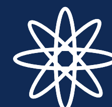

meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Clearly, the quarter has been most remarkable for the consequences of the U.K.'s Brexit vote on the 23rd June. Our table below shows pleasing returns from equity markets generally, enhanced enormously in the case of the U.K. by the effect of sterling's sharp post referendum fall. At the same time, bonds have advanced significantly, leading to an unusual combination of bond and equity price rises. The extent of sterling's weakness is shown in the currency table. In the commodity markets, it is noticeable that oil has started to weaken again after its recent recovery.

The tables below detail relevant movements in markets :

International Equities 29.04.16 - 29.07.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.4	+17.0	+6.0	+8.6
Finland	+7.0	+15.3	+4.5	+7.0
France	+2.2	+10.1	-0.3	+2.2
Germany	+3.5	+11.5	+1.1	+3.5
Hong Kong, China	+5.8	+16.6	+5.7	+8.3
Italy	-6.6	+0.6	-8.9	-6.6
Japan	-1.3	+13.7	+3.0	+5.5
Netherlands	+3.0	+11.0	+0.6	+3.0
Spain	-3.3	+4.2	-5.5	-3.3
Switzerland	+2.5	+12.2	+1.7	+4.1
UK	+8.6	+8.6	-1.6	+0.8
USA	+5.9	+16.8	+5.9	+8.5
Europe ex UK	+1.7	+9.6	-0.7	+1.7
All World Asia Pacific ex Japan	+6.1	+17.8	+6.5	+9.3
All World Asia Pacific	+2.2	+16.2	+5.1	+7.8
All World Latin America	+4.9	+16.0	+5.2	+7.7
All World All Emerging	+6.1	+17.0	+6.0	+8.6
All World	+4.8	+14.7	+4.0	+6.5

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +9.7%

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

Currency	29.04.16	29.07.16
Sterling	1.73	0.80
US Dollar	1.84	1.48
Yen	-0.08	-0.27
Germany (Euro)	0.27	-0.18

Sterling's performance during the quarter ending 29.07.16 (%)

Currency	Quarter Ending 29.07.16
US Dollar	-9.6
Canadian Dollar	-5.9
Yen	-13.4
Euro	-7.3
Swiss Franc	-8.6
Australian Dollar	-9.4

Other currency movements during the quarter ending 29.07.16 (%)

Currency	Quarter Ending 29.07.16
US Dollar / Canadian Dollar	+4.1
US Dollar / Yen	-4.2
US Dollar / Euro	+2.5
Swiss Franc / Euro	+1.4
Euro / Yen	-6.6

Significant Commodities (US dollar terms) 29.04.16 - 29.07.16 (%)

Currency	Quarter Ending 29.07.16
Oil	-8.4
Gold	+6.8

MARKETS

International equity markets have enjoyed a good quarter with the FTSE All World Index returning 4.8% in local currency terms, 14.7% in sterling terms, 4.0% in U.S. dollar terms and 6.5% in euro terms. Looking at local currency returns first, we note above average performances from the U.K. (+8.6%), Australia (+6.4%), Asia Pacific ex Japan and Emerging Markets (both +6.1%) and the U.S.A. (+5.9%), all as measured by the relevant FTSE indices. Underperformers included the FTSE Japan Index (-1.3%) and most of the European markets where the FTSE Europe ex U.K. Index returned 1.7%. However, the sterling returns changed dramatically as the currency fell sharply post the EU referendum. The FTSE U.K. Index's above average performance in local currency terms became a well below average return as currency movements enhanced the performance of overseas markets. Above average sterling adjusted performers came from Australia (+17.0%), the U.S.A. (+16.8%), Asia Pacific ex Japan (+17.8%), Latin America (+16.0%) and Emerging Markets (+17.0%). The sharp appreciation in the value of the yen meant that the sterling adjusted return on the FTSE Japan Index of 13.7% was only slightly below the sterling adjusted return on the FTSE All World Index of 14.9%. Besides the U.K., the FTSE Europe ex U.K. Index with a return of 9.6%, also underperformed the FTSE All World Index, although still, of course, a more than acceptable return for sterling based investors.

International bond markets also enjoyed an extraordinary quarter. Looking at ten year government benchmark bonds, we see that the gross redemption yield on the U.K. government bond fell by 93 basis points to 0.80%, on the U.S. government bonds by 36 basis points to 1.48%, on the Japanese government bond by 19 basis points to -0.27% and, on the German bund, by 45 basis points to -0.18%, all truly extraordinary figures.

