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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

A promising quarter for equity investors was brought to an abrupt halt by deteriorating conditions in a number of eurozone countries' finances leading to fears about the solvency of some countries as concerns spread from the Greek sovereign debt market. As a result, there was little movement in equity returns over the quarter. Perceived high quality sovereign bonds benefited from a flight to quality whilst, in the currency markets, the US and Canadian dollars stood out even though the USA, unlike Canada, is heavily indebted.

The tables below detail relevant movements in markets:

International Equities 26.02.10 - 31.05.10

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-4.0	-5.8	-10.1	N/C
Finland	+0.2	-5.6	-9.9	+0.2
France	-1.7	-7.4	-11.6	-1.7
Germany	+7.1	+0.9	-3.7	+7.1
Hong Kong, China	-1.8	+2.5	-2.1	+8.8
Italy	-4.8	-10.4	-14.5	-4.8
Japan	-1.1	+1.2	-3.4	+7.4
Netherlands	+2.1	-3.8	-8.2	+2.1
Spain	-8.1	-13.4	-17.4	-8.1
Switzerland	-2.9	-5.5	-9.8	+0.3
UK	-2.1	-2.1	-6.6	+3.9
USA	-1.1	+3.6	-1.1	+10.0
Europe ex UK	N/C	-5.2	-9.6	+0.6
Asia Pacific ex Japan	-1.5	N/C	-4.5	+6.2
Asia Pacific	-1.4	+0.6	-4.0	+6.8
Latin America	-1.9	+2.3	-2.4	+8.5
All World All Emerging	+0.7	+5.1	+0.3	+11.5
The World	-1.0	+0.9	-3.7	+7.1

Source: FTSE World Indices

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

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

Currency	26.02.10	31.05.10
Sterling	4.03	3.57
US Dollar	3.62	3.30
Yen	1.31	1.27
Germany (Euro)	3.11	2.66

Sterling's performance during the quarter ending 31.05.10 (%)

Currency	Quarter Ending 31.05.10
US Dollar	-4.6
Canadian Dollar	-5.2
Yen	-2.2
Euro	+5.5
Swiss Franc	+2.5
Australian Dollar	+1.1

Other currency movements during the quarter ending 31.05.10 (%)

Currency	Quarter Ending 31.05.10
US Dollar/Canadian Dollar	-0.6
US Dollar/Yen	+2.6
US Dollar/Euro	+10.6
Swiss Franc/Euro	+2.9
Euro/Yen	-7.3

Significant Commodities (US dollar terms) 26.02.10 - 31.05.10 (%)

Significant Commodities	26.02.10 - 31.05.10
Oil	-3.8
Gold	+8.9

Markets

After the sharp fall in equity markets in May, what promised to be a satisfactory quarter ended up being one of little change, although significant currency movements had an important influence on the final returns. In local currency terms, the FTSE World Index returned -1.0%, in sterling terms +0.9%, in US dollar terms -3.7%, and in euro terms +7.1%. In local currency terms, there was not much change in the main markets with no significant deviations from the -1.0% recorded, as we have said above, in the FTSE World Index. However, currency strength against sterling meant a satisfactory 3.6% return from the FTSE USA Index, 2.3% from the FTSE Latin America Index and 5.1% from the FTSE All World All Emerging Markets Index. On the other hand, the weakness of the euro meant that the FTSE Europe ex UK Index returned a disappointing -5.2%. The UK market, as measured by the FTSE UK Index, showed a below average performance, returning -2.1%.

Top quality international bond markets, as opposed to those where there were default or restructuring fears, benefited from a flight to them resulting in a sharp fall in yields, replicating the strategy of many investors during the 2008 banking crisis. The gross redemption yield on ten year sterling government bonds fell by 46 basis points to 3.5%, on US government bonds by 32 basis points to 3.3% and on German government bonds by 45 basis points to 2.66%.

Currency markets were very unsettled by sovereign debt worries within the eurozone. Although sterling fell by 4.6% against the US dollar, 5.2% against the Canadian dollar and 2.2% against the yen, it rose 5.5% against the euro and even 2.5% against the Swiss Franc, itself exhibiting strength against the euro.

In the commodity markets, the eurozone's sovereign debt woes took its toll on oil where the sharp rise in price seen recently was checked and it fell by 3.8%. Gold, on the other hand, benefiting from currency fears, rose by 8.9%.

Economics

Whilst sterling based investors may, until recently, have expected the result of the UK's General Election to be the most important short term issue, it has paled into insignificance compared with the upheavals in the eurozone, caused initially by the debt crisis in Greece. It has been an unsavoury spectacle, with politicians hitting out on all sides in an effort to divert blame and attention from themselves. The fundamental flaws in the euro project, which many had identified and warned against from the start, have been exposed in a brutal way and, as we have come to expect, the politicians are in denial. Although, as a company, we never engage in short selling of any securities and we have no real sympathy for the motives behind such action, nothing was so crass as the recent German action, taken unilaterally, to ban certain types of short selling of securities. It is difficult to know where to begin in making criticisms of the authorities' action. Unilateral action could not have been effective as the type of trades which have been banned could easily take place elsewhere. By announcing such action, did the authorities know something that the market did not? That is certainly how markets took it as they fell sharply the next day. But, above all, they were shooting the messenger rather than recognising the root causes of the problem which is that some eurozone countries have been profligate and have built up debts which some of them may not be able to repay in full. Attacks by countries at the opposite ends of the eurozone's spectrum of financial strength, Germany and Greece, on speculators, trying to cite them as the cause of the currency union's woes, are absurd. One understands that politicians, as a way of diverting unwelcome attention, play the blame card, and it might be harmless on occasions, but not in this case, because it reinforces the view that the politicians are in denial and have no idea what to do, and this makes uncertainty even worse.

