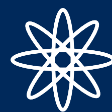

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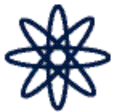
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

This has been a disappointing quarter for bond and equity investors with significant weakness in June dragging down prices. Concerns about the effect of the problems of some financial institutions which is restricting the availability of finance, energy and food price inflation and weakness in several countries' housing markets have contributed to the sullen mood in markets. In what follows, we try to give a balanced assessment of the economic situation and, of course, markets.

The tables below detail relevant movements in markets :

International Equities 31.03.08 - 30.06.08

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-0.6	+4.3	+4.5	+5.1
Finland	-12.9	-13.5	-13.4	-12.9
France	-2.5	-3.2	-3.1	-2.5
Germany	-1.1	-1.8	-1.7	-1.1
Hong Kong, China	-4.6	-4.9	-4.8	-4.2
Italy	-3.8	-4.5	-4.4	-3.8
Japan	+9.1	+2.3	+2.4	+3.0
Netherlands	-9.9	-10.5	-10.4	-9.9
Spain	-8.0	-8.7	-8.5	-8.0
Switzerland	-2.1	-5.1	-5.0	-4.4
UK	-0.9	-0.9	-0.8	-0.2
USA	-2.4	-2.5	-2.4	-1.8
Europe ex UK	-4.2	-5.2	-5.1	-4.5
Asia Pacific ex Japan	-3.5	-2.9	-2.8	-2.2
Asia Pacific	+2.6	-0.4	-0.2	+0.4
Latin America	+4.5	+10.9	+11.0	+11.7
All World All Emerging	-1.5	-1.1	-1.0	-0.4
The World	-1.2	-1.7	-1.5	-1.0

Source FTSE World Indices

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

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

Currency	31.03.08	30.06.08
Sterling	4.35	5.13
US Dollar	3.43	3.98
Yen	1.28	1.60
Germany (Euro)	3.90	4.63

Sterling's performance during the quarter ending 30.06.08 (%)

Currency	Quarter Ending 30.06.08
US Dollar	+0.1
Canadian Dollar	-1.0
Yen	+6.6
Euro	+0.7
Swiss Franc	+3.1

Other currency movements during the quarter ending 30.06.08 (%)

Other Currency	Quarter Ending 30.06.08
US Dollar/Canadian Dollar	-1.1
US Dollar/Yen	+6.5
US Dollar/Euro	+0.6
Swiss Franc/Euro	-2.3
Euro/Yen	+5.9

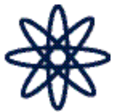
Significant Commodities (US dollar terms) 31.03.08 – 30.06.08(%)

Significant Commodities	31.03.08 – 30.06.08
Oil	+35.3
Gold	-1.1

Markets

A poor performance from international equities in June pulled back performance figures into negative territory for the quarter. In local currency total return terms, the FTSE World Index returned -1.2%, in sterling terms -1.7%, in US dollar terms -1.5% and, in euro terms, -1.0%. On the positive side, there was one stand out market, Japan, which in local currency terms, returned 9.1%. This market has tended to move in inverse relationship to the currency and weakness in the yen during the quarter has helped Japanese equities as companies are deemed by investors to benefit from the yen's more competitive level. Even allowing for the Yen's weakness during the quarter, the FTSE Japanese index's return in other major currencies has been satisfactory, being 2.3% in sterling terms, 2.4% in US dollar terms and 3.0% in euro terms. In local currency terms, the declines in the UK and USA were relatively modest at -0.9% and -2.4% respectively, as measured by the relevant FTSE index. Europe ex UK had a relatively disappointing quarter, returning -4.2%. Elsewhere, as so often recently, the most notable feature was Latin America which returned 4.5% in local currency terms. However, currency strength meant that sterling, US dollar and euro based investors enjoyed very pleasing returns from this area of 10.9%, 11.0% and 11.7% respectively. The other area in which currency movements made a significant difference to returns was Australia where the Australian dollar performed strongly over the quarter and raised a negative return in local currency terms on the FTSE Australian index of -0.6% to 4.3%, 4.5% and 5.1% respectively in sterling, US dollar and euro terms.

As the table shows, bond markets endured a poor quarter as a realistic assessment of yields made many investors realise that they were too low, even for high quality government bonds. Measured by the gross redemption yields on ten year government bonds, we see that yields on sterling bonds rose by 78 basis points to 5.13%, those on US dollar bonds by 55 basis points to 3.98%, those on yen bonds by 32 basis points to 1.6% and those on German government euro denominated bonds by 73 basis points to 4.63%. These are very significant movements. If we look at the Bloomberg/EFFAS index for government bonds with maturities of more than one year, we note the quarter's return on sterling bonds at -3.8%, on US government bonds at -2.1% and on euro denominated bonds at -3.0%.

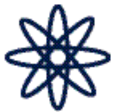


In the currency markets, the most significant feature was the weakness of the yen against which sterling rose by 6.6% during the quarter. The Swiss franc was also weaker as sterling rose 3.1% against it during the quarter. Sterling showed only very minor movements against the euro and US dollar, up just 0.7% and 0.1% respectively.

Gold was slightly weaker during the quarter, down 1.1%, but oil was a feature rising by 35.3% and was constantly in the headlines.

Economics

- *The economic background has been unsettled doing the quarter* ...... rising inflation and slowing growth at the macroeconomic level and the state of some financial institutions and the housing market in certain countries at the micro level have been the main issues.
- *Sentiment towards bonds has changed* ...... yields rise sharply as investors take on board that yields have been too low in relation to inflation.
- *Commodity prices make daily headlines* ...... the Jefferies/Reuters CRB index rises 30.4% in the first half of 2008. Food and energy prices are high profile commodities driving consumer prices.
- *Oil subsidies are a market distortion and, at the current level of the oil price, they are becoming an impossible financial burden for some countries* ...... China and India, amongst others, act to reduce subsidies. It makes no sense to stoke up demand for a finite resource by subsidising it.
- *Although few have predicted such a rapid and steep increase in the oil price, the market mechanism is the best way of resolving it* ...... in the short term consumption will be discouraged and, in the longer term, more expensive supplies will be brought on and the search for alternative fuels intensified.
- *Food price inflation is causing politicians to re-think the biofuels strategy* ...... one of the reasons for rising food prices is the loss of growing capacity to biofuels.
- *The difficulty for central bankers is that there is a significant cost push element in the current inflation levels* ...... food and energy prices will not necessarily respond to tighter monetary policy. The demand pull element is more susceptible to the effect of higher interest rates.
- *The different mandates of the Federal Reserve, Bank of England and ECB have led to different policies being followed in the current economic environment* ...... The Federal Reserve looks at the big picture and cuts interest rates aggressively. The Bank of England and ECB, to different degrees, focus on their inflation targets to the exclusion of most other negative economic factors.
- *The word "stagflation" is being heard* ...... the situation it describes is as unappealing as the word. If it does become a feature of the world economy, some companies can still do well for their shareholders. Depending upon the level of yields (and we still think they are too low), the "inflation" part is not good for bonds.
- *Whilst certain financial institutions still produce bad news, we sense the concerns about a major financial institution's failure have lessened* ...... fear of the unknown is what spooks investors. Official action on Bear Stearns and Northern Rock as well as new investment from sovereign wealth funds and action to ensure that the money markets do not seize up, support this view.
- *Sovereign wealth funds are good news for investors* ...... they aim to increase the long term returns on their assets and this should benefit equities as one of the asset classes most likely to achieve the highest long term returns.
- *Financial institutions will become more conservative* ...... regulators and shareholders will insist on this. In the longer term, this should lead to a better quality of economic growth as it will be less susceptible to the kind of shocks recently experienced by some financial institutions which have a knock on effect on the world economy.



