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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equity markets have moved modestly higher during the quarter, except for euro denominated portfolios, where at least a temporary recovery in the currency has affected the return on non euro denominated assets. Whilst the eurozone crisis continues there has been no surprisingly bad news and the ECB's announcement of its proposed Outright Monetary Transactions, although not yet effective, was helpful to market sentiment. In the high quality sovereign bond markets, except to Japan, yields on ten year government bonds drifted higher. Sterling strengthened against most major currencies except the euro and the Swiss Franc, whilst, in commodity markets, taking into account the US dollar's weakness, there was little change in gold or the oil price, as measured by Brent crude.

The tables below detail relevant movements in markets:

International Equities 31.07.12 - 31.10.12

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+7.2	+2.8	+5.7	+0.4
Finland	+7.3	+9.8	+12.9	+7.3
France	+5.0	+7.4	+10.4	+5.0
Germany	+7.1	+9.6	+12.7	+7.1
Hong Kong, China	+11.1	+8.1	+11.1	+5.6
Italy	+11.8	+14.4	+17.6	+11.8
Japan	+2.1	-3.0	-0.3	-5.2
Netherlands	+2.0	+4.3	+7.3	+2.0
Spain	+17.5	+20.3	+23.7	+17.5
Switzerland	+3.2	+5.2	+8.1	+2.8
UK	+3.8	+3.8	+6.7	+1.4
USA	+3.0	+0.2	+3.0	-2.1
Europe ex UK	+5.6	+7.7	+10.7	+5.3
Asia Pacific ex Japan	+4.7	+2.9	+5.8	+0.5
Asia Pacific	+3.6	+0.5	+3.3	-1.8
Latin America	+2.1	+0.2	+3.0	-2.1
All World All Emerging	+4.8	+2.5	+5.4	+0.2
The World	+3.8	+1.9	+4.8	-0.4

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -1.5%

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

Currency	31.07.12	31.10.12
Sterling	1.47	1.84
US Dollar	1.49	1.70
Yen	0.80	0.78
Germany (Euro)	1.30	1.47

Sterling's performance during the quarter ending 31.10.12 (%)

Currency	Quarter Ending 31.10.12
US Dollar	+3.0
Canadian Dollar	+2.7
Yen	+5.2
Euro	-2.3
Swiss Franc	-1.8
Australian dollar	+3.7

Other currency movements during the quarter ending 31.10.12 (%)

Currency	Quarter Ending 31.10.12
US Dollar/Canadian Dollar	-0.3
US Dollar/Yen	+2.2
US Dollar/Euro	-5.1
Swiss Franc/Euro	-0.5
Euro/Yen	+7.7

Significant Commodities (US dollar terms) 31.07.12 - 31.10.12 (%)

Currency	Quarter Ending 31.10.12
Oil	+3.6
Gold	+5.5

Markets

International equity markets generally drifted higher during the quarter, consolidating the modest improvement noted so far this year. In local currency total return terms, the FTSE World Index returned 3.8%, in sterling terms 1.9%, in US dollar terms 4.8%, but in euro terms -0.4%, reflecting the euro's recovery during the quarter. Looking at local currency movements first, we note that, as measured by the relevant FTSE index, the best major region was Europe ex UK which returned 5.6%. Australia was also a good performer returning 7.2%. Within the Europe ex UK section, it is interesting to note the strong recoveries of the Italian and Spanish markets with respective returns of 11.8% and 17.5% respectively. Quite large currency movements over the quarter changed the sterling based returns substantially in some cases. Europe ex UK performed well above average, returning 7.7%, but Japan moved into negative territory, -3.0%, and the USA barely scraped into positive territory, returning just 0.2%. The weakness of the Australian dollar pulled the sterling return down to 2.8%. The UK performed slightly better than average, returning 3.8%.

