



meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Shares have edged higher during the quarter and bond yields have fallen in an unusual combination of movements. Shares suggest that the modest international economic recovery is on target; bond yields suggest something worse. We will discuss this issue in our review. Currency movements were relatively modest by some recent standards.

The tables below detail relevant movements in markets :

International Equities 28.02.14 - 30.05.14

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+2.9	+6.9	+7.0	+8.3
Finland	+4.7	+3.3	+3.4	+4.7
France	+4.8	+3.5	+3.6	+4.8
Germany	+2.4	+1.1	+1.2	+2.4
Hong Kong, China	+4.8	+4.8	+4.9	+6.2
Italy	+8.3	+6.9	+7.0	+8.3
Japan	+0.1	+0.3	+0.4	+1.6
Netherlands	+2.8	+1.5	+1.6	+2.8
Spain	+9.4	+8.0	+8.1	+9.4
Switzerland	+4.7	+3.1	+3.2	+4.4
UK	+1.7	+1.7	+1.8	+3.0
USA	+3.8	+3.7	+3.8	+5.1
Europe ex UK	+4.8	+3.3	+3.4	+4.6
Asia Pacific ex Japan	+3.7	+6.4	+6.5	+7.8
Asia Pacific	+1.9	+3.4	+3.5	+4.7
Latin America	+8.0	+11.9	+12.0	+13.3
All World All Emerging	+4.8	+8.2	+8.3	+9.7
The World	+3.6	+3.7	+3.8	+5.0

Source FTSE World Indices

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

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

Currency	28.02.14	30.05.14
Sterling	2.72	2.57
US Dollar	2.66	2.47
Yen	0.59	0.58
Germany (Euro)	1.63	1.36

Sterling's performance during the quarter ending 30.05.14 (%)

Currency	Quarter Ending 30.05.14
US Dollar	+0.2
Canadian Dollar	-1.6
Yen	N/C
Euro	+1.5
Swiss Franc	+1.9
Australian dollar	-3.8

Other currency movements during the quarter ending 30.05.14 (%)

Currency	Quarter Ending 30.05.14
US Dollar/Canadian Dollar	-1.8
US Dollar/Yen	-0.3
US Dollar/Euro	+1.2
Swiss Franc/Euro	-0.4
Euro/Yen	-1.5

Significant Commodities (US dollar terms) 28.02.14 - 30.05.14 (%)

Currency	Quarter Ending 30.05.14
Oil	+0.3
Gold	-5.7

MARKETS

International bond and equity markets have edged ahead this quarter. The total return on the FTSE World Index was 3.6% in local currency terms, 3.7% in sterling terms, 3.8% in US dollar terms and 5.0% in euro terms. In local currency terms, the returns were fairly closely bunched but it was pleasing to note previous underperformers like Latin America and Emerging Markets producing above average returns. The FTSE Latin American Index returned 8.0% and the FTSE All World All Emerging Markets Index returned 6.4%. The UK performance was slightly below average with the FTSE UK Index returning 1.7% whilst the FTSE Europe ex UK Index was slightly above average at 4.8%. Of the major markets, Japan was the poorest performer with the FTSE Japanese Index returning 0.1%. In sterling terms, because of currency recoveries in Latin America and Emerging Markets, we saw a very strong performance from the FTSE Latin American Index, +11.9%, and for the FTSE All World All Emerging Markets Index, +8.2%. The partial recovery in the Australian dollar meant that the local currency return on the FTSE Australia Index of 2.9% expanded to 6.9% in sterling terms.

High quality government bonds also performed well. Taking ten year government bonds as the benchmark, we saw a fall of 15 basis points in the sterling government bond to 2.57%, of 19 basis points in the US Treasury bond to 2.47%, of just 1 basis point in the Japanese government bond to 0.58% and of 27 basis points to 1.36% in the German Bund.

In the currency markets, there was some recovery in the Australian and Canadian currencies against which sterling fell by 3.8% and 1.6% respectively. Against the Swiss Franc sterling rose by 1.9%, against the euro by 1.5% and against the US dollar by 0.2%.

