meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

This has been a standstill quarter following an extended period of rises in international equity markets. This must be considered a satisfactory result in this context. Bond markets have started to experience some turbulence at the end of the period and into the beginning of the new quarter. There have been some significant currency movements as our table shows and, in the commodity markets, oil has been very weak.

The tables below detail relevant movements in markets :

International Equities 31.03.17 - 30.06.17

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-2.0	-5.1	-1.4	-7.6
Finland	+7.0	+9.9	+14.1	+7.0
France	+3.2	+6.0	+10.1	+3.2
Germany	+0.4	+3.1	+7.1	+0.4
Hong Kong, China	+7.3	+2.8	+6.8	+0.2
Italy	+3.1	+5.9	+10.0	+3.1
Japan	+6.4	+1.5	+5.5	-1.1
Netherlands	+0.9	+3.6	+7.6	+0.9
Spain	+0.9	+3.6	+7.6	+0.9
Switzerland	+4.9	+5.6	+9.6	+2.8
UK	+0.9	+0.9	+4.8	-1.7
USA	+3.1	-0.7	+3.1	-3.3
All World Europe ex UK	+2.6	+4.6	+8.7	+1.9
All World Asia Pacific ex Japan	+5.4	+1.3	+5.2	-1.3
All World Asia Pacific	+5.8	+1.4	+5.3	-1.2
All World Latin America	-0.5	-5.5	-1.8	-7.9
All World All Emerging Markets	+3.8	+0.2	+4.1	-2.4
All World	+3.2	+0.5	+4.4	-2.1

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : -1.3%

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

Currency	31.03.17	30.06.17
Sterling	1.22	1.33
US Dollar	2.41	2.28
Yen	0.07	0.09
Germany (Euro)	0.33	0.47

Sterling's performance during the quarter ending 30.06.17 (%)

Currency	Quarter Ending 30.06.17
US Dollar	+3.7
Canadian Dollar	+1.3
Yen	+4.7
Euro	-2.8
Swiss Franc	-0.5
Australian Dollar	+3.3

Other currency movements during the quarter ending 30.06.17 (%)

Currency	Quarter Ending 30.06.17
US Dollar / Canadian Dollar	-2.3
US Dollar / Yen	+0.9
US Dollar / Euro	-6.3
Swiss Franc / Euro	-2.3
Euro / Yen	+7.7

Significant Commodities (US dollar terms) 31.03.17 - 30.06.17 (%)

Currency	Quarter Ending 30.06.17
Oil	-9.7
Gold	-0.2

MARKETS

The second quarter has been one of consolidation for international equity markets. In local currency terms, the FTSE All World Index has returned +3.2%, in sterling terms +0.5%, in US dollar terms +4.4% and in euro terms -2.1%. Looking at local currency returns first, the best performing market was Japan where the FTSE Japan Index returned +6.4%. The FTSE All World Asia Pacific Index and FTSE All World Asia Pacific ex Japan Index also showed above average returns, respectively +5.8% and +5.4%. On the other hand, there were below average performances from the FTSE Australia Index, -2.0%, the FTSE All World Latin America Index, -0.5%, and the FTSE UK Index, +0.9%. In sterling terms, the picture changes. Japan still shows a slightly above average performance with the FTSE Japan Index returning +1.5%, but the stand out performer was the FTSE All World Europe ex UK Index which returned +4.6%. The worst performers in sterling terms were the FTSE All World Latin America Index, -5.5%, the FTSE Australia Index, -5.1%, and the FTSE USA Index, -0.7%. The total returns in the FTSE Asia Pacific and FTSE Asia Pacific ex Japan indices were slightly above average at +1.4% and 1.3% respectively.

In the government bond market, using ten year bonds as benchmarks, the gross redemption yield on the UK gilt rose by 11 basis points to 1.33%, on the Japanese Government Bond by 2 basis points to 0.09%, on the German Bund by 14 basis points to 0.47%, whilst that on the US Treasury bond fell by 13 basis points to 2.28%.

In the currency markets, the strongest performer was the euro, against which sterling fell by 2.8%, followed by the Swiss Franc where the fall was 0.5%. The weakest currency was the yen, against which sterling rose by 4.7%, followed by the US dollar, +3.7%, the Australian dollar, +3.3%, and the Canadian dollar, +1.3%.