- *Protectionism remains one of the main threats to medium and long term economic growth* ...... in the USA some Democrats are playing the populist card and protectionist sentiment is never far from the surface in Europe. The downside of open markets is more visible than the upside, the greater benefits of free trade. If the USA and Europe become more protectionist, it would threaten economic growth and, by association, the stock market.
- *In its latest Economic Outlook, the OECD, not surprisingly, reduced its economic growth forecasts* ...... amongst its members, it now sees growth in 2008 at 1.8% and 1.7% in 2009. These figures are below the potential growth rate of the economies in question but not seriously so.
- *On inflation, the concern of central banks at present, the OECD expects some relief next year* ...... amongst its members it expects the rate of inflation to fall to 2.1% from 3.0% this year.

USA

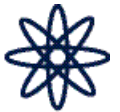
- *First quarter growth estimate is raised for the second time* ...... it is now put at an annualised rate of 1.0%.
- *The Federal Reserve's Beige Book detects signs of stabilisation* ...... although conditions "remained generally weak" it reported signs of stabilisation in five of its twelve districts.
- *A change of emphasis is detected from the Federal Reserve* ...... it emphasises more the risks to inflation than to growth, inflation, as elsewhere, being above target.
- *Some tentative signs of stability in the housing market* ...... amongst the negative news, there are some encouraging signs. But it is early days, and too soon to be sure.
- *Recent economic data is mixed* ...... the benefit of the tax cuts is starting to be seen and the Administration will hope that the momentum will continue. The news is no longer mostly negative.

Japan

- *A reasonable forecast from the OECD* ...... it forecasts growth of 1.7% this year and 1.5% next year. If achieved, this would be satisfactory in current circumstances.
- *Headline inflation is positive* ...... but the recent history of deflation means the Bank of Japan can be more relaxed about its interest rate policy because households will be more influenced by past inflation data. In time, though, the Bank of Japan will want to have more normal interest rates.
- *Encouraging news from the government* ...... there is evidence of a desire to open up the economy more to foreign investors and to encourage foreign investment The rather protectionist nature of Japan has been an irritant for potential investors.
- *The OECD emphasises the importance of tackling the high level of public debt* ...... the need is to address public spending and achieve a primary budget surplus as well as structural reforms.
- *The stock market has performed relatively well in the second quarter* ...... a weaker yen attracts investors to companies which will benefit from this. The yen may well remain weak for a while because of possibly widening interest rate differentials against other major currencies.

Europe Ex UK

- *First quarter eurozone growth estimate raised slightly* ...... it goes up to 0.8% from 0.7%.
- *The IMF raises its eurozone growth forecast* ...... it now expects growth of 1.75% this year against 1.4% previously. This is almost exactly the same as the OECD's forecast for this year. Next year's IMF forecast is 1.2% against 1.4% for the OECD.
- *The ECB raises interest rates to 4.25%* ...... inflation at 4.0% is more than double the top of its target range so it feels it must act notwithstanding weaker economic growth. The interest rate increase was well flagged.



- *Most of the short term data from the eurozone has been weaker* ...... the purchasing managers' index, retail sales and consumer confidence data all fall into this category.
- *Political pressure on the ECB increases* ...... the high value of the euro causes difficulties for business and the politicians respond. The "one size fits all" interest rate is proving unsustainable because of different conditions obtaining in eurozone economies. Investors' credit assessments of the various eurozone members differs greatly with wide spreads on yields between different countries' bonds.

UNITED KINGDOM

- *Particularly difficult problems face the UK* ...... high levels of public and private debt, an over extended housing market, an important dependence on the finance industry and evidence of weakening overseas confidence in the UK.
- *Unlike the USA and eurozone, first quarter growth estimates have been revised down* ...... the initial estimate of 0.4% has come down to 0.3%.
- *The Treasury's forecast made in the last Budget is now shown to have been too optimistic* ...... estimates of government borrowing were predicated on this and, accordingly, look too optimistic. The OECD forecasts that public borrowing will rise to 3.8% of GDP this year against the Treasury's forecasts of 2.9%.
- *Public finances leave no room for fiscal reflation* ...... the government had to borrow the money to raise personal allowances to offset the cost of abolishing the 10p income tax band. It faces a dilemma - tax increases appear to have hit the limit of the electorate's tolerance whilst public spending cuts, a better option, would be very difficult for it politically.
- *As elsewhere, inflation is well over its target* ...... the Governor of the Bank of England indicated that it may exceed 4% this year, over twice its target level. For this reason, notwithstanding weakness in the economy, opinion is hardening about the possibility of higher interest rates or, at least, of no foreseeable reduction.
- *Perceptions of inflation are rising* ...... the latest survey of future inflation expectations registers 4.3%. The Bank of England will be worried by this.
- *There is now no doubt that the housing market is in decline* ...... nearly all the indicators point in this direction. The impact of this will, amongst other consequences, make consumers very cautious with effects throughout the economy.
- *After a long period strength, there is evidence of a weakening employment market* ...... both measures of unemployment are rising and this trend will almost certainly continue.
- *The fall in sterling in recent months (but not this quarter) has helped manufacturing* ...... we would not be surprised to see sterling resume its weaker trend given economic trends in the UK.

CHINA

- *Inflation remains the authorities' main concern* ...... it is running at nearly twice the level targeted. But May contained some better news with the annual rate declining to 7.7%.
- *China has reduced the level of fuel subsidy* ...... the cost was becoming excessive. This change in policy has to be carefully managed in terms of the effect in inflation.
- *Foreign exchange reserves continue to build up through continuing large monthly current account surpluses* ...... part of the resources are being directed towards China's sovereign wealth fund to invest for higher returns.
- *China continues to attract foreign protectionist sentiment because of the size of its current account surplus and suspicions about its sovereign wealth fund* ...... we regard these protectionist sentiments as dangerous. It is important for the world economy that they pass.

SUMMARY

- *Sentiment is poor* ...... the news flow seems unremittingly gloomy.
- *The spectre of "stagflation" increasingly exercises economists' minds* ...... inflation is rising and growth is slowing.
- *But world economic growth is still expected* ...... the OECD sees recovery accelerating in the latter half of 2009.
- *Although the outlook for corporate profits is deteriorating, shares are moderately rated* ...... bonds, on the other hand, still look dear, notwithstanding a significant rise in yields this quarter.

The economic background has remained unsettled during the quarter. Concerns about rising inflation and slowing growth have been the macroeconomic issues whilst, at the micro level, financial institutions' write offs and the housing markets in certain important countries have been ever present.

In terms of markets, a significant casualty during the quarter has been the bond market. This is not surprising. For a number of reasons, yields on top quality bonds have been unrealistically low. A misguided view that somehow bonds were safe investments has often been put forward. If we take top quality government bonds, they are clearly safe in the sense that the issuer will not default on capital or interest payments. However, if yields are unrealistically low, real returns over time can be negative so an investment which diminishes in real terms can hardly be called safe. Furthermore, although, as an asset class, bonds are considered to be less volatile than equities, they can still fall heavily in price if bought on the wrong yield basis. At one stage, investors were buying fifty year UK gilts on a yield of about 3.75%. With the gross redemption yield at approximately 4.4% now, the unrealised capital losses are enormous. Institutions were pushed into buying long dated issues to match liabilities but, in investment terms, the results are likely to be very bad. Investors are beginning to realise that nominal bond yields must provide them with a substantial cushion over present inflation levels if they are to look interesting. We think that there is a need for bond yields to rise considerably further at the medium and longer end of the market for them to be considered attractive investments.

Equity markets have weakened significantly towards the end of the quarter and June was a poor month. Within equity markets, performances have differed widely with the financial sector being under particular pressure. Generally, volatility has been lower although there have been some large day to day movements in June.