Currency markets were equally remarkable as a result of the U.K.'s Brexit vote. Against the yen, sterling fell by 13.8%, against the U.S. dollar by 9.6%, against the Australian dollar by 9.4%, against the Swiss franc by 8.6%, against the euro by 7.3% and against the Canadian dollar by 5.9%.

In the commodity markets, oil showed renewed weakness but gold picked up a little, rising by 6.8%.

ECONOMICS

The strength of international stock markets since the U.K. voted to leave the EU on 23rd June will have surprised many people. Given the emotional nature of the campaign with its apocalyptic warnings and unsubstantiated and unprovable statements made as the campaign became ever more angry and bitter, the outcome, unexpected by many, therefore came as a shock, but weakness in equity markets on the 24th June gave way to more positive sentiments in the days which followed. As we look back over events since the 23rd June, one of the most significant effects has been seen in the movement of sterling which has weakened significantly, as our table of currency movements for the last quarter shows. In the run up to the EU referendum, although the opinion polls did not point in any clear direction as to the outcome, "groupthink" appeared to take over and, on referendum day, sterling touched US$1.50. The disconnect between what the opinion polls were saying, namely that the result was too close to call, and what the markets were saying, that "remain" would win, was quite apparent. "Groupthink" occurs when a group of like minded people believe that their views will prevail. In the financial markets, which would be dominated by "remainers", this phenomenon led to positions being taken which were not justified by the limited evidence available, i.e. the opinion polls. Sterling and the U.K. stock market (although the fall in the latter was small and only lasted a short time) were therefore bound to react badly if the weight of the money was backing the losing side.

Since the 24th June, the U.K. and other equity markets have moved higher, whilst sterling has remained at around its immediate post referendum level. Whilst recognising that only a short time has elapsed since the EU referendum and that we cannot, therefore, be certain that the post referendum pattern of markets will be maintained, it is nevertheless instructive to consider the divergent movements of sterling, on the one hand, and the U.K. and other equity markets, on the other.

Firstly, let us consider why sterling may have fallen. In the very short term, the unwinding of speculative positions in the currency built up in the expectation that "remain" would win, will have exerted downward pressure on the currency and caused some heavy losses to those on the wrong side of the trade. One would expect this cause of sterling's fall to have worked its way out of the system, so we are now left with the more fundamental reasons for the weakness of sterling. One issue which we have raised in many of our past economic reviews is the potential vulnerability of sterling resulting from the U.K.'s very weak current account position, with the deficit in the latest quarter running at 6.9% of GDP. This is a dangerously high level. In order to bridge the gap, the U.K. has to attract substantial capital inflows and, for that to happen, the U.K. has to be an attractive country in which to invest. Those with a negative outlook will advance the proposition of a weaker U.K. economy caused by lost access to the EU on Single Market terms, difficulties for the U.K. financial sector which may cause financial institutions to downsize in the U.K. and that weaker economic growth will affect the property sector and, thus, the attraction of U.K. real estate assets to foreign investors. Foreign investors put off the U.K. by loss of access to the Single Market on current terms will switch investment to other countries. Lower growth resulting from these factors will damage further the public finances and could make government securities less attractive to overseas investors who held around 27.3% of the U.K. government bond market at the end of 2015. As well as foreign investors losing confidence in the U.K., domestic companies would defer investment plans which would, again, be another factor contributing to a weaker economy.

