meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

It has been a pleasing quarter for investors with our table below showing a full house of positive returns in all currencies with loose monetary policy and signs of a better corporate earnings outlook keeping shares firm. Bonds have been mixed, depending on the relevant markets. Compared to some recent quarters, currencies have been quite quiet and sterling has shown a mixed performance, as have commodities

The tables below detail relevant movements in markets :

International Equities 30.12.16 - 31.03.17

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+5.5	+9.8	+11.1	+9.6
Finland	+5.5	+5.7	+7.0	+5.5
France	+5.8	+5.8	+7.3	+5.8
Germany	+7.2	+7.4	+8.7	+7.2
Hong Kong, China	+12.9	+11.3	+12.6	+11.0
Italy	+5.8	+5.8	+7.3	+5.8
Japan	+0.2	+3.6	+4.9	+3.4
Netherlands	+9.4	+9.6	+11.0	+9.4
Spain	+13.0	+13.3	+14.6	+13.0
Switzerland	+7.3	+7.6	+8.9	+7.4
UK	+3.7	+3.7	+5.0	+3.5
USA	+6.3	+5.0	+6.3	+4.8
Europe ex UK	+6.8	+7.1	+8.3	+6.8
All World Asia Pacific ex Japan	+8.7	+11.2	+12.6	+11.0
All World Asia Pacific	+5.0	+8.0	+9.3	+7.8
All World Latin America	+7.4	+10.6	+11.9	+10.4
All World All Emerging Markets	+7.5	+8.9	+10.2	+8.7
All World	+5.8	+5.8	+7.1	+5.6

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : +1.6%

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

Currency	30.12.16	31.03.17
Sterling	1.24	1.22
US Dollar	2.46	2.41
Yen	0.00	0.07
Germany (Euro)	0.11	0.33

Sterling's performance during the quarter ending 31.03.17 (%)

Currency	Quarter Ending 31.03.17
US Dollar	+1.6
Canadian Dollar	+0.5
Yen	-3.0
Euro	+0.2
Swiss Franc	-0.1
Australian Dollar	-4.1

Other currency movements during the quarter ending 31.03.17 (%)

Currency	Quarter Ending 31.03.17
US Dollar / Canadian Dollar	-1.1
US Dollar / Yen	-4.6
US Dollar / Euro	-1.4
Swiss Franc / Euro	+0.3
Euro / Yen	-3.2

Significant Commodities (US dollar terms) 30.12.16 - 31.03.17 (%)

Currency	Quarter Ending 31.03.17
Oil	-5.7
Gold	+8.6

MARKETS

It has been another solid quarter for international equity markets. In local currency terms, the FTSE All World Index returned +5.8%, in sterling terms +5.8%, in US dollar terms +7.1% and, in euro terms, +5.6%. Looking at individual markets in local currency terms, there was quite a narrow dispersion of performance. Japan and the UK came in below average with the FTSE Japan Index returning +0.2% and the FTSE UK Index returning +3.7%. On the other hand, there were above average performances from the FTSE Europe ex UK Index which returned +6.8%, the USA where the FTSE USA Index returned +6.3%, the FTSE All World Asia Pacific ex Japan Index which returned +8.7%, the FTSE All World Latin American Index which returned +7.4% and the FTSE All World All Emerging Markets Index which returned +7.5%. If we then look at the sterling adjusted indices, we see relatively strong performances from the FTSE All World Asia Pacific ex Japan Index which returned +11.2%, the FTSE All World Latin American Index which returned +10.6%, the FTSE Australia Index which returned +9.8%, the FTSE All World All Emerging Markets Index which returned +8.9% and the FTSE Europe ex UK Index which returned +7.5%.

In the international bond markets, taking ten year government bonds as a benchmark, the largest move was in the German Bund where the gross redemption yield rose by 22 basis points to 0.33%. The yield on the UK government bond fell by 2 basis points to 1.22%, on the US Treasury by 5 basis points to 2.41% whilst, on the JGB, the yield rose by 7 basis points to 0.07%.