The Jefferies/Reuters CRB index, covering commodities generally rose by 30.4% in the first half of the year. Oil has been a daily issue for investors and has never been out of the headlines. At the consumer price level, the rising cost of oil has continued to stoke inflation and led to widespread protests. A more recent development, which is economically sensible, but hard on those affected, is a reduction in subsidies, particularly in Asia. With oil rising steeply in price, the subsidies paid by governments, including China, have been rising rapidly and have become unbearable for many governments. Looking at the issue from an economic point of view, the subsidy of a finite resource makes no sense since it encourages its consumption. The overall approach to tax and subsidies on oil throughout the world lacks any consistent approach, oil being heavily taxed in some countries like the UK and subsidised by others in Asia and Latin America, for example. However, reducing or eliminating subsidies is difficult at the best of times but, in the current environment, it is fraught with danger. Because the cost of the subsidies is becoming intolerable, some governments are having to face the issue. The dangers are twofold, one economic and the other, social. Rising petrol prices, occurring because of the subsidy reduction, will cause a sharp rise in the rate of inflation and raise serious social issues, possibly threatening the survival of some governments. Conversely, the pressure on governments which heavily tax oil related products is to cut the tax on them in order to reduce costs for hard pressed businesses and individuals. At the end of the day, it is market mechanisms which provide the best long term answer to the problem of finite oil supplies because higher prices will change consumption habits and encourage innovation. The problem, at present, is that subsidised prices encourage over consumption. Action on subsidies should be helpful but governments will have to find alternative methods of helping those who are affected by the subsidy reduction, otherwise there could be serious social unrest.

One of the puzzles which taxes experts is why the oil prices should have risen so sharply in such a short period of time. Consumption is increasing ahead of production but the steep size of the rise in such a short time is difficult to understand. There seems to have been no supply or demand factor which can easily explain such a move. Attention has been focused on speculators but, again, there is no consensus as to how much or how little they have contributed to the present situation. The one redeeming feature of the present record oil prices is that, as an input per unit of output, it is much less important than in previous oil spikes. Compared with the 1970's, it is about half as important. Comparisons with previous oil spikes have to take this into account and should be borne in mind when making economic forecasts. Whilst, on the demand side, rising oil prices will change habits, restrain usage and encourage investment in alternatives, it should also stimulate the supply side. As oil fields approach commercial exhaustion, the cost of recovering the remaining oil rises. Higher oil prices will encourage higher levels of recovery. High cost sources of oil, for example the tar sands, become more attractive for oil companies. The risk/reward ratio for exploration also improves. So, market mechanisms, if not impeded, can be very helpful in circumstances which we face at present.

But high oil prices are also making oil producers more confident and stoking economic nationalism. Agreements are being changed unilaterally in some countries. Apart from making oil companies more wary of dealing with these countries, the private sector expertise is lost, affecting the efficiency of the state run enterprises. Western governments have the potential to cause damage. Populist politicians like talking about "windfall" taxes on energy companies. The Italian government has just announced such measures in another setting but, in the USA, both candidates of the Democratic presidential nominations threatened windfall taxes on oil companies. They hope that this seemingly painless way of raising money will play well with the electorate, and it probably does, but, in terms of helping the search for more oil or encouraging innovation by oil companies, it is a crass policy. Politicians, when seeking election or re-election, are not always the people ready to take rational economic decisions.

The re-appearance of significant food price inflation is equally unwelcome for consumers. The link with oil is that some land, originally used for food production, has been turned over to biofuels and financial incentives have been given to do just this. Now there is some political backtracking on this policy as the unwelcome consequences become apparent. Fast growth and rising living standards in the east have also contributed to food price inflation.

For government ministers and central bankers, the difficulty of commodity inflation is that it is of the cost push variety rather than demand pull and more difficult to deal with. Although market forces will work on commodities eventually in that higher prices will encourage more production or exploration, it is a slow process and resources are ultimately finite. Although it is hard to believe with oil at the current price, OPEC is concerned about the possibility of a price fall and it is not hard to imagine OPEC reducing production levels if it felt it necessary to sustain the price of oil.

Demand pull inflation caused by excessive demand in an economy is more easily tackled by the conventional means of interest rate rises and, perhaps, fiscal tightening. But with major economies slowing down, neither of these options looks straightforward and fiscal tightening looks out of the question. Monetary policy is very difficult to decide at present because of the conflicting signals on growth and inflation. The ECB and the Bank of England are in a more hawkish mode than the Federal Reserve. The ECB has not cut rates at all in this cycle and, indeed, has just raised them whilst the Bank of England has cut them reluctantly and the Federal Reserve has cut them aggressively. The ECB and Bank of England are constrained by their inflation targets which are being considerably exceeded. The Federal Reserve has much more latitude in being able to take a much wider view of the economy.

The dilemma for the ECB, which prompted its latest interest rate increase, is that, although the eurozone has performed relatively well, it is slowing down. There is no excessive demand in the eurozone to be cooled down and, in countries like Spain and Ireland, where the housing market is weakening substantially, interest rate rises could cause serious damage. However, there is a problem in Germany where, after a period of pay restraint which has increased Germany's competitiveness considerably, some large pay increases have been given with

some political blessing. Although it is accurate to say that this represents some catching up, it is not realistic from a central bank's viewpoint to ignore this development because it sets a precedent. The ECB may feel that a tightening of monetary policy does have some justification in these circumstances as a warning against inflationary pay increases in the eurozone. In these circumstances, it may have some bearing on inflation.

The dilemma for the Bank of England is acute because of what is happening to the economy in a number of respects, perhaps particularly the housing market but also on the earnings front. Inflation in the UK is driven by the same factors as elsewhere and is well over target and likely to get worse. But the housing market, which makes the UK economy particularly vulnerable, is deteriorating and raising interest rates is likely to exacerbate the weakness. The knock on effect on the economy would be serious. The reduction in the availability of mortgage finance and, where it is available, its increasing cost will have ripple effects on the economy which would worsen if house prices fall further. That is the balancing act which the Bank of England has to consider. Its judgement may also be influenced by developments on the pay front in the public and private sectors. The settlement in the Shell tanker drivers dispute was high. But industrial muscle will not impress the MPC because it cannot regard it as a special case. Even for unions with a much weaker bargaining position, high headline figures, already achieved, influence pay negotiations. In the public sector, government efforts to restrain pay are being tested by the appearance of higher inflation with threats of industrial action. One feels the Bank of England would have to press the pedal very hard on interest rates for them to have an effect in the public sector. The transmission effect would be through the private sector where a weakening employment market, partly resulting from the effect on business of rising interest rates, could have some effect on public sector wage negotiations. It would not, however, be a strong pressure in the first instance. The judgement call for the Bank of England is very difficult.

In the USA, the Federal Reserve can take a different stance because it can look at the big picture. If one takes the federal funds rate as a benchmark, real interest rates are negative. Together with recent fiscal inflation, the sharp cut in official interest rates to 2% represents a significant stimulus to the US economy, giving a reasonable expectation of some economic recovery later this year. From an inflation perspective, it is not desirable to have negative real interest rates for any significant period of time. Japan is a different issue again. Having experienced a long period of deflation it would welcome modest inflation, one reason being to enable the Bank of Japan to operate a more normal monetary policy.

So, different conditions apply in different countries or areas and since this review provides background work to investment policy, we should consider the implications of macroeconomic policy. A word currently being used increasingly is "stagflation". As its name implies, it describes an economic situation which is stagnant, realistically meaning little or no growth, and where inflation, at above an acceptable level, exists. The economic situation would be as unappealing as the word sounds. If we look at the "stag" part of the word, it does not suggest a good background for companies. After all, one invests in equities for growth and the driver for share prices is rising profits and dividends. In practice, however, a mixed picture emerges from a position of little or no economic growth. More defensive companies, demand for whose products is less susceptible to economic fluctuations, may still be able to grow their profits and even have some pricing power. For those companies, where levels of profitability are more geared to the state of the economy and where pricing power may be weaker, such a background can be difficult. Depending on a share's rating, investment opportunities should exist. What about the inflation part? This is a function of a company's pricing power. If it provides a product or service which is required, whatever the economic circumstances, and for which competition is limited, it is well placed. If economic conditions affect demand or if competition for business is intense, inflation can be damaging to the company. There is, therefore, no general rule for the inflationary part of "stagflation" but it bears saying that some companies will still do well.