So, it is very easy to make a plausible case for sterling's post referendum weakness with the above arguments and others forming part of the "remain" case. But because they are plausible, it does not mean that they will be correct. Although it probably applies less than in the past because of the decline of manufacturing in the U.K. and the loss of capacity in heavy industry, steel making, for example, and, with it, price sensitive items, there is still a case that the beneficial effect of devaluation through the "J curve" effect will have some impact in time. The very simple theory is that a lower currency will make imports more expensive and exports cheaper. Domestic consumers and businesses will, where possible, switch from buying imported items to domestically produced ones, whilst foreign consumers and businesses will buy goods and services from the country whose currency has devalued. So, whilst the trade deficit worsens in the short term as imports become more expensive and exports cheaper, after a while import substitution reduces imports which can be made domestically and export volumes rise as the devaluing country's goods and services become cheaper for foreign purchasers. This is a gross simplification of the reality these days but it does point the way to some competitive advantages later on provided that the inflation which comes with devaluation is kept under control. A number of important factors reduces the value of the "J curve" theory these days. One is that manufacturing accounts for only about 11% of the U.K. economy now so the beneficial effects of devaluation are much less than in the past. Manufacturing industry is much more specialised and in the higher value added end of the market, where price sensitivity is less important than quality. Price competitiveness is much more important in basic items, which cannot be easily differentiated from what is produced elsewhere. The U.K. is really out of that market. The "J curve" theory also assumes that exporters will not change their sterling prices and will pursue larger volumes or market share. In reality, they may maintain their prices in foreign currency terms in order to increase profitability rather than volume. Where devaluation should be a help is in invisible exports such as tourism. Notwithstanding unsettling events in a number of favourite tourist places abroad, rising holiday costs caused by devaluation could feed through the system fairly quickly, encouraging more domestic holidays, whilst the U.K. would be a more attractive holiday destination for foreign visitors. The conclusion is that it would not be wise to talk up the benefits of sterling's devaluation. They may be rather limited. In the wider current account deficit, one of the reasons why it has been so large is that

the traditional surplus on overseas income from investments has reversed. The sterling value of the overseas income will now be increased.

Insofar as the Bank of England decides to ease monetary policy further at its August or subsequent meetings, that may weaken sterling further as its interest rate advantage, such as it is, may be further eroded and make sterling a less attractive currency to hold. Given the magnitude of sterling's fall since the 24th June and the very low level of interest rates anyway in the U.K., it may only be small issue. After all, when Japan introduced negative interest rates, the currency soon rose, quite the opposite reaction to that expected and wished for by the Bank of Japan. Nevertheless, with the understandable uncertainty about what will happen in the short term post the referendum, it is difficult to make a case for a short term recovery in sterling. The reaction of the currency markets, once the bullish short term positions had been moved, probably remains correct.

For sterling investors who invested internationally and who did not hedge their currency position, the sterling value of their portfolios will have increased significantly, thus proving the value of geographical diversification. With the U.K. equity market representing less than 7% of the world's market capitalisation, an unhedged international equity portfolio which did not have significant home bias (i.e. invests much more heavily in the U.K. than the country's weighting in the world index) will have provided excellent protection so far from sterling's devaluation. That is one point to make but the second is whether, on top of the currency benefit, the rise in international equity markets in the U.K. and elsewhere since 24th June's weakness is rational.

Dealing with the U.K. first, we note the outperformance of the FTSE 100 index against the FTSE 250, the latter being much more domestically based. The rationale is that, one way or another, most of the business of FTSE 100 companies is overseas and that the FTSE 100 companies' profits will benefit either on translation of overseas earnings back to sterling or because exports might become more profitable and/or increase in volume. Furthermore, a number of them declare dividends in U.S. dollars which immediately increases the sterling value of these dividends provided they are maintained.

Whilst Brexit is an enormous issue for the U.K. and the EU, the further away from the U.K. and Europe one goes, the less is its significance in terms of the world economy. Yes, confidence in the U.K. and EU will be dented, perhaps only temporarily, but the referendum is unlikely to cause a world recession. What it does mean in terms of economic policy is that international interest rates are likely to be lower for longer. We already have US$11.7 trillion of bonds, nearly all government ones, standing on negative gross redemption yields at the end of June, and any extension of this extraordinary phenomenon is likely to increase the attraction of equities, if only for their dividend yields. In their search for yield, investors, who would not normally do so, are including equities in the asset classes they would consider for yield, albeit they also have to be selective. Whilst the U.K. equity market has performed well since the referendum, it has done so selectively. Sectors including financials and real estate have been hit. One of the post Brexit knee jerk actions was against the property sector, so much so that a number of large open ended funds exhausted their cash buffers and had to suspend dealings. This is a sector which is popular with investors partly because of the yields available but one which might temporarily be chalked off by some investors in favour of equities in other sectors. One of the surprises for many people post referendum was that bond yields fell further and therefore prices rose at the same time as equity prices were rising, an unusual situation. It represented a flight to quality and safety in some people's eyes at the same time as others took the view that equities were a good investment in the current situation. But with yields at the sort of level as we show in our table at the beginning of this review, one has to take an apocalyptic view of the outlook for the world economy to believe that those returns in any way represent value and, certainly, represent a major risk when yields turn upwards as they must do at some stage.

