meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The main event of the quarter has been the turmoil in the credit markets arising from problems in the sub-prime mortgage market in the USA. However, equity markets have help up well, as the tables below show, and good quality bonds, as measured by ten year government bonds, have seen yields fall.

The tables below detail relevant movements in markets:

International Equities 31.07.07 - 31.10.07

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+11.9	+18.4	+21.0	+14.5
Finland	+18.3	+22.4	+25.1	+18.3
France	+1.8	+5.2	+7.6	+1.8
Germany	+6.7	+10.3	+12.8	+6.7
Hong Kong, China	+32.6	+31.0	+33.9	+26.7
Italy	+1.8	+5.3	+7.6	+1.8
Japan	-4.3	-3.3	-1.1	-6.4
Netherlands	+1.8	+5.2	+7.6	+1.8
Spain	+7.5	+11.1	+13.6	+7.5
Switzerland	+1.4	+3.0	+5.3	-0.3
UK	+6.7	+6.7	+9.0	+3.2
USA	+7.1	+4.8	+7.1	+1.4
Europe ex UK	+3.0	+6.3	+8.7	+2.8
Asia Pacific ex Japan	+13.9	+15.8	+18.4	+12.0
Asia Pacific	+4.1	+5.7	+8.1	+8.1
Latin America	+14.8	+18.5	+21.2	+14.6
All World All Emerging	+15.4	+16.8	+19.4	+12.9
The World	+5.9	+6.3	+8.7	+2.9

Source FTS E World Indices

FT Government Securities Index All Stocks (total return) : +2.4%

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

Currency	31.07.07	31.10.07
Sterling	5.25	5.00
US Dollar	4.78	4.46
Yen	1.80	1.61
Germany (Euro)	4.32	4.29

Sterling's performance during the quarter ending 31.10.07 (%)

Currency	Quarter Ending 31.07.07
US Dollar	+2.2
Canadian Dollar	-9.1
Yen	-1.0
Euro	-3.3
Swiss Franc	-1.5

Other currency movements during the quarter ending 31.10.07 (%)

Other Currency	Quarter Ending 31.07.07
US Dollar/Canadian Dollar	-11.1
US Dollar/Yen	-3.2
US Dollar/Euro	-5.4
Swiss Franc/Euro	-1.8
Euro/Yen	+2.3

Significant Commodities (US dollar terms) 31.07.07 – 31.10.07 (%)

Significant Commodities	30.04.07 – 31.07.07
Oil	+18.0
Gold	+19.0

Markets

International equity markets have experienced a pleasing quarter. In local currency terms, the FTSE World Index has shown a total return of 5.9%, in sterling terms 6.3%, in US dollar terms 8.7% and in euro terms 2.9%. The only main exception to the positive numbers has been Japan where the FTSE Japanese Index returned -4.3% in local currency terms, -3.3% in sterling terms, -1.1% in US dollar terms and -6.4% in euro terms. Elsewhere, the main markets produced good local currency returns, as measured by the relevant FTSE World Index series. The USA returned 7.1%, the UK 6.7% and Europe ex UK 3.0%. Within Europe ex UK, Finland was a feature with a return of 18.3%, thanks to the strong performance of Nokia which dominates that market. Elsewhere, as so often is recent quarters, the star performers have been Australia, 11.9%, Asia Pacific ex Japan, 13.9%, Latin America 14.8%, and emerging markets, 15.4%. Despite the weakness of the US dollar, the US returned 4.8% in sterling terms, whilst the strength of the euro raised the Europe ex UK return to 6.3% in sterling terms. Continued strength in the Australian dollar raised the sterling return in that market to 18.4%, whilst the Asia Pacific ex Japan return rose to 15.8%, the Latin American return to 18.5% and the emerging markets return to 16.8%.

Bonds also showed a positive return as measured by the ten year government bond yields. The gross redemption yield on sterling bonds fell by 25 basis points to 5.00%, on US dollar bonds by 32 basis points to 4.46%, on yen bonds by 19 basis points to 1.61% and on euro denominated German government bonds by 3 basis points to 4.29%.

In currency markets, sterling rose by 2.2% against the US dollar but fell by 9.1% against the Canadian dollar, 1.0% against the yen, 3.3% against the euro and 1.5% against the Swiss Franc. The US dollar fell an astonishing 11.1% against the Canadian dollar.

In commodity markets, there was a big rise in oil and gold with respective rises of 18.0% and 19.0%.