Clients who have read our economic reviews going back to the time of the inception of the euro, will know that we have always been sceptical about its chances of success because it was not an optimal currency area. Broadly speaking, the original members of the eurozone and those countries which joined later, most notably Greece, had widely differing economic systems, cultures and attitudes, which meant that the chances of economic convergence, which were vital for the success of the eurozone, were very small. For a long time it has been evident that there was economic divergence, rather than convergence, within the eurozone. Along the way, distractions came along, such as the debate as to whether the UK should join the single currency area. As in Europe, the impetus for the UK joining the euro came from those whose europhile political instincts brooked no economic arguments for, in truth, there were hardly any good ones for joining. In this respect, one should recognise Mr Brown's good judgement, as Chancellor, in keeping the UK out of the euro when he had been under political pressure from colleagues to join. The five economic tests, the subject of deep Treasury analysis, showed that the UK was not ready to join. Although the UK's economic position is very serious at present, it would have been much worse if the UK had been in the eurozone. Now, as a result of a new government in the UK and the crisis for the eurozone, UK membership can be ruled out and, in any case, the euro may not survive.

In our view, it was inevitable that the euro would get into trouble because of the fundamental problem that it was not an optimal currency area and that, far from converging, the economies of the eurozone were diverging as stated above. One critical issue we did not emphasise over the years, although it was always implicit when trouble arose, was that to be successful, monetary union had to be accompanied by fiscal union, effectively to form a eurozone economic superstate transcending national boundaries. The nature of the current eurozone crisis makes the point and we will come back to this.

The "one size fits all" interest rate which governs a single currency in a currency union was always going to be a problem, with the inevitable results which we now see. In particular, interest rates were normally too low for Ireland and some of the southern European countries which are now in trouble. The results appeared in an uncontrolled property boom and relatively high inflation which has left these countries uncompetitive with northern European members of the eurozone. So money was borrowed at cheap rates, relative inflation rates rose and public finances deteriorated in the wake of some sort of belief that fiscal discipline could be dispensed with now that a particular country was in the euro. But investors, too, were culpable in believing that a euro was a euro of the same strength whichever country issued euro denominated debt. If we look back a year to the end of May 2009, we see that the yield premium on 10-year Greek bonds over those of Germany was approximately 184 basis points. At the time of writing, it is about 573 basis points. It goes without saying that there was a significant mispricing of the risk and it is true that the Greek government had not come clean about its finances this time last year but, even so, the relatively modest yield premium a year ago for a lower rated issue must have reflected some sort of belief that the euro was a seamless currency. In other words, there was far too much complacency for, although things look reasonably calm above the surface, there was furious activity going on underneath, as we now know.

So where do we go from here? One factor investors should always bear in mind is that politicians, in particular, and also central bankers, to some extent, have a strong vested interest in trying to sort things out because of the embarrassment it would cause to them if events spun out of control. We recall how the banking crisis was stabilised, albeit at enormous long term cost which will be with us for years. For the eurozone, the problem will be particularly difficult to resolve, notwithstanding what we have said above because we are not dealing with just one government although we do have just one central bank, albeit with different views within it.

Let us look at the politics of it first. Although Germany is regarded as the strongest eurozone economy, with an austere financial ethic, the Greek debt crisis has caused the government acute political problems and the coalition appears to have lost its sure touch. Public anger at the funds contributed to the Greek bailout is influential in its loss of the North Rhine Westphalia state election and a strongly populist campaign waged by some parts of the German press against a German contribution to the bailout. It has left the government struggling to assert its authority and has led to the much criticised unilateral decision to ban certain types of short selling without consulting its partners. It has aggravated the fracture in the Franco-German relationship and encourages the view that there is no real political leadership within the eurozone. A particular issue for Germany is its Constitutional Court which strictly protects the country against any loss of national sovereignty implied by fiscal transfers to other countries. There is no shortage of individuals prepared to test the legality of a German contribution to a bailout of other members of the eurozone and we have certainly not heard the last of their challenges.

It is this state which brings us back to the issue we raised earlier which is that, for monetary union to be successful, it must have some kind of central fiscal management and policy as well as the "one fits all" monetary policy implied by a single interest rate decided by a single central bank. This would imply a major step up from here for the eurozone countries, i.e. handing control of their national budgets to a central authority which could then make fiscal transfers to various countries, as needed, rather as can happen in the USA to the different states. It is almost impossible to see how this can happen. In practical terms, it would need another EU treaty, comprising not just the eurozone members but the whole EU membership. The UK, for example, would not countenance this, and Germany would almost certainly not be able to do so because of popular opposition, let alone the judgement of the Constitutional Court. This, now, is the major fault line in the eurozone. It has no fiscal means of rectifying the problem caused by an incomplete project with a potentially fatal structural flaw. But, of course, this not a problem which can wait to be sorted out. The euro has been rumbled and something will have to be done. The basic problem is not the markets, which are the messengers of the problem but which the politicians would like to blame, but the appalling financial condition of a number of eurozone members which have allowed their finances to deteriorate on a plethora of plentiful and cheap money and there are realistic doubts as to whether they will be able to repay their debts in full. Public spending has run out of control in a number of eurozone countries, whilst additional factors in countries like Ireland and Spain have been a collapse in tax revenues caused by the slump in the property market which had become overheated in the boom years and, in Ireland's case, the need to bail out the banks which had become heavily involved in property loans which have turned bad. In eurozone countries which have seen a particularly bad deterioration in their finances, Ireland, Greece, Spain and

Portugal, drastic public spending cuts have been announced, including public sector pay cuts, something that would have been unthinkable until recently, especially from left wing governments such as we see in Greece, Spain and Portugal. Of these countries, Ireland was first into debt reduction action and, whilst there have been protests, they have been nothing like as serious as they have been in Greece. Whilst Ireland's ten year government bond yield premium is significant against that of Germany, currently 213 basis points, it is nothing like the one of Greece, mentioned earlier, suggesting that investors are more sanguine about Ireland's ability to service and repay its debt.