In the commodity markets, there was very little movement in oil as measured by Brent Crude where the price rose by 0.3%. Gold fell by 5.7%

ECONOMICS

Although it still seems likely that the world economy will grow more quickly this year than last, there have been some disappointing growth figures from the USA and the eurozone. There is less cause to be concerned about the former than the latter with special factors, particularly the very bad weather in January and February, affecting economic growth. The USA is expected to bounce back but it is difficult to say the same for the eurozone. China is being watched particularly carefully with its economy in a transitional phase. Japan's first quarter growth was flattered by pre-emptive buying in front of 1st April's consumption tax increase so the after effects will be felt in the second quarter. The UK is the star performer with most indicators pointing to strong growth albeit from a very depressed level.

The latest economic forecasts from the IMF and the OECD point to accelerating economic growth this year and next, although to modest levels. In its April edition of its World Economic Outlook, the IMF projects world economic growth this year at 3.6% compared with 3.0% last year. For 2015, it forecasts 3.9%. Amongst the advanced economies it projects growth of 2.2% this year and 2.3% next year compared with 1.3% last year. The strongest performers amongst the G7 economies are

the UK with projected growth of 2.9% this year and 2.5% next year and the USA with projected growth this year of 2.8% and 3.0% next year. In 2013, the UK grew by 1.8% and the USA by 1.9%. Canada, too, is expected to show slightly above average growth against the advanced economies' average with projected growth at 2.3% this year and 2.4% next year. After contracting by 0.5% in 2013, the eurozone is projected to grow by 1.2% this year and 1.5% next year, below the average level for the advanced economies. Of the four largest eurozone economies, the strongest, not surprisingly, is Germany, with the IMF projecting growth for this year of 1.7% and, for next year, of 1.6% against 0.5% last year. The growth forecasts for France are 1.0% and 1.5% respectively, for Italy 0.6% and 1.1% and for Spain 0.9% and 1.0%. After growing by 1.5% in 2013, Japan is forecast to grow by 1.4% this year and 1.0% next year. As one would expect, Emerging Market and Developing Economies' growth rates remain superior to those of advanced economies. After growing by 4.7% in 2013, the IMF expects them to grow by 4.9% this year and by 5.3% next year. Of the BRIC countries, growth in Brazil is forecast to remain at disappointing levels, 1.8% this year and 2.7% next year, whilst Russia's growth rate is likely to be affected by the fall out from Ukraine. The IMF's March forecast of growth this year of 1.3% and of 2.3% for next year have almost certainly been overtaken by events and Russia may now be looking to grow by 1% this year or even less. With inflation likely to be around 7%, this is what the UK used to know as "stagflation", an unpleasant experience. India, which by its standards has experienced disappointing growth, is forecast to grow by 5.4% this year and 6.4% next year, an improvement on 2013's 4.4% level, whilst China is projected to grow by 7.5% this year and 7.3% next year compared with 7.7% in 2013.

If we move on to the OECD Economic Outlook published in early May, it is forecasting growth for its members of 2.2% this year and 2.8% next year. Its forecast for the USA is 2.6% and 3.5% next year, higher than the IMF's forecast. For the eurozone, its forecasts are for growth of 1.2% this year and 1.7% next year, in line with the IMF for this year and slightly more optimistic for next year. Within the eurozone, it is more optimistic for Germany than the IMF with 1.9% growth forecast for this year and 2.4% for next year. There is little difference in the respective forecasts for France and Italy. It is slightly more optimistic for Spain for this year than the IMF at 1.0% but much more optimistic for next year at 1.5%. It is quite a bit more optimistic for the UK than the IMF, perhaps reflecting its later forecast based on continuing positive news. It sees the UK growing by 3.2% this year and 2.7% next year. There is not much difference in the forecasts for Japan, a little less optimistic for this year and a bit more optimistic for next year.