It goes without saying that we have witnessed remarkable events in the U.K. in the last six weeks but, as we write this, there is a calmer atmosphere with a new Prime Minister in place and the government set up with new departments and responsibilities established to put in train the Brexit programme both

in terms of negotiations as to how this is achieved and, on the positive side, how to open up new opportunities such as free trade deals which the U.K. will be able to implement itself once outside the EU. After the initial shock, things are calmer in the U.K. and a plan is being developed. It is always worth remembering that the EU has a lot to lose if the situation turns ugly and it is to be hoped that the separation can be handled as amicably as possible. The EU exports far more to the U.K. than vice versa although U.K. exports to the EU are a far greater percentage of the U.K.'s total exports than the reverse situation. However, the eurozone remains in a precarious position with multiple political problems and more specific ones, the latest of which to move up the list is the Italian banks which have very substantial bad loans on their books. How to resolve the position is proving troublesome because of the EU's state aid rules. Ideally, the Italian government would like to use state aid to deal with the problem but they are bound by the rules which make a bail in by bondholders and other creditors come first which would cause immense problems for the Italian government. Budget deficit disciplines are also being challenged in the eurozone and low growth, which hinders the ability of countries to reduce their debt burden, remains an ever present problem. This is going over old ground but the point to make is that the problems of Brexit are ones for both parties to the separation, not just the U.K., and, in that, lies some hope that the results of the negotiations will be satisfactory. We shall see.

So, whilst bond and equity markets are, at the moment, generally rising on a sea of cheap money, quantitative easing and, overall, extremely loose orthodox and unorthodox monetary policy, what are the immediate economic prospects? The IMF has reduced its economic growth forecasts in the light of the EU referendum vote as it deems that there has been a materialisation of an important downside risk for the world economy. Compared with the IMF's April 2016 projections, it now reduces its forecasts for world economic growth by 0.1% for each of 2016 and 2017 taking the figures to 3.1% and 3.4% respectively. If the projection for 2016 is correct, it would mean that world economic growth will be the same as in 2015. The IMF has reduced its forecast for Advanced Economies by 0.1% for 2016 and by 0.2% for 2017 to leave them at 1.8% for both years which would be a slight reduction on 2015's level of 1.9%. Within this sector, its forecast for the U.S.A. has been reduced by 0.2% for 2016 to 2.2% (down from 2015's 2.4%) but left unchanged for 2017 at 2.5%. The eurozone's forecast growth rate for 2016 has actually been raised by 0.1% to 1.6% but reduced by 0.2% for 2017 to 1.4%. The forecast for Germany for 2017 has been particularly sharply reduced by 0.4% to 1.2% which, if correct, would put it at the same level as France. Perhaps not unexpectedly in view of its overall judgement on the consequences of the EU referendum vote, the forecast for the U.K. has been reduced by 0.2% for this year to 1.7% and by 0.9% in 2017 to 1.3%. Elsewhere, Japan has seen its forecast cut for 2016 by 0.2% to 0.3% whilst it has been raised by the same amount for 2017 to give a slightly positive figure of 0.1%. The IMF has left its forecasts unchanged for Emerging Markets and Developing Economies at 4.1% for 2016 and 4.6% for 2017. Within this category, there is very little change in the forecasts for China and India. The forecast for China has been raised by 0.1% this year to 6.6% and left unchanged for next year at 6.2%. The forecasts for India have been shaved down by 0.1% for 2016 and 2017 to 7.4% for both years. One positive difference from the April 2016 forecasts came from the IMF's assessment of the outlook for Brazil where the forecasts have been raised for 2016 and 2017 by 0.5% to -3.3% and 0.5% respectively, still obviously a very poor performance but at least a revision in the right direction. For Russia, the forecasts for 2016 and 2017 have been raised by 0.6% and 0.2% respectively to -1.2% and 1.0%, obviously still very poor figures.