Economics

- *The IMF downgrades 2008 growth forecast* ...... the world economy now forecasts growth of 4.8% compared with a previous forecast of 5.2% and against 5.2% this year. This is still a satisfactory rate of growth.
- *Asia continues to lead the way* ...... the IMF forecasts that developing Asia will grow 8.8% in 2008 compared with 2.2% for advanced economies.
- *Credit market turmoil affects world interest rates* ...... the US cuts interest rates twice whilst the ECB defers a rise and so possibly does the Bank of England.
- *Despite the credit market turmoil, equity markets hold up well* ...... growth will undoubtedly be affected by what has happened but, on the other side of the equation, interest rates will be lower than they would otherwise have been and the level of growth forecast by the IMF still means corporate earnings should be moving ahead in 2008.
- *But some countries continue to raise interest rates* ...... Sweden and Switzerland raise them because of fears about inflation.
- *The credit market problems are likely to continue with companies in the financial sector continuing to report losses* ...... although some of these are very large, it does not look as if any major international institution will be in trouble. In international terms, Northern Rock is very much a localised UK problem.
- *Sovereign Wealth Funds become an issue* ...... the huge surpluses being run up in the Middle East and China are looking for higher return investments. Over the long term, international equities should benefit at the expense of bonds but protectionist sentiment is a concern.
- *Despite strong economic growth, some countries have been running unacceptably large structural budget deficits* ...... if there is to be a slowdown, it will cause problems for countries such as the UK because the fiscal leeway available to take offsetting action will be non-existent.

USA

- *Third quarter growth has been strong* ...... the first estimate shows an annualised rate of 3.9% compared with 3.8% in the second quarter. Exports and consumer spending have been the catalyst.
- *The Federal Reserve cuts interest rates* ...... two cuts amounting to 0.75% had been taken as a result of credit market problems and the Federal now holds a neutral position.
- *The weak US dollar remains a talking point* ...... but US exports are benefiting strongly from its very competitive level. September showed a sixth consecutive month of rising exports and they reached a record level whilst imports fell. The current account deficit is shrinking, albeit it remains far too high.
- *Inflation is a little higher than the Federal Reserve would want* ...... but credit market problems neutralise this concern in the short term.
- *The housing market remains weak* ...... on almost every indicator the market is still weakening when, by now, it had been hoped that it would have stabilised.

China

- *Growth remains very rapid* ...... third quarter annualised growth was 11.5%.
- *The Chinese continue to tighten policy* ...... interest rates and bank reserve ratios continue to rise.

- *The Chinese trade surplus continues to grow* ...... for the first nine months of the year it was US$185.7 billion compared with US$177.5 billion for the whole of 2006.
- *Foreign exchange reserves continue to pile up* ...... they are up 45.1% in the first nine months of the year to US$1,430 billion.
- *China looks to raise the return on its reserves and allow individuals to invest overseas* ...... its Sovereign Wealth Fund could be huge and measures are being taken to allow individuals to invest overseas. This is a gradual measure.

Japan

- *The carry trade still seems to be evident* ...... although some of it was unwound in the August credit market turmoil, evidence is strong that it continues and the yen remains undervalued because of its low interest rates.
- *The Bank of Japan would like to follow a more normal monetary policy* ...... but it gets no help from inflation on this score. Consumer prices were down 0.2% year on year and core prices were down 0.1%.
- *The yen is extremely competitive* ...... the Japanese trade surplus is rising rapidly. It was at a record high level in September and was up 63% on a year earlier. Asian exports help.

Europe Ex UK

- *The ECB would have raised interest rates had it not been for credit market problems* ...... October's consumer price index rose 2.6% compared with 2.1% in September, way above its upper limit. Further interest rate increases must be expected as soon as the ECB feels able to do so.
- *The euro's strength against the dollar is increasingly unhelpful* .... manufacturers complain about the effect of competitiveness and it is likely to slow down growth.
- *Germany moves to undo some of the last government's labour market reforms* ...... surprisingly, in view of the current success of the Germany economy, some of which is attributed to these reforms, politicians in both main parties seem to bow to anti reform feeling. Four economic institutes regard the proposed policy as "absurd".
- *In France, President Sarkozy faces trade union opposition to his reforms* ...... this was always likely to happen. He has a strong mandate and he will not have a better time to proceed with them. Meanwhile, there will be more industrial trouble.

United Kingdom

- *The government reduces its forecast for next year's growth* ...... it now expects economic growth of 2.0% to 2.25% instead of 2.5% to 3.0%.
- *Public finances continue to deteriorate* ...... public borrowing is now forecast to be £36 billion in 2008/9 compared with an earlier forecast to £29 billion.
- *Public finances are a concern* ...... the Treasury has consistently underestimated borrowing forecasts. The UK is running a significant structural deficit at a time of strong growth and is particularly vulnerable to weakness in the financial sector. There is no leeway for fiscal reflation should the economy hit bad times.
- *First estimate of third quarter economic growth is good* ...... the estimate is 0.8% to give an annualised growth rate of 3.3% with business services and finance the catalyst. These figures are historical and times will get more

difficult.

- *The housing market looks to be weakening* …… evidence from most house price indices and from house lenders suggest this although the evidence is not all one way.
- *The Bank of England will remain concerned about inflation* …… it could obviously not raise interest rates in the current environment but although the CPI is below target, there are inflationary pressures in the pipeline.

Summary

- *The credit market turmoil is obviously significant* …… it will affect economic growth but there should be offsetting interest rate implications, and China and India remain significant catalysts to economic growth, with the USA being less important, but still very important in its own right, than before.
- *If the IMF's forecasts for 2008 are in the correct area, corporate earnings should continue to grow* …… growth will vary between sectors, but with shares reasonably rated, we do not think that significant liquidity should be introduced. The opportunity cost is something that long term investors should consider carefully if they are out of the market.
- *There will, however, be more bad news in the financial sector* …… investors have to look ahead and see what the authorities' reaction will be. Interest rates will be the main weapon to offset any significant prospect of economic downturn.