Accelerating economic growth, even if not to elevated levels, and the level certainly will not be elevated for this year, is important for international equity markets. After rising in 2013 at a rate well in excess of corporate earnings' increases, share prices in 2014 need the support of rising company earnings to validate last year's rise which left share price ratings more elevated. Whilst there are obviously not going to be spectacular rises in corporate earnings this year, there is some prospect of an acceleration through the year even if there has been a disappointing start in the eurozone. The very modest movement in share prices so far this year, whilst encouraging in the context of last year's performance, reflects what we expect to be a slow grind upwards during the year.

Along with many, we have been surprised by the movements in the bond market this year. With bond yields artificially depressed by monetary policy and starting at yield levels which appear to offer no value and to be dangerously low, and the prospect of faster economic growth, not to mention the Federal Reserve's tapering policy, one would have expected them to start rising. If we go back to the start of the year and take ten year government bond yields as a benchmark, we see that the gross redemption yield on the US Treasury bond has fallen by 56 points to 2.47%. For the UK, the fall is 47 basis points to 2.57%, for Germany the fall is 58 basis points to 1.36% and for

France it is 78 basis points to 1.77%. Elsewhere in the eurozone, the yields on the bonds on two troubled countries, Italy and Spain have also fallen sharply, in the case of Italy by 115 basis points to 2.96% and in the case of Spain by 28 basis points to 2.86%. Another troubled country, Portugal, has seen its ten year government bond yields fall by 250 basis points to 3.63%, whilst those for the most troubled country of all, Greece, have fallen by 210 basis points to 6.3%. So, what is going on in the bond markets?

A consistent theme over recent years in explaining depressed bond yields is the very loose monetary policy in existence almost everywhere. But, given that the US Federal Reserve has embarked upon its tapering programme, which is likely to reach its conclusion later this year, one would have expected an upward movement in bond yields. Of course, monetary policy is still extremely loose so we are talking only about a relative tightening. At the moment, the Federal Reserve is continuing to create money for asset purchases. Internationally, though, one would not have expected that bond yields would fall further. So why might the yields have fallen? If the international economic outlook had deteriorated and growth expectations been revised downwards, a fall in yields would have been logged. Downgrades have been relatively minor. For example, the IMF's latest forecast compared with its one in January reflects just 0.1% reduction in its forecast for world economic growth in 2014 and 2015, the main reason for the deterioration in the Advanced Economies being Japan and a modest reduction in the forecasts in 2014 and 2015 in Emerging Market and Developing Economies. Is it a flight from perceived weaker countries into what are considered to be harder currencies? Whilst this might have been the case last year, some stability has been restored this year in the currency markets. So far in this calendar year, currencies like the Brazilian Real, the Indonesian Rupiah, the Indian Rupee and the Turkish Lira have all risen against the US dollar. Only the Argentine Peso has been really weak and that is due to the special problems of that country. Could it be connected with the eurozone? First quarter eurozone GDP was, undoubtedly, very disappointing at 0.2%. With some eurozone countries having very high outstanding public debt levels as a percentage of GDP (examples are Greece 175.1%, Italy 132.6%, Portugal 129.0%, Ireland 123.7%, Spain 93.9% and France 91.8%), eurozone growth is essential to stabilise their debt positions. Economic growth should improve public finances. Each year that the government runs a budget deficit, it has to borrow more. The low level of interest rates has pushed back the threat of unsustainable finances but, as and when interest rates start to rise, debt funding costs will start to increase and worsen the problem. It may be that the disappointing growth reported in the first quarter is trumping the second issue, the sustainability of present debt levels in some of these countries. Economics would tend to suggest that, if eurozone growth was accelerating, bond yields would, in most circumstances, start to rise, with the reverse case true also. But, if it is the latter, it is a dangerous game. There is really no sign of these debt levels coming down and the current low level of government bond yields in some of these highly indebted eurozone countries look anomalous and these countries' bond markets vulnerable to changes in sentiment. The trend in bond yields could also be a function of very low inflation in the eurozone or the fears of deflation. Taken in isolation, the prospect of deflation could appear to be good news for bonds and help to justify very low yields in the eurozone bond market since falls in the price level would mean that real yields were higher than normal yields. Although the latest eurozone inflation rate for May is 0.5%, some countries such as Greece (-1.6%) and Portugal (-0.1%), are already in deflation. Other troubled countries like Spain are close to deflation at 0.2%. However, even if the eurozone does not move into deflation as a whole, very low inflation (the ECB's target is around 2%) is also problematic because of the denominator effect. In an inflationary environment, borrowers benefit at the expense of lenders. Because debt is fixed in nominal terms (we exclude inflation linked bonds here), inflation will raise nominal GDP by more which will help to stabilise or limit the rise in the proportion of outstanding public debt to GDP. However, if public debt is growing each year because economic growth is not sufficient to