In the commodity markets, oil was very weak with Brent crude falling by 9.7%. Gold was little changed, down 0.2%.

ECONOMICS

Except in the case of the UK, it could be argued that the political background for international markets is more stable than it has been for a while. This is in relative terms, of course, because there are plenty of areas for concern, brought home by the series of atrocities which have been committed and the escalation of concerns about North Korea’s nuclear programme. Economic conditions have shown some improvement including in the eurozone, always an area of concern.

However, on this occasion, we will start our review with a discussion of the situation in the UK, given that most of our client portfolios are sterling based. On the scale of political shocks in recent times, the UK General Election in June was right up there with the biggest of them. The landslide for the Conservatives, which many had predicted at the start, ended up as a hung parliament and a formal agreement between the Conservatives and the Democratic Unionist Party to shore up their position and ensure a majority in Parliament. The ramifications of the General Election result are extensive and cause us to rate the UK market as high risk now. The extensive geographical diversification which characterises our clients’ portfolios at any time assumes even greater importance now in providing protection against the risks inherent in the UK as a result of the current political situation. Just as Brexit provided a shock to sterling, which was mitigated in our clients’ portfolios by extensive unhedged overseas exposure, so, to a lesser extent, did this happen once the General Election result was known, although the effect on sterling was much smaller. Nevertheless, given the potential risks to the UK arising from uncertainty on a number of fronts, who is to say that sterling will not fall further? Although a large market in absolute terms, and ignoring China, the UK only accounts for just over 6% of the FTSE All World Index. To hold a multiple of that amount in the UK equity market without good reason elevates a portfolio’s risk.

So what are the risks for the UK? Very obviously, there is the political risk. Even though the Conservatives’ manifesto was untraditional in many respects, the Labour manifesto was extreme by UK standards and the fact that Labour received over 40% of the popular vote showed that its contents resonated with many voters. Nonetheless, if it had been elected and the programme implemented, it would have been almost inevitable that sterling would have fallen sharply and the stock market with it. Notwithstanding the agreement with the DUP, the government’s position is fragile and political risk is high. The Queen’s Speech, which ditched many of the Conservatives’ manifesto commitments including some which were considered to be anti-business, has been crafted to be as uncontroversial as possible as all attention is focused on Brexit and the negotiations leading up to the UK’s departure from the EU in 2019. One of the reasons for calling the General Election only two years after the previous one was to take the current parliament to 2022, if necessary, which would happen under the Fixed Term Parliament Act, thereby giving the country the experience of three years outside the EU and reducing the difficulties the government would almost certainly have faced internally, with negotiations coming to an end not long before a General Election would have been due in 2020. Now that an agreement between the Conservatives and the DUP has been reached, it is possible that this parliament will run for five years, but there can be no certainty. It is likely that the government’s hand in the Brexit negotiations will be weakened. The majority of MPs were Remainers, and that includes the Conservatives, and they could still make life difficult for the government, as could the House of Lords, which may try to argue that, because the Conservatives did not win a majority of seats in the recent General Election, the Salisbury convention of not blocking items which were in the governing party’s manifesto does not apply. Given all of the surprises which we have seen in various elections and the UK referendum, who knows what will happen?

There have been signs that the UK economy, which surprised many people post the Brexit vote by performing quite well and not falling off a cliff, as some had forecast, is facing some headwinds as a result of a squeeze on real incomes following the post Brexit devaluation of the pound which is affecting growth. Probably the greatest danger is a fall off in confidence by businesses and consumers as they assess the post election landscape. The possibility of a change in government leading to anti business policies being enacted could have a chilling effect on confidence. It is very early days, but there is clearly an elevated risk surrounding the UK economy because of recent events and a more difficult bargaining position for the UK’s Brexit negotiations.