In the high quality sovereign bond markets, ten year benchmark government bond yields rose quite sharply, except in Japan, where the gross redemption yield fell by 2 basis points to 0.78%. In the UK government bond market, the yield rose by 37 basis points to 1.84%, the US Treasury bond by 21 basis points to 1.70% and the German Bund by 17 basis points to 1.47%.

In the currency market, the euro made at least a temporary recovery. Against the euro, the pound fell by 2.3% and against the Swiss Franc by 1.8%, but against the yen it rose by 5.2%, against the Australian dollar by 3.7%, against the US dollar by 3.0% and against the Canadian dollar by 2.7%. In the commodity markets, oil rose by 3.6% and gold by 5.5%.

Economics

The background remains difficult and the reasons are the same as they have been for a long time. A dysfunctional monetary union continues to bring economic misery to southern eurozone countries, whilst the UK continues to grapple with its public finances. In the USA, the approaching "fiscal cliff" is causing concern because it is far from certain whether agreement can be reached on measures to tackle the large US budget deficit, whilst China, an engine of international economic growth, has been slowing down. There are, however, flickers of hope. The USA is showing modest growth, there are some signs of life in the UK economy and China may have turned the corner. These are only straws in the wind but temper the overall feeling of pessimism. Deleveraging by governments and individuals exerts a brake on growth and this deleveraging has a long way to go before public and/or private debt is brought down to sustainable levels.

Nevertheless, stock markets have held up well in the face of this unpromising economic background and, so far this year, have turned in a positive performance. In our view, the reason is the one that we have previously given, namely very loose standard and non standard monetary policy which is raising some asset prices including shares, bonds and commodities. Very low interest rates increase the attractions of assets which provide a higher yield, subject to the asset quality being satisfactory, whilst newly created money should drive up asset prices. There are enormous risks with this very loose monetary policy, which is being followed in many countries but, for now, it is helping to do the job required. Higher asset prices have the result, or so it is hoped, of creating a positive wealth effect which will encourage individuals and businesses to spend and so kick start economies. It is highly likely that monetary policy, at least in the USA, UK and eurozone, will be very accommodative for the foreseeable future and this gives encouragement to equity investors when, at other times, they might be very cautious, given the economic background. Whilst equities do not look expensive at the present time, unless profits fall dramatically, which we think unlikely, the same cannot be said for bonds which, in our view, continue to look significantly overpriced. Quantitative easing, or money printing, has been used by central banks to keep down interest rates as newly created money has been used to buy government bonds and, sometimes, other securities in the market. Whilst that has eased borrowing costs, it has hit many savers hard and seen many of them looking for better yields than they can obtain on bank deposits. Certain bonds have been attractive to them, as well as equities, and the good performance of many good quality high yielding equities reflects this type of investor interest. Very cheap money might seem good news all round but it is not. There are more savers than borrowers so, as we have just said, they have been badly affected. So, too, have UK pension funds as the low yields on government bonds have meant a low discount rate for future liabilities and, therefore, increased their shortfalls so that money is being put into pension funds which could otherwise have been invested in their businesses.