The quarter has been dominated by the problems in the international credit market caused by the US sub-prime lending problems. We sent out a note to clients on the 17th August regarding the situation and our conclusions remain as stated at that time.

Stock markets do not like uncertainty and the way in which these loans found their way onto banks' books around the world was unsettling because it was not certain where they would turn up next. In the old days, a bank would make a loan and it would stay on its books, so the problems could be isolated and known as far as investors are concerned. Nowadays, loans and other receivables are packaged up and sold on in the form of asset backed securities and could end up anywhere. We have seen high profile casualties in the banking and hedge fund markets but, so far, no really major player and it is likely that the situation can be contained even though some banks have taken major losses. Investment is like a game of chess because investors should be looking ahead to the next stage of the game. If the world economy does get into trouble because of the sub-prime loan situation, central banks, in particular, will act to try to alleviate the situation by lowering interest rates and, so far, we have seen two cuts amounting to 0.75% by the Federal Reserve. We have also seen action in the money markets to try to relieve a seizing up of markets as banks were initially unwilling to lend to each other. Although the situation is still very difficult, the mechanism by which central banks provide funds to the market one way or the other seems to be working. As we said in our note on the 17th August, it has never been our policy to invest in the type of securities where problems have emerged and our indirect exposure would be through holdings in the financial sector where it is our policy to stay with high quality names although, obviously, some of those have taken losses.

There will obviously be macro economic effects from the fallout from the US sub- prime crisis. Credit will become more difficult as banks tighten up lending criteria and, although stock markets have performed relatively well, there will be negative wealth effects in certain areas. The City of London is a case in point. The demand for highly paid financial personnel will be lower than it would otherwise have been and this will have a multiplier effect in the housing market and on those businesses which provide services to these people or their companies. The government will also suffer because tax revenues will be less than they would otherwise have been and the

UK is particularly vulnerable in this respect because of the importance of financial services.

Takeover activity, a support for markets in recent times, will also be more subdued. It will be more difficult for private equity vehicles to raise finance for takeover bids but those takeovers with solid commercial reasons will still proceed. Although companies are generally in a very strong financial position, many will feel more cautious about buying back their shares, also an important source of support for markets in recent times. Nevertheless, holders of equities should, in our view, hold their nerve for reasons we outlined in the 17th August note. The world economy is likely to continue to grow and this will provide a support for share prices as profits and dividends rise. This will be at a lower pace than recently but the figures should still be positive and, in our view, share prices are not expensive at present. Earnings yields in most markets are well above bond yields and, unless one sees a major fall in profits, which we do not at present, we do not think markets look overstretched. Although this bull market has longevity, having been going for nearly five years, corporate earnings have been very strong, so much so that, in some cases, shares are more lowly rated than they were at the start of this market recovery. Companies remain very shareholder conscious both in regard to their dividend policy and other means of adding value for shareholders, like share buy backs. Then, of course, there is China and India and much of the rest of Asia, the economic drivers for international growth. They have been relatively unaffected by the sub-prime crisis and remain on a very strong growth path which is providing impetus to the world economy. It is, therefore, less important what happens in the USA than before, although, of course, in absolute terms, the USA remains very important as the world's largest economy. Although growth is likely to be more subdued than would have been the case had there not been a sub-prime crisis, the International Monetary Fund in its latest forecast is still fairly sanguine about growth prospects for next year, as the following abridged table shows:

Latest IMF Forecasts for Economic Growth (Real GDP) %

World	2007	2008
World	5.2	4.8
Advanced economies	2.5	2.2
USA	1.9	1.9
Euro area	2.5	2.1
Other advanced economies (ex USA, euro area and Japan)	3.7	3.1
UK	3.1	2.3
Developing Asia	9.8	8.8

Source: International Monetary Fund

World economic growth is expected to slow down from 5.2% this year to 4.8% next year, still a satisfactory rate, and the breakdown of the advanced economies still shows reasonable growth but, at the bottom, developing Asia, although expected to slow down slightly, is still forecast to grow by 8.8% in 2008, a very significant figure.