Monetary union deprives these heavily indebted countries of a vital escape hatch, devaluation of their currencies. The problem at the moment for these troubled eurozone countries is that the measures to be taken to cut public expenditure and raise taxes will have a depressing effect on economic activity in their countries and therefore on tax revenue. So they risk slipping into a vicious downward spiral of lower economic activity and lower tax revenues. At the margin, the lower value of the euro, which we now see, may help exports outside the region, but these countries will be deprived of the benefit of a further devaluation independent of the eurozone's strongest countries which, in normal circumstances, should be helpful to exports and allow some import substitution, thus helping to stimulate their respective economies, improve growth and, through higher economic activity, help address the weakness in public finances. So, compared with, say the UK, also with parlous public finances, these countries lack the advantage of the UK with its own currency and the ability to gain a competitive advantage through devaluation which can help to stimulate economic activity.

Against this unpromising background, the eurozone looks completely dysfunctional at present. The politicians are quarrelling amongst themselves and hitting out at the wrong targets to deflect attention from themselves. There is no proper mechanism for directing tax revenue to badly affected countries and, furthermore, it is impossible to see how a new EU treaty can obtain unanimous agreement on fiscal transfers. Without devaluation, heavily indebted countries like Greece, Spain, Portugal and Ireland can only restore their competitiveness through deflationary policies which restore their lost competitiveness against eurozone countries like Germany. The social cost of this will be enormous and possibly not acceptable to the population of the countries involved. Social unrest, such as we have seen in Greece, could be a foretaste of what is to come in some countries, particularly the southern European ones. The ECB is divided. The bail out for Greece was not universally popular. For Greece, at least, the problem is not only one of liquidity but also of solvency. The ECB and IMF, which is also involved, can provide funds to enable Greece to roll over its debt in the short term but that does not address the solvency issue for, with current levels of debt and the interest thereon, it is difficult to see how Greece can repay its debts in full. At least the severity of Greece's debt problems and the markets' reaction to them have goaded Spain and Portugal into further action to address their deficits, however reluctantly.

For European governments, there is a further major worry besides the solvency of some of the eurozone governments and that is about the holders of these governments' debts, the banks. Having battled with one banking crisis with private sector debt, governments would not, until recently, have expected to worry about a sovereign debt crisis. How might the authorities deal with this problem? A banking system in crisis is something that the authorities cannot countenance. If we look at the three eurozone countries which are concerning investors most at present, Greece, Portugal and Spain, the Bank for International Settlements estimates that combined foreign bank exposures to these countries is €1.2 trillion, of which €762 billion comes from eurozone banks, with French and German banks' combined contribution at €436 billion, roughly equally shared. That these banks should be crippled by exposure to other eurozone countries' sovereign debt would be unthinkable and, if we ever got near that stage, action would be taken. But any action would have to be improvised as there is no explicit mechanism for dealing with current problems and none was envisaged in the euro project. But a desperate situation requires desperate measures.

As part of the €750 billion rescue package for Greece, announced on 9 May, comprising an increase in the EU balance of payments facility of €60 billion, eurozone bank loan guarantees of €440 billion and IMF loans of up to €250 billion, the ECB has taken action in the securities markets by reversing its previous policy and buying the affected governments' bonds in the market to provide support and liquidity. At the moment, these purchases are sterilized, meaning that the money put into the banking system by these bond purchases is neutralised by the money being taken back out of the system another way. An example in the UK would be the Bank of England issuing Treasury Bills for cash, thus taking money out of the system, and with that money buying gilts in the market from the private sector, thus putting it back in but, overall, having a neutral effect. In extremis, one might imagine that the ECB would extend this in an unsterilized manner to rescue the banking system if it was in danger of being brought down by a sovereign debt crisis. All this is a million miles from what the ECB would see its role as being and a complete anathema to it, but, in a situation which was never envisaged when the euro was established and for which no answer was provided, needs must. This would take the ECB into the realms of quantitative easing such as we have seen in the UK and USA, in other words, printing money. This is obviously a highly dangerous policy to follow and risks debasing the currency and throwing into the bin the ECB's inflation targets. So, whilst a Greek debt default or restructuring might be manageable, if it spread, particularly to Spain, an economy nearly five times the size of that of Greece, it would represent a major crisis.

To be talking in these terms is extraordinary, or, at least, would have been a year ago, in the same way as the fragmentation or break up of the eurozone might have been considered unthinkable. We have always felt that, because of the inherent contradictions of the eurozone, break up or fragmentation was quite possible, but this thought has not gained traction until recently as the crisis within the eurozone has developed.

What are the possibilities from here? The eurozone cannot stumble on as it is doing from one crisis to another. Something has to give. One option, as we discussed earlier, is the transfer of fiscal policy to a central taxation and spending agency, to run side by side with the ECB. As we mentioned earlier, this would involve a further treaty. With the loss of sovereignty which this would involve and, at the very least, one veto (that of the UK) for this would not just be a eurozone matter, this can effectively be ruled out. It would probably be unacceptable to many other countries as well. Most countries in the eurozone are having to introduce very painful measures to get their budget deficits under control, but the most pain is being administered in the four countries which we have mentioned most frequently, Greece, Ireland, Spain and Portugal and, now, a fifth, Italy, which has now announced some severe measures. Given that this deficit reduction programme is going to be a protracted affair, will the respective populations wear it? In normal circumstances, opposition parties will try to capitalise on a government's unpopularity by promising better times or more attractive policies, such as financial giveaways, but this course of action will not be possible. Political upheavals are quite possible, particularly in southern Europe. The deflationary pain would have to be endured until competitiveness was regained against low inflation eurozone countries like Germany and domestic finances restored. In simple terms, the deflationary policies would be implemented by reducing relative wages back to what they were when the euro started. That will prove unpalatable and, quite probably, impossible, such will be the economic pain. That leaves the final possibility, and the one which we believe to be most likely, that one or more countries will find the pain of staying in the eurozone just too great. The inability to have a flexible exchange rate is a killer blow for many countries. It denies them an escape hatch from an impossible position. Of course, the infuriating fact about this mess in which the eurozone now finds itself is that this is not a "volcanic ash" moment which no one could have foreseen. It was patently obvious that the project was deeply flawed from the outset, but the politicians in their pursuit of the objective of monetary union would have none of it. Every way out of this problem is fraught with danger. We have said why staying in will cause all sorts of political problems but so will leaving. Debts and contracts, designated in euros, would cause all sorts of legal disputes. Defaults would be much more likely as the new currencies (perhaps the legacy names) would be at a devalued rate against the euro, thus raising the value of debts and making defaults more likely. But notwithstanding the enormous problems which would be thrown up as a result of a country or countries leaving the eurozone, we would see this as the more likely outcome, for we cannot see politicians in those countries, which are facing years of austerity, holding the line against a very angry populace.