eliminate the budget deficit, but nominal GDP is falling, static or growing at a low percentage rate, then it worsens the ratio of outstanding public debt to GDP. This can be expected to influence the perceived creditworthiness of the borrower and, with such high debt levels in a number of eurozone countries, deflation or very low inflation threatens to exacerbate an already very difficult situation. So far, we have been talking about public debt but there are also eurozone countries where the level of private debt is very high and such a situation as described above reduces the creditworthiness of the private sector, threatening problems for the banks.

So, if the fall in eurozone bond yields is a function of the reduced outlook for inflation or even deflation and may therefore seem intuitive, the counter intuitive may be more rational in saying that the fall in bond yields is misguided because the market has become a more risky place.

The poor growth prospects for the eurozone and the failure to meet the ECB's inflation target have led to expectations that the ECB would act in June to try to stimulate the economy and this it did by cutting its benchmark interest rate by 0.1%, paying a negative interest rate on banks' balances with the ECB (-0.1%), offering up to €400 billion of cheap long term loans to banks to stimulate lending to small businesses. However, a bad lending proposition may be even more unattractive to banks than negative interest rates and this would seem a highly controversial move to make. It could try quantitative easing, and it has hinted at this, but this could prove controversial and the question of what assets to buy would be difficult. With much of the eurozone in austerity mode, flooding the area with money is unlikely to get the economy moving. There has to be a rousing of Keynesian "animal spirits" which could be happening in the UK but which is difficult to see happening in Europe. Nevertheless, despite the unpromising position of the eurozone economy, we do not think that international economic prospects are so poor as to justify the fall in bond yields this year on the conventional reasoning of a deteriorating international economic outlook.

The results of the elections for the EU parliament represent a strong repudiation in a number of countries of the current austerity policies. It would be surprising if there were not to be repercussions from these results and the fall out in France might be particularly relevant. The victory of the FN and the dismal performance of the governing party, in particular, but also the opposition, could put into doubt the government's resolve to go through with the EU deficit mandated reduction or at least the speed of it. The strong anti EU sentiments of the FN may well reflect themselves in a weakening of the austerity programme so fiercely denounced by the FN. But, if that were to happen, it would throw into doubt the whole of the EU's austerity programme and the commitment to deficit reduction and that would cast a doubt over some countries' creditworthiness which one would expect to be reflected in higher bond yields. It is, of course, very early days and the dust has not settled in the aftermath of these results but there could be implications for the bond markets.

So, we have the conundrum this year of falling bond yields implying forthcoming economic weakness and a steady to slightly rising international equity market which, on top of last year's rise, suggests that investors do not share the sentiments of bond investors. The pessimists will say that, although the US and UK economies appear to be performing quite well, first quarter eurozone growth figures are indicative of problems and that deflation or negligible inflation justify very low bond yields in the area, even for countries with a modest credit rating. The optimists will point to the forecasts from organisations like the IMF and OECD which see a pick up, albeit modest, in economic growth this year and next. We side with the optimists here in that we believe that there is enough economic evidence to suggest world economic growth will accelerate this year albeit modestly. We rely heavily here on the economic data from the USA which suggests that the economy will perform quite well. The performance of the second largest economy, China, will also

be very important here. We are taking a view that in overseeing the transition of the Chinese economy from investment and exports to consumption, the Chinese authorities will take the necessary action to stimulate the economy if it appears to be slowing too much. China, unlike many other economies, is able to act quickly. The UK economy, although too small compared to these two, is also performing well and, at the margin, this is helpful as, too, is the performance of the German economy in a very weak eurozone. But this is a judgement. There is no overwhelming evidence either way.