Whilst the currency markets were not as volatile this quarter as in some previous ones, there were still some significant movements. Whilst sterling rose by 1.6% against the US dollar, 0.5% against the Canadian dollar and 0.2% against the euro, it fell by 4.1% against a very strong Australian dollar, 2.5% against the yen and by a very marginal 0.1% against the Swiss Franc.

In the commodity markets, oil fell back by 5.7%, as measured by Brent crude, as doubts about OPEC's ability to hold the line on prices increased, but gold rose by 8.6%.

ECONOMICS

Although there is nearly always plenty to worry about in the world economy, and there are more uncertainties than usual, not least the course of US economic policy under President Trump, the world economy has got off to a good start in 2017 and this may be one of those reasons why international equity markets have continued to rise in the first quarter of 2017. At the same time, volatility has been low suggesting some degree of confidence by investors although others would call it complacency.

There is clearly no shortage of issues for investors to consider but, firstly, it might provide some context to this review to look at the economic projections contained in the latest Interim Economic Review from the OECD, published in early March. In 2017, it sees world economic growth slightly higher than in 2016 at 3.3% against 3% last year. This represents an unchanged projection from last November's Economic Outlook. Breaking down its projections, there has been a slight increase in the forecast for the USA since last November where the OECD now projects growth of 2.4% against the 2.3% it suggested then. For the eurozone, there is no change. It still projects growth of 1.6% but, within that figure, there is an uplift of 0.1% for each of the eurozone's three largest economies Germany, France and Italy, to 1.8%, 1.4% and 1.0% respectively. Japan, too, has seen an increase in the projected growth rate this year. The OECD now sees growth of 1.2% compared with its November projection of 1.0%. Canada has seen quite a significant uplift from 2.1% to 2.4%, whilst for the UK, in common with many forecasters who were pessimistic post Brexit only for them to see the UK economy to hold up well, the projection for 2017 has been raised by 0.4% to 1.6%. The Chinese economic growth rate projection has been raised very modestly by 0.1% to 6.5% but the OECD has reduced its projection for Indian growth by 0.3% to 7.3% (this is for the fiscal year starting in April). As for last November, Brazil's economy is expected to be flat. For the G20, countries as a bloc, the OECD has downgraded its projection very modestly by 0.1% to 3.4% and for the Rest of the World by 0.1% to 2.7%.

Likewise, for 2018, the OECD left its overall projection unchanged since November so still sees world economic growth at 3.6%, 0.3% higher than for 2017. Within that overall total, it has reduced its projection for the USA by 0.2% to 2.8% and for the euro area by 0.1% to 1.6%. Whilst no change in its projections for Germany and Italy have been made (the figures are 1.7% and 1.0% respectively it has downgraded its figure for France by 0.2% to 1.4%. Japan's growth rate is projected as unchanged at 0.8%, Canada's at 2.2% (0.1% lower than projected last November) and the UK at 1.0% (unchanged). Elsewhere, the Chinese projection has been raised by 0.2% to 6.3%, India's left unchanged at 7.7% (for the fiscal year starting in April 2018) and Brazil's raised by 0.3% to 1.5%. Overall, there has been no change in the projections for the G20 bloc at 3.8% and for the Rest of the World at 3.2%. Given where the world economy has come from, these projections, if roughly accurate and, of course, there are a lot of imponderables, might be deemed satisfactory, but the truth is that, for heavily indebted countries where a strong rate of economic growth is essential to make a dent in the debt burden, growth is not nearly fast enough. A number of countries in the eurozone as well as Japan and the UK come to mind, in looking at these figures. Growth is also important to validate the rise in equity market indices in so far as the rise comes as a result of improving corporate earnings. Quite rightly, the OECD lists a number of important risks which could upset these projections and some of these we will detail in the course of this review.