For bonds, at least initially, this not a happy state of affairs. Inflation eats away at the real value of the capital and bond yields, except those linked to administered short term rates (i.e. short dated bonds), should reflect higher inflation. An exception is a position of extreme fear in markets where there is a flight into supposedly safe assets and top quality bond yields can be driven down to unrealistic levels. But this is generally a poor background for

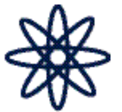
bonds and, as we have recently seen, bond yields have reacted quite badly to rising inflation. If the "stag" part is persistent, price competition and lessening cost pressures, perhaps through low pay increases, could bring the inflation part down. Because of the nature of the present cost push inflation, i.e. food and energy prices, this is not an imminent scenario.

It is not an encouraging outlook for property either. Low economic growth does not provide the background for rising rents whether in the retail, office or industrial sectors. Suddenly, there may be an excess of property on the market which can only be cleared at much higher yields. Although rising costs will make property construction more expensive, that may be academic if demand is so weak that there is plenty of empty property available. In terms of property shares, a deteriorating market may be reflected in the size of their discount to net asset value.

The usual issues with cash arise. Short term interest rates, especially after tax, may not be sufficiently high to provide a real return. Cash may give the feeling of security in the short term and also the flexibility to pounce on or invest in attractive assets. The danger arises from the anticipation of lower inflation eventually being felt which is likely to raise the prices of the classes of assets, i.e. shares and an opportunity cost being incurred.

Concerns about the financial sector have been well aired following the problems which arose in the US subprime market. In one sense, the situation has improved in that there is evidence from the USA and UK that the authorities will do whatever is necessary to prevent a major financial institution from failing. The Federal Reserve's part in the rescue of Bear Stearns and the UK's nationalisation of Northern Rock are cases in point. Major and innovative actions in the money markets to stop them seizing up have been taken. There is now plenty of evidence that major financial institutions have been able to raise capital necessary to restore their ratios from existing shareholders or new investors, like sovereign wealth funds.

The issue of sovereign wealth funds is one which we have raised often in recent reviews. We regard them as a positive influence for investors. Unfortunately, some protectionist politicians are using them as whipping boys against globalisation but the reality is different. As a result of significant current account imbalances in the world economy, now being exacerbated by the effect of the high oil price, the recycling of surpluses helps to play a major role in stabilising the world economy. Although critics point to the secrecy of some of the funds, many of them are long term investors which can help to provide stability for the companies in which they invest. The aim of these funds is increasingly to look to raise the return on their investments. Whilst Treasury bonds and bills might be safe in the sense that capital and income will be paid, they carry the risks of low nominal returns and, perhaps, negative real returns, whilst being subject to uncertain exchange rate fluctuations. Over the long term, and these funds are long term, they will expect to gain better returns from equities, private equity and property. The larger their surpluses grow (Middle Eastern oil producing nations are a good example), the more they will feel able to increase the amount of their funds devoted to these areas. In the short term, the most visible manifestation of this is additional capital being provided for major financial institutions. As this is written, Qatar is one of the investors putting significant capital into Barclays, just one of a number of high profile examples. Some earlier sovereign wealth fund investments, made since the sector's problems emerged, have proved to be poor investments but their investment horizon is long term and they can afford to be patient in the expectation that their investments will prove to be profitable. Furthermore, at a time when there is too much concentration on very short term returns, the long term nature of many of their investments provides stability for those companies which receive additional capital from them or in which they have chosen to invest. At the general level, the recycling of their current account surpluses helps to finance the current account deficits of recipients of their investments. But these funds are run by hard headed people who will want to see acceptable returns on their investments and their presence on companies' share resisters should sharpen managements' focus. Only in very few cases, defence is a case in point, can there be a justification for blocking investments. Over time, the likely result of increasing investment in equities by sovereign wealth funds is that shares will benefit at the expense of bonds as cash is diverted towards potentially higher yielding securities. We believe that sovereign wealth funds are likely to be a positive influence for equity investors.



Whilst sovereign wealth funds are providing capital for some financial institutions and thereby helping to stabilise them and reassure markets and nervous investors, all investors need to consider the economic consequences of what has happened, both for the financial sector and the authorities, whether they be governments, central banks or regulators.

We are already seeing the consequences in the credit markets. It is becoming more difficult to borrow and more expensive relative to official interest rates. We can cite an example nearer home. The supply of mortgage finance has dried up and, what is available, has become more expensive. The various effects of this will subdue economic growth. It will also damage government finances and less activity means less revenue. In the particular instance of the UK, the Exchequer has benefited handsomely in recent years from rising activity in the housing market and higher prices as it has collected substantial sums from stamp duty. Governments will have to consider how they tackle these issues, for most non energy rich economies will feel this effect. Those with strong finances will consider counter cyclical measures like tax cuts and/or increases in public spending, others, where public finances are in a more neutral position, may choose to borrow more, whilst those with weak finances, where increased borrowing is not an option, will have to choose between tax rises and spending cuts. Which way different governments go should be stock market influences both for bonds and equities. Of one thing one can be certain, and that is, at least for a while, there will be a more sober approach to banking and financial activities in general. It is quite clear that excessive financial risk has been taken which has led to an unpleasant financial hangover. Banks will tighten up their lending criteria and risk matrices and exotic financial instruments will be examined much more sceptically, regulators will be more prescriptive and governments may become more involved, not wanting to experience more embarrassments. From a short term perspective, economies like that of the UK, which have benefited from the strength of the financial sector which counts for as an important part of GDP, will be particularly hard hit. However, and this applies everywhere, economic growth in the future founded on more conservative banking principles will be of better quality and more sustainable. Although this scenario might imply lower economic growth, it should be of better quality and more sustainable. Apart from the pressure from regulators and governments on financial institutions, investors will demand this also, many having been scarred by the fall in share prices in the financial sector.

Slower, better quality and more sustainable growth, although it might seem dull, should be attractive to investors as it will raise their levels of confidence in the economic outlook. What we still consider the most serious threat to investment prospects is protectionism. We have discussed this in the context of sovereign wealth funds but we are seeing worrying elements of this in the USA and Europe. In the USA, Senator Obama wants to look again at NAFTA and protectionist sentiment against China is strong with populist politicians accusing China of effectively costing Americans jobs. The economic arguments for directly and indirectly raising trade barriers are poor. The downside of open markets is quite visible. Businesses, which cannot compete, close causing redundancies in those businesses. This is the point which the politicians make. What they do not say is that low priced Chinese imports, for example, have helped to hold down inflation, increasing the purchasing power of consumers and causing interest rates to be lower than they would otherwise have been. This additional spending creates more employment opportunities elsewhere. Because the benefits are not so obvious as the downside costs, they tend to go by default and not be recognised whilst making it easy for populist politicians to bang the drum of protectionism. The economic danger of protectionism and, by extension, the danger for investors, is that barriers to trade will adversely affect international economic growth and raise price levels. The first effect is self evident - there will be less trade. The purchasing power of the countries operating protectionist policies is reduced by higher prices whilst those countries whose exports are affected by tariffs or quotas suddenly enjoy lower purchasing power. A poorer growth outlook is not good for stock markets because it reduces profits and dividend growth potential.

The world is presently witnessing a significant shift in purchasing power from most industrialised countries to oil producers and other countries with natural resources which are in demand. We have already mentioned how surpluses are being recycled but, in terms of trade, large orders are being placed with western companies. Airbus

and Boeing, for example, have received substantial orders from airlines in the Middle East at a time when difficult financial conditions in the US airline industry have prevented US airlines, which used to be industry leaders, updating their fleets on a significant scale. In the past, US airlines would have been in the lead in ordering new models of aircraft. Other examples of industries benefiting from oil wealth are those involved in the power generation industry and oil service industry and there are many other industries, whether in manufacturing or services, which benefit. Again, investors need to consider the beneficiaries. More indirectly, western companies, say in the consumer goods industry, are benefiting from being involved in faster growing areas of the world economy than their own. In times like the present, there are winners and losers but the losers are more obvious. Investors need also to look to benefit from the winners.