However, a straw in the wind pointing to better times is the fact that discussion in the USA and UK has turned to the consideration, aided by press speculation, of how to exit from the extremely loose monetary policy being followed in the USA and UK. This is obviously not an issue in the eurozone given its weak economic members, nor in Japan with its enormous monetary experiment, but the improving economic news in the USA and UK has advanced discussion of an issue which was always going to occur given that the threat to monetary policy, as presently practised, is unsustainable in anything but the short term. The UK is maintaining the level of quantitative easing but not expanding it whilst the USA is continuing its programme of quantitative easing albeit that it is being tapered month by month. As we have remarked in many of our past reviews, the stock market's most difficult challenge will be to deal with the rise in interest rates to more normal levels which must happen. Whilst the rise in stock markets since 2009 has been very pleasing, the quality of the rise has not been high, driven, as it has been, by cheap and plentiful money. This was one of the aims of monetary policy since rising asset prices lead to a positive wealth effect which should spread out into the wider economy. However, whilst much of the present economic discussion centres on the possibility of deflation in the eurozone, the possibility of the re-emergence of inflation as a problem has not received as much attention as it deserves. Monetary policy should be proactive rather than reactive so action taken in good time, to ward off the threat of deflation is desirable. That rises in interest rates will have to occur is not in doubt. The question is when? One of the important determinants is central banks' estimates of the output gap, the difference between the potential output of an economy and the current level. This cannot be measured precisely because the judgement of an economy's potential output level is subjective. The theory is that, whilst output in an economy is below its potential level, inflationary pressures will not come to bear. Examples of why this might possibly not be the case are that overtime will not have to be worked, pay pressures might be moderate because there is slack in the labour market, raw materials may be in plentiful supply and therefore not expensive and equipment is not being worked beyond its capacity and therefore less prone to breakdowns. Once full capacity is reached and there is no slack left, costs could rise through the need for more overtime working, pay rates might rise as there is competition for staff, raw materials might become harder to obtain, thus pushing up prices, and machinery might have to be worked more than optimal, leading to breakdowns and the expense of finding alternative short term capacity. These are just some of the factors which might push up inflation and, once it starts rising, it is difficult to put the genie back into the bottle. Therefore, in an ideal world, central banks have to make a judgement on the level of spare capacity in an economy and, if the economy in question is working below capacity, when to start to make a pre-emptive move to raise interest rates. Obviously, the level of capacity does not stand still and, if businesses are optimistic, they will have acted to raise capacity which can head off a closing of the output gap. The relevant central bank's objective in raising interest rates is to try to refine the growth rate in such a way as to avoid stoking inflation. This is the reason why it is wrong to be complacent about the low level of inflation at present. With the USA and UK economies growing moderately well at present and with the low level of business investment in recent years, the importance of the output gap is obvious and it is encouraging to see that business investment in the USA and UK is picking up. After such a severe financial and economic crisis, confidence amongst businesses and consumers in

the USA and UK, whilst it has improved noticeably, must still be considered vulnerable to bad news or unhelpful developments which is why the central banks have to read very carefully. Too sharp or quick a rise in interest rates could set back economic growth. The central banks have to finesse this programme very carefully and making the market aware of their thinking should help to avoid surprises and make the task of raising interest rates less troublesome for investors. However, as we saw last year, when the markets twice reacted badly to the possibility of tapering when it was discussed, even though everyone knew that it was going to happen at some stage, not everything turned out as expected. However, rate setting committees of central banks do not always feel the same way and in the USA and UK we can see different views beginning to emerge which can muddy the waters as far as onlookers are concerned. Generally speaking, however, the start of the move to normalising interest rates and monetary policy should be encouraging if it signals the start of a return to more normal economic times. A stock market, whether it relates to bonds or equities, which relies for its strength on cheap and/or printed money is not in a healthy long term position which is why, although being pleased with the recovery in markets over the last five years, we should also be realistic about its foundations.