We have mentioned the response by central banks in terms of interest rate policy. The US Federal Reserve has a very wide remit and has shown itself prepared to act quickly in response to changing circumstances. Thus, it moved its concern about inflation to the effect on growth from the turmoil in credit markets and was prepared to act quickly. But no other central bank has acted this way. Inflationary pressures are never far away with the oil price rise that we have seen recently and it has, of course, been very strong in this latest quarter, albeit that the effect has been reduced in non dollar terms by the weakness of the dollar. Other countries, such as Switzerland, Sweden and Australia, have raised their interest rates during the last quarter in response to concerns about inflation so the pattern overall is mixed. In the eurozone and, possibly also the UK, the effect of the problems in international credit markets could have been to postpone interest rate rises so that they are currently lower than they would otherwise have been. But as we have mentioned above, two of the non eurozone European countries, Sweden and Switzerland, have been prepared to raise interest rates. Whether the rise in the oil price is due to a shortage of supply, not being able to meet increased demand or speculation, is difficult to tell. Certainly, some people in the industry blame speculators for the rising price. The world economy has coped well so far and, as we have mentioned before, a rise in the price of oil is far less damaging if it is accompanied by economic growth rather than if there is a supply shock which is much more difficult to deal with. Although oil is approaching an all time high in real terms now, following the recent rise, it is a much less important input to GDP than it was in previous oil crises. So, whilst there is absolutely no reason to be complacent about what is happening in the oil market, it appears to be manageable at the moment, although one would think that it is bound to have some effect on growth. From the 1st November, OPEC is pumping 500,000 barrels a day more for the market.

One of the most important economic developments, which is clear to everyone, is that economic power is shifting eastwards, whether it is to the Middle East, because of many countries' oil wealth there, or to India and China because of their remarkable economic growth or, indeed, to many other Asian countries which are performing well. The wealth may have arisen from natural resources, such as oil in the Middle East, or from very competitive exports, such as in the case of China, which has resulted in a large build up of foreign exchange reserves. Other countries, like Norway, with its enormous energy wealth, is also a case in point. These countries have developed enormous Sovereign Wealth Funds which are increasing as a result of very large trade surpluses and they are looking to invest, at least a part of their wealth, in assets which are likely to provide a better return than cash, treasury bills or treasury bonds. Equities, private equity and property are obvious areas and we have already seen some of this wealth deployed, but only a tiny portion. It is interesting that whenever the market has fallen over the last two or three months, it has usually bounced back quite quickly and it is possible that there has been an accumulation of shares by some of these funds.

Unfortunately, the Sovereign Wealth Funds bring out some of the worst aspects of politicians in certain countries as they become protectionist. Whilst there may be a case for having a level of protection for a few strategically important companies, it cannot be sensible to deny these funds the opportunity to invest in companies which are non strategic. The USA and some European countries, like Germany, are the culprits here. But, assuming that protectionism does not get out of hand, in the case of Sovereign Wealth Funds, their influence can be expected to benefit equities, at the expense of bonds as they look for higher returns on part of their funds. We are talking about very substantial figures which will grow over time and it is a development which equity investors should be aware of. At a time when companies have been buying back shares quite aggressively, although this has slowed down of late for obvious reasons, the shrinkage of supply plus this potential increasing demand is a factor which is likely to support equities particularly when they do not look highly rated, as they do not at present.

We might mention at this stage, one other possible development, which we touched on above in the UK, concerning a slowdown in the world economy caused by recent events in the credit market. During a period of fairly strong economic growth, such as we have witnessed for some time, a sensible fiscal policy would be to improve the budgetary position of a country, at least to balancing the budget and, if possible, to run a surplus so that there was a cushion allowing for fiscal stabilisation if economic growth were to slow down and it was necessary to provide some fiscal stimulus. Unfortunately, a number of important countries, including the USA (only to some extent as the situation has improved considerably), the UK and, in Europe, France and Germany, for instance, have been running structural deficits during this period of growth and they will be particularly vulnerable to any slowdown. We will particularly talk about this in the UK section where the situation appears difficult.

We turn now to look at individual areas of the world, starting with the United States.

The first estimate of US economic growth for the third quarter showed the economy growing at an annualised rate of 3.9%, compared with 3.8% in the second quarter. If this figure is confirmed by later estimates, it will be the fastest quarter of growth since the beginning of 2006. Positive catalysts for this strong figure were consumer spending and exports. It is paradoxical that this strong figure should occur in a quarter which has seen the problems in the credit markets becoming apparent and it may, of course, affect later growth rates but the figure is nevertheless striking. During the quarter, we have had two interest rate reductions in the USA, the most recent one on 31 October when the Federal Reserve cut interest rates by 0.25% to 4.5%. It was a difficult decision for the Federal Reserve to make and there must have been a great deal of discussion on both sides of the argument but, at the end of the day, the Federal Reserve wants to protect economic growth in the USA. It had shifted to a neutral stance on interest rates and the statement that "the upside risks to inflation roughly balance with the downside risks to growth" sums up the situation well. The Federal Reserve must have had difficulty in seeing its way forward clearly for the US economy. The statement was very much a balance of both sides of issue. This second rate cut "should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time". It acknowledged that growth would slow in the near term because of what had happened and its statement on inflation was balanced. It noted that readings on "core inflation have improved modestly ...... recent increases in energy and commodity prices" may put "renewed upward pressure on inflation". So the Federal Reserve is keeping all options open which must be sensible in the present situation. There was one dissenter at the October meeting and the vote in September was not clear cut. At that meeting, the Federal Funds target rate was cut by 0.5% to 4.75% with seven banks in favour of a 0.5% decrease, four banks seeking a 0.25% decrease and one not wanting an interest rate change at all. This is symptomatic of the difficulty of reading the situation which had blown up very suddenly. One source of guidance for the Federal Reserve is the Beige Book which reports on business conditions in the different Federal Reserve regions. Its reading for August was that the US economy was still growing but, in five of the regions, the rate of increase had decelerated.