So far, we have looked at this from the vantage point of the weakest members of the eurozone but there have also been suggestions that the strongest members of the eurozone, Germany is the prime example, might want to leave. So far, this suggestion is regarded as at the extreme end of outcomes, but one can see why it has been made. Germany, by tradition, is a country which values economic orthodoxy, with a fear of high inflation and an emphasis on sound finances, although the latter is a relative position at the moment. If, as is happening at present, the euro is dragged down by the problems of the weakest members and this causes inflation to rise, Germany will not be happy. Would one of the perceived stronger members of the eurozone leave it? President Sarkozy was recently reported to have threatened to do so when Germany was dragging its feet on supporting the Greek bailout. Whilst it was probably a negotiating ploy, the fact that such a move was even threatened by one of the strongest supporters of the eurozone, shows that discussion of the subject cannot be laughed out of court, as was, until recently, the more probable scenario of one or more of the weaker members leaving the eurozone. If one mentions a hitherto taboo subject like this, even as a threat, the idea gains credibility and President Sarkozy has set a hare running.

What are investors to make of this dysfunctional grouping that is the eurozone? We can write at length about what might or might not happen to the eurozone and it is certainly a very interesting subject but the bottom line for investors is what effect it will have on securities markets in the eurozone and elsewhere. At the time of writing, stock markets are weak because of the turmoil within the eurozone but it is beyond this stage that we need to look.

A point always to remember is that it is in the interests of politicians, central bankers, regulators and civil servants to try to restore some semblance of order. This may seem self-evident, but the problems of the eurozone represent an enormous embarrassment for advocates of monetary union. Therefore, they will do everything possible to stabilise the position in the short term in just the way that governments, central bankers and regulators acted to stabilise the banking system in 2008 and early 2009. In the case of the latter action, it was a short term success and paved the way for the remarkable stock market recovery which started in March 2009. It removed a major negative for the market, even though it may have stored up longer term problems which will need to be addressed. The surprise action to bail out Greece, announced on 9 May, caught markets by surprise because the initial feeling was that the package, described earlier, was so large that it would do the trick of restoring confidence. The result was, briefly, a very large rise in the stock market which, because of other subsequent events, has not lasted, but gives a clue to how sentiment can change under the right circumstances.

Because of the sheer size of the potential problem, if, for example, Spain is drawn into the issue as the eurozone's fourth largest economy, something dramatic would have to be done. We mentioned a really significant possible move earlier, unsterilized support from the ECB. If one had mentioned such a possibility a year ago, those suggesting it would have been considered extreme in their views, yet so far have we moved that loans and quantitative easing on a massive scale may be necessary. Such a move would almost certainly weaken the euro considerably and may help to inflate some countries out of their debt problems. But it could buy time.

In the short term, such a move could buy time for the banks of weaker eurozone members. On the first day of trading, 10 May, after the announcement of the Greek bailout measures, the gross redemption yield on the 10-year government Greek bond fell by 492 basis points, a truly staggering amount, reflecting what a surprising and what was considered, at the time, meaningful move, could do to markets. One thing is fairly certain is that monetary policy will remain very loose in the eurozone. The ECB is likely to keep short term interest rates very low and unorthodox measures such as quantitative easing are likely to be seen for reasons mentioned above. The problems of the eurozone are likely to keep the euro weak. This argues for a favourable background for eurozone equities, based on current modest valuations and attractive dividend yields and, for exporters, the benefit of a weaker currency, which should improve the value of their overseas earnings and make exports more competitive at a time when domestic markets are going to remain sluggish. On the latter point, there is a line of thought which suggests that current account surplus countries like Germany and the Netherlands should loosen domestic economic policy, effectively fiscal policy, since they cannot control monetary policy, thus helping offset the deficits elsewhere in the eurozone by encouraging consumption. Given the German mindset of following an orthodox economic policy and the fact that it, too, is running a large budget deficit, expected to be 5.0% of GDP this year, plus the natural caution of the German consumer, it is difficult to see how this can be made to happen, given the lack of a fiscal union which we imagine would be strongly opposed by Germany. Given the lack of consultation with the German people over going into the euro in the first place, and the fact that popular support for the project is lacking, we cannot see that the German government would be able to carry the electorate with them. So, we do not think that the eurozone economy will obtain a boost from a domestically induced fiscal stimulus from surplus countries, but we do think that the benefit which eurozone countries with large overseas businesses will derive from the weakening of the euro will be helpful for eurozone equities.

This is not a good background for eurozone bonds. At present, because the sovereign debt concerns have led to a flight to quality within the eurozone bond market, we see German 10-year government bond yields down to 2.57%, below the yield of German equities, almost 3.2%. That yield is artificially depressed at the moment but, for the eurozone, the combination of an easy monetary policy and a devaluation of the euro is likely to cause inflationary problems later on. This is without taking into account the enormous sums of money which eurozone governments will have to raise in the bond markets. Bond yields of those eurozone countries where public finances look relatively secure (although in absolute terms very stretched in some cases), such as Austria, Belgium, Finland, France, Germany and the Netherlands, where government 10-year bond yields vary between 2.57% and 3.49%, do not look attractive in normal circumstances. Other much higher yielding eurozone countries' bonds are at the mercy of the market's view of their underlying government's solvency. Furthermore, if the euro is debased in value, as a result of the orthodox and unorthodox measures we have talked about earlier in this review, and inflation rises significantly, even the best quality eurozone government bond yields will look very inadequate.