From the theoretical to the real world where we look at the economic data being published, starting with the USA. The first quarter's revised GDP data showed negative growth of 1.0% quarter on quarter, and 2.0% year on year. Investors did not take much notice of the data because it was affected by the poor weather in the USA in January and February and other data being produced appeared to tell a different story. The latest Purchasing Managers Indices for May for manufacturing and non manufacturing were reasonably strong at 55.4 and 56.3. The unemployment rate was 6.3%, having fallen faster than expected in recent months, although the figures have been flattered by the low participation rate of the potential workforce. The Conference Board's leading indicators rose by 0.4% in April although, disappointingly, industrial production fell by 0.6% in April. The housing market has come off the boil somewhat but the S & P/Case-Shiller Composite Index of prices in twenty US cities showed a rise year on year in March of 12.4%, slightly down from February's level of 12.9%. Housing starts in April rose by 13.2% at an annualised rate in April compared with March. The Thomson Reuters/University of Michigan sentiment index for May stood at 81.9 in May which was a decrease from 84.1 in April. The latter's figure was a nine month high. A very useful insight into the US economy is the Federal Reserve's Beige Book which reports each month on economic activity in each of its twelve districts. The latest report, published in mid April, suggests that economic activity increased in most regions of the country. Ten of the districts reported a pick up in activity and only two, a decline. Earlier weather related economic weakness was reversed, resulting in an increase in consumer spending. Auto sales improved in most districts. Most districts reported an increase in manufacturing activity. Across most districts, home prices rose modestly, with inventory levels remaining low. Construction generally strengthened. Encouragingly, loan demand strengthened and labour market conditions were generally positive, although wage pressures were contained or normal. Prices were stable or slightly higher. The evidence provided by the Beige Book is consistent with that of a moderately improving economy.

Whilst the attention in the U.S.A. is on how the Federal Reserve may gradually tighten monetary policy, no such dilemmas face the ECB, hence its further policy measures around on the 5th June. First quarter GDP data was very weak, with quarter on quarter growth at just 0.2% and year on year growth at 0.9%. Of the four leading eurozone economies, only Germany can be said to have performed well, with quarter on quarter growth of 0.8% to give year on year growth of 2.3%. In France, the second largest economy, the first quarter was very disappointing, showing no change over the previous quarter, and the year on year growth rate was 0.8%. In Italy, the economy contracted by 0.5% in the first quarter and by 0.1% on a year on year basis. Spain showed a quarter on quarter

growth rate of 0.4% and a year on year growth rate of 0.6%. Bearing in mind what we said earlier about the weaker and/or more highly indebted eurozone countries and the consequences of low inflation and low or no growth on the level of outstanding public debt in relation to GDP, these figures remain a cause for concern. Looking at the latest inflation figures from a number of the eurozone countries, we see why the insidious effects on this inflation profile are causing concern. Germany is obviously not a problem at present, although the latest monthly inflation figure for May shows up at -0.1% with a year on year level of 0.9%. There should be more concern for France where there was no inflation in April on a month on month basis and just 0.7% year on year. Italy showed a 0.1% increase month on month in April and just 0.4% year on year. For Spain, the respective figures were 0.9% and 0.5%. Other figures pointing to weakness in the eurozone economy include the industrial production figures. March's figures showed a 0.3% month on month decline and a 0.1% year on year decline. Delving down into the eurozone's numbers, we note that Germany's industrial production fell by 0.5% in March but was up 3.0% year on year. France, on the other hand, showed a month on month decline of 0.7% and a year on year decline of 0.8%. For Italy, the respective figures were -0.5% and 1.1%, but Spain reported strong figures of 6.1% and 8.1% respectively. The divergence of performance between France and Germany is a concern and further evidence of this movement come from the latest Purchasing Managers Indices. The composite index for the eurozone stands at 53.5 indicating modest growth but, within that, we have some quite strong readings for Germany and Spain, at 55.6 in both cases, and a weak one for France of 49.3. Unemployment stands at the unacceptable level of 11.7%.