We touched upon the twin deficits briefly in our earlier discussion. The US federal budget deficit has been falling steadily, as it should during a period of strong economic growth and, for the year to the end of September, it reached its lowest level for five years, US$162.8 billion. At least the trend has been moving in the right direction although, ideally, it would be moving into surplus because budgetary positions will become more difficult in the future. But it is better than in some other countries. The US dollar, of course, has been the focus of much attention as it has continued to weaken during the quarter. But economists recognise the "J curve" principle which reflects the fact that, after a devaluation, the trade deficit will worsen as imports become more expensive and exports have not had time to react to their more competitive situation. After a while, more expensive imports are displaced and cheap exports are in greater demand leading to an improvement in the trade balance. That is a very simplistic description of what happens because, in the USA, as in much of the industrialised world, manufacturing ability in low value added products has gone so price changes will not be effective. But we note that, in September, exports rose for a sixth consecutive month to a record US$138.3 million whilst imports fell to US$195.9 billion resulting in a non oil trade gap of US$40.2 billion which is the lowest level since 2004.

In terms of inflation, there was a 1.1% rise in US producer prices in September as energy prices rose. Core producer prices rose by just 0.1%, following a 0.2% rise the previous month. Year on year, core producer prices were up by 2.0%. The headline inflation rate rose to a six month high of 2.8% in September as food and petrol prices rose. The core annual rate was 2.1%. Housing is obviously the key to the US economy in the short term and the news has generally been poor. Earlier in the year, one had hoped for some stabilisation at this stage but it has not yet occurred. The Commerce Department reported that construction of new homes fell by 10.2% in September, which is the slowest pace of US building in more than fourteen years. Building permits fell by 7.3%, the sharpest drop since 1995. The National Association of Realtors said that sales of existing homes fell by 8% in September to an annual level of 5 million and they said that this sales fall was the largest since records began. Sales of new homes in September were nearly 25% lower than the same time last year. But, in September, new home sales rose by 4.8% and the backlog of homes for sale fell to 8.3 months supply with the median house price posting a 5% rise as against last year. These figures are an exception to the trend reported. Sales of US single family homes fell in August and, according to the Standard and Poors / Case-Schiller national home price index covering ten US metropolitan areas, they were 5% lower than a year earlier.

The US economy, therefore, provides a mixed picture. Historical growth figures for the third quarter are good but the effect of problems in the financial markets has yet to occur. The housing market remains a drag on the economy but other sectors, such as exports, remain on a firm trend. Large US companies, in particular, which derive a significant proportion of their business overseas, are benefiting not only from the competitive rate of the dollar but faster growth rates overseas and profits in these companies are still moving ahead. It is easy to be bearish on the US economy but it is still growing and there are still world class companies that are reasonably valued and many US companies are benefiting strongly from the level of the dollar which should have some reflection in their share prices.

As we see from the table at the beginning, in a generally satisfactory time for international equity markets, Japan has been the one that has under-performed. It is difficult to relate this directly to the economic situation in Japan, which, although obviously not perfect, is certainly not bad. Overseas investments seem more attractive to the Japanese and the "carry trade" still has some resonance, notwithstanding the problems in the credit markets, although we still regard this as a high risk strategy.

The reason why the yen is used for carry trade purposes is the very low interest rates that still exist in Japan. The Bank of Japan would like to pursue a normal monetary policy but is getting no help from inflation on this score which, despite the weakness of the yen, remains stubbornly in flat or negative territory. Consumer prices in September were down 0.2% year on year with "core" prices, excluding fresh food, down by 0.1%. The latest data from Tokyo show flat inflation compared with -0.1% in September. A further technical problem on inflation might arise from a price war in the mobile phone market which, depending upon how prices are treated by Japanese statisticians, could cause the consumer price index to fall. In maintaining interest rates at 0.5%, the Bank of Japan gave warning about global risks and cut its forecast for growth and inflation so that it is very difficult to see how it can raise interest rates to more normal levels in the near future and this may keep the yen weak. But a weak yen has not caused inflationary problems in Japan as it might have been expected to do, so it creates a real dilemma for the Bank of Japan. Meanwhile, Japan continues to run a very large current account surplus which might, in normal circumstances, be expected to give some support to the currency. As a result of the weak yen, Japanese exporters remain fiercely competitive. This is evidenced by the latest figures for the Japanese trade surplus which moved to a record high level in September even though there was a sharp fall off in exports to the United States. Compared with the year earlier, the trade surplus rose by 63% to the equivalent of US$14 billion. In value terms, they rose by 6.5% although, to the USA they fell by 9.2%. The profile of Japanese exports has been moving more towards Asia and the strength of that region, especially Japan, is an important source of support for Japanese exports. In the third quarter of this year to the end of September, total Japanese exports rose by 10.3% and, in September, exports to China were up by 16.5% and Asia as a whole by 8.3%. European exports were also buoyant. So the Japanese economy will be better insulated that in the past from any slowdown in the US economy.