Forecasts can only be very tentative but whilst these forecasts are unlikely to set the economic pulse racing, they show the world economy overall muddling through. This might seem to be at odds with resilient equity markets which we are witnessing at the moment but the performance of equities must be seen in the context of alternative investment opportunities. The table of ten year government bond yields at the beginning of this review, as for many months, hints at something extraordinary, with negative yields in German and Japanese government bonds. Why, may one ask, would anyone want to buy a security which, if held to maturity, would provide a guaranteed loss? There are some financial institutions which have to hold bonds in large quantities for various reasons but, excluding that type of investor, one can speculate on the nature of other types of investor who are free to choose which

type of asset they buy. One reason could be that the investor foresees a long period of deflation, the quantum of which exceeds the negative gross redemption yield on a bond, thus giving a positive real return. Is this scenario likely? It is difficult to believe that it is. There is some growth in the world economy which does not sit easily with the idea of steadily falling prices and it is hard to see oil prices falling much further and staying permanently low as market forces will eventually come into play. Food prices are unlikely to be in a permanent state of deflation if only because of natural weather variations. Wage pressures may increase as governments seek to increase pay to reduce income disparities but companies will react by seeking to boost productivity in order to contain unit costs, so the effect on inflation is uncertain but very unlikely to be negative. Again, looking at the latest updated IMF forecasts for consumer prices, the expectation or Advanced Economies is that inflation will be 0.7% in 2016 and 1.6% in 2017, an unchanged forecast for this year against last April's IMF projections and 0.1% higher for 2017. For Emerging Market and Developing Economies, the forecast for 2016 inflation is 4.6% and for 2017 4.4%, increases on April's forecast of 0.1% and 0.2% respectively. Because we do not think that the world economy will suffer from deflation, other than possibly for very short periods, we think the argument for buying and holding bonds offering certain losses if held to maturity is very weak. An associated argument for holding bonds in this category is that they might be the least bad investment of any asset class and that one would be less likely to lose money than elsewhere. This might be the time if one were expecting equities to perform poorly but it also implies concern about holding cash. What could those concerns be? One would be that the banks were unsafe and that depositors would have to "bail in" the banks, whereas high quality government bonds would pose much less risk of default on capital or interest. It has happened but it is unlikely in our judgement. There are risks and Italian banks' non performing loans are a major issue for the eurozone but, overall, we do not believe that we are in an environment where depositors have to consider banks so risky that they could not deposit cash with them. Of course, in Europe and Japan, because of monetary policy, there are negative official interest rates which are being passed through to bank depositors in some cases, but that would not generally validate switching to a fixed interest security with a negative gross redemption yield. It seems to us that investors, who are not constrained by having to invest in certain asset classes, would have to take a very negative view of the outlook for the world economy to justify investing in negative yielding assets.

Whilst we have been dwelling on negative interest rates and bond yields, we should not forget that interest rates may move in the opposite direction elsewhere, notably the U.S.A. Although the IMF has trimmed its forecast for U.S. growth to 2.2% this year, it is still the most buoyant G7 economy based on the IMF's forecasts and the expectation had been that an interest rate increase would come within the next six months. However, expectations changed considerably after very disappointing second quarter GDP figures were published at the end of July. In the second quarter to the end of June, the U.S. economy expanded at an annualised rate of 1.2% compared with 0.8% in the first quarter meaning that the average growth rate in the first half of the year was an annualised 1%. Weak investment was a major culprit. The situation is complicated by November's Presidential and Congressional elections because, although independent, the U.S. Federal Reserve is unlikely to want to move interest rates close to the elections for fear of being accused of favouring one party or the other. Had it not been for concerns about the U.K.'s EU referendum and the effect which it might have had on international economic confidence and some very poor employment figures for May, which now look to have been an aberration in the light of very strong figures for June, the Federal Reserve may have already started to raise interest rates. Before the disappointing GDP data, there are enough economic indicators to give the Federal Reserve a reason to start the process. It is important that monetary policy starts to move away from its present extreme position not only because of the distortions which it has caused in markets but also because it has lost most of its power to be effective, given the current level of interest rates. Should another recession come along, monetary policy's leverage through meaningful interest rate cuts would be very small to non existent if they were to stay at these levels. So besides the very strong June non-farm payrolls figures (287,000 against 11,000 for May), we see reasonably strong purchasing managers indices for June (53.2 for manufacturing and 56.5 for non manufacturing). The housing market has been quite strong with the FHFA House Price Index up 5.9% and the S & P/Case-Shiller Composite Index up 5.2%, housing starts strong