So, it is against this background that the ECB acted on 5th June. Although eurozone stock markets have been performing quite well so far this year as sentiment has improved, the fundamentals remain very difficult due to the flawed nature of the monetary union. Whilst fiscal discipline is necessary, if the countries in the eurozone did not have their hands tied by being in the euro, they would have been able to achieve some relief through devaluation to make themselves more competitive. As it is, the austerity packages aimed at achieving budget deficit and debt ratio targets are dampening economic activity. With the weight of debt overhanging a number of eurozone economies, it is difficult to be positive even about medium and long term growth prospects. What happens in France will be very important. The result of the European elections in France which handed President Hollande's party a very poor result and the anti EU FN a very strong result, will make it hard for him to pursue the austerity path vigorously without creating a further backlash. If the second largest EU member has second thoughts on EU mandated austerity, it will cause a serious problem for the EU. The eurozone crisis could resurface at any time and there is absolutely no reason for complacency.

Turning to Japan, recent economic growth figures have been flattered by the introduction of a 3% rise in consumption tax to 8% on 1st April. This brought forward purchases to the first quarter. As a result, the first quarter's increase in real GDP over the previous quarter was 1.5% and on an annualised basis it was 5.9%. The first quarter's year on year increase was 3.0%. There will obviously be a negative reaction in the second quarter to the bringing forward of purchases into the first quarter and the GDP figure will therefore look poor. The latest PMI figures for Japan all read below 50, the dividing line between growth and contraction. The composite index reads 49.2. The industrial production figure for March showed a month on month decrease of 2.5% to give a year on year increase of 4.1%. The latest Tankan survey showed a reading of 12, unchanged from the previous quarterly reading, and the one before that showed a reading of 2, so confidence has been maintained by business. The jury remains out in Abenomics. Whilst it was a risk raising consumption tax given that it might offset the monetary and fiscal stimulus to the economy, the state of Japan's public finances is so dire that failure to go through with the planned tax increase could have led to doubts about Japan's resolve to

tackle the problem of its public finances with a corresponding loss of international confidence in the country. Japan faces other challenges as well. The shutdown of its nuclear power plants has led to a big increase in energy imports resulting in deterioration in its current account situation. This could have implications for the Yen which might go beyond the weakness which may be considered helpful in making Japanese manufacturers competitive. Whilst the vast majority of Japanese public debt is owned domestically and, therefore, the risk of a run on the currency should be reduced, Japan cannot afford to be reckless with its finances. If Abenomics works, with the stimulus to the economy and the end of deflation restoring the economy's growth path, then the stock market will look excellent value. If it does not, then it is vulnerable. It is a high risk/high reward market and, so far this year, after its good performance in 2013, it has been a disappointment. As the world's third largest economy, we favour a modest allocation to the equity market.

For China, it is the success or otherwise of the transitioning of the economy from one led by fixed asset investment and exports to consumption which will be the key to its economic performance. Whilst it will be difficult to return to the days of double digit growth, the success of this transition will mean better quality growth and better quality growth will mean more sustainable growth. It is a task which will require a bit of skill because, if growth slows down too much as a result, social problems could arise. The growth target this year is 7.5%. The year on year growth rate to the end of March was 7.4% and the quarter on quarter growth rate was 1.4%. Amongst the economic indicators which the market watches for guidance on the performance of the Chinese economy are the industrial production figures, quite respectable at a 0.8% month on month growth in April and a year on year growth rate of 8.7%. The latest Purchasing Managers Indices reflect slightly positive figures at 50.8 for manufacturing and 55.5 for non manufacturing. These figures demonstrate an economy in transition but, as we said earlier, China has more ability than most economies to act quickly to address economic issues, whether they are excessive growth or too little growth. The banking sector is a concern, including the shadow banking sector. Overinvestment in fixed assets and property causes bad debt problems. Whilst the authorities can probably deal with the issues of the state banks, the shadow banking sector is a more delicate issue. China remains one of the key market indicators.