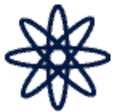
In June, the OECD published its latest Economic Outlook, number 83. For the OECD as a whole, it saw growth in 2008 at 1.8% compared with 2.7% in 2007, whilst its forecast for 2009 is 1.7%. Fourth quarter 2008 growth compared with fourth quarter 2007 is forecast at 1.3%, pushing up to 2.2% for the same comparative period in 2009. In the USA, it forecasts 2008 growth at 1.2% compared with 2.2% in 2007 and 1.1% in 2009. The OECD is expecting very little fourth quarter 2008 growth compared with fourth quarter 2007 in the USA, just 0.3%, but it sees an acceleration in 2009 with the respective figure being 1.9%. For the eurozone, the OECD sees growth this year at 1.7% and 1.4% next year. Its fourth quarter on fourth quarter growth estimate for 2008 is 1.4% rising to 1.7% for the same comparative period in 2009. So, compared with the USA, what we are seeing is an expectation from the OECD that the dip will be shallower in the eurozone then in the USA this year with a corresponding greater bounce back in the USA as next year progresses. Japan is forecast to grow by 1.7% this year and 1.5% next year with fourth quarter 2008 growth 1.7% above that of 2007 with the figure for 2009 forecast to be 1.6%. In the UK, 2008 growth is expected to be 1.8% compared with 3.0% in 2007 and 1.4% is forecast for 2009.

On the inflation measures used by the OECD, the outlook seems perhaps surprisingly reassuring given the current concerns about food and energy prices. In the USA, this year's forecast inflation level of 3.2% is expected to fall to 2.0% in 2009, in Japan from 0.9% to 0.4%, in the eurozone from 3.4% to 2.0% and in the OECD as a whole from 3.0% to 2.1%. As a result of the economic slowdown this year, unemployment, not unexpectedly, is forecast to rise from 5.6% in 2007 to 5.7% in 2008 and to 6.0% in 2009.

In looking at the USA, the OECD points to the difficulties which it is facing. These are the ones which make every day headlines - the credit squeeze, which is affecting most countries, declining household wealth caused by the fall in house prices and pressure on disposable income caused by sharply rising commodity prices. But, unusually amongst the major industrialised economies, the USA has taken substantial action to offset these pressures.

Monetary policy has been eased substantially and fiscal reflation has been aimed at households, in particular, but also businesses. Also, as we have mentioned in previous reviews, the competitive level of the US dollar has boosted exports and this has helped to offset some of the contractionary influences on the economy. Now that the USA has to import significant quantities of oil, the strength of exports is not so obvious in the trade figures but it is a positive development for the economy. The OECD's rationale for expecting a moderating of inflationary processes next year is the opening of an output gap, higher unemployment and a stabilisation of commodity prices. For the eurozone, the OECD sees pressures arising from tighter credit, as elsewhere, and the squeeze on real incomes caused by inflationary pressures but, unlike the USA and because of the strong currency, exports and market share will suffer. It also cites falling housing investment. We have mentioned in previous reviews the problems in the Spanish and Irish housing markets. The OECD continues to see inflationary pressures in the eurozone.

For Japan, the OECD sees as positive factors a rebound in housing investment and wage gains even though output growth is slowing. It expects underlying inflation to pick up only slowly. For the UK, the OECD expects a further slowing in the growth rate in the coming quarters due to credit tightening and weakness in the housing market. The general thrust of the OECD's current view is that difficult conditions in 2008 will give way to improving conditions as 2009 develops. It is predicated on some easing of inflationary pressures and, for this to happen, commodity prices must behave in a more normal manner.



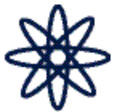
We now move on to look at individual areas, starting with the USA where first quarter growth was revised upwards for the second time. From first estimate of 0.6% annualised growth and a second of 0.9%, the third estimate puts annualised growth at 1.0%. In the latest Beige Book, published in June, the Federal Reserve said conditions "remained generally weak". It saw some stabilisation in at least five of its twelve districts, a better observation than reported in April. Where conditions were still worsening, the issues were lower consumer spending as a result of rising food and energy prices as well as weakness in the manufacturing and residential real estate sectors. The banks, not surprisingly, were being more cautious about lending, seeking "tighter credit standards". Again, not surprisingly, the survey noted inflationary tendencies with input costs rising and current or future plans to pass on these increases. Unusually, but at a different time, Ben Bernanke strayed into areas normally reserved for the Treasury when he commented upon the currency, indicating that he did not want it to weaken further because of the risks to inflation.

In maintaining official interest rates at 2%, the Federal Reserve moved the balance of its assessment more towards the dangers of inflation rising and away from the risks to growth. Its short term assessment of the economy was that "it continued to expand partly reflecting some firming in household spending". It emphasised the oil price as a risk to growth and inflation.

The US dollar is very competitive at present and the USA's exports are benefiting but, because of the Federal Reserve's wider monetary policy remit, which is enabling it to keep official interest rates below the inflation rate, and the expectation, now realised, that the ECB's next interest rate move might be upwards, the pressure still remains on the currency. Ben Bernanke's venture into the Treasury's territory suggests that, as soon as the Federal Reserve feels it can safely be done, interest rates will follow a more normal trajectory which may give added support to the currency.

The latest headline consumer price index figures for May show a month on month increase of 0.6% and a year on year increase of 4.2%. The respective core figures, excluding food and energy, were 0.2% and 2.3%. At the producer price level, the month on month increase was 1.4% whilst the year on year increase was 7.2%. The personal consumption deflator rose by 0.4% in May as a result of rising food and energy prices. Although the inflation figures are by no means disastrous, they do show how unusually low official interest rates are in relation to inflation. The risks of having official interest rates at negative levels in real terms, which would normally lead to inflation, are mitigated by the credit crunch which reduces the availability of loans and, where they are provided, they are often at much higher margins than would normally have been expected. Notwithstanding this, one detects an increased emphasis on inflationary risks coming from the Federal Reserve. As with other central banks, it will also be watching well respected business surveys for evidence of economic trends. So, for example, it will note the latest ISM survey of the manufacturing sector which showed the prices paid index rising from 84.5 to 87.0 in May, the seventeenth consecutive month when it reported price increases.

One of the factors restraining the Federal Reserve on interest rates and contributing to recent aggressive interest rate reductions has, of course, been the housing market, the root of present financial problems. The causal link between falling house prices and bank loans makes the Federal Reserve wary of taking any action which will exacerbate the position of the housing market or further damage financial institutions. Once there are signs of recovery in the housing market, the Federal Reserve will surely move to normalise interest rates relative to inflation and the state of the economy. There are just tentative signs of better times, no more than that at this stage. What are these possible signs? The National Association of Realtors reported that its index of pending home sales rose by 6.3% between March and April to 88.2 from 83.0 in March although it is still 13% lower than in April 2007. Evidence suggests recovery in those areas of the USA which experienced the steepest declines. The other possible more hopeful indicator is a rise of 2% in existing US home sales in May. But one swallow or, in this case, two swallows, do not make a summer and the majority of the news from the housing related market remains negative. The number of new housing projects started in May fell by 3.3% to the lowest level in seventeen years. Two surveys of house prices continued to point to declines. The S&P/Case-Shiller house price index covering



twenty cities showed a year on year fall of 15.3% although the rate of decline was slightly less than in April. The index produced by the Office of Federal Housing Enterprise Oversight reported an acceleration in the rate of decrease of house prices. It reported a 0.8% fall in April compared with 0.6% in March. Finally, sales of newly constructed homes fell by 2.5% in May to be 40% lower than a year ago. Just a touch of optimism is in order and the next two or three months' data will confirm, or otherwise, if a more favourable pattern is developing.

