point of highlighting some of this eurozone data for the four largest economies is that the divergence of economic performance between the countries comprising the eurozone is very serious. Although the powers that be in the eurozone will not admit to it, partly because of loss of face, the fact that the countries which constitute the eurozone do not reflect an optimal currency area is making for great economic hardship in a number of countries as evidenced, for example, by the unemployment levels especially amongst the young, and adversely affecting growth prospects.

In the process, it is acting as a drag on international growth prospects and it is difficult to find reasons for optimism. We are waiting for the result of the ECB's bank tests which may well throw up further problems. However, as always, we differentiate between the prospects of the eurozone and the individual countries within it and companies based in the eurozone. Many of the latter have much better prospects than their sovereign because of their international diversification and their ability to handle currency fluctuations and the area, together with non EU countries like Switzerland, home to a number of world class companies, forms an important part of our investment strategy. At the moment, we have not factored in an effect from the Ukraine crisis and sanctions on Russia but it could obviously become an even more serious issue given the eurozone's close trading links with Russia.

The jury remains out on Japan because of the uncertain effect of the 1st April increase in consumption tax from 5% to 8% in an effort to deal with Japan's appallingly high budget deficit and level of outstanding debt as a percentage of GDP at around 227% of GDP. Because of expenditure brought forward to avoid the consumption tax increase, first quarter GDP was 1.5% higher than that of the previous quarter (5.9% annualised) and 3.0% higher year on year. The latest purchasing managers indices give a residual picture with the composite figure for June starting at exactly 50, the level between expansion and contraction in an economy. The manufacturing index stood at 51.5 and that for services at 49.0. The Tankan survey of businesses showed a decline in the June quarter to 7 from 12 the previous quarter, reflecting slightly less optimism amongst businesses. After falling in May by 2.8%, industrial production rose by 0.7% in May but fell back by 3.3% in May. The rise in consumption tax was obviously a risk for the Japanese economy but the dire state of public finances dictates. Even though most of Japanese public debt is held internally, which reduces the risk of a run on the currency as foreigners dump government bonds, it is a potentially dangerous risk for the economy if the debt situation is not tackled at some stage. The fiscal stimulus, one of the Prime Minister's three arrows (the other two being monetary and structural), has been used as a cushion for the longer term fiscal tightening implied by the consumption tax increase (another one is currently planned next year to take it from 8% to 10%) but its effects will wear off and this is one of the reasons for the IMF scaling back its projected growth forecast next year from the level expected this year even, though it is 0.1% higher than it expected last April. The key issue to us is the third arrow, the structural one. Just as in the eurozone, monetary policy (and, in the case of Japan, fiscal as well) can only do so much. If there are structural rigidities in an economy which limit the potential rate of growth, these other two arrows will not work. Given the looseness of monetary policy in Japan, the 2% inflation target could ultimately be exceeded if the economy's output gap was closed. Whilst Japan wants some inflation, it does not want too much and the best way to achieve the desired outcome is to increase the long term productive potential of the economy. In Japan, there are significant rigidities in the employment and product markets but, as in the eurozone, major vested interests have to be confronted. How successful Mr Abe is will determine the success or otherwise of Japan's huge economic gamble which means the risk/reward ratio of the Japanese stock market is high.

One of the key issues for investors at present is how China manages the transformation of its economy towards consumption and away from fixed asset investment. There is certainly more optimism about China, as evidenced by the recovery in the market after a disappointing performance. There was a slight increase in the year on year GDP growth to the end of the second quarter. The rate of increase rose from 7.4% at the end of the first quarter to 7.5% at the end of the second quarter. This was slightly ahead of expectations. The latest purchasing managers indices for July were fairly stable. That for manufacturing increased slightly from 51.0 to 51.7, whilst that for non manufacturing fell slightly from 55.0 to 54.2. In June, there was a slight acceleration in the year on year and month on

month rate of increase of industrial production. The year on year increase rose from 8.8% to 9.2% and, month on month, industrial production was up by 0.77% against 0.7% the previous month. One of the main concerns about China is the banking sector. Early in July, the Chinese Prime Minister, Ki Keqiang, warned about the risk that credit conditions could hamper private business. What one can say about China is that it can act more quickly than any other major country to implement its economic policies. At this stage, one can note a slightly more optimistic view on China as a result of recent economic data.