as well as new home sales, pending home sales, existing home sales and building permits. As well as the strong employment numbers for June, the Labour Force Participation Rate has been rising, now standing at 62.7%. Low participation rates amongst the potential workforce can flatter the unemployment rate and this accounts for the seeming paradox of the unemployment rate rising to 4.9% in June from 4.7% in May even though the non farm payroll figures were strong. Retail sales have been good with June's figure showing a 0.6% month on month increase and a year on year increase of 2.7%. Obviously, there have been some weak spots. The latest figures for durable goods orders for June were down 4.0% month on month and 3.6% year on year. The University of Michigan consumer confidence index fell to 89.5 in July against 93.5 in June. Before the GDP figures were announced one would have said that the case is hardening for a rise in U.S. interest rates which would only be the second one in this cycle. Now the case looks weaker. At some stage, we will be speculating about the U.S. elections in November but markets appear unfazed at the moment despite the extraordinary nature of the U.S. Presidential contest.

The eurozone remains in a subdued state and is not growing nearly quickly enough to make meaningful inroads into its accumulated debt. If the IMF growth forecast for 2016 is correct at 1.6%, it will turn out to have been lower than the 1.7% figure achieved in 2015 and next year's forecast is lower again at 1.4%. Recently published second quarter GDP data shows that the eurozone grew by just 0.3% in the second quarter compared with 0.6% in the first quarter. Disappointingly, the French economy showed no growth at all as it suffered from prolonged industrial unrest. As we mentioned earlier, Brexit is a two edged sword with risks both in the U.K. and EU and the fragilities of the eurozone, in particular, may be accentuated by Brexit. The latest purchasing managers indices for July, at 51.9 for manufacturing and 52.7 for services, were consistent with only very modest economic growth. With the larger economies of the eurozone, France remains in difficult territory with its manufacturing purchasing managers index at 48.6 and for services at 50.3. Industrial production figures remain lacklustre with the latest figures showing a modest rise of 0.5% year on year but 1.2% lower month on month. Although falling slightly, unemployment remains very high at 10.1%. The Italian banking problems have to be addressed with a delicate balance having to be maintained between retaining the integrity of the eurozone's banking resolution scheme and the need not to inflame tensions in Italy in front of the forthcoming constitutional referendum which, for Mr Renzi, would be serious if he lost it. The Five Star Movement is performing strongly and one of its pledges is to hold a referendum on whether Italy should remain in the eurozone. For a currency which has no proper economic grounding, a move to drop the euro in Italy could spell the end. On top of all these economic problems are the political ones. The rise of non mainstream parties could mean a tipping point is reached in the EU as they react against the establishment. With the dam having been broken by Brexit, the future is unpredictable. Eurozone bonds are particularly expensive with so many showing negative gross redemption yields and our belief is that good quality eurozone equities with an international spread of business, and often a relatively attractive yield, remain attractive investments within the area.

As we saw from the IMF's forecasts for Japan, the picture is not a good one with expectations for growth very low. In the case of the IMF's forecasts growth is projected at 0.3% for this year and 0.1% for next year. Japan's problems remain as daunting as ever with very high government debt at around 240% of GDP, the highest level of the major industrialised nations. The budget deficit is very high at 6.7% at the end of last year, the demographics are poor and the Bank of Japan's 2% inflation target is out of reach at present with the latest year on year consumer price index being -0.4%. This will not encourage consumers and businesses to spend. That is why the Bank of Japan targeted 2% inflation. The collapse in the oil price undermined its inflation target and the move to negative interest rates did not have the desired effect on the yen given negative interest rates elsewhere. Most of the recent data has been disappointing. Consumer confidence is quite low with the index reading at 42.1, below the 50 level and so a negative reading. Retail sales are 1.4% lower over the year, industrial production is down 1.9% over the same period and the latest Tankan survey shows a reading of 4 against 7 previously. Whilst the monetary and fiscal levers have been pulled, the third arrow of Mr Abe's economic policy, structural reform, has proved to be disappointing. A more flexible economy in the labour and product market should increase the Japanese economy's long term potential growth