It is often noted that this has been one of the most reluctant bull markets ever. There has certainly been no over exuberance and, whilst this may seem to be a flippant remark, it gives more credibility to the markets' performance and some confidence that, apart from normal setbacks in a general uptrend in markets, that there will not be a very sharp and sudden fall. This is not to be complacent and there may be some unknown unknowns out there which cause this to happen but it is a valid point for those, like ourselves, who continue to see equities as the favoured asset class. It is also reported in the financial press that there are a lot of high net worth individuals who are sitting on very high percentages of cash because of all the economic worries which they have seen and still see. The counter argument is that there is always a host of factors to worry about, political and economic, and, if one was sufficiently influenced by them not to invest, then history tells us that considerable opportunity costs would have been incurred. Anecdotal evidence, suggested in the financial press, is that some of this money is being committed to the market as investors have been forced to abandon their negative stance which has, so far, proved costly. But one can see why they might have been reluctant to invest in the stock market given some of the bad news and uncertainties but, as always, it is a judgement required to balance the risks and rewards. So, what might those still taking a negative view of equities (we still consider fixed investment securities to be seriously overvalued), either because of price or because of the dangers to the asset class, currently be concerned about?

At the moment, most investors would probably consider that the course of US economic policy is the biggest uncertainty, if only because it became a major issue recently with most investors having discounted the possibility that Donald Trump would win the US Presidential election. In another strange twist, apart from the immediate negative reaction on election night as the results came through, Wall Street has reached all time highs, although slightly off at the time of writing. Why might this be? President Trump is clearly a very controversial President who polarises opinion, not only because of what he says but also because of the style in which he does so. There has been no President like him. But he does have some policies which resonate with investors and, in the initial stages of his Presidency, these have held the upper hand as far as share prices are concerned. What the bulls have latched on to is his desire to cut corporate and personal taxes, including perhaps making the repatriation of corporate cash held overseas more attractive than it is at present with a large tax bill arising if it is brought back. They also like his deregulation agenda - for every one new regulation, two rescinded. It is easy to see why, on the surface, these policies would attract investors. Reduced taxes leave more money in people's or corporates' pockets to invest for longer term growth or, in the shorter term, to raise returns to investors either through higher dividends or share repurchases or M & A activity which could be expected to be positive for share prices. In recent years, swathes of new regulations have been introduced. Whether they are necessary or represent regulatory overload, they represent a big cost for businesses so, for them, deregulation represents a cost free way of helping them and promoting growth. This, therefore, is the part of President Trump's policies which appeals to many investors and has helped to propel share prices since his election.

There are, however, many aspects of President Trump's pre election policies which are distinctly unwelcome and economically dangerous, which investors have chosen not to believe will be enacted. But, first, we would make the point which we have made in a number of these reviews which is that there are considerable checks and balances in the US constitution which limit the power of the President. It is true the Republicans control both houses of Congress and, in normal circumstances, that is an enormous advantage for a President. However, President Trump's economic views are not those typically associated with mainstream Republicans. Whilst lower taxes and deregulation would generally find favour (subject to the federal government's budgetary position), the protectionist policies he has been promoting would be strongly opposed by many Republicans who are free traders. Furthermore, whilst tax cuts, in principle, would find favour, the effect on the budget deficit horrifies balanced budget Republicans. The America First policies, whilst they undoubtedly won the election for President Trump in states like Pennsylvania, Wisconsin and Michigan, will not be so easy to enact when he does not have the full support of Republicans in Congress. At the moment, Wall Street is saying that the most dangerous parts of his proposals will not happen and it is probably right as we can see the difficulties he has had with dismantling parts of Obamacare partly because of opposition with his own party which has led to the abandonment of his proposals.