One clear lesson from the recent UK General Election is that there are no votes in trying to repair the UK’s public finances. There is a feeling that policies in the Conservatives’ manifesto such as ending the pensions triple lock, or means-testing the winter fuel allowance and proposals for financing social care, cost them their majority as they antagonised some of their traditional supporters. On the other hand, the promise of free tuition fees clearly helped to galvanise the student vote. All of this means that a weakened government has to have an eye on the next General Election, even if it is five years away, possible because of the Fixed Term Parliament Act, assuming the government does not lose a vote of confidence or that two thirds of MPs vote to overturn the fixed term. This means that fiscal policy will almost certainly be looser than it would have been had the government achieved its expected larger majority. This is likely to mean that sterling will be weaker than it would otherwise have been, although the converse of this is that monetary policy may be tighter. The recent Monetary Policy Committee decision to keep interest rates unchanged, at 0.25%, was tighter than expected, at 5 to 3. With the latest Consumer Price Index showing a year on year increase of 2.9%, official interest rates look right out of line with traditional relationships. Were looser than would have been expected fiscal policy in the event of an outright Conservative majority to lead to a weakening pound as investors doubted the discipline of the government, the Bank of England's MPC might feel minded to raise interest rates to give some support to the pound, although, if confidence was low, it would be doubtful if raising interest rates would be very effective.

If this all sounds too negative about the UK, it is only because at this stage, with the future so uncertain, investors should give more thought in their investment policies to the political risks in the UK rather than to the potential rewards. Investors have the luxury of being able to spread their risk and some overseas markets look lower risk at the moment. This is not to say that we are exiting the UK market completely. Blue chips with substantial overseas earnings remain a sensible way of playing the UK equity market whilst these uncertainties persist. As for sterling bonds, we see absolutely no value and plenty of risks. A ten year government bond yield of 1.30% and a thirty year one of 1.93% at the time of writing with inflation at 2.9%, even though we can understand the reasons behind these yields, bears no relation to reality. So, of the major stock markets, we gauge the UK to have by far the highest level of risk at the moment. What is the position elsewhere?

Whilst the US equity market stands at around all time highs, the reasons why the markets soared after President Trump's victory last November have not so far proved to be generally valid. The excitement arose because of proposed tax cuts for individuals and businesses, deregulation and the possibility of a more lenient tax regime for money parked overseas by companies because of prohibitive tax rates on funds being repatriated. If funds were to be repatriated, the possibility of their being invested in the USA would have been attractive to investors for a number of reasons. So far, however, the only progress has been on deregulation, and this only to a limited extent in the energy industry and in the financial sector by the appointment of various regulators who are more sympathetic to the President's viewpoint in the way that they are likely to administer the regulations of the various financial bodies which they head. The lack of action and conflicting signals coming from the executive arm of government in the USA does not seem to have had a negative effect on markets judging by Wall Street's current levels. With fiscal policy action apparently stymied at present, most attention in US economic matters is currently focused on monetary policy. The Federal Reserve recently raised interest rates again by 0.25% to give a target rate for the federal funds rate of 1.00% - 1.25%. Some of the signals from the US economy have been weaker, although not seriously so, and inflation remains more subdued than expected. The core consumer price index, excluding food and energy, is 1.6% and the Federal Reserve's preferred inflation indicator, the core Personal Consumption Index stands at 1.4%. Even though these inflation figures are more subdued than expected, the target federal funds rate in relative terms is below what one would normally expect. The Federal Reserve said that it expects inflation to return to its target level of 2% but stated the usual caveats about watching the position closely. Perhaps of more consequence in the longer term is the Federal Reserve's plan to shrink its balance sheet which has been swollen by quantitative easing which is potentially risky. A move towards the shrinkage of central banks' balance sheets is desirable at the right time but it depends upon the state of the economy in question. Whilst not expanding its balance sheet, the Federal Reserve is reinvesting the coupons and proceeds of maturing bonds but, in signalling its desire to reduce the size of its balance sheet, it is doing so in the most careful way by saying that it will put a limit on the amount of reinvestments from these sources and gradually reduce the amount of money which can be reinvested, thus steadily tightening monetary policy, but in a less high profile way than selling fixed interest securities back to the private sector. As we have noted previously, one of the biggest tests for securities markets will be the reversal of quantitative easing, which is necessary to avoid inflationary risks in the future, but which has to be undertaken delicately in order to avoid disrupting markets. We recall the taper tantrum of 2013 when, in the USA, Ben Bernanke mentioned the possibility. Although it temporarily upset markets, it should not have done given that it was going to have to occur at some time but the fact is that it did for a while. Careful market signalling is essential to try to avoid the equivalent of taper tantrums. One would say that the signals given by the Federal Reserve and the actions it proposes to reduce the size of its balance sheet are about as gentle as they can be because of the gradual and low profile way it plans to go about reducing the amount it reinvests from maturing securities and coupons. Against a central bank balance sheet of US$4.5 trillion, its initial moves are likely to be very modest. There is an academic argument about the sequencing of monetary tightening, which is whether interest rates should be normalised just before reversing quantitative easing or whether the moves can be run in tandem. One would guess that raising interest rates would have more effect in tightening policy which remains very loose almost everywhere if only because it is a more high profile action. Some economists expect that there will be one more 25 basis point rate increase in the USA this year to take the target federal funds rate to 1.25% - 1.50%. That the world economy is growing only at a modest rate, and this after the enormous amounts of quantitative easing which has taken place, shows how dependent it has been on the extraordinarily loose and unorthodox monetary policy which has been followed since the 2008 financial crisis. To achieve a smooth exit from quantitative easing without destabilising a fragile world economy is going to be a very delicate and skilful task with the USA leading the way. The way the exit is handled is one of the biggest challenges which the international equity and bond markets face in the coming years and, as this is written, bond markets are experiencing a significant wobble on concerns about what the ECB might do in respect of tightening monetary policy.