Finally, we turn to the UK where, as we noted earlier in this review, it is likely to show by far the fastest growth rate of the major economies this year. The IMF, which had been critical of the UK's economic policy at the beginning of 2013, has now reversed its view and now forecasts economic growth of 3.2% this year and 2.7% next year. Confidence about the UK has manifested itself in a strong exchange rate partly brought on by expectations that the UK's improving economic performance will bring about an early increase in interest rates.

The rise in sterling is beginning to raise mutterings of difficulty from some firms as it makes life more difficult in export markets and overseas profits are reduced in sterling terms on translation. The level of the various purchasing managers' indices shows some of the highest readings around. The composite PMI for July stood at a high level of 58.8. Within that, manufacturing was at 55.4, services at 59.1 and construction at 62.4. Second quarter GDP rose by 0.8% and the size of the economy now exceeds the level of the first quarter of 2008. So about six years of economic growth has been lost, and regaining the level of the first quarter of 2008 is a psychological boost, but a lot of hard work remains to be done and it is important that there is no let up in tackling the horrendous deficit problem. The breakdown of growth in the last quarter showed that the dominant services sector of the economy grew by 1.0%, production by 0.4%, whilst construction, the smallest element, decreased by 0.5%. The employment figures, whilst still far too high, continue to improve. The May unemployment level fell by 0.1% to 6.5% with an extra 2,541,000 jobs created in the last quarter. Encouragingly, as we touched upon earlier, business investment is starting to improve. In the first quarter, it rose by 5.0% over the final quarter of 2013 and was 10.6% higher year on year. Notwithstanding the much improved growth outlook for the UK, the economy remains unbalanced and needs to rotate to investment and exports away from consumption and housing where the sharp rise in house prices has raised concerns about a crash. There are slight signs of a cooling off in the housing market and the authorities have certain macroprudential tools in their armoury to manage the market. Evidence of consumers feeling more confident comes from the retail sales figures. Spending increased by 1.6% compared with the previous quarter. Of course, not everything is rosy in the UK economy. Whilst record numbers of people are in work, real wages are still falling, with the latest inflation figure showing an unexpectedly high figure of 1.9%. Over the year to May, wages, excluding bonuses, rose by 0.7%. Productivity has been disappointingly weak and the ideal economic position would be for pay increases to come about which were matched by productivity increases. Despite strong economic growth, public borrowing figures have been disappointing, not greatly different from this time last year, although it is hoped that tax receipts will pick up later this financial year.

Our view is that the biggest threat to the UK stock market is the political one. In the short term, September sees the Scottish independence referendum. At the moment, almost nothing seems to be priced in for a "yes" vote and, according to the opinion polls, that is the correct assumption. Yet, if, against the current evidence of the opinion polls, a "yes" vote occurred, it would undoubtedly hit the markets and, probably, sterling as well. The next political issue after that is next May's General Election which present opinion polls suggest will result in a change of government. At present,

there is a high degree of polarisation seen in the two main parties' economic policies. One of the disturbing trends in the UK at present is the upsurge in anti-business sentiment which, if this manifests itself in legislation, is likely to cause difficulties for the UK stock market. Whilst the economic outlook, from a low base, looks promising, the political uncertainties are considerable. At present, foreign confidence in the UK is high. It is important that it remains so because foreign capital inflows are important to the UK which is running a large current account deficit. In the last two quarters of 2013, the deficit was running at over 5% of GDP and at 4.5% for 2013 as a whole and it is expected to be something around 4% this year. The current strength of sterling could prove precarious if confidence in the UK weakens and, in this context, it is worth noting that foreign investors are starting to disinvest in the UK government bond market.

At present, we see no reason to change our view that international equity markets will grind higher this year but with setbacks along the way caused by economic or political events which have not been discounted, in other words ones which are over and above what are already known. That there is bad news around is not a reason for a poor stock market if investors have been able to factor that into their investment strategy. Russian sanctions are going to cause economic issues for other countries, particularly in Europe, and we have to see how this situation will develop but it is not good news. If it deteriorates even further and threatens more economic problems for the eurozone, we can expect the ECB to take further action along the lines of formal quantitative easing. But on the basis, that the IMF's forecasts are broadly correct, there should be enough growth in the world economy to support equities. For the reasons we have mentioned before, we consider bonds to be greatly overvalued.

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