However, it is worth pointing out again, as we have in previous reviews, the danger of the sort of the sort of protectionist policies that President Trump was espousing in his election campaign. Punitive tariffs on Chinese imports or those from Mexico (ignoring for a moment that Mexico is part of NAFTA with Canada) have no economic merit whatever unless there is clear evidence of currency manipulation or dumping aspects (i.e. selling goods below cost) since that would mean no level playing field which is essential for free trade to work. As the second largest economy, and not a country to take hostile action lightly, punitive tariffs on Chinese imports would be very likely to start a trade war from which no one benefits and many lose as it slows down economic activity causing a recession or depression. Currency manipulation is very difficult to prove at a time when the depletion of China's foreign exchange reserves, which is unusual at a time of current account surplus, indicates heavy intervention in the currency markets to support the renminbi. The protectionist arguments put forward for saving US jobs are typical of politicians promoting apparently vote winning policies without spelling out second and later order effects which are entirely negative. Just to emphasise the most obvious ones. Import prices would rise thus reducing the disposable income of those who need to buy either the more expensive imports (as a result of the tariffs) or domestically produced goods which are more expensive than the previously available imports at pre tariff prices. Whilst some US jobs would be saved or even added, others would be lost as reduced consumer spending power affected demand for the goods and reduced employment in other industries. Economic growth would be adversely affected. The effect would spread more widely. Supply chains are integrated with US car manufacturing being a good example. A lot of components from US manufactured cars come from Mexico. Besides US car manufacturers being damaged, Mexican demand for US goods would also suffer. One would have thought that the lessons from the Great Depression had been learned. It seems not. A more refined idea which has been circulating recently is the Border Adjustment Tax which effectively taxes US imports whilst exports are tax free. Whatever form of protectionism is considered, it is a thoroughly bad idea and damaging to the world economy, especially given that it is the world's largest economy which would instigate it. At the moment, the US stock market is suggesting that the bad part of the President's policies will not see the light of day. We must hope that is the case.

Another concern has been China. The economy is transitioning from an investment led one where there has been excessive fixed asset investment with consequential problems of low or no profitability for the companies involved and problems for the banks and, as an export led one, to a more consumption and service orientated economy. This will lead, if it is successful, to slower but more sustainable growth. That is well known but what has been disturbing is the run down in China's foreign exchange reserves. For a country with a current account surplus of around 2.0% of GDP, one would not normally consider capital flight to be an issue but the substantial run down in China's foreign exchange reserves to around US$3 trillion implies not only support for its currency to prevent it depreciating too quickly but also some capital flight. The authorities have been tightening their control over certain capital movements for purposes not considered desirable. China's importance as a driver of the world economy means that investors are alert to any problems in that country. One recalls how the sharp fall in the Chinese stock market on the first day of trading in 2016 reverberated around markets in the opening weeks of that year before markets recovered their poise to produce a good return for the year.

Despite quite a good start, in relative terms, economically, the eurozone remains a perennial concern. The issues are exactly the same as they always are and relate to the problems caused by countries with different economic characteristics being joined together by a common currency. There remains no appetite to recognise this and, as a result, the problems remain chronic. From the OECD's projections, we can see that economic growth is likely to remain quite modest and not enough to make a dent in countries with a large debt burden like Italy. Pre monetary union, Italy was able to offset losses in competitiveness through the devaluation of the lira. This is no longer possible and with outstanding public debt at around 133% of GDP and a troubled banking sector, Italy represents just one problem for the eurozone and wider EU. Meanwhile, the Greek debt saga rumbles on. So, as for a number of years, the eurozone threatens to cause wider economic issues. Added to that, various degrees of political uncertainty arising from elections in France, Germany and, perhaps, Italy and one can be sure that the eurozone will never be far from investors' minds when considering possible problems in 2017. Substantial quantities of money have been pumped into the eurozone through the ECB's version of QE but the amount involved has been reduced to €60 billion a month from €80 billion even though the period of the purchases has been stretched out to December. Whenever the programme ends, financing issues may arise for some highly indebted sovereigns.

The UK is in uncharted territory now that the decision to leave the EU has been made. So far, the UK has defied the pessimists and performed well, but many, including the OECD, as our earlier comments on its Interim Economic Outlook show, expect any noticeable slowdown to occur next year rather than this one. On many metrics, the UK has an enviable position, relative growth and employment levels being two such ones, and economic forecasting is particularly difficult at this time. We do not know how the negotiations will go for there are bound to be surprises. We continue to believe it prudent, where possible, to have a wide geographical spread of investments to mitigate the risk to the UK implied by this uncertainty.

Then, there are always political issues about which to be concerned. Who knows what will happen in North Korea, a particularly worrying concern? The Middle East is always an issue, and so it goes on. If one is in a pessimistic frame of mind as an investor, one can mull over all of these potential problems and more, but, as we will attempt to show, looking at what actually is happening may justify current market conditions and purposes.