Given what we believe are reasonable equity valuations, the stance of monetary policy in most countries is likely to continue to be supportive of equities. It is true that investors are paying up for yield in some cases, but not dramatically so, given the yield difference (significant in some cases) between equity dividends and cash yields and also high quality government bond yields. For bond investors, the situation is different. Being conservative in our policies, we are not inclined to invest in low grade bonds. It is true that they can produce spectacular returns if things go right, or if investors are in "risk on" mode, but the risks are also significant and are ones that we are not happy to take, particularly given the uncertain economic environment that is facing us at present. In the case of high grade government bonds like US Treasuries, UK gilts and German Bunds, if we take ten year benchmark yields, investors are buying on negative real gross redemption yields. It is true that there might be a trading opportunity but, with such low yields and ones which, in normal circumstances, are out of touch with reality, the risks are very high. At some stage, yields are going to move towards more normal levels, which are considerably higher than present levels, and this will entail substantial losses or opportunity costs for investors. The dangers for bond investors arise from several sources. One is the issue we have just mentioned. To buy bonds, and here we will make the assumption that they will be held to maturity, in the almost certain knowledge that money will be lost in real terms, implies (unless bonds have to be held) an extremely negative view of the outlook, suggesting that other investments will lose even more. Whilst there are many economic concerns, we do not share this rather apocalyptic view of economic prospects. We think that it is the consequences of quantitative easing that bond investors should consider. Because economic confidence is low in countries which have instituted quantitative easing, the money created has not started to find its way around the economies and thereby stimulate activity. If and when it does, an inflationary threat will appear with increased amounts of money chasing a finite amount of goods and services and it will become difficult to put the inflationary genie back into the bottle. Although inflation seems benign at present, it is not right to be complacent. The theory is that, in order to prevent the inflationary consequences of money creation, the additional money should be withdrawn at some stage, the most obvious way, although not the only way, being the sale by central banks of the bonds they have bought to the private sector. This would pose a clear threat to interest rates. Even assuming over indebted countries manage to reduce their budget deficits, they will still be borrowing since it is very hard to believe that they will move into surplus. If, at the same time, central banks are selling the securities, acquired as a result of quantitative easing, back into the market, there will be significant upward pressure on interest rates. Either way, through a sharp increase in inflation or a reversal of quantitative easing, there is a big threat to interest rates and, therefore, bond prices.

It is in these circumstances that other assets have attractions, though these have to be qualified depending upon the circumstances. For equities, the attraction is generally a higher base dividend yield and the possibilities for dividends to grow as they have been doing. Dividend growth provides protection to income in real terms. Although, as we have seen from US companies' third quarter earnings reports, the going is becoming tougher, corporate profits and margins are at a high level and the outlook for dividends stable, if not exciting. In current monetary conditions, that is a satisfactory result. Using the printing press reduces public trust in paper currencies and so, as well as shares, which give investors a stake in real assets, commodities, such as gold, can be considered a store of value in inflationary times and, perhaps, property, although macro economic conditions and access to finance can determine demand for the latter.

The cautious attitude of many investors, investment advisers and managers towards equities and earlier bullishness (but not so much now) on bonds perhaps reflects traditional thinking, namely that the poor economic environment makes shares risky and bonds safe. Although we still have two months of the year to go, the fact that share prices overall are higher now than at the start of the year is a surprise to some. We believe, however, that investors should concentrate upon the extraordinary monetary conditions being created to deal with the aftermath of the financial and economic crisis. This is a situation which investors will not have faced before and it requires non traditional thinking. Although it is not a clinching factor, it is worth remembering that one of the objectives of current monetary policy is to raise asset prices and create a positive wealth effect, which can have a positive economic multiplier effect on the relevant economy as some offset to the fiscal squeeze being operated, particularly in the UK and parts of the eurozone. This, then, is the intellectual argument in favour of equities (and certain other asset classes representing a store of value) and against bonds in these extremely unusual times.

As ever, the main focus of interest remains the eurozone, although, as the 1st January approaches, the US "fiscal cliff" is gaining more attention. There is a better feeling about the eurozone's prospects, as evidenced by the stability of eurozone markets during the quarter. This is not due to any fundamental improvement in the eurozone's economic position, in fact it has worsened, but rather to a masterful display of shaping expectations by the President of the ECB, Mr Draghi, with his assertion that, to paraphrase, he will do what it takes to save the euro and his plan for bond buying through the proposed ECB's Outright Monetary Transactions (OMT) programme. So far, nothing has actually happened, but Mr Draghi's shaping of expectations has kept Spanish and Italian bond yields under control, albeit at levels which are unsustainable in contracting economies. However, for the ECB to purchase, say, Spanish and Italian bonds, these countries have to request a bail out and, effectively, cede economic control, which is a very difficult point for these countries' governments to accept, so, whilst most observers expect Spain to require a bail out, the government is very reluctant to request one. As ever, with the eurozone, nothing is ever what it seems. Spain, in particular, thought that it had an agreement last summer that a bail out for its banks was agreed outside the scope of a sovereign bail out, but it now turns out that the northern eurozone states say that it is for future needs, not legacy loan problems, so it is back to being a sovereign problem. The unsatisfactory summit over the eurozone banking union revealed the differences between Germany, in particular, and many of the other eurozone members. As indicated above, Mrs Merkel does not want to use the €500 billion European Stability Mechanism to deal with legacy bond assets of Spanish and Irish banks. This is contrary to what a number of other eurozone countries thought had been agreed last June.