The exit from quantitative easing will be more complicated in the eurozone and will occur later than in the USA. The amount of securities being purchased by the ECB has been reduced from €80 billion a month to €60 billion, but extended to December. The dilemma for the ECB is a wide variation in economic conditions amongst the eurozone members and this, of course, is one of the central problems of the euro. What is good for Germany may not be good for Greece or, as an example of a larger economy, Italy. Negative interest rates are highly inappropriate for an economy as strong as Germany's but, in extreme circumstances, they could be for Greece. Too low and they could set off inflationary forces, too high and they could cause or exacerbate a recession. In terms of the ECB's bond buying programme, it has undoubtedly helped countries whose debt profile is poor but, when the programme is run down and eventually ends, it could cause problems for countries like Italy. Without the backstop of central bank buying in the secondary market in the background, the interest rates which countries like Italy have to pay will be credit related. But, as in all countries which have used the monetary tool of quantitative easing, thought has to be given as to how to exit it, given the potential dangers of a much enlarged central bank balance sheet. With the eurozone economy performing more strongly, inevitably thoughts turn as to how to begin the exit process. It will be more problematic than in the USA or UK when the time comes because of the number of interested parties but, as elsewhere, how it is undertaken will be an important influence on stock markets.

Apart from the UK, the other country where elections have been the main focus of attention is France. Following his assuming the Presidency, Emmanual Macron's party, La République en marche, won a solid majority in the National Assembly gaining 355 out of 577 seats leaving him and his party in a very strong position to govern. France's difficulties are well known and have not been seriously tackled. The lack of supply side reforms, particularly in the labour market, and a state which accounts for 56.2% of GDP have caused it to lose economic ground against Germany, thus reversing the position at the beginning of this century when Germany was struggling. Investors have been excited about President Macron's proposed labour market reforms and plans to cut back the public sector. These are strong imperatives if France is to improve its long term growth potential since the private sector is suffocated by the size of the public sector and firms are reluctant to hire people because of the high level of job protection which poses a risk to business if they need to react to difficult market conditions. However, the side of President Macron's views which have not been aired as widely is his protectionist one. In particular, he wants greater protection from foreign takeovers in certain strategic industries, this to be on an EU scale, and he also wants state contracts placed with local companies and protectionism in the jobs market against foreign workers from the EU countries. So, his policies, as outlined, are very much a curate's egg, some sensible and overdue, others positively retrograde. It is a strange mixture. Some of his protectionist plans which involve EU agreement are bound to meet opposition from some of the more economically liberal members of the EU. Judgement therefore needs to be reserved but his initial plans affect France only and are likely to be welcomed. All this assumes that he will be able to build on his election winning momentum and face down opposition to his labour reform policies which is bound to come.