When international equity markets have performed well, it is perhaps natural to concentrate on issues which could cause a setback in markets over and above the natural fluctuations in markets which are healthy. So far, we have discussed the issues which could be problematical for the stock market but, as the OECD projections suggest, if they are anyway near accurate, the outlook, whilst it certainly cannot be called buoyant, is satisfactory. Against this background, we will review each major area, starting with the USA.

The main news in recent days, apart from President Trump's defeat at the hands of his own party on the repeal of Obamacare, has come from the Federal Open Markets Committee which, at its March meeting, raised the target for the federal funds rate to 0.75% to 1.00%, a rise of 25 basis points. The economic news from the USA has been quite encouraging for some time with strong employment numbers as well as an upturn in inflation towards the 2% target. At present, projections point to two more interest rate increases this year to end at 1.375% (representing the 1.25% to 1.50% range if increased at 25 basis points each time). For 2018, the central rate, on the "dot plot" projections, is shown at 2.125% (a range of 2.00% to 2.25%), representing three more 25 basis point rises and, for 2019, 3.00%, representing at least three increases. If this path of interest rate increases turns out to be roughly accurate, that is good news. The latest headline rate of consumer price inflation on a year on year basis in 2.7% (although the Federal Reserve's favoured measure, the Personal Consumption Expenditure (PCE) index stands at just below 1.8% on the latest year on year figures). With the federal funds target rate at 0.75% to 1.00%, interest rates on this measure (borrowers obviously pay more) are still strongly negative in real terms and this is not a normally desirable position. It could raise inflation to unhealthy levels as borrowing and demand increases in the economy, propelled by cheap money, and companies come up against capacity constraints. March's interest rate decision by the FOMC marks a further step (with much further to go) on the march to normality in monetary policy following emergency measures taken to respond to the financial crisis in 2008. In terms of individual data, the high value indicator, the Purchasing Managers Index, provided two strong readings in February. The index for manufacturing stood at 57.7 and that for non manufacturing at 57.6, both indicators of quite strong growth in the economy. The unemployment rate for February fell to 4.7% from 4.8% in January, whilst the increase in non farm payrolls was a higher than expected 235,000. With numbers like these, there was nothing to stop the FOMC raising interest rates at its March meeting. The Labour Force Participation rate has tended to flatter the unemployment numbers edged up from 62.9 to 63.0. The capacity utilisation level crept up from 75.4722 in January to 75.50 in February. With the US stock market having performed so well, it is important that US corporate earnings, which started to turn positive on a year on year basis in the third quarter, continue to show a positive trend to justify share price ratings. In this respect, a possible cloud on the horizon is the strength of the US dollar. But, overall, the economic data coming out of the US economy is positive and investors should not be deterred by the upward trend in interest rates. They are so low that they are unlikely to change the US economy's growth prospects. Looking further ahead, it is important to restore monetary policy as an effective tool of economic policy. With interest rates so low in the USA and most of the rest of the world, they need to be high enough to be effective next time a recession appears imminent. At the moment, if the world economy was facing a recession, most countries would not have the scope to make an effective cut in interest rates which would contribute to stabilising an economy. Because of the relatively strong state of the US economy, as evidenced in a small sample of economic data shown above, and the expectations of growth levels for this year and beyond as seen in some economic projections, such as the one quoted earlier from the OECD, the USA is the country most likely to come closest to normal interest rates for the economic cycle. Perhaps nominal interest rates will be lower than in the past because of the continuation of historically low inflation rates, but there is a good chance that they will reach high enough levels in this cycle to be effective if they are required as a monetary weapon to stimulate the US economy. We believe that investors can be comfortable with stock markets levels in the USA, based on our knowledge of the current state of the economy, with the unknown being the extent to which President Trump's agenda can be implemented, both the good and the bad parts and which of the parts gains the upper hand.