Short term economic news has been slightly negative for Japan, although the latest Japanese Tankan business survey showed an unchanged diffusion index over the last quarter. The decline in industrial production in September was not unexpected given that there was a strong rise in August following previous disruptions by typhoons and the earthquake. Unemployment in September rose by 0.2% to 4.0% with a very slight decline in the ratio of available jobs to applicants. However, the figures are not greatly off the low of 3.6% recorded in July. One positive feature was quite a strong rise in average household expenditures in September which were 3.2% higher than a year earlier. One might have expected quite strong growth in consumer spending because of the relatively low level of unemployment but household income has been very subdued.

It is true that political problems in Japan have not been helpful with the opposition controlling the upper house. But one should not give up on the Japanese market. Investors can become disillusioned by markets which underperform but there are enough positive features in Japan, including its increasingly positive export profile, and very competitive exports which should attract the attention of contrary thinking investors and its remains a modest part of our international portfolio.

We turn now to look at the eurozone where policymakers have difficult decisions to make in terms of interest rates. The problems in the international credit markets have stayed the hand of the ECB in raising interest rates as was almost certainly its original intention because it wished to see how the situation would turn out. The ECB is focused on inflation rather than being able to take a wider view of an economy, such as the Federal Reserve, and it will be disturbed by the latest inflation figures which show October's CPI rising to 2.6% compared with 2.1% in September and way above the upper limit of close to 2%. In normal circumstances, that would have prompted an interest rate rise and possibly a series of them but the ECB also has to be sensitive to conditions in the credit markets and, further along the line, the high value of the euro against the dollar is going to make life more difficult for eurozone exporters. At some stage, that should reflect itself in the value of the euro relative to the US dollar because, as we have seen, US exports are now responding strongly to the very competitive level of the US dollar. The recent rise in the value of the euro itself involves economic tightening which should have some effect on inflation, in the same way as a rise in interest rates might do. The ECB is keeping its options open and not signalling its future intentions, as it had done in the past. In October, the Chairman of the euro group of finance ministers warned about the effects of the euro's strength as he said that "it is possible that there will be slower growth in 2008 in the eurozone", as he blamed "the historically high foreign exchange rate of the euro in relation to other currencies, the dollar, the yuan and the yen".

At the moment, the effect on industrial production and exports has not really been felt but there are always lags and we can expect to see the opposite effect of the "J curve" that we talked about in relation to US exports following the weakness in the US dollar. In August, eurozone industrial production rose by 1.2%, to give a figure 4.3% higher than the previous year. Germany led the way in August with a 1.7% rise in production. Eurozone exports in August rose by 4.9% compared with a fall of 1.0% in July.

On the other hand, there is some sign of weaknesses in the services sector with the purchasing manager's index of eurozone services falling to 54.2 in September from 58.0 in August. In this case, Germany is being hit particularly hard. A further straw in the wind, arising from the problems in the international credit markets, is that the ECB reported a very sharp slowdown in demand for loans to business and a significant toughening of credit standards applied by banks. More banks reported falling than rising net demand for house loans. Certain of the housing markets in the eurozone, Spain and Ireland, for example, have shown particularly fast rises in the past and there is a risk of a sharp fall as a result.

So, overall, there is a mixed picture of the eurozone. It seems to be doing quite well at the moment but the lagged effects of the euro's strength against the dollar have yet to be felt on the manufacturing side. Tougher bank lending conditions following upon some very sharp rises in property prices do offer the risk of a sharp slowdown which could have economic effects in those countries particularly affected. A slowdown in eurozone growth is likely to mean interest rates lower than they would otherwise have been but, at this stage, it still looks likely that further interest rate increases will be made by the ECB as soon as it safely feels it can do that. A slowdown in the rate of growth relative to the USA which is likely to happen at some stage will also probably mean a reversal of currency movements.

Looking at Germany, there have been disturbing developments over the last month or so resulting from domestic political considerations. The SPD, which has been suffering a sharp fall in its ratings, has moved sharply leftwards and the Christian Democrats appear to be following suit on the back of anti-reform feeling. The German economy has performed very well recently and the labour market reforms of the previous government have been given credit for at least some of this performance. Now, in moves that the leading German economic institutes describe as "absurd", the coalition seems to be moving towards undoing some of the reforms. The four institutes say plans to create sectoral minimum wages and increase unemployment benefits for older workers would result in higher unemployment. Business organisations are also very exercised by the government's plans for an inter-ministerial caucus to vet investments by foreign state controlled investors. One is beginning to get the feeling that the reforms introduced so painfully by the previous government were only agreed because there was no option but, as soon as things get better, there are moves to reverse the trend. Admittedly, this has something to do with the state of German domestic politics but it is nevertheless very disappointing from an economic point of view given that, if carried out, these moves are likely to damage economic prospects.