Who would have thought a year ago that the UK would be the star of the show? At the beginning of last year, some of the pessimists were talking about a triple dip. In the event, it never materialised and now it is expected by many that it will be the fastest growing G7 economy this year. In the first quarter of 2014, GDP grew by 0.8% for a year on year increase of 3.1%. Most of the numbers coming from the UK have been good or, at least encouraging in that they are pointing in the right direction. For example, the Purchasing managers Indices have been amongst the strongest around. The May composite PMI stood at 59.0 with that for manufacturing at 57.0, for services at 58.6 and for construction at 60.0. The trends for industrial production and manufacturing point in the right direction although they are not strong. Year on year industrial production was 2.3% higher in March and manufacturing 3.3%. The trends in business investment are encouraging. In the first quarter, business investment rose by 2.7% and the year on year increase was 8.7%. Unemployment at 6.8%, whilst obviously too high, has shown an encouraging fall. House prices are exercising economists' minds at present with London prices having risen so strongly. Overall, if we take the Nationwide's index of national house prices, the year on year rise is 11.1%. London is really a country within a country these days but the USA and UK know to their cost the problems which a housing bubble can cause. Critics of the UK performance will point to the unbalanced nature of the UK's growth with consumption and housing leading the way when one would prefer to see business investment and exports to the fore. As we have noted above, business investment does seem to be improving and that is encouraging. The imbalance in the economy is shown by the large current account deficit

which the UK is running. The deficit came in at 4.4% of GDP last year but in the first two quarters was averaging about 5.5%. What has hit the current account is the balance of overseas earnings with a fall in income on the UK's foreign investments and more foreign earnings leaving the UK, a reversal of the historical position. It is against this background that the strength of sterling might seem counter intuitive. Currency movements are very hard to forecast but much easier to rationalise after the event. In the case of the UK, one could say that the strength of the economy would attract investors into sterling based on the view that it would bring forward the time when interest rates will start to be increased. It is clear from the recent Bank of England's Monetary Policy Committee's minutes that a collection of views is beginning to form about the future path of interest rate increases. But confidence is a fragile thing and, as we have been saying in recent reviews, the main concern to us is not the economic outlook for the UK which is looking relatively bright but the political situation. With under one year to go before the next General Election, main UK parties' economic policies are more polarised than they have been since the 1970s. At present, the outcome of the next General Election is very unclear and the UK market is likely to factor this in as the months go by. What is clear is that interventionist policies in the energy, banking, rail and house building industries are not likely to be well received. Business leaders are already warning that investment decisions could be held up by the uncertainty over future UK economic policy. The energy industry is a classic case of interventionist policies damaging the industry. Whilst a price freeze may be popular, the effect on investment is likely to be dire and, with the UK facing a very tight supply/demand situation, such a policy like this is highly dangerous. A very unwelcome anti-business culture is developing in the UK which could lead to unwise policy decisions being implemented. So, whilst the economics is good, the politics is very uncertain and this will be an area we will be watching closely.

As markets have edged higher during the quarter, a feeling of calmness has prevailed which can lead to an unwise feeling of complacency. This state of affairs might have originated from the lack of any unexpectedly new bad news, but this is not the same as saying that the news is not bad. The eurozone remains in a very difficult economic state and the recent elections for the European parliament show increasing voter disaffection, a particularly serious issue in France. Our view is that the main positive factor, a modest worldwide economic recovery, outweighs the negative factors, so that shares, although now much more highly rated than a year ago, still have modest growth potential, although we warn that it will be an uneven ride. We still see no value in bonds and find the fall in yields, to which we alluded in our review, anomalous.

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