As we saw earlier, the OECD's projections for the eurozone are fairly modest this year with growth forecast at 1.6%, 0.1% lower than in 2016. The current news is not too bad as far as the data is concerned. For example, the latest Purchasing Managers Indices are quite buoyant. The index for manufacturing stands at 55.4 and that for services at 55.5, both levels consistent with moderate growth. Furthermore, there is quite a low dispersion of outcomes with nearly every reading over 50. If we look at the four largest eurozone economies, we note the German manufacturing PMI at 56.8 and its services PMI at 54.4, the readings for France are 52.2 and 56.4, for Italy they are 55.0 and 54.1 and for Spain they are 54.8 and 57.7. The extreme monetary policy being followed by the ECB is clearly having some effect in stimulating activity. But that is really the point. Eurozone monetary policy is extreme and this is all the economic growth we may see. Short term interest rates are negative and a significant amount of quantitative easing ECB style is in place, meaning that monetary policy is severely distorted. Should the eurozone face a recession with interest rates at anywhere near these levels, monetary policy would be incapable of playing its part in avoiding or improving the position. A year ago, many were concerned about deflation becoming entrenched in the area but we did not feel that it was likely and, if it happened, it would only be for a short period and not enough to change consumers' or businesses' mindsets. The latest consumer price index for the eurozone shows a February year on year increase in prices of 2.0% with the flash estimate for March at 1.5%, some of which reflects the recovery in the oil price, but the best estimate is that inflation will remain low but not negative. The latest year on year core price inflation index, omitting volatile items, is 0.9%. Within the core price indices, there is one of note which has the potential to cause problems for the ECB. Germany's year on year core inflation level is 2.2% higher than a year earlier. Germany is particularly hawkish on inflation and with a relatively strong economy, the negative real interest rates resulting from the ECB's policy are not going down well. The ECB has to act for the eurozone as a whole and Germany's relatively low, by eurozone standards, rate of unemployment, 5.9%, compares favourably with that of the other countries in the eurozone's top four. Spain has an 18.2% level of unemployment, Italy 11.9% and France 10.0%, whilst the rate for the whole of the eurozone is 9.6%. Even though the labour markets in these three countries are inflexible to different degrees and therefore the effect of high unemployment on labour costs is not great because wages are sticky downwards, these high unemployment levels will still weigh heavily with the ECB when considering what is a suitable interest rate and quantitative easing level, in the ECB's version, for the eurozone as a whole.

Germany, because of the euro, is very competitive. Had it retained the Deutschmark, the currency would have been much stronger, the economy less competitive and the current account surplus much smaller. Theoretically, from an economic point of view, it could be argued that, because Germany is in a monetary union, ultra low interest rates (at a level quite unsuitable for Germany) will cause price levels to rise in Germany relative to elsewhere in the eurozone and help to inflate away its competitive advantage. Whilst that may be true, it would take a long time for this to happen and would not solve the problems caused by a monetary union which does not encompass an optimal currency area. Partly as a result of its competitive currency relative to other eurozone countries, Germany has built up an enormous current account surplus which is expected to be over 8.0% of GDP this year. Combined with a strong domestic budgetary position which is expected to show a surplus of around 0.5% of GDP this year, Germany has been under strong pressure to spend more money to help other eurozone countries. This is where the thinking behind the framework of the euro breaks down. Because Germany, by law, has to limit its budget deficit, it cannot go on the kind of government spending spree which might indirectly increase imports, reduce its current account surplus, raise its inflation rate relative to other eurozone countries and, at the same time, reduce other eurozone countries' current account deficits as well as increasing the level of growth in the eurozone. All of this matters because, if one takes a heavily indebted country like Italy where the outstanding public debt is around 133% of GDP and where growth has been practically non existent since it joined the euro, there is no way that at present it can work its way out of its debt problem. As and when interest rates move towards more normal levels, the servicing of the debt will become even more burdensome. Add to that the probability that the ECB's quantitative easing programme will be up for review at the end of 2017, one has to ask oneself how easily and at what interest rates countries like Italy will be able to finance themselves. This is to put aside all the political problems which Italy has as well as a strong anti euro feeling amongst most of Italy's political parties. It is not just Italy but it serves to point out why the eurozone's problems could erupt at any time and still remain a threat that investors should bear in mind, notwithstanding a certain calm in the eurozone markets at present.