In the short term, there has still been some good news from Germany despite the government reducing the economic growth forecast for next year from 2.4% to 2.0%, although it has raised slightly the forecast for this year from 2.3% to 2.4%. A strong euro and high oil prices have caused this revision. One good piece of news, however, is that the Bundesbank has raised its estimate of the long term economic potential growth rate of the economy consistent with stable inflation. It has raised its estimate from 1.5% to 1.75%. In economic policy terms, if it were to affect Germany only, it would mean that the central bank could be more sanguine about growth prospects before it felt it necessary to raise interest rates to dampen down inflationary prospects. Even in the eurozone, because Germany is the largest economy, it may have some effect on the ECB's thinking on interest rates in the long term.

In items of individual news, the ZEW Institute reported that its economic sentiment indicator was unchanged in October. That might be slightly surprising in view of the problems of the credit market but it seems to suggest that, up until now at any rate, it will not have a significant effect. The Ifo Institute's business climate index only fell marginally in October from 104.2 in September to 103.9. The Ifo President described the reading as "a continuation of the upswing, although with decreased dynamism". Unemployment continues to trend downward. The seasonally adjusted unemployment fell by 40,000 to 3.657 million in October to give a jobless rate of 8.7% compared with 8.8% in September. This is the lowest figure since May 1993.

In France, we are now starting to see trade union reaction against the proposed economic reforms of President Sarkozy with significant industrial trouble in the public sector in October which threatens to be repeated in November. It will be a big determination of the President's will to proceed with his reforms. He will never have a better mandate because, as time goes on, it will be more difficult to revive the momentum of a recent electoral victory and public support for his reforms seems to be quite strong.

Prospects for the UK have taken a turn for the worse and long standing concerns about the state of public finances have been heightened as a result of the problems in financial markets which will have an impact on the UK given the importance of the finance sector. The Treasury's search for money to fill the gap in public finances has led to some controversial decisions. The proposals to have a flat rate of capital gains tax at 18%, ostensibly in response to the low rate of tax paid by private equity owners, did in fact lead to measures which were expected to raise an additional £900 million. Similarly, it was announced that the upper ceiling on national insurance contributions would be raised by 15%, effectively a tax increase.

It seems to us that the main problem for the UK economy revolves around the poor state of public finances. This is not unique to the UK but it is accepted by economists that a strong period of economic growth should be used to strengthen public finances perhaps by running a budget surplus so that, when times become more difficult, as they inevitably do, fiscal policy can be used to offset economic weakness. There is a significant structural element in the UK's budget deficit and there is no room for fiscal policy to be used to offset more difficult times which appear to be facing the UK economy. The rapid expansion of public expenditure will be difficult to moderate, even though that it what the government is attempting to do. Budget deficits are the difference between two very large numbers, income and expenditure. Expenditure will be difficult to control whilst government revenue could be badly affected by weakness in financial sector profits or by the loss of tax from those in the City affected by financial markets' problems. Hence, every single source of additional revenue is being examined but this will not be enough to plug the hole in government finances and very hard decisions will have to be made. The Treasury has consistently underestimated the level of borrowing and this looks likely to continue. The pre budget report indicates the additional borrowing expected this year compared with what was previously forecast. Public borrowing is now forecast to be £36 billion in 2008 / 9 compared with an earlier forecast of £29 billion, with 2008 economic growth now expected to be 2.0% - 2.25% instead of 2.5% - 3.0%.

The immediate news from the UK economy has been good with the first estimate of third quarter growth being 0.8% compared with the previous quarter, to give an annualised growth rate of 3.3%. Catalysts for growth were business services and finance which grew at 1.7% and this more than offset slower growth in manufacturing production, weaker agricultural output and a flat contribution from the public sector. However, this is backward looking information and perhaps the most relevant sector to look at for an indication of how things may go in the short to medium term, is the housing sector where, although the information is mixed, there are clear signs that it is weakening and, because of the importance of the housing sector to the UK economy, it could cause serious problems if it really turns sour. This was underlined by a warning from the IMF which said that the UK is amongst the countries most at risk of a steep housing downturn with property even more overvalued than it was in the USA before the recent downturn. According to the IMF, the most vulnerable markets are those where a surge in house prices was less easily explained by factors such as income growth, interest rates and demographics. To quote, "if you look at the price to rent ratios or price to disposal income ratios, these have increased significantly more in the UK and some other European markets than in the USA".