A general issue which has surprised some people is that worldwide inflation has remained low despite the huge monetary stimulus. Whilst bond yields have been kept artificially low by quantitative easing, another contributory factor is that wage pressures in most countries are quite subdued. Even in countries with relatively low unemployment, like the USA and the UK, that is true. Quite possibly the answer lies with the disappointing level of productivity increases. The best driver of real wage growth is increased productivity. If employees' productivity rises, significantly higher wages may pay for themselves but, if productivity growth is low, employers are reluctant to award pay increases which cannot pay for themselves and therefore become inflationary and damage their competitiveness. So, even in a country like the UK which has been successful in creating jobs, many of them have been low paid. If labour becomes cheap relative to capital, companies will not invest but use relatively more labour and this may well explain the productivity puzzle in many countries, a significant economic issue, as well as companies' reluctance to invest. Cash which has built up in many companies has often been used to buy back shares and to pay dividends. Whilst this may be welcome to shareholders in the short term, longer term corporate prosperity and, hence, shareholder returns, will benefit from an upturn in capital expenditure.

China is always in investors' sights but the most recent news of interest has been MSCI's decision to include, from next year, in a modest way at least at the outset, certain Chinese "A" shares, which are those listed in China on the Shanghai and Shenzhen stock exchanges. China is the second largest stock market but, because of its exclusion from the indices, its importance can be pushed into the background and foreigners' holdings are relatively small. There have been a number of issues for the MSCI decision makers to consider before including "A" shares in its Emerging Markets index. Included in these are corporate governance issues, the role of the state in many Chinese companies and sudden halts to trading as occurred at the beginning of 2016. For the moment, MSCI will add 222 "A" share large market capitalisation stocks next year to its Emerging Markets index which will account for just 0.73% of the MSCI Emerging Markets Index. Only 5% of their market capitalisation will be included initially. These "A" shares should be distinguished from Chinese listed "H" shares listed in Hong Kong and others listed overseas. These account for about 27% of that index. So, this is a significant, albeit modest, start to including Chinese shares in a larger number of portfolios. With more foreign investors, there will be more pressure to raise corporate governance standards.

The other significant event in recent weeks in China has been action by the Chinese regulators to test systemic risk in the context of some large acquisitions made by Chinese companies. Those which fell sharply on the news included Wanda Film, Fosun International and HNA as well as the unlisted insurer, Anbang. The action of the regulator suggests some concerns about these companies' spending sprees abroad. The level of debt in China is high and house prices in some major Chinese cities have been rising rapidly. These are danger signs for an economy which the authorities have been acting to mitigate either by tightening interest rate policy or through action in the property market to try to take the heat out of rising prices. At the moment, investors are relaxed about China and the stock market is performing well. Any moves to increase foreign participation in the Chinese stock market can only be good news but, as we saw at the beginning of 2016, when the market fell sharply and trading halts were instigated, it can take centre stage very quickly and spill over into other markets.

The Bank for International Settlements, often referred to as the "bankers' bank" at it operates as the banker for central banks, is a very well respected organisation and it has issued a strong warning about the dangers of high debt ratios. We have talked about a crucial test for markets being how the exit from quantitative easing is handled and, as this is written, bond markets are exhibiting some jitters. The BIS says that aggregate debt ratios are almost 40% higher than ten years ago with spectacular rises in countries like China (+191%), Canada (+70%), France (+67%), Japan (+52%) and South Korea (+49%). The UK and USA almost look paragons of virtue, +36% and +29% respectively, but, of course, they are not. One only has to look at the size of these increases to imagine the chilling effect which they would have on many countries' public finances if interest rates rose to anything like historical levels. There would also be a significant transmission effect of rising interest rates from one country to another. These warnings make it vital that the exit from quantitative easing is handled very carefully.