Japan reported modest growth in 2016 at 1.0% with fourth quarter annualised growth at 1.2%. Significantly, hopefully, inflation has returned, a key target for policymakers. There are various measures of consumer prices. That for the one, excluding fresh food, was 0.1% higher in January than a year previously. Consumer prices in January were 0.5% higher than a year ago and the index for consumer prices, excluding volatile food and energy prices, was 0.2% higher than a year previously. Turning deflation into inflation has been a key policy target of Mr. Abe because it is hoped that this will start to change the mindset of Japanese consumers so that they will be more willing to spend and enable the economy to expand. Although Japan, with its own currency, does not share all of the problems of the heavily indebted eurozone economies, it has a vast level of public debt in relation to GDP and unfavourable demographics which will make the problem even worse. Like all heavily indebted countries, the Japanese economy needs to grow to eat into its debt problem. The Bank of Japan is doing everything possible to stimulate the economy with a very powerful quantitative easing policy aimed at keeping a zero per cent cap on ten year JGB yields. The Bank of Japan's asset purchase programme has expanded the Bank of Japan's balance sheet enormously and its relative size is the largest in the world. Potentially, this stores up trouble for the future. Whilst Mr. Abe has fired two arrows from his bow, monetary and fiscal, action on the third, increasing the flexibility of the economy through structural reform, has been lacking. Deregulation, to increase the potential growth rate of the economy, estimated at only 0.5% per annum, has been disappointing and the other two arrows will only work if the long term potential growth rate of the economy improves from its present very low level. In the short term, the weakness of the yen following President Trump's victory last November is helpful but compared to a year ago there is very little change in the yen's value against the US dollar. Japan is not generally one of those markets where one would say that there is obviously something which could cause a major problem for world markets in the near term but, further ahead, public finances and poor demographics remain potential problem areas.

Turning now to China, economic growth has been reported at 6.7% for 2016, roughly in the middle of the government's target rate of growth. Given the transitioning of the economy towards consumption and services, it is inevitable that this will involve a slower growth rate in the future albeit one which should be of higher quality because it is more sustainable. In early March, the Chinese Prime Minister, Li Keqiang, announced that the new target for economic growth was around 6.5%. The authorities are well aware of the risks to the economy from overinvestment in fixed assets, leading to low or non existent profits and bad debt problems for the banks. In terms of economic data, the latest Purchasing Managers Indices are moderately in positive territory. That for manufacturing stands at 51.6 and the one for non-manufacturing at 54.2. The elephant in the room is, of course, US trade policy under President Trump. If he does enact what he was proposing in his election campaign in relation to tariffs on Chinese imports, the situation would be serious. One hopes that wiser counsels prevail. In the absence of any harmful measures, China looks to be progressing satisfactorily, helping to create a more positive atmosphere for Asian economies in general. What investors have to monitor is the movement in the country's foreign exchange reserves. The Chinese authorities, as we mentioned earlier, have been concerned about what appears to have been quite a big capital outflow from the country. What it means is difficult to understand but the authorities have been taking measures to deal with the issue, looking, for example, at overseas purchases by Chinese companies and individuals and stopping certain ones.

Looking at the UK, the outlook is dominated by Brexit. So far the economy has held up well, forcing those forecasters, who thought that the economy would fall into recession after the referendum, to raise their outlook. Now they tend to say that the problems will come later. As we saw earlier, and quite typical of many forecasters, the OECD has raised its forecast for UK economic growth this year quite sharply compared to what it was expecting last April. However, like many others, it expects next year to be a slower one for the UK with its forecast for growth starting at 1.0% compared with its upwardly revised forecast of 1.4% growth for 2017. One reason why this might occur is because rising inflation as a result of the fall in sterling will put pressure on disposable incomes and restrain demand. At the moment, whilst there is some evidence of the economy slowing down, the UK's relative position remains quite good. To take a couple of items of economic data which are high value, the Purchasing Managers Indices, whilst off their best levels, still point to moderate growth. The latest composite index stands at 53.8 and, within that figure, that for manufacturing stands at 54.6 and, for the much larger and dominant services sector, 53.3. The employment market, whilst showing signs of slowing growth, is still strong and the unemployment level at 4.7% is one that many countries in Europe can only dream of.