Until the problems in the credit markets, it was thought quite likely that the Bank of England would raise interest rates beyond 5.75% because of its concern about inflationary pressures. Whilst it was not as strong a probability that it would do this as in the case of the ECB, its hand has been stayed by the problems in the financial markets. One of the factors it will be looking at is the trend in the housing market which, as indicated above, is very important for the UK economy. According to the Halifax, the average house price fell by 0.6% in September compared with the downwardly revised 0.3% gain in August. According to Halifax, annual house price inflation was 10.7% in September, down from 11.4% in August. A quarterly measure of growth fell from 2.3% in the second quarter to 0.9% in the past three months. The RICS said that 15% more of its members reported house price declines in September than increases, which suggested that prices were falling at their fastest rate since 2005. According to the Financial Times house price index, prices in England and Wales grew by 0.3% in September compared with 0.4% in August, with the annual growth rate falling to 8.8% in September from 9.4% in August. According to the Financial Times survey, house prices have risen by 2.5% in the last six months compared with more than 5% in the previous six months. The property website, Rightmove, reported a 2.7% rise in September. Its measure of annual house price inflation was 10.4% in September compared with 9.6% in August. Its three month growth rate fell to 0.5% for the quarter to early October compared with 1.5% in the previous three month period. The Land Registry reported that house prices in England and Wales rose by 0.4% in September and by 8.7% year on year. Figures for August were 0.2% and 9.4% respectively. But, going against the trend, Nationwide reported that house prices in October were up 1.1% and, over the year to October, were up 9.7% compared with 9.0% in September. This measure does seem to go against the trend which suggests some cooling off in the markets. The Council of Mortgage Lenders said, in October, that loans for house purchase fell by 11% in August compared with a year ago. It also reported that gross mortgage lending in September amounted to £30 billion, down from £34 billion in August. The year on year rise in lending was just 2.5%, which was the lowest figure since August 2005. The British Bankers Association reported that the number of mortgage approvals for home purchases fell by 27% in September, compared with a year earlier, with the value being down by 21%. This is the fourth consecutive monthly fall. The Council of Mortgage Lenders also forecast that the level of house sales will fall 15% next year with house prices remaining almost flat. The Bank of England has reported that the number of mortgages approved but still to be taken up fell in September to 102,000, against 108,000 in August, and by nearly 20%

from a year earlier. Net mortgage lending showed the biggest gain for February, rising by £9.8 billion. So, from all these various statistics, there is strong evidence of a slowdown, although the Nationwide figures are an exception. If it were to turn into major weakness, the effect on the UK economy would be significant. A negative wealth effect would affect consumer spending and the implications for government finances would be poor.

The inflation picture is something that the Bank of England will be watching closely as it has expressed its unease before. Manufacturers' input costs rose by 3.2% in September with the annual rate rising to 6.4%. Output inflation rose by just 0.1% in September with the annual rate rising to 2.7%. Rising energy costs will be an important factor in these costs and the figures are beginning to look a little uncomfortable. The ONS reported that the consumer price index rose by 0.1% in September to give an annual rate of 1.8%, the third consecutive month it has been at this level. Core inflation, excluding food, energy and tobacco, fell to an annual rate of 1.5% in September. The former measure, the Retail Price Index, fell from 4.1% in August to 3.9% in September, whilst RPIX was at 2.8% in September compared with 2.7% in August. For many people, the latter two measures are more relevant to their own rate of inflation. Average earnings in September, including bonuses, rose by 0.2% to 3.7%. Overall, these figures do not look immediately serious, but inflationary pressures remain, with food and energy being the obvious ones and it cannot be assumed that the Bank of England will not raise interest rates further if the financial background is more accommodating and it remains concerned about inflation.

The issues with China remain much the same as before. The Chinese authorities remained concerned about the rapid rate of growth of the economy and inflation. While China needs to grow rapidly to absorb people coming in from rural areas, it has also to be aware about inflationary pressures. In the light of third quarter economic growth of an annualised 11.5%, the Chinese authorities continue to make it clear that they will continue to tighten monetary policy externally. Other countries continue to remain concerned about China's trade surplus and lack of significant appreciation in its currency. For the first nine months of the year, the Chinese trade surplus was US$185.7 billion, compared with US$177.5 billion for the whole of 2006. Foreign exchange reserves have risen by 45.1% in the first nine months of the year to US$1,430 billion. China plans to try to raise the rate of return on its reserves, as we mentioned earlier, through its new sovereign wealth fund whilst it is also making it easier for individual investors invest overseas. However, sovereign wealth funds have created alarm in some overseas countries, as we mentioned earlier, but, as we have also mentioned before, it is not sensible to press the Chinese too hard because they do have weapons at their disposal which could cause other countries significant problems, for example, by rearranging their reserves. China remains a vital catalyst for world growth, especially if the United States slows down and its influence becomes ever greater directly and indirectly on stock markets.

Elsewhere, Australia, which has been a very successful investment area, faces a general election in November with a possibility of a change in government. Australia has enjoyed a period of remarkable economic success with an economic position that other countries can only envy. Should the opposition win, it has promised to undo some of the present government's labour market reforms and, as we have mentioned in the context of Germany, this could cause some economic difficulties later on, especially in a country like Australia which effectively has full employment.

The stock market situation is inevitably dominated by the problems in the credit markets which arose in the summer and continue to rumble on with some very high profile casualties. It will make markets continue to be volatile but it does seem that any setback is met with buying as shares soon recover. It is not inevitable that this will continue but we remain comforted by the reasonable valuations upon which shares are selling and the fact that economic growth next year, absent something really disastrous, should be supportive of share prices as earnings continue to rise, albeit more slowly than they have done. Bonds remain threatened by inflation and we think the absolute levels of yields is too low. After a long string of mainly positive returns each quarter, it is inevitable that we will have one or two negative quarters. As always, we believe that, unless the economic outlook looks so bad that it is necessary to raise significant amounts of liquidity, we think it safer to remain invested in order not to suffer an opportunity cost if markets continue to rise. If they do, and a portfolio has significant liquidity, then the loss of profit cannot be recovered.