At the root of the problem are the vast political and economic differences within the membership of the eurozone, which denied it the characteristic of an optimal monetary area from the start. Whilst it took time for the economic divergences to manifest themselves, these have now done so with a vengeance. In political terms, it is leading to major tensions between what broadly may be called the northern eurozone creditor countries like Germany, the Netherlands and Finland and the southern eurozone debtor countries like Greece, Portugal, Spain and Italy. The resistance to continual bailouts and increasing financial guarantees in the north is growing whilst, in the debtor countries, racked by high and rising unemployment, social unrest is growing. Whatever the pro euro feelings of eurozone governments, they are undoubtedly behind the growing belief amongst their populations that the euro must bear a major part of the responsibility for the area's woes. The main reason why we believe that the eurozone will break apart is that the social and economic suffering, which individuals in the troubled eurozone countries are experiencing as a result of a fixed exchange rate against their major trading partners, will be deemed unacceptable. Whilst these countries must share a lot of blame for what has happened because they thought that membership of the euro was a one way pass and did not follow appropriate economic restraint in the areas of government borrowing and inflation, they would normally have been able to buy time to restore at least temporary competitiveness through devaluation which is, of course, impossible in a common currency area. The alternative, which is being inflicted upon them by their creditors, namely an internal devaluation, is likely, before long, to prove unacceptable to these countries' electorates. Internal devaluation, which means reducing wages, pensions and benefits (some or all of these) is aimed at reducing relative costs to restore competitiveness. It is quite clear that electorates in Greece, Portugal and Spain are near to the end of their tolerance of such measures. In Greece, we have seen the emergence of extreme parties and, in Spain, secessionist feeling is growing in Catalonia. Sooner or later, governments will emerge which will want to leave the eurozone rather than tolerate the degree of economic control dictated to them from outside. We would also watch France, a country somewhat in the middle of these two groups. Its economic model is unsustainable and it has been losing competitiveness steadily against Germany. Its large public sector, inflexible labour market and special economic model, which is unaffordable, present the new government with serious challenges. Neither party at this year's election prepared voters for what was needed and the emphasis on tax increases rather than the drastic public spending cuts, which France needs to liberate the private sector which is currently being "crowded out" by the public sector, is worrying. The increasingly vocal business sector reflects serious worries about France's declining competitiveness. The public reaction to the drastic measures which are needed to address the situation may not be favourable. The indications are that the government, for ideological reasons, does not have the desire to address France's fundamental problems which would involve drastically cutting back the size of the public sector. If that is the case, the chances of markets bringing matters to a head are increasing.