Although even the first quarter's revised growth rate was low, it was at a sufficient level to suggest that there were some positive features in the economy. May's ISM index of manufacturing activity rose by one point to 49.6, still below the level which implies economic expansion, but a move in the right direction. Rising exports were the driver of this improvement, a good omen. Factory orders were strong in April, up 1.1%, and, excluding the volatile transportation services, were up by 2.6%. March's figure was revised up to 1.5%. Productivity growth has accelerated in the first quarter of 2008 at an annualised rate of 2.6%, an increase on the earlier reported figure of 2.2%. Year on year quarterly growth in productivity was 3.3%, the largest increase since 2004. If sustained, this gives some encouragement on the inflation front. Retail sales were stronger in May, rising by 1%, and, excluding autos, were up by 1.2%. Tax cuts are helpful in this respect. Disposable incomes rose by 5.7% in May, the biggest monthly increase for thirty three years. Consumer spending rose overall in May by 0.8%. The optimists will hope that the momentum given by the tax cuts can be sustained, and the pessimists will say that comparisons will look poor by the end of the year. Another mildly positive sign is that the Conference Board's leading indicators for May showed a fractional increase of 0.1%. We are not looking at big moves at this stage, just indicators of a better trend. On the negative side, there was a slight fall in the ISM's non manufacturing index for May. Although in positive territory and therefore suggesting economic expansion, the index dipped to 51.7 in May from 52.0 in April. The employment market continues to weaken with unemployment in May rising to 5.5% compared with 5.0% in April. 49,000 jobs were lost in May. Although exports have been performing well, as they benefit from the competitive level of the US dollar, the rising price of oil in a country which is not self sufficient has taken its toll on the trade deficit which widened to US$60.9 billion in April from US$56.2 billion in March. The increase was more than accounted for by the rise in the country's oil imports. Looking at the current account as a whole for the first quarter of 2008, the deficit showed a small rise from US$167.2 billion in the final quarter of 2007 to US$176.4 billion in the first quarter of 2008. According to the Conference Board's index of consumer confidence, there was a sharp decline in sentiment in June with the index falling from 58.1 in May to 50.4. The latest Reuters/University of Michigan survey of consumer sentiment showed it to have deteriorated in June also with the index falling from 59.8 in May to 56.4 in June. An indeterminate signal came from the data for new orders for durable goods which showed the index to be unchanged after two months of decline.

To sum up the prospects for the USA as we see them in investment terms, we can see some growth being restored by the tax cuts which may give some momentum to the economy. The export sector of the economy is buoyant although if world economic growth were to slow down very sharply, it would be affected. There are glimmers of hope in the housing market. At some stage, it will turn the corner - the question is whether it is now. On the negative side, higher inflation could free the Federal Reserve's hand on interest rates before it would want to start restoring them towards a more normal level. The tax cuts could fizzle out without establishing the wished for momentum in the economy. Of course, the problems of financial institutions could become worse and lead to more investor nervousness. From the political side, investors could start considering what effect the forthcoming elections might have on the market. Financially, we have to consider whether markets are expensively valued. We think not, and that much of the bad news is priced in. If there is some evidence that the positive factors are gaining traction, we believe that the market would respond quite quickly.

From the evidence currently available, the outlook for Japan is quite satisfactory. By recent standards, the growth which the OECD is forecasting, 1.7% for this year and 1.5% for next year is not bad although it would clearly be better to return to the 2.4% growth rate of 2006. Japan has the important benefit of substantial trade levels with

Asia, the fastest growing area of the world economy. Within this area, China is likely to continue to grow strongly which will help Japan because the profile of its exports well matches China's needs.

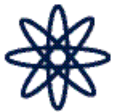
The important industrial production figures, which give a good indication of the state of the economy, indicate a stable position showing a rise of 2.9% in May. The Trade Ministry is forecasting a decline of 0.9% in June but, for July, it expects a rise of 2.2%. If the overall forecasts for June and July are achieved, it will be a good result in the short term. But to obtain a better balance within the economy, domestic consumption should be stronger. It is a feature of recent Japanese economic history that, despite steady economic growth, incomes have remained restrained. Now, with headline prices having turned positive, consumers are turning cautious. Household spending in May was 3.2% lower than a year previously. The headline consumer price index rose by 0.8% in May to give a year on year increase of 1.3%. Excluding food and energy, there was a 0.1% decrease in prices. However, food and energy feature strongly in households' budgets and, for a nation which is very cautious, this price inflation has a disproportionate effect on household spending.

For a long time, Japan has frustrated foreign investors because of its seeming hostility to foreign takeovers and suspicion of foreign investment in general. It was therefore encouraging to note that the Ministry of Economy, Trade and Industry is arguing the case for tax reforms which will encourage more foreign investment in Japan. The Ministry has concluded that foreign investors, including hedge funds and buyout funds, could provide risk capital, financial skills and information crucial to the development of the financial sector and industrial base. The Ministry used the word "indispensable" as these funds' potential contribution to the development of industry. These are strong words from such a traditionally conservative ministry and, if acted upon, would represent a very encouraging development for foreign investors. The government is also looking at corporate tax rates in an effort to make Japan more internationally competitive.

Although the official Japanese interest rate, 0.5%, is below the headline rate of inflation, and must therefore represent a temptation to the Bank of Japan to raise interest rates and move towards a more normal level of interest rates to regularise monetary policy, other indicators of inflation, which exclude food and energy, still point to deflation or flat prices. Although we have argued that it is becoming increasingly difficult to set the level of interest rates, based on core inflation, in many countries because the headline rate has influenced people's expectations of inflation, this probably does not yet apply to Japan. There has been such a long period of deflation that individuals will almost certainly take much longer to adjust their actions to rising prices. The risk of stoking up inflation by having interest rates too low in relation to inflation is probably low in Japan.

Very low debt servicing costs have meant that the very high level of public debt has not seemed as dangerous as it would do if interest rates were at more normal levels. In its report on Japan in its latest Economic Review, the OECD emphasises how essential it is that Japan cuts public spending and implements a comprehensive tax reform to achieve a primary budget surplus by 2011 as a first step to reducing the public sector debt to GDP ratio. It also emphasises the need for structural reforms.

The current economic position in Japan and outlook is not the worst and there are some encouraging longer term signs of change, as we have indicated above. The recent relatively good performance of the Japanese stock market may even be of encouragement to foreign investors who have been wary of it, notwithstanding the potential strengths of the economy, the benefit of the trade links with China being one. We maintain a modest weighting in Japan. Given the outlook for interest rates elsewhere, relative interest rate differentials may widen against Japan so that last quarter's currency weakness may continue giving assistance to equities.



Turning now to the eurozone, the estimate of growth for the first quarter was revised upwards from the initial estimate of 0.7% to 0.8%. Early in June, the IMF raised its forecast for economic growth from 1.4% to 1.75%, almost the same as the level of growth which the OECD is forecasting. Next year's forecast of 1.2% compared with 1.4% forecast by the OECD. The IMF's description of the eurozone was that it had proved "a good shock absorber, but not an impenetrable shell". The IMF is also quite optimistic about the inflation picture in the eurozone expecting it to return by late 2009 to the ECB's target range.

However, that time seems a long way away because, for now, the ECB is greatly exercised by eurozone inflation. Eurostat's initial estimate for June's inflation figures is 4.0%, the highest level it has reached since the eurozone came into being. This level, if confirmed, would be over twice the ECB's target and almost certainly ensures an interest rate increase. When it left interest rates unchanged at its June meeting, the ECB gave a fairly strong hint with Mr Trichet describing the ECB as being "in a state of heightened alert". Different opinions were expressed at the meeting, including discussions within the membership. Later, in June, Mr Trichet expressed his anti-inflation credentials even more strongly. He said that "upside risks to price stability over the medium term have intensified further over the past few months in the context of very rigorous money and credit growth. He indicated that he expected inflation to remain high this year before moderating only gradually next year. According to ECB staff forecasts, inflation is expected to average 3.4% in 2008 and 2.9% in 2009.