In the eurozone, the issue boils down to the sovereign debt risks undermining the eurozone's banks. This is the equivalent to the fears about western banks in the light of the subprime mortgage bond crisis in 2008 and 2009. Governments and central banks stepped in. The alternative was too awful to contemplate. If the sovereign debt crisis threatens a similar catastrophe, and nothing is worse than a run on the banks, we think similar action will be taken to shore up the banking system to restore confidence, albeit at an enormous long term cost.

Unexpectedly, for sterling based investors, the eurozone has pushed the UK General Election off the main news headlines, apart from in the immediate aftermath of the General Election when it was unclear who was going to form the next government. That could have been a very dangerous time for the pound and gilt edged market but, fortunately, it was not and, although the pound has been weak with the euro, the gilt edged market has been firm, somewhat surprisingly being regarded as something of a safe haven when investors were concerned about some of the eurozone credits.

Before the election, we indicated that we thought a "hung" parliament would be the worst possible result, with an outright majority for one of the two major parties preferable in view of the very serious economic situation facing the UK. For some time, the opinion polls had been pointing to a hung parliament but not many people would have forecast a formal coalition between the Conservatives and the Liberal Democrats. That being the case, we need to revise our assessment, at least for the time being, because what we had envisaged in the event of an inconclusive result was a minority government at the mercy of opportunistic opposition parties. Given the need to take very drastic measures to tackle the UK's budget deficit, the Governor of the Bank of England's reported remarks to someone in Australia that whoever wins the General Election would be out of power for a generation rang very true. If one is looking at the benefit for the UK from having its first coalition government since the last war, it is that, firstly, if it holds together, it has a majority which is not in danger from by-election defeats or modest defections to the opposition and, secondly, that the opprobrium will be shared between two parties which accounted for roughly 60% of the vote in the recent election. Although there have to be the inevitable compromises on policy, the two parties, which had different views pre General Election about the timing of the

£6 billion cuts which the Conservatives wanted to introduce immediately, have now come together on the need to institute them urgently, the troubles of the eurozone probably having concentrated minds and leaving no doubt as to what is needed.

The coalition Treasury team seems to have set out on the right path. The £6 billion of cuts, initially announced for this year, are, of course, just a drop in the ocean compared with what is needed and they are relatively easy to achieve and uncontroversial, but they are symbolic, and symbolism has its place in influencing sentiment. With the UK having to borrow around £430 million a day because of the shortfall between revenue and expenditure, the action to reduce the deficit will have to be dramatic. The sums are frightening, but the price of failure in the form of a collapsing currency, inflation and rising interest rates does not bear contemplation. So, the coalition government, having announced the "easy" part of the cuts first, will have to make some extremely unpopular decisions in the areas of spending and taxation. Two things may make this slightly less difficult. The first is the admission by the outgoing Chief Secretary to the Treasury that there was no money left. Even if it was meant in a jocular way, his statement is a recognition of the obvious and may make the inevitable attacks on the government's policy less convincing. In fact, as one journalist said, this statement is not actually true because there is about minus £160 billion left. The second helpful factor may be the severe measures being taken in the eurozone, seemingly gathering in intensity each day, which are getting significant headlines in the UK. This is particularly the case in respect of actions to cut government spending, the area that will see the bulk of the measures which are going to be taken to cut the deficit. In Ireland and southern Europe, wage freezes, pay cuts, later retirement and having freezes or job cuts in the public sector are the order of the day, so the measures to be taken in the UK will not be out of line with what is happening elsewhere and should not come as such a surprise, although none of the political parties came clean with the electorate before the General Election about the true size of the remedial action to be taken.

The Chancellor of the Exchequer's aim is to reassure markets that the country's prized A A A credit rating is not compromised. The rating agencies, one felt, gave the UK the benefit of the doubt prior to the General Election, but one doubted that they would do so afterwards unless convincing measures were taken to bring down the deficit. A lower credit rating would mean higher borrowing costs and even a crisis of confidence in the UK's debt market. Early indicators are encouraging, for both partners in the coalition seem to be of the same view about the urgency of action. We will hear more in the June 22 emergency budget.

For the moment, though, the UK is enjoying the priceless benefit of being outside the eurozone and avoiding some of the pain of those eurozone countries which have lost competitiveness within the currency area. One of the solutions which would normally be applied to countries with the level of problems of a country such as Greece would be a devaluation of the currency to kick-start export growth and import substitution and establish some economic growth. The significant devaluation of sterling in 2008, which still remains, has boosted certain sections of the UK economy. The big concerns about the UK before the General Election were, firstly, that there would be an indecisive election result and, secondly, that the politicians would remain in denial about the gravity of the UK's debt problem leading to a serious fall in the currency and problems financing the budget deficit. The unexpected result of a hung parliament has been a coalition which seems determined to address the deficit and is not in denial about the dire state of public finances. This appears to have bought some time for the UK with the problems of the eurozone directing attention from the UK's problems.

The requirement to scale back public spending in Europe, including the UK, is certainly going to lead to major industrial unrest and, in some countries, probably social unrest also. It is not impossible that opportunist opposition parties may try to use the resulting problems to try to bring down one or more governments but, if that does happen, markets, particularly bond markets, in those countries are likely to react very badly. In the UK, even though there is a coalition government, the closeness to the last General Election makes the latter possibility unlikely, but it will not avoid a very difficult time for industrial relations as public sector unions try to resist the inevitable cuts.

Because so much of the largest UK companies' business is outside the UK, the equity market in the UK can probably weather this storm, and the test for the bond and currency markets is whether they believe the government will hold its nerve. Our pre election view of the UK that UK equities offer much better value than government bonds remains unchanged. The prospects for the latter are better than they were by virtue of there being more realism about the public debt in government circles, but the task of tackling the deficit is enormous, and sterling government bond yields (ten year government bonds currently yield 3.52%) do not recognise the scale of the problem.

