meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equity investors and high quality bond holders have experienced a positive quarter. Most international equity investors at the end of the third quarter will now show positive returns for the year, a satisfactory position given the extent of the stock market recovery in the final three quarters of 2009. As the review indicates, although we must expect setbacks, equities, in our view, remain the preferred asset class.

The tables below detail relevant movements in markets:

International Equities 30.06.10 - 30.09.10

Total Return Performances (%)

Country	Local Currency	£	US$	€
Australia	+8.1	+17.6	+23.9	+11.2
Finland	+14.3	+20.9	+27.4	+14.3
France	+8.7	+15.0	+21.1	+8.7
Germany	+4.6	+10.7	+16.6	+4.6
Hong Kong, China	+21.1	+15.3	+21.5	+9.0
Italy	+7.3	+13.5	+19.6	+7.3
Japan	-0.5	+0.1	+5.5	-5.4
Netherlands	+5.2	+11.4	+17.3	+5.2
Spain	+14.7	+21.4	+27.8	+14.7
Switzerland	+2.9	+7.9	+13.6	+1.9
UK	+13.7	+13.7	+19.7	+7.4
USA	+11.3	+5.7	+11.3	-0.1
Europe ex UK	+7.2	+13.6	+19.6	+7.3
Asia Pacific ex Japan	+12.3	+14.8	+20.9	+8.5
Asia Pacific	+6.2	+7.7	+13.4	+0.7
Latin America	+13.9	+14.8	+20.9	+8.5
All World All Emerging	+13.2	+12.1	+18.1	+6.0
The World	+9.7	+8.7	+14.5	+2.7

Source FTSE World Indices

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

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

Currency	30.06.10	30.09.10
Sterling	3.35	2.95
US Dollar	2.96	2.52
Yen	1.09	0.94
Germany (Euro)	2.58	2.29

Sterling's performance during the quarter ending 30.09.10 (%)

Currency	Quarter Ending 30.09.10
US Dollar	+5.1
Canadian Dollar	+1.9
Yen	-0.9
Euro	-5.4
Swiss Franc	-4.3
Australian dollar	-7.8

Other currency movements during the quarter ending 30.09.10 (%)

Currency	Quarter Ending 30.09.10
US Dollar/Canadian Dollar	-3.1
US Dollar/Yen	-5.8
US Dollar/Euro	-10.0
Swiss Franc/Euro	-1.1
Euro/Yen	+4.7

Significant Commodities (US dollar terms) 30.06.10 - 30.09.10 (%)

Significant Commodities	30.06.10 - 30.09.10
Oil	+9.7
Gold	+5.6

Markets

Following a setback in the second quarter, stock markets have recovered their poise, at least for the moment, as a result of a strong performance in September. In local currency terms, the FTSE World Index showed a total return for the quarter of 9.7%, in sterling terms 8.7%, in US dollar terms 14.5% and in euro terms 2.7%. In local currency terms, there were some particularly good returns from the UK (13.7%), the USA (11.3%), Asia Pacific ex Japan (12.3%), Latin America (13.9%) and Emerging Markets (13.2%). The only real disappointment was Japan (-0.5%). There were, however, some significant currency moves and this altered the returns, depending upon in which currency the returns were measured. The strength of the European currencies increased the return on the FTSE Europe ex UK Index for sterling investors to 13.6%, whilst weakness in the US dollar reduced the sterling return on the FTSE USA Index to a still very acceptable 5.7%. The Australian market was a feature, with an excellent local currency return on the FTSE Australia Index of 8.1%, becoming an exceptionally good 17.6% in sterling terms as the Australian dollar recovered strongly. The Japanese market just struggled into positive territory, with the FTSE Japanese Index returning 0.1% in sterling terms.

In bond markets, which we discuss in some detail in our review, good quality bonds enjoyed a very strong quarter, as opposed to some of the weaker eurozone credits. Taking ten year government bonds as a benchmark, sterling government bonds saw the gross redemption yield fall 40 basis points to 2.95%, US dollar bonds by 44 basis points to 2.52%, Japanese government bonds by 15 basis points to 0.94% and German government euro denominated bonds by 29 basis points to 2.29%.

In the currency markets, the main feature was the weakness of the US dollar. Sterling increased by 5.1% in value against the US dollar over the quarter but against the euro it declined by 5.4%, against the Swiss Franc by 4.3% and against the Australian dollar by 7.6%. Given the troubles of the eurozone, it may seem strange that the euro has strengthened but it probably reflects investors' expectations that the USA and UK will initiate another round of quantitative easing.

In the commodity markets, oil rose by 9.7%, although, as mentioned above, it is denominated in a weak currency, the US dollar. Gold, which we discuss in this review, continued to rise, up 5.6%, although the same point about the US dollar applies.

Economics

The world economy continues to be a curate's egg, doing well in some areas but suffering problems in others. Here in the west, it is easy to be influenced by problems in the UK, USA and eurozone but, in many parts of the east and elsewhere, such as Brazil, the picture looks quite different. Fortunately, because many investors are free to invest internationally, they can take advantage of opportunities to invest in economies which are performing strongly, as well as in domestically based companies in their own struggling economies which have exposure to these faster growing markets.

In deciding upon their investment policy, investors have to consider what remain extraordinary times and how best to respond to them. Overall, the world economy looks to be in a far better condition than two years ago when the financial storm was brewing and real fears existed for the health of the international banking system. This fact is reflected in a recovery in world stock markets. The rise since March 2009 has been very significant and, with the benefit of hindsight, it is clear that international equities were heavily oversold. It is easy, however, to see why investors were so fearful. It should always be borne in mind that politicians and central bankers have a vested interest in trying to ensure economic and financial stability so addressing the banking crisis was an act of necessity for them and they had some tools for the job which they used and this is the extraordinary legacy which we see now in monetary and fiscal matters.

In fiscal matters, public finances in many countries were allowed to deteriorate dramatically in order not to squeeze the relevant economies further. In times of recession or slow growth, "automatic stabilisers" come into play in fiscal matters. Government expenditure rises because of, for example, additional social security payments to those who become unemployed whilst tax revenue suffers because of lower economic activity. By not seeking to raise taxes or cut public spending to cover the deterioration in public finances, governments are allowing automatic stabilisers to work. The converse of this situation in times of strong economic growth is that governments should let the automatic stabilisers work in reverse. Growth in tax revenues and less government spending strengthens public finances and gives the financial fire power to deal with the adverse economic conditions described above. We would characterise this as putting money aside for a rainy day. Unfortunately, although this is a generalisation, politicians' time horizons are short, perhaps only until the next election, and exercising prudence in good times is