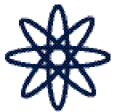
The ECB will not want inflationary expectations to become embedded in people's mind to the extent that they lead to inflationary pay settlements. Some large pay increases agreed in Germany have been justified on a "catch up" basis but making exceptions is very difficult to sustain as a policy. Eurostat reports that hourly labour costs in the eurozone rose by 3.3% in the year to the first quarter. Wage growth at 3.7% was the highest since the end of 2001.

The ECB monitors money supply and bank lending growth carefully. These are important factors influencing its interest rate decisions. Rapid growth of money supply growth has caused concern as a precursor of higher inflation and, looking back, this could be the case. The latest money supply figures showed M3 growth in the eurozone at 10.5% in May. The annual growth in loans to non financial corporations fell from 14.9% in April to 14.2% in May, still a strong figure. For households, however, the growth was much lower at 4.9% compared with 5.2% in April. This suggests that individuals are being affected by the more difficult economic background. However, the monetary data did nothing to dissuade the ECB from raising interest rates at its July meeting, from 4.0% to 4.25%.

Whilst data from the USA has been mixed, perhaps pointing to better times, in the eurozone it has mostly been negative in recent weeks. Retail sales fell by 0.6% in April following a 0.9% fall in March. Business activity declined. The purchasing managers index fell from 51.9 in April to 51.1 in May and to 49.5 in June. This was the lowest level for nearly five years. The EC's confidence index fell from 97.6 in May to 94.9 in June.

As the largest eurozone economy, what happens in Germany is important for the bloc as a whole but also in influencing the ECB's monetary policy. The short term news has been mainly disappointing but the Bundesbank is expecting a recovery later this year. Items of negative news include a fifth consecutive monthly fall in industrial orders. They were down 1.8% in April. Industrial production fell by 0.8% in April. Economic sentiment has declined. The ZEW expectations index reached -52.4 in June compared with -41.4 in May. The index is at its lowest level since December 1992. There was also a reduction in the Ifo business climate index, down to 101.3 in June from 103.5 in May. In absolute terms, however, the index was still at quite a high level. The German purchasing managers index was at a three month low in June. Consumer confidence has also declined. The GfK Institute's latest reading fell to 3.9 in June from a revised figure of 4.7 the previous month.

The ECB will also note what happens to German inflation and it will not be encouraged by present data. The Bundesbank's latest inflation forecast is for it to average 3% in 2008. Last December, it had forecast 2.3%. May's inflation figure was 3.3% year on year, the highest level since 1993. May's producer price figures showed a 1% increase in May compared with the previous month and 6.0% on an annual basis. The latest OECD forecast puts growth in Germany in 2008 at 1.9% and 1.1% in 2009.



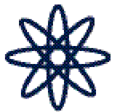
For France, the eurozone's second largest economy, the OECD is forecasting growth this year of 1.8% and 1.5% next year. The French statistics office, INSEE, is expecting growth of 1.6% this year. The pattern it sees for this year is growth of 0.2% in the second quarter, no growth in the third quarter and a pick up to 0.2% growth in the final quarter. Shorter term news from the French economy has been better. April saw a 1.4% increase in industrial output and consumer spending on manufactured goods rose by 2% in May. As in Germany and elsewhere, inflation has been ticking upwards. The latest annual rate for May is 3.7%.

The "one size fits all" problem for the eurozone remains and is not likely to go away. The problems evident in the Irish and Spanish housing market could require different levels of interest rates to those in Germany, for example. Political pressure is mounting on the ECB to respond to weaker economic growth but the ECB does not see its role in this light given its inflation mandate. Stresses in the eurozone bond markets are evident in the wide differentials on bond yields between, say, Germany and Italy and Greece and, to a lesser extent, between Germany and France. There is divergence rather than convergence in the cost of money reflecting investors' perceptions of different risks.

An issue which eurozone politicians have found particularly frustrating is the high value of the euro which is making life difficult for many businesses in the region. The different mandates of the Federal Reserve and ECB are partly responsible for this situation as the latter would not take into account, to any degree, the effect of raising interests on the euro as it attempts to rein in inflation. The differential between US and eurozone official interest rates is wide, currently 2%, and may widen further.

We turn now to look at the UK where conditions are particularly difficult. The importance of the housing market and financial sectors in the economy means that difficult conditions there are a threat to the economy as a whole. We have often expressed our concerns about the potential threats to the UK economy even when things seemed to be alright on the surface. Now the problems are surfacing and policy options are very limited.

High levels of public and private debt provide an unpleasant threat to the economy. We have been concerned in recent years about the magnitude of the relentless growth in public spending in the UK. Its growth far outstripped the potential growth rate of the economy and was bound to lead to problems when an economic slowdown, such as we are presently seeing, occurred. Although the overall level of public debt to GDP is not large in the UK, public finances are still in a fragile position and the level of deficit gives no room to take counter cyclical fiscal action, such as, for example, has been taken in the USA. The money for the recent raising of personal allowances to pay compensation to those who lost out by the abolition of the 10p income tax band has had to be borrowed. Although the Exchequer has gained from the rising price of oil, it is losing out from the problems in the housing sector as stamp duty receipts are bound to be falling sharply. In the absence of any measures to tackle the deficit, problems will emerge. The government has received influential warnings about the state of the deficit. The EC is examining the position although, with sterling being outside the eurozone, it cannot impose sanctions on the UK. It is, nevertheless, an embarrassment for the government. The latest OECD report suggests that the deficit is likely to rise significantly above 3% of GDP. The high level of private borrowing is likely to cause some real problems. Disposable incomes will be squeezed by rising prices making debt servicing more difficult. The probable rise in unemployment will worsen the position for those affected. Many have borrowed more money on the increasing value of their property. Negative equity is likely to reappear. All of this is likely to have a geared effect on consumer spending as people become more cautious. This is likely to cause a reverse multiplier effect, adversely affecting the prospects of some businesses and individuals. The UK is particularly vulnerable on this score. This is likely to continue to affect perceptions of it from abroad. Given the UK's large current account deficit and the consequent need to finance it, foreign confidence is important. Bank of England data for April, although obviously only representing one month, showed an ominous trend. Non resident net sales of government stock and Treasury bills amounted to £2.3 billion, the highest level since September 2002. The importance of this negative figure is that, in 2006, net purchases were £35.3 billion and in 2007 £25.4 billion.



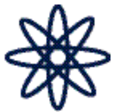
Weaker economic growth will not be helpful. First quarter growth has been revised downwards to 0.3% compared with an initial estimate of 0.4%. The forecasts of growth made in the last budget were widely considered too optimistic and now that judgement is almost certainly right. At that time, the Chancellor was forecasting growth of 1.75% - 2.25% for 2008/09 and, in 2009/10, it was forecast to be 2.25% - 2.75%. The Bank of England is forecasting growth in 2009 of 1.5%. The OECD forecasts growth of 1.8% this year falling to 1.4% in 2009. In its latest forecast, the CBI forecasts 1.7% growth for this year and 1.3% next year. It is only a matter of time before the Treasury falls into line. The problem is, however, that these optimistic growth forecasts informed the government's borrowing forecasts which now look wildly optimistic. For some time, the UK has been running a structural deficit and the larger deficit, which will occur, will be a mixture of cyclical and structural, with the latter militating against counter cyclical fiscal reflation. The OECD forecasts that public borrowing will rise to 3.8% of GDP this year compared with 2.9% forecast by the Treasury. Its forecast for next year is 3.8% of GDP against the Treasury's forecast of 2.5%. The European Commission sees the deficit rising sharply above the 3% figure and, as mentioned earlier, is investigating the position. Although it is early in the new fiscal year, borrowing is well ahead of the same period last year. For the first two months of this fiscal year, net borrowing is £12.7 billion, £4.4 billion more than last year. Why does this matter? More debt, depending upon the level of interest rates, will add to debt servicing costs and thereby increase government expenditure. It will also add to the burden of future generations of taxpayer. More government borrowing may push up interest rates. A plentiful supply of new issues may require a higher interest rate to attract investors. It could also be inflationary as loose economic policies can drive up prices. It is therefore important that the UK addresses the issue of public finances, ideally by cutting spending rather than raising taxes. This will be difficult to do in the second half of a parliament.