Whilst the eurozone crisis continues, the forthcoming possibility of a "fiscal cliff" in the USA is likely to become a more prominent issue for investors. The result of the US elections is now known and there remains a split Congress, so we may be no nearer to knowing if the "fiscal cliff" has been avoided. This refers to the effect on the US economy of the expiry of the Bush era tax cuts, payroll tax cut expiration, extended unemployment benefits expiration and sequestration measures on government spending, half from defence and half from elsewhere, which the Congressional Budget Office reckons will knock 4% off GDP between 2012 and 2013, or US$607 billion in cash terms. Investors remember the stand off, in August 2011, over the US debt ceiling which temporarily spooked markets, although, in theory, because the US controls its own currency, it should not have any problem paying its bills, even if it is in debased currency. The threat to default, because Congress will not lift the debt ceiling, is a serious one which would damage the USA's credit standing. The problem remains the polarisation of US politics and the absence of much of a centre ground which there used to be in the USA. The Republicans have generally set their face against tax rises and the Democrats against entitlement spending cuts. In practice, there will have to be some mixture of both to deal with the USA's very serious debt problems which will only get worse without action. The checks and balances in the US Constitution do not serve well the need for the type of action that the UK Coalition government took when it assumed office. It was able to take decisive action because it could command support in the House of Commons. This is not usually possible in the USA because it is not the norm for the Presidency and the two houses of Congress to be controlled by the same parties. Decision making becomes very protracted and the process does not make for good government. The economic situation does not lend itself to the kind of manoeuvres we have been witnessing in recent years. One would like to think that common sense will prevail but it can only be a wish given the antipathy between the parties. At the moment, the steady performance of Wall Street suggests that investors feel confident that a deal will be reached, although they may be taking the view of what is rational as opposed to what the politicians may do in the highly charged atmosphere of US politics. With a deficit of 7.0% of GDP in the fiscal year to September 2012, the politicians need to act. The problem is that, whilst action on the deficit is imperative, the pace of action is also important in the current fragile circumstances. The Congressional Budget Office said, in August, that, if the "fiscal cliff" occurs, growth in 2013 would be just 0.5% and unemployment 9.0% by the end of 2013 (it is currently 7.8%). If the "fiscal cliff" does not occur because the tax cuts etc are extended indefinitely, then growth would be 1.7% and unemployment would be 8% by the end of 2013. The budget deficit would be US$1 trillion (US$1.089 trillion in the year to September 2012). Whilst, as we have often said before, the USA has important advantages in that it issues its own currency and is the world's largest reserve currency, which means that it has to be held in other countries' foreign exchange reserves, this situation is not written in stone. In years to come, assuming liberalisation of the renminbi, the US could face much greater competition and, if there were a loss of confidence in the USA, the consequences could be devastating.

Whilst the west, particularly the UK, eurozone and, elsewhere, Japan, struggle, the importance of China in helping to keep the world economy as a whole moving forward, increases, hence the nervousness about the slowdown in the Chinese economy. As we will show later, there are some tentatively encouraging signs from China, but a conclusive turnaround from a slowing rate of growth has to be confirmed. China is the third significant economic issue for investors, along with the eurozone crisis and the looming US "fiscal cliff".

Turning now to look at different areas of the world economy, we start with the USA. As we have said and discussed above, the big issue is the forthcoming "fiscal cliff" and we will have to wait until we know if the elections have made any difference to attitudes. In terms of the US economy, the third quarter growth rate has initially been estimated at 2.0%, giving a year on year increase in real GDP of 2.3%. The third quarter figures were boosted by an increase in defence spending which will not be sustained. On the other hand, and less positively, there was a fall in business investment. This has been blamed partly on uncertainties about the "fiscal cliff", which is understandable given the effect which its consequences should have on economic growth. The slowdown in the Chinese economy has also been blamed for the fall in business investment. Besides the 0.7% contribution to growth from defence spending, consumption contributed 1.4%. Whilst the US economy will need to grow faster than this to reduce the unemployment level, currently standing at 7.8%, relative to what is going on in the eurozone, the outcome looks good.