The issues which we have discussed in the previous pages will continue to inform investors' outlook for markets, but the solid start for international equities in 2017 and low levels of volatility suggest a degree of confidence about the world economic outlook. That is probably justified on the evidence which we currently have available. Growth will not be high but it is likely to be acceptable given where we have come from. The OECD's latest Economic Outlook has recently been published. Amongst its own members, it sees economic growth in 2017 and 2018 at 2.1% compared with 1.8% in 2016. Looking at different countries and areas, it sees US growth at 2.1% this year and at 2.4% in 2018. This compares with 1.6% in 2016. For the euro area, it sees growth at 1.8% for both 2017 and 2018 compared with 1.7% in 2016. Looking at the forecasts for the 4 largest eurozone economies, the OECD projects growth in Germany of 2.0% in both 2017 and 2018 compared with 1.8% in 2016. In the case of France, it sees growth of 1.3% this year and 1.5% next year, this compared with 1.1% in 2016. For Italy, growth of 1.0% is forecast for 2017 and 0.8% for 2018 compared with 1.0% in 2016. For Spain, a recent success story from a low base after its travails in the financial crisis, it sees growth at 2.7% this year and 2.3% next year, a slowdown on 2016's 3.1% but still well above the eurozone average projection by the OECD. Japan's forecast growth for 2017 is 1.4% and 1.0% for 2018 compared with 1.0% in 2016. For another G7 country, Canada, the OECD currently expects growth of 2.8% in 2017 and 2.3% in 2018 compared with 1.4% in 2016. Finally, amongst the G7 economies, the OECD expects the UK to show growth of 1.6% this year and 1.0% next year compared with 1.8% in 2011. Forecasts generally for the UK are influenced by expectations of the approaching Brexit. Elsewhere, amongst the industrial nations where we hold investments, Australia's very long period of continued economic growth, 25 years, is expected to continue. Against growth of 2.4% in 2016, the OECD sees growth of 2.5% in 2017 and 2.9% in 2018. Elsewhere, outside the OECD, Brazil, an economy which is particularly difficult to forecast given its enormous political problems, is forecast to grow by 0.7% this year and 1.6% in 2018, these figures after 2 years of serious recession with growth of -3.8% in 2015 and -3.6% in 2016. Russia, also, after two very difficult years with economic growth of -2.8% in 2015 and -0.2% in 2016, is forecast to perform better in 2017 and 2018 with forecast growth rates of 1.4% and 1.6% respectively. India is expected to continue to show the fastest growth rate with the OECD forecasting 7.3% for 2017 and 7.7% for 2018 compared with 7.1% in 2016. Finally, for the world's second largest economy, China, the OECD sees growth of 6.6% this year and 6.4% next year compared with 6.7% in 2016. The conclusion to draw from these projections, if they are broadly correct, is that they should provide a favourable background for corporate earnings which is very important given the rise in stock markets and the expansion of price/earnings ratios, although, from a medium and long term perspective, it is highly desirable for interest rates to move to more normal levels relative to inflation. Because of the large economic and market distortions which ultra low or negative interest rates have caused, the growth rates projected are not likely to be fast enough to trigger a sea change in monetary policy, which is likely to remain very easy although less so than before. The tightening in US monetary policy, discussed earlier, will be gradual and, if signalled carefully, should not affect equity markets. However, the reversal of quantitative easing, to be carried out over what we would expect to be quite a number of years, has to be handled delicately. At present, we judge the initial tightening of US monetary policy and an increasing feeling that we are approaching the time when monetary policy in the eurozone and UK will start to be tightened very marginally, set against modest international economic growth, to be a balance which international investors can accept as not being damaging to the equity cause. Were something more aggressive to occur on the interest rate front, that would be different, but one senses that, after the taper tantrums in 2013, central bankers will go out of their way to ensure a gentle reversal which is clearly signalled. This will affect the way in which interest rate expectations and quantitative easing withdrawal are shaped and, probably, as in the USA, in the least aggressive way, which means allowing maturity and coupon reinvestments to be gradually reduced in size. This seems less aggressive than selling securities back to the private sector in the market. So, it is a fine balance, but modest growth expectations, such as those projected by the OECD, and subdued inflation should be able to tie in with a very modest tightening in monetary policy at the relevant time in the major economies.

Whilst we have discussed at some length the early stages of the reversal of quantitative easing and tightening monetary policy through interest rate increases as well, we need to bear in mind that levels of public and private debt have risen enormously in recent years. Because of the ultra low level of interest rates, the difficulties of servicing these debts have not surfaced in a major way but, as and when interest rates move to more normal levels, the stress will become apparent. Furthermore, a high level of indebtedness and the consequent stress on budgets, whether in the public or private sector because of debt servicing costs, weighs down on economic growth. In the indebted countries, an increasing amount of taxation revenue has to be used to pay interest charges which could result in higher taxation and/or cuts in government expenditure, both of which would depress economic growth and, for individuals, increased interest costs would bite into income available for spending. Investors must keep the high level of indebtedness at the front of their minds as it will be an investment issue further out. According to the Institute of International Finance, based in Washington, and quoted in the Daily Telegraph, global debt has reached US$217 trillion, which amounts to 327% of world GDP. This is a seriously large percentage and ties in with what we were discussing earlier in the context of the BIS's comments. For the moment, investors should park this information for when interest rates start to move up on a general scale and consider how to adjust their investment stance, if at all.