A further issue for the UK is the worrying level of inflation. We have never felt that deflation was going to be an issue for the UK although, for some, it has been a concern. The significant depreciation in the value of sterling in 2008 continues to feed through to prices. The latest Consumer Price Index showed a year on year rise from 3.4% to 3.7%, whilst the Retail Price Index rose to an eighteen year high of 5.3% compared with 4.4% the previous month. These figures are certainly above what the Bank of England has been expecting, although it remains confident that inflation will fall back. Of course, if VAT is increased, which is quite possible, inflation may not come down. Producer price inflation has also been rising with the level, year on year, at 5.7% in April, compared with 5.0% in March. Of course, with inflation at this level, interest rates would normally be much higher, and it is interesting to note that the OECD is recommending to the Bank of England that it raises the base rate to 3.5% by the end of 2011. One would normally feel very uncomfortable with such a large negative real interest rate, at least as measured by base rate against inflation, but these are not normal times, and the extent of the fiscal squeeze to come is such that, as we mentioned earlier, very loose monetary policy is likely to be retained to provide some offset for the effects of cutback in public spending and tax increases. Nonetheless, one cannot be comfortable about such a position for such loose monetary policy would normally have investors worrying about inflation.

We can sum up the position of the UK as one moving from politicians being in pre-election denial about the drastic measures needed to repair the UK's battered public finances, to post-election realism by the coalition's Treasury team. However, the fact that there is a big gap between what was said before the election and what has been hinted at since and will become reality on June 22, means that people may not be fully prepared for what is to come. In this respect, the government may have had some luck with the timing of the eurozone's sovereign debt crisis. Whilst the UK electorate may have winced at the measures taken by Ireland last year, they may have been soothed by UK politicians warning against early public expenditure cuts. Then came the Greek debt crisis and news of a clampdown on public sector pay, bonuses and early retirement options. But what may really start to prepare the UK electorate for what is in store are the measures announced by Italy, Spain and Portugal to tackle their deficit problems. This is much nearer to home and, although these countries' freedom of manoeuvre is limited by being part of the eurozone, they suffer the same serious debt problems. Realistically, people in the UK may be more prepared for what is to come than one might have believed before the election, because of what is happening in Europe. Nevertheless, there is almost certainly going to be serious industrial unrest in the public sector, as measures to tackle the level of public spending bite. Will this be a stock market influence? Probably not, if the government holds its nerve and does not back down, because investors will look to the longer term benefits to be derived from appearing to be on top of the debt problem. Should the government back down (unlikely), and this applies for the relevant eurozone countries as well, then there is likely to be serious trouble in the bond and currency markets. Equities, based in the UK and eurozone, with their significant overseas businesses, would be the insurance policy, providing some protection through currency benefits and the earning power of their businesses overseas.

It is very easy for any review, currently written in Europe, to be dominated by the debt problems of some of the eurozone economies and of the UK to the exclusion of other parts of the world. But life goes on and the news is much better in other parts of the world.

We have recently had two sets of international economic forecasts, one from the IMF in April and one very recently from the OECD at the end of May. They both paint a much brighter picture for 2010 and 2011, compared with 2009 although that improvement is from a very depressed level.

The forecast below is an excerpt from the IMF's World Economic Outlook Update of April 2010.

IMF Projections (world output year over year % change)

	2009 (actual) %	2010 (estimate) %	2011 (estimate) %
World output	(0.6)	4.2	3.3
USA	(2.4)	3.1	2.6
Euro Area	(4.1)	1.0	1.5
Germany	(5.0)	1.2	1.7
France	(2.2)	1.5	1.8
Italy	(5.0)	0.8	1.2
Spain	(3.6)	(0.4)	0.9
Japan	(5.2)	1.9	2.0
United Kingdom	(4.9)	1.3	2.5
Canada	(2.6)	3.1	3.2
Newly Industrialised Asian Economies	(0.9)	5.2	4.9
Russia	(7.9)	4.0	3.3
China	8.7	10.0	9.9
India	5.7	8.8	8.4
Middle East & North Africa	2.4	4.5	4.8
Brazil	(0.2)	5.5	4.1

Source: IMF World Economic Outlook Update - April 2010 (excerpts)

The very recently published OECD Economic Outlook has economic projections as follows, this being an excerpt from the OECD's overall projections.

Real GDP Growth

	2009 (actual) %	2010 (estimate) %	2011 (estimate) %
USA	(2.4)	3.2	3.2
Japan	(5.2)	3.0	2.0
Euro Area	(4.1)	1.2	1.8
Germany	(4.9)	1.9	2.1
France	(2.5)	1.7	2.1
Italy	(5.1)	1.1	1.5
Spain	(3.6)	(0.2)	0.9
United Kingdom	(4.9)	1.3	2.5
Canada	(2.7)	3.6	3.2

Accession and Enhanced Engagement Economies			
	2009 (actual) %	**2010** (estimate) %	**2011** (estimate) %
Brazil	(0.2)	6.5	5.0
China	8.7	11.1	9.7
India	6.6	8.3	8.5
Russia	(7.9)	5.5	5.1

Source: OECD Economic Outlook - May 2010 (excerpts)

The contrast between different areas of the world is quite stark and those in the west who take rather a gloomy view of events can draw some solace from what is happening in the east and some other parts of the world. Of the G7 countries, those best placed appear to be the USA and Canada. But even there, there is a big contrast between those countries. The USA is swimming on a sea of debt, whilst Canada is seen as a symbol of financial rectitude, having had a near death experience in the 1990s. How Canada escaped from a very serious crisis in its public finances has been studied by interested countries having similar problems now.

Like the UK, the USA has the benefit of having its own currency and therefore being able to control monetary as well as fiscal policy. But its advantage over the UK is much greater because of the size of its economy and the fact that the US dollar is by far the world's largest reserve currency. For countries like China, an enormous holder of US dollars in its foreign exchange reserves, to sell down the US dollar would be self defeating because it would reduce the value of its remaining US dollar holdings. So, the USA benefits by default. Although it is borrowing frightening amounts of money, it is a zero sum game and, if its main rival as a reserve currency, the euro, is having a worse time of it, the chances are that the US dollar will perform better and that is exactly what is happening. Having control over its own money and being able to print money, put at its most crude, is an advantage here and one that, as we mentioned, the UK also enjoys. As we see from the economic projections of both the IMF and OECD, with the latter the more optimistic, US economic growth is expected to be far superior in 2010 and 2011 to that of the eurozone even though, overall, the current budget deficit is worse than for Europe as a whole. The US economy is more dynamic than that of Europe, suffering less from the economic rigidities of the European economic model which holds back the area's growth potential, even in more normal economic times than we are experiencing now.