A useful indicator of how the US economy is performing, comes from the Federal Reserve's Beige Book, which records economic activity in the Federal Reserve's twelve districts. The latest report, published in October, suggests growth in every one of them. The Beige Book said that activity "expanded modestly" nationwide. It cited positive trends in the housing and construction markets, albeit from a very low level and the cause of the original financial crisis. There were indicators for a modest improvement in the manufacturing and services sectors' activity. This report seems to fit in with the message of the preliminary third quarter growth figures. Also fitting in with this pattern of modest, but below potential, economic growth is the employment data, with the headline unemployment rate falling from 8.1% to 7.8% in September and 7.9% in October. Whilst this drop looks encouraging, the reality is that a lot of people have dropped out of the labour market, which flatters the figures. Nevertheless, there was some cause for satisfaction. There was an upward revision to the recent jobs numbers for July, August and September. The increase for October was 171,000. These numbers, whilst encouraging, are consistent with an economy growing modestly, although a low participation rate, as just mentioned, qualifies any major optimism. We noted that consumption growth was the main reason for the 2.0% annualised quarterly growth noted for the third quarter. Consistent with this, but not conclusive, was a 1.1% gain in retail sales in September, following a 1.2% increase in August. This is also consistent with the improved reading for consumer confidence as measured by the University of Michigan's consumer confidence index which rose from 78.3 in September to 83.1 in October. A really positive step for the US economy would be an improvement in the housing market, the root cause of the USA's original financial problems and a continuing drag on the economy. As the Beige Book suggests, there is a modest improvement in activity but the housing market has a long way to go before normal conditions are restored. In September, housing starts rose by 15%, the quickest pace since July 2008. Building permits, a forward looking indicator, rose by 11.6%.

For companies, life is becoming a little more difficult, albeit at a generally good level of profitability. The earnings figures for the third quarter show a small decline, year on year, as more difficult market conditions, sometimes overseas, cause a bigger than expected slowdown in revenue growth. We do not think that this is a problem for the stock market at this stage, given our earlier observations about the contribution of very loose monetary policy for the foreseeable future to asset prices and the relative yield attractions of shares against cash deposits and US Treasuries, since we do not see a collapse in corporate earnings. The most important influence on the stock market is likely to be negotiations on the "fiscal cliff".

Whilst the USA can, at least, point to some economic growth, the same cannot be said of the eurozone. The economic details of various countries' economic performance is almost irrelevant set against the eurozone's fundamental problems, which we have outlined above and on many previous occasions. Suffice it to say that the eurozone, as a whole, is likely to contract this year, and even mighty Germany may show growth of less than 1% this year as its export markets slow, but at least its relatively good budgetary position enables it to propose measures which should help to offset the economic slowdown. As a result of falling unemployment, tax and insurance revenues have increased, enabling the government to propose a cut in pension contributions as part of a stimulus package. The bail out and potential bail out countries are all likely to show economic contraction this year as the measures they are taking to try to improve their finances make matters worse. France is teetering on the brink of economic contraction and it remains to be seen, as we have said earlier, whether the new government has the political courage to tackle public spending, the popular parts of their programme of increasing taxes on big business and the rich having been taken. For the moment, although ten year French government bond yields stand at about a 79 basis point premium to German Bunds, the market is giving the country the benefit of the doubt. Its bond yields, however, are also higher than those of Austria, Finland and the Netherlands.

It remains our view that the eurozone will fragment. Whilst the authorities so far have been able to stave off the inevitable with short term fixes, the unsustainable will, in the end, be just that. One understands the state of embarrassment of those involved with the euro project and this is leading to a state of denial manifested by the "more Europe" phrase, but there are certain economic verities, and the clear fact that the eurozone is not an optimal currency area is one of them. It is, therefore, likely to fail under its own contradictions and, even if some of the eurozone's leaders want to move towards a giant superstate where money can freely be transferred between what were individual nations, it is hard to see their electorates standing for this. The question is asked why one would want to hold investments in the eurozone if one is sceptical about its survival chances given that partial or total fragmentation is bound to be extremely messy. We would argue that companies, especially large internationally focused ones, are in the best position to cope. They are used to dealing with currency exposures and we know that, from what some of them have reported, they are actively addressing the possibility by, for example, sweeping cash balances out of high risk countries and also matching assets and liabilities, as far as possible, in potentially risky eurozone countries. At the trading level, many eurozone based companies, as is the case with those in, say, the UK and USA, have widely spread geographical businesses which provide some diversification away from the troubled area. Having a stake in such businesses, in our view, provides some protection from a break up of the eurozone. The world is so inter-connected nowadays that investors cannot properly isolate the eurozone from elsewhere. Most countries are affected by the eurozone's troubles but companies are being given plenty of time to prepare for the worst.