Opinion has hardened on the possibility of interest rate rises in the UK rather than falls, as some commentators have suggested. The Governor of the Bank of England has indicated that inflation may top 4% this year which would be over twice the upper target level. In May, the consumer price index rose by 3.3% year on year compared with 3.1% in April. Core inflation was 1.5% and the Retail Price Index showed a 4.3% increase. The year on year increase in producer prices was 8.9% in May compared with 7.6% in April. Input costs rose by 27.9%, year on year, the highest rate since the 1970's. Given the Bank of England's inflation mandate, the MPC would now seem to have little short term opportunity to reduce interest rates even though the economy is weakening.

The position is further complicated by the fact that credit is tight and becoming more expensive as lenders widen their margins to protect profitability in the light of lower lending volumes to some categories of borrower. This double blow is hitting the housing market hard. At present, the weakness of the housing market is likely to moderate hawkishness on the part of the MPC rather than induce it to cut interest rates.

The Bank of England will be concerned that inflationary expectations amongst the public are running high. This is an indicator which will register with the MPC when it makes its interest rate decisions. In May, future inflation expectations registered 4.3% whilst the perception of the current inflation rate was that it was 4.9%, well above the 3.3% level of the consumer price index which, for many people, is not a realistic measure of their inflation rate.

Nobody can now have any doubt that the housing market is in decline. Every indicator points to this and we detailed the adverse effects of this on the economy earlier on. This is the evidence. The Halifax reported that house prices in May fell by 2.4% to give a year on year fall of 6.4%. It increased its forecast for house price falls to 9% this quarter from 5% previously forecast. The Department for Communities and Local Government reported that year on year house price inflation was 4.9% compared with 5.2% the previous month. According to the FT house price index, house prices fell by 0.6% in May in England and Wales. For the index, it was the third consecutive monthly fall. The Land Registry reported unchanged prices in May and up just 1.8% over the year. Hometrack has reported that average house prices fell by 1% in June to give an annual decrease of 3.2%. Plenty of other evidence on volumes and activity support this grim outlook for the housing market. The RICS reported that market conditions became worse in May. The number of surveyors reporting house price falls rather than



rises was 92.9%, slightly lower than the 94.7% reported in April but still representing overwhelming evidence of weakness. The Council of Mortgage Lenders reported a rise in mortgages approved for house purchase in April of 9% at 50,700 but this compared with 80,500 in April last year. Gross mortgage lending was 5% down in April last year. May saw a 19% fall in mortgage lending compared with the same month last year. HMRC reported a fall of over one third in housing transactions in May compared with a year previously. The British Bankers Association reported a 56% fall in mortgage approvals in May compared with a year earlier. The Bank of England has reported that mortgage approvals for house purchase in May fell by 28% compared with April and 64% down on a year earlier. None of this augurs well for the housing market in the near future. Unlike the USA, where there is the possibility of a turning point, the UK cycle seems well behind that of the USA.

A further depressant on consumer sentiment is likely to be the employment market. After a long period of strength it is starting to weaken. On both measures, the unemployment figure is rising. The number of people out of work and claiming benefit rose by 9,000 in May after an upward revision to 11.2000 in April. On the labour force survey measure, there was a 38,000 increase to the end of April to raise the unemployment rate from 5.2% to 5.3%. Almost daily there is news of further redundancies.

Really only in the now modest manufacturing sector is there some room for optimism. Although sterling was slightly higher over the quarter, it has fallen substantially against the euro, amongst other currencies recently, and that has increased the UK's manufacturing competitiveness. A slowdown elsewhere could, of course, dampen exports.

We would not be surprised to see sterling fall further. Although interest rates are sustaining it at the current level, they cannot be relied upon. We have outlined a significant number of weaknesses in the UK economy. However, many good quality shares are lowly rated and many companies have a substantial exposure to faster growing markets (as is the case in the USA also). However, at a time of above average risk to the UK economy, important overseas exposure diversifies the risk.

China is one of a number of countries which has started to reduce fuel subsidies which have been becoming increasingly costly as the oil price has risen substantially. There is no doubt that subsidising a scarce resource is unwise economically because it creates or sustains artificially high demand. But one of the problems of being in that position is that it creates problems moving away from it, both socially and economically so it has to be managed carefully. Inflation has been the main economic concern of the Chinese authorities as it has risen well past their target. Regular interest rate and bank reserve ratio increases as well as administered prices have been the chosen weapons to fight inflation. But the authorities will be pleased with a fall in the rate of inflation to 7.7% in May.

Exports from China of low cost goods have been a major contributor to the maintenance of low inflation in the world economy. This state of affairs is gradually changing. Domestic inflation is pushing up prices and the Chinese authorities have allowed the exchange rate to appreciate quite significantly against the US dollar. Domestically, this has the advantage of weakening inflationary pressures compared with what they would otherwise have been but, internationally, it is a force for raising inflation. Labour costs are also rising in China, partly because of employment law changes The Chinese authorities have to ensure that economic growth is fast, but not excessive, as the need to absorb into the workforce those coming in from rural areas remains of paramount importance.

Meanwhile, China keeps on building up foreign exchange reserves as its current account surplus continues to remain strong although showing signs of stability, at least temporarily. China's May trade surplus of US$20.2 billion compared with US$16.7 billion for April but it was 10% lower than in May last year. The current account surplus in 2007 was an astonishing US$371.8 billion compared with US$249.9 billion in 2006. The surplus on the capital and financial account was US$73.5 billion compared with US$10 billion a year earlier. Part of the country's massive foreign exchange reserves, the world's largest, will be directed to potentially higher returning investments through its sovereign wealth fund, increasing its economic influence still further. As we said earlier, we believe that the sovereign wealth funds should have a positive influence for investors but, in the case of China, protectionist sentiment is strong in the USA and EU, and investors most hope that this does not get out of hand because a trade war would be very bad news for the world economy.

Another very large economy, India, which is also a driver of world economic growth, is also suffering from inflationary problems and the policy initiatives to deal with the problem may be expected to slow down growth. In the year to 7 June, inflation had risen to just over 11%, double the Reserve Bank of India's target. The central bank raised interest levels to 8% but this still represents a negative real rate. The government has acted to cut down on the hugely expensive oil subsidies but more difficult decisions have to be made in India where coalition politics often hamper decision making.

The likelihood is that Asia ex Japan growth will continue to outpace significantly growth in the West and Japan but that economic conditions, as elsewhere, are becoming more difficult. Food price rises are a particular problem for many countries and have to be handled carefully politically. This is something that investors will be watching closely.

It is easy to get caught up in the euphoria or depression of markets. Right now, in most quarters, the glass is looked at as half empty. There is a lot of bad news around, both from financial institutions and the real economy. But, as always, it is important to take the long term view because decisions made on the basis of short term sentiment can be costly. We need to remember that most businesses continue to operate in markets where their goods and services are required and that most will make profits and pay dividends. Whilst that may be seeming to state the obvious, the negative media news can drown out more balanced assessments. It is true that shares have risen substantially over the last five years but so have corporate earnings and we are not in bubble territory with shares. Even allowing for a difficult time for corporate profits in 2008, earnings yields are likely to well exceed bond yields and provide a solid base for shares before the economic recovery begins. Selling good quality equities on reasonable multiples, risks being caught by a sudden rebound in share prices and experiencing an opportunity cost which cannot be recovered.

June 2008

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