Whilst most attention is, naturally, paid to the debt woes of the west and, in particular, the eurozone, on the other side of the world, the Chinese authorities are preoccupied with the problems of success, to put the issue in very general terms. The strong financial position of China enabled the Chinese authorities to take decisive action when the financial crisis threatened economic growth, as they pump primed the economy. Economic growth of 8.7% in 2009 contrasts with the negative economic growth shown in all of the G7 countries. Both the IMF and OECD are forecasting very strong growth this year, 10% and 11% respectively, and next year at 9.9% and 9.7% respectively. The rate of growth which the OECD is forecasting this year for China, 11.1%, is probably excessive for China because of the inflationary dangers which such a growth rate would pose for the Chinese economy. For this reason, the Chinese authorities have been tightening economic policy, in order to cool things down. It is a delicate balance which they must strike. On the one hand, growth must be sufficiently strong to provide the employment opportunities for those coming in from rural areas. On the other hand, inflation must be kept under control, so action must be taken to prevent overheating in the economy. Two events have occurred which has made the task of controlling inflation rather harder. China does not respond to outside pressure, so the actions of US politicians in threatening China, if it does not allow its currency to appreciate against the US dollar, are bound to be counterproductive. In normal circumstances, if there was not this extraneous political "noise", one would expect the Chinese authorities to sanction a rise in the value of the renminbi in order to cool inflationary pressures in the Chinese economy. However, a further complication has been introduced by the effect which the eurozone's sovereign debt crisis has had on the euro.

It means that the renminbi has shown an appreciable rise against a major trading partner. To allow the currency to rise against a strong US dollar, which means an even larger rise against the euro, would be too great an immediate adjustment. The threat to Chinese exports would risk an unpleasant adjustment to the Chinese economy which could threaten the delicate balance it needs to maintain between keeping economic growth strong, in order to provide employment opportunities to those coming in from rural areas, and keeping economic policy sufficiently tight to keep inflation under control. Even if it were not for the first point about the noises from US politicians, the euro's problems would probably put a controlled rise in the renminbi out of court at present. The brake on inflation from a weak euro is much less than from a weak US dollar because commodities are generally priced in the latter currency.

Investors take the "glass half full/empty" view of China's effect on the stock market depending upon their current mood. The rapid growth of the Chinese economy and others, like India, have been an obvious benefit to the world economy at a time when it has been in such serious trouble. That is the "half full" view. The "half empty" view is that policy initiatives by China to restrain the economy will be bad for the parts of the world economy which are not performing so well. The truth is that if the Chinese economy became seriously overheated and it had to clamp down hard to restrain inflation, the effects would be more dramatic and damaging than if it acted proactively. In a febrile atmosphere, a timely move towards tightening can sometimes frighten investors when it should actually have the opposite effect. From an investment aspect, the way China is handling the current situation should give some confidence as, indeed, should the way China has acted since the financial crisis started in 2008.

Unfortunately, the same cannot be said for politicians in a number of other countries. A classic ploy is to try to deflect blame on to another party. Many seem to be in denial. In the eurozone, bankers, hedge funds and private equity vehicles are the favourite scapegoats. The problem in the eurozone, as we have mentioned above, is that monetary union is structurally flawed and a number of countries have been profligate in their spending which has led to fears about sovereign debt in a number of eurozone countries. Grandstanding politicians are not a new phenomenon, but their antics threaten to have unintended consequences. For example, in their urge to excoriate the banks and bankers, they may make it more difficult for banks to lend in future, surely not an outcome the politicians desire. Similarly, in the USA, bankers are a convenient whipping boy, but the politicians must be careful what they wish for if they are not to run a similar risk to that being run in Europe. Countries seem to be going their own way, with a signal lack of co-ordination. It is an unedifying spectacle and one which investors should not ignore for unintended consequences. Whilst it is completely understandable that people are very annoyed about having to pick up the bill for all the mistakes made in the banking world and also about the remuneration received by some of those employed in the financial services industry, we are where we are, and the most important thing is not to prejudice the restoration of health to the banking system and thereby economic recovery. Investors need to be comfortable that politicians, in their attempts to divert attention from the current important issues, such as eurozone sovereign debt concerns and their origins, by shooting the messenger rather than dealing with the causes, do not harm economic prospects and, through that, investment returns.

Even in countries which have emerged relatively unscathed from the financial crisis, politicians do not seem immune from taking counterproductive actions. In Australia, a country which has provided excellent returns for investors, the government, not far off an election, has announced a populist measure to levy a super tax on mining companies with the justification that the mining resources belong to the Australian people and that the mining companies have had it too good in recent years. Amongst a number of objectionable features is that it is retrospective, applying to projects already started. Until this time, Australia has enjoyed a reputation as a stable country in which to invest. It effectively avoided the recession and, because of its mineral resources, has been a major beneficiary of the Chinese boom as a result of the latter's insatiable demand for commodities. In projecting an anti-business attitude and hoping to gain popular support for this policy by bashing the mining industry, immense damage to the country's image has already been done and this will have financial consequences. Mining companies do not have to invest in Australia and, if they believe the returns are inadequate, they will look elsewhere. It is not only that. Many Australians, either individually or through pension funds, are investors in Australian mining companies so if the companies' profits are reduced by additional axes, it will affect dividends and share values. Employment will be affected in mining and related industries and, ultimately, if expansion is curtailed, exports will suffer. In some countries where there are serious economic and financial problems, such as parts of the eurozone, one can understand, but not excuse, politicians hitting out at the wrong targets in order to divert attention from the real problems. In a country like Australia, which has been performing relatively well, it is a serious self inflicted wound. It is possible that, if there is a change of government and at the next election, the measure will be scrapped but, as one of the affected companies said, Australia is now considered a sovereign risk, not because of its financial position which is currently good, but because of its uncertain taxation background. Australia has a lot of ground to make up and the government's actions on mining taxes might be one reason for the Australian dollar's recent weakness. One of the predictable but still regrettable consequences of the financial crisis has been the resurgence of strong anti-business sentiment which, if translated into policy measures, such as in the banking sector or mining sector in Australia, as discussed above, is not helpful to stock markets.