Turning to Japan, short term attention has focused on the dispute with China over a group of uninhabited islands which the Japanese know as Senkakus and the Chinese as Diaoyus. The dispute has caused many short term problems for Japanese companies operating in China whether through a boycott of Japanese goods or through the temporary closure of Japanese companies' manufacturing operations. One can only hope that this dispute fades away. Although the Japanese economy appears to be doing relatively well with year on year growth to the second quarter of 2012, it must be remembered that the comparison was with an economy depressed by the earthquake and tsunami of March 2011. There is, therefore, an element of recovery in this year's figures. The problems of Japan remain the same as for many quarters, a terrible budget deficit, estimated at over 9% of GDP for 2012, a shocking level of outstanding public debt as a percentage of GDP (around 230% at the gross level), political stalemate which usually precludes taking the necessary measures, although plans to double consumption tax are a step in the right direction, and structural rigidities in the economy. The energy position is now in doubt in the aftermath of last year's nuclear power station accident. The closure of most of the country's nuclear reactors in response to the disaster has obviously left an energy gap which has been bridged by imports, as a result of which the trade balance has moved into deficit and the current account surplus is weakening. Whilst most of the country's debt is financed internally, which leaves it less vulnerable to a flight by overseas holders of Japanese government debt, this situation cannot last indefinitely. But, with attention focused on countries seemingly with more pressing problems, Japan has escaped attention for the time being. In a warning about the potential for danger in Japan, the Vice Minister of Finance for International Affairs warned the country not to hold out for economic recovery before cutting its deficit. He said that any delays risked a "violent" reaction in bond markets. For Japanese companies, the high value of the yen remains a problem. The problems facing some of Japan's manufacturers were illustrated by the 10.3% decline in Japanese exports in September. In the immediate future, a political impasse threatens over a bill which would be required to allow the government to borrow the funds required to fund the budget deficit. The impasse is occurring because the opposition is demanding that the Prime Minister, Mr Noda, calls for a general election. Shades of the US budget stand off in 2010 are apparent. Japan needs major supply side reforms to give it the ability to raise its long term potential growth rate, but these have nearly all met with resistance from vested interests. In this context, it is encouraging that the privatisation of Japan Post has returned to the agenda, having been stalled by coalition tensions which meant that one third would have to remain in government hands as opposed to the original plan for Japan Post to be fully privatised by 2017. It is not only the money which this would raise for a cash strapped government but also the cultural change from being in the private rather than public sectors.

China's economic data is carefully monitored by investors, given its status as the world's second largest economy because, with most industrialised economies in a difficult state, it is important that Chinese growth does not falter significantly. The latest third quarter growth level on a year on year basis is 7.4% against 7.6% in the second quarter and on an annualised basis in the third quarter of 9.1% against the second quarter compared with 7.4% the previous quarter. The October Purchasing Managers Index came in at 50.7 against 49.8, a modest improvement. There was encouraging news on inflation which, until recently, had been a concern because, apart from the worries about social unrest which inflation threatens, especially from food prices, it limited the policy options of the authorities on policy easing. Without giving a hostage to fortune, it does look as if the Chinese authorities have been able to stabilise the situation and accelerate growth again. Further evidence will be needed to prove this conclusively but, if this is a correct analysis, it is unqualified good news.