But, of course, whilst current data is interesting, it is the future that will provide the puzzles as the UK starts the process of leaving the EU. It will be a long time before there can be a definitive judgement on whether or not it was the correct decision for the UK. It is possible, however, that the answer could come sooner than people expect from within the EU. As an economic force, although still very important, of course, the EU's economy has been in relative decline. Growth has been low compared with more dynamic economies. The euro is a significant economic burden given that its members do not represent an optimal currency zone. Although there is a huge political will to keep the eurozone intact, economics may well overwhelm politics at some stage, leading to a break up of the eurozone and threatening the EU itself. This is an unlikely event within two years but the former risk cannot be entirely discounted. Assuming the possibility of such an event happening at some stage, but not within two years, investors can face only uncertainty about the UK's position, but it is not a given that it will face significant economic problems because the UK it is starting from quite a strong position in some respects and we have already seen how the UK equity market has recovered from its post referendum weakness. There are political concerns as well, of course, with the future of Scotland being the most obvious one. All of this points a course for investors, and one which we have always followed, and this is geographical diversification to spread the risks. Although it is the third largest stock market, the UK at a 6.1% weighting in the FTSE All World Index compares with 52.6% for the USA. Unless an investor absolutely has to have sterling investments, it is only prudent to diversify the risk. If an investor has a significant multiple of the UK's weighting in his or her portfolio, that represents a large bet on the UK and, when things are as uncertain as they are at the present, it represents an even bigger bet and potential risk. Such a policy of diversifying geographical risk was vindicated by the Brexit vote on the 23rd June, if unhedged and sterling based. It represented an excellent insurance policy which has so far paid off handsomely. The FTSE 100 companies themselves represent a good indirect hedge given that the majority of the business of companies in the index is overseas in one form or the other, but ownership of companies in the index is not a straight alternative for holding a diversified portfolio of companies in many markets. One of the ways in which the insurance policy of a diversified portfolio geographically has paid off is in the protection given against the reduced purchasing power of a weak pound. Forecasting currency movements is very difficult but with all the uncertainty of the Brexit negotiations, which will linger for two years, and unknown consequences afterwards, the likelihood is that the pound will not recover its post Brexit fall in the foreseeable future. Most UK direct exposure should be through companies which have a large proportion of overseas business.

Our attitude towards the fixed interest market remains unchanged. We see it as significantly overvalued. The thrust of economic policy seems to be moving away from monetary policy, which can offer little more in terms of economic firepower, towards fiscal policy. For instance, in the USA, the President, if he can get his plans passed, would be increasing the federal deficit whilst the Federal Reserve is starting to raise interest rates as a step to normalising monetary policy. In the eurozone, the ECB's bond buying programme is up for review at the end of the year. Whilst we may be in a low inflation period historically, it is hard to see how fixed interest securities with such low returns can compete with equities. Furthermore, if yields do return to anything like traditional levels, there are going to be some serious losses in the bond market which will not be recovered or, if the bonds are held to maturity, offer a return which is minuscule and unattractive relative to assets like equities.

After such a consistently long run of positive returns from international equity markets, at least for sterling based investors with unhedged overseas exposure representing a significant part of their portfolios, it is very important to be realistic about immediate expectations. We may experience some negative quarters as markets take a breather or react to some event which is not currently discounted. We will want to see corporate earnings rise to underpin the rise in equity prices which has occurred at a time when earnings have not been rising and therefore share price ratings have expanded. Whilst interest rates will rise from very low levels in countries like the USA and, perhaps, the UK, they should not threaten the relative attraction of dividend yields against bond yields and, as we suggest, we can generally find no case for holding fixed interest securities when there is an alternative option. The well known expression about the importance of "time in the market, not timing the market" is very valid. If one holds a high quality equity portfolio and it falls in value from time to time against the background of a long term upward trend, the portfolio's dividends will still be coming in and one can reasonably believe that the shares will recover ground and then move ahead again. With fixed interest securities at current yields, one is either tied to an inadequate return if the bonds are held to maturity or a loss if sold during the term of the bond with interest rates having moved towards more normal levels. So, we want to emphasise that, whilst it is pleasing to report another positive quarter, we must be realistic and expect some temporary halt in the market's upward progress. That is not a reason for long term investors to change their policy. If there is a temporary setback in markets of a meaningful amount, we are likely to commit cash which has built up to further equity purchases.