So far, we have concentrated on the major problems of sovereign debt and the implications which arise from these, particularly in the eurozone. But down at the ground level, we are seeing some encouraging economic indicators in various countries and, as the projections from the IMF and the OECD indicate, some parts of the world are going to perform relatively well this year and next year if they are correct in their forecasts.

In the USA, the latest estimate of first quarter GDP growth is an annual rate of 3%. There have also been a number of encouraging micro indicators coming out of the United States. US consumer spending rose by 0.6% in March, compared with a rise of 0.5% in February. The ISM index for US manufacturing showed a reading of 60.4 in April compared with 59.6 in March. Its index for the US services sector was unchanged in April at 55.4, but still indicating growth as the indicator was over 50. There was a slight improvement in construction spending which rose by 0.2% in March, after falling 2.1% in February. The IBD/TIPP economic optimism index, although still below 50, rose slightly in May to 48.7, compared with 48.4 in April, showing a slight move in the right direction. The Commerce Department reported that wholesale inventories rose by 0.4% in March compared with 0.6% in February, and inventories stood at their highest level for eight months. Industrial production increased by 0.8% in April compared with 0.2% in March. The University of Michigan's economic confidence indicator rose to 73.3 in May, up from 72.2 in April. The Philadelphia Federal Reserve Bank reported that its index of mid Atlantic business activity rose to 21.4 in May from 20.2 in April. The US Conference Board reported that its consumer confidence index rose to 63.3 in May compared with 57.7 in April. US factory orders for big ticket manufactured goods rose by 2.9% in April, compared with 4.8% rise in March. In the housing market, there were some positive indicators. In March, pending home sales rose by 5.3% from a month earlier, as measured by the relevant index. In April, the figures showed that the construction of new US homes rose by 5.8%, the highest level since October 2008. Against this, building permits fell by 11.5% to the lowest rate since October 2009.

In the eurozone, as one might expect from what is happening at present and also from the very modest forecast for economic recovery this year, there has not been nearly as much good news. The Markit purchasing managers index for eurozone manufacturing rose to 57.6 in April from 56.6 in March. The purchasing managers index of eurozone services activity rose to 55.6 in April, compared with 54.1 in March, and this was the eighth consecutive month that the reading was above 50. Markit's flash services purchasing managers index for May rose to 56.0 compared with 55.6 in April. That for the manufacturing sector dropped 55.9 in May from 57.6 in April although it still does reflect growth, albeit at a slowing rate. New industrial orders in the eurozone rose by 5.2% in March, their best rate of growth for ten years, taking the annual increase to 19.8%. In Japan, although the news has been overshadowed by political events, notably the resignation of the Prime Minister, there have been some items of positive economic news. Japanese consumer confidence rose for the fourth month running in April to a level of 42 compared with 40.9 in March. This is the highest level since October 2007. Japan's industrial output rose by 1.2% in March after a 0.6% fall in February. Overall, official figures showed that the Japanese economy grew by 1.2% in the first quarter, which translates into an annualised growth rate of 4.9%, better than the USA and eurozone. Whilst keeping its key interest rate unchanged at 0.1%, the Bank of Japan upgraded its assessment of the Japanese economy, saying that it was starting to recover moderately because of global economic growth.

The startling comparison between the Chinese economy and those of the G7 countries is shown by the fact that industrial output in April was 17.8% higher than a year earlier.

In the UK, against a sombre economic background, there have been some positive items. The manufacturing purchasers managers index for April rose to 58.0 from 57.3, which is the fastest rate of growth it has seen in more than fifteen years. The purchasing managers index for the construction sector rose to 58.2 in April from 53.1 in March. This is the fastest rate of increase since September 2007, with the biggest increase seen in the home building sector. The Markit/CIPS services purchasing managers index was 55.3 in April, against 56.5 in March, still showing growth, but a slowdown in the rate of increase in activity. UK industrial output rose by 2.0% in March, the fastest rate of growth for almost eight years. This compares with a 0.5% increase in February. Nationwide Building Society's confidence of consumer index rose slightly to 74 in April, from 73 in March, but 23 points higher than in the same month for the previous year. The British Retail Consortium reported a very slight increase in its consumer confidence index to 3 in March compared with 2 in December. The volume of high street sales rose by 0.3% in April, following an upwardly revised 0.5% in March. Sales rose at an annual pace of 1.8%. In the housing market, the British Bankers Association reported that the number of loans approved for house purchase rose slightly in March to 34,905 compared with 33,360 in February. The level for March 2009 was 29,212.

The unbalanced nature of the world economy provides opportunities as well as threats for investors. The threats are obvious enough surrounding the state of public finances in the G7 area and a number of eurozone economies which are outside the G7. We have dwelt at length on those in this review. But Asia, notably China, parts of Latin America and emerging markets offer great opportunities, not only because of their current relatively strong rates of economic growth but also because of the prospects for future growth far in excess of what the main industrial countries are likely to achieve. Many western and Japanese companies are well placed to benefit from this prospect. So, whilst equity markets are very jittery at present because of the news emanating from the eurozone, many of the companies based there, as well as in the USA and UK, are well placed to benefit. Whilst it is impossible, as always, to be able to forecast short term market movements, valuations are reasonable enough to give comfort to investors that shares remain an asset class in which to be invested. The bond markets are in a very confused state. Yields in countries deemed to be the safest are being driven down to unrealistically low levels. We say this because the very loose monetary policy being followed in many countries runs inflationary risks for the future. Bonds of countries deemed more risky (eurozone country credits of less than AAA are a case in point) are seeing elevated spreads against German bonds as a sign of stress and corporations are also being affected. The magnitude of many governments' financing needs, worries about solvency of some countries and the future inflation risks being run, makes bonds, as a class and, for different reasons, show inadequate yields at present.