Moving from the general to the particular and looking at the USA, we see that the important purchasing managers indices are staying well in positive territory. The latest PMI for manufacturing stands at 57.8 and that for non manufacturing at 57.4. These figures translate into a reasonable rate of growth. In February, the respective index levels were 57.7 and 57.6. One of the influences on the Federal Reserve's decision to raise interest rates again in June was its view of the strength of the labour market. It reduced its medium forecast for the unemployment rate at the end of 2017 to 4.3%, and cut it to 4.2% for 2018 and 2019. In economics, the Phillips curve points the relationship between unemployment and inflation, with a fall in unemployment to a particular level causing inflation to rise as the labour market becomes overheated. The Federal Reserve believes that a strong employment market will push inflation to its 2% target rate. At the moment, the Federal Reserve's preferred measure of inflation, the core Personal Consumption Expenditure Index, is not behaving quite as expected and it has reduced its forecast for inflation on this measure to 1.7% at the end of the year, down from its 1.9% forecast last March. Some of the short term indicators have been weaker in the USA, although it is too early to say whether this is anything other than a short term dip. The labor force participation rate, which had been creeping up earlier in the year to reach 63%, has dropped back in May to 62.7%. The unemployment rate should be considered in conjunction with the labor force participation rate. Retail sales weakened in May, down by 0.3% compared with April and pushing the year on year increase down to 3.8% from 4.6% in April. Durable goods orders were down by 0.8% in May compared with April. In a measure of consumer confidence, the University of Michigan's widely followed indicator showed a fall to 95.1 in June compared with 97.1 in May and a 2017 peak in January of 98.5. Observers are undecided about whether there will be another interest rate increase this year in view of weaker data, including inflation figures, so data in the near future will be watched with above average interest.

We have concentrated heavily on the monetary side of economic policy in the USA and elsewhere in this review but, before we leave our discussion of the US economy, we should look at the fiscal side in the context of the White House's budget blueprint set out in May. Whilst details were in short supply, the stated aim of eliminating the fiscal deficit in ten years relies on an heroic assumption about US economic growth reaching 3% by 2021 and delivering US$2 trillion of extra revenue over ten years. Whilst the average growth rate in the USA was 3.4% between 1992 and 2002, only twice since then, in 2004 and 2005, has growth exceeded 3%. We discussed earlier on why the high level of debt in the world economy might weigh down on economic growth. The document aims for spending cuts of US$3.6 trillion over its timeframe with cuts in healthcare support and education, whilst sheltering social security and Medicare and increasing defence spending. This all sounds very difficult and it will be a tough sell in Congress. Some of the excitement on the fiscal front after last November's election looks out of place, although the stock market is yet to register any serious disappointment, given that Wall Street is at around its all time high.

Finally, and on a positive note which we touched upon earlier, corporate earnings in the USA and elsewhere have been rising. US corporate earnings growth in the first quarter, estimated at 13.5%, was at the strongest rate for six years and the expectation is for further growth on a quarter by quarter basis. Those US companies with significant overseas businesses performed particularly well. Earnings growth is important in validating the strong rise in share prices. This is particularly relevant given the support which U.S. equities have received from substantial share buy backs. According to work from S & P Dow Jones Indices and quoted in The Financial Times, board approvals for new buy back programmes have fallen to the lowest levels since 2012. It said that, in the first quarter of 2017, they were down 1.6% from US$135.5 billion in the last quarter of 2016 and down from US$161.4 billion at the start of 2016. This may be a reflection on the higher level of share prices which can make share buy backs unattractive from a financial viewpoint or companies may be preparing to increase their capital expenditure which would be positive for economic growth in the medium term.