For the struggling UK economy, there was some good news in October but, as always, one set of figures should not be over emphasised. The first estimate of third quarter GDP showed 1% growth between the second and third quarter, the strongest rate of growth for five years. Because of the Diamond Jubilee, the Olympics and Paralympics, figures this year have been distorted and this was the case here as it was in earlier more disappointing quarters. Looking at a breakdown of the figures, the UK services sector, by far the most important in the economy and accounting for about three quarters of it, grew 1.3% having fallen 0.1% in the second quarter. In the production industries growth was 1.1% but, on a disappointing note, but not surprisingly, construction output was down 2.5%. As we have noted before, there has been some conflict between the real GDP figures and other data such as the employment figures which have been much more buoyant. In due course, it is possible that the GDP figures will be revised upwards but we will not know for some time. Besides the positive data on employment, inflation has been falling, currently standing at a three year low of 2.2% but likely to rise shortly as utility bills increase. This does, however, reduce the pressure on disposable income and is a positive force for the UK economy after a time when real incomes have been declining, with resulting pressure on consumption. As the latest UK manufacturing purchasing managers index, which stands at 47.5, shows, life is very difficult in that sector as export markets, particularly in the eurozone, are affected by the economic woes there. The services sector PMI at the end of October is better in that it was over 50, at 50.6, but this was down from September's figure of 52.2.

Being a finance minister at a time like this in any country where action has to be taken on essentially out of control public finances is a thankless task with few, if any, plaudits coming one's way and plenty of brickbats. It is always much easier to criticise when one does not have to make any decisions and the UK Chancellor has been subject to plenty of criticism for those who say he is cutting too fast and should perhaps spend some more in order to boost the economy, thereby helping to boost revenues and cut expenditure and tackle the deficit that way. This is a seductive, but highly dangerous, line of reasoning. Apart from anything else, it ignores market reaction which would be likely to be very unforgiving if it felt that the government was losing its nerve. Foreigners hold about 30% of the gilt market, much the same as the Bank of England as a result of its quantitative easing, and any loss of confidence could see gilt edged yields rising quickly. We know that, partly because of quantitative easing but also because the UK's deficit reduction programme has more credibility than most, the UK government bond market has been favoured, but it is not written in stone that this is the case. The programme to eliminate the structural deficit, originally planned for the end of the current parliament if it runs its full term, has been put back two years and this is likely to be extended further because of the international economic situation. Critics of the government blame its austerity programme for the stagnant state of the UK economy, so it is interesting to note the Office for Budget Responsibility's analysis of why its growth forecasts have been too optimistic. It said that deficit reduction was not the main cause of the UK's weak economic performance over the last two years. It put it down to unexpectedly stubborn inflation and weak export markets. Opponents of the government's policy have seized upon the IMF's latest assessment of the UK economy, where it has downgraded its forecast. There was something for both sides but, essentially, the IMF was saying, not only of the UK but elsewhere, that "if growth should fall significantly below current projections, countries with room for manoeuvre should smooth their planned adjustment over 2013 and beyond". Our view remains that investors should take notice of markets and they certainly would not like to see the government doing a U-turn. It could take years to restore credibility.

On the assumption that the government sticks to its plans for structural deficit elimination, even if they are pushed out further by the sluggishness of the world economy and, particularly, the eurozone, we think UK equities still represent reasonable value, based on the diversified geographical spread of their businesses, which provide some defensive qualities, and, in many cases, attractive dividend yields. As we have emphasised before, these are important and the overall dividend experience from UK equities remains good.

In the unique set of economic circumstances, which include the potential fragmentation of an enormous currency union and money printing on a vast scale, investors have to think on their feet. There is no precedent for this. We have explained how we rationalise investment policy in these circumstances and why we believe equities to be the asset class of choice, at least against bonds and cash. It is not because life is going to be easy for companies in this low growth environment but they are coming off a high level of profitability in many countries and, with generally strong corporate balance sheets, we think dividend prospects are reasonable. This is very important given that competing yields on high quality bonds and cash are very low. We know that bond yields are being artificially suppressed and that this suppression has led them to be significantly overvalued against any yardstick except for a move into deflation, something we regard as very unlikely. Investors should not be complacent as a result of the upward drift of equity prices so far this year, for this movement does not reflect the reality of the economic situation but rather the effect of very loose standard and non standard monetary policy. It is likely that there will be setbacks in markets along the way as there are bound to be negative economic developments, perhaps with regard to the eurozone or the USA's "fiscal cliff" but, for long term investors, equities seem to be the most attractive asset class.