rate but the Prime Minister is facing vested interests opposed to his plans. Plans to implement the second part of the consumption tax increase next year have been put back for fear of affecting economic growth. This has happened before, but postponing the second part of the increase from 8% to 10% will have a negative effect on the government's already very stretched finances. As Japanese bond yields show, the government has no difficulty borrowing the money it needs to fund its budget deficit and bond redemptions but, as and when interest rates turn, servicing the debts will place a heavier burden on the Japanese budget. Having its own currency helps Japan, and the vast majority of government debt is owned domestically leaving the country less vulnerable to foreign sales of Japanese government bond holdings. Extreme monetary measures are being taken with heavy Bank of Japan purchases of securities but the outlook is highly problematic. There had been hopes at the end of July that the Bank of Japan would take further strong action to stimulate the economy, but, in the event, its actions did not meet expectations. The Bank of Japan chose to increase its purchase of exchange traded equity funds to JPY6 trillion (£44 billion) from JPY3.3 trillion. Earlier in the week, the Prime Minister had announced more than JPY28 trillion of spending to stimulate the economy.

With everything else going on in the world, the emphasis on China as a guide to investors' investment policies is slightly less at the moment but its influence is as important as ever. We are approaching the first anniversary of the shock administered to international markets by the decision of the Chinese authorities to widen the band within which the renminbi traded. This was taken by some investors to be a signal that China was devaluing its currency on concern that its economy was weakening too much. In due course, calm returned to the markets. However, less attention has been paid to recent weakness in the Chinese currency. A year ago, one U.S. dollar bought 6.21 renminbi, now it purchases around 6.67 renminbi. The Chinese authorities are now looking at the renminbi against a basket of currencies, not just the U.S. dollar. The latest GDP figures from China show year on year GDP advancing by 6.7% and second quarter GDP 1.8% higher than in the first quarter. The latest purchasing managers indices show a neutral reading of 50.0 for the manufacturing sector and a moderately bullish reading of 53.7 for non manufacturing. Industrial production in June shows a year on year increase of 6.2% and just under a 0.5% increase month on month. Retail sales appear to be quite strong with a 10.6% increase year on year in June and a 0.9% increase over May. As soon as attention to Brexit starts to diminish, it is likely to focus on the far bigger economy, China. For the moment, the transition from an investment and export led economy to one with more emphasis on consumption and services continues. There has been no major news over the quarter to disturb investors but events in China will be an important influence on world stock markets.

As for the U.K., we have discussed the broader issues arising from the U.K.'s decision to leave the EU and it is obviously far too early to make any realistic assessment of the outcome for the U.K. economy. Similarly, in the short term, the economic data will be distorted because of the effect of the (to many people) unexpected result. Whilst the second quarter GDP figures were satisfactory showing a 0.6% increase over the first quarter and 2.2% year on year, this captured hardly any of the post 23rd June data. A more immediate impact has been seen in the various purchasing managers indices for July. The index for manufacturing stood at 48.2 against 52.4 in June, the services index at 47.4 (52.3), construction at 45.9 (46.0) and the composite index at 47.7 (52.4). However, we must emphasise that the data is bound to be erratic and investors should not pay excessive attention to the figures in the short term. The constructive way to look at the U.K. from an investor's point of view is that a new government is in place, fiscal policy is to be "reset", which means that it will be easier with the 2020 target for a balanced budget being abandoned, the government has a department specifically dedicated to Brexit and one part being detailed to look out for new opportunities particularly in the area of trade agreements. The risks are obvious, mainly brought about by uncertainty, but high quality U.K. based multinationals are an obvious investment play as the pound is likely to remain weak. Substantial overseas equity holdings have stood portfolios in good stead this year providing they have been unhedged and that sensible strategy should remain in place in order to reduce the risks of being too U.K. centric. Although bonds have enjoyed a strong quarter, they are, we think, even riskier than before in terms of the potential for capital losses.

It is important to be realistic. The magnitude of returns seen so far this year is quite out of proportion to the rate of economic growth or inflation and, as such, are not sustainable. At the beginning of the year, we said that we expected international equity markets to grind higher during 2016 with setbacks from time to time reflecting the economic and political problems which the world was facing. We did not anticipate what has happened in relation to a Brexit vote but our long standing policy of spreading the risk amongst high quality securities and by countries, treating the U.K. as just one out of many in which one can invest, reflects a prudent approach and it has enabled investors to cope with the extraordinary events of recent weeks. It may be an unsteady ride forward for the rest of the year but equities remain our asset class of choice.

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