As we mentioned earlier on in this review, the eurozone has started 2017 quite well, leading to speculation about a tightening of monetary policy from an extremely loose base. If we look at the important purchasing managers indices, we note that the composite index remains firmly in positive territory, implying moderate growth. The latest composite PMI index stands at 56.3 with the one for manufacturing at 57.4 and the one for services at 55.4. The German manufacturing index stands at a high level, 59.6, whilst the services sector is rather lower at 54.0. The composite index stands at a healthy 56.4. The brighter economic news from France this year is reflected in a composite PMI reading of 56.6. The EC consumer confidence index has been improving from a low level, now standing at -1.3, up from its lowest point in February of -6.2, whilst the EC Euro Area Business Climate Indicator has been improving steadily since the beginning of the year. Retail sales have shown a slow but steady improvement with retail sales up 2.5% year on year against the January figure of 1.8%, whilst each month so far this year has seen a month on month increase, albeit sometimes modest.

Moving on to Japan, the country has received some positive news from the IMF which has reported positively on Abenomics, declaring itself comfortable with Japan's policy stance. So far this year, the country's purchasing managers indices have been in modestly positive territory consistent with a year on year economic growth rate of 1.3% and a first quarter annualised rate of 1.0%. Monthly industrial production rates have been erratic but the year on year figure shows an increase of 6.8%. The unemployment rate did jump in May to 3.1%, having stayed below 3.0% since February. The IMF stresses the importance of the third arrow of Mr. Abe's revival plan, structural reform, which has been lagging. The aim of monetary policy is to get inflation to 2%. The latest year on year consumer price index is 0.4% higher than a year previously, whilst core consumer prices are in negative territory. The importance of the inflation target is to encourage consumer and business spending on the basis that, if spending is delayed, purchases will cost more, the reversal of Japanese thinking in the years of deflation. Japan had been aiming at a primary budget balance (i.e. excluding interest payments) by 2020, but progressing more slowly on fiscal tightening, as the IMF suggests, would mean pushing back that target date. Although Japan has a very high level of indebtedness, it is not a country which often features on investors' radar as one to be particularly concerned about, given the potential problems elsewhere.

We have discussed China at some length earlier. The main issue is the effect which high leveraging will have on the financial system if anything goes wrong in the property market, given the sharp run up in some prices in major cities, as well as companies with high borrowings such as the ones which the regulator is examining with regard to systemic risks. The central bank has been tightening monetary conditions to try to dampen down enthusiasm for credit, with the so called shadow banking system in its sights. Growth appears to be broadly in line with expectations. First quarter GDP was 6.9% above the level a year earlier and the first quarter's annualised growth rate was 5.3%, a little below expectations. The major issues for investors in looking at the Chinese economy are the debt levels and the problems which overleveraging could cause for the banking system and progress towards transforming the economy towards consumption and the services industries.

We have discussed the UK at some length at the beginning of this review, and the real issues for investors are not the day to day items of economic data which are released, but the much bigger picture relating to political instability and a weakened government's ability to face up to fiscal issues and Brexit. Voter fatigue with attempts to bring the budget deficit under control will weaken the government's fiscal stance at a time when the country is borrowing approximately £1 billion a week. Since there is no political consensus about taking measures to eliminate the budget deficit, any move to continue the previous path to this objective, which had already been stretched out, looks likely to face resistance. With this problem and the Brexit negotiations, it is quite easy to accept that the UK is a high risk area and determine a geographical asset allocation accordingly. We may be surprised but, for now, a cautious view towards the UK is justified.

Probably the most significant political problem at the moment, and there are many, is the escalation of tension with North Korea. The stakes could not be higher. One might think it strange that this situation has not unsettled markets but the reason almost certainly is that one cannot base an investment policy on a nuclear war, so cataclysmic would be the result. This is different from the slow burn of worrying economic issues, some of which we have outlined and which can be factored into investment policy.

In summary, we must repeat our warnings that, after such a long period of good performance from equities and what must be considered a satisfactory standstill quarter after that series of rises, investors must expect some negative quarters but, for long term investors, as our clients are, this does not mean reducing equity positions since equities, in our view, remain the preferred asset class. In the environment we have outlined in respect of a very gradual tightening of monetary policy, especially the start of the reversal of quantitative easing, bonds continue to look very vulnerable given the extremely low levels of yields at which they sell. The political difficulties in the UK emphasise the absolute necessity, where possible, of significant geographical diversification. We will generally look to invest cash which has built up on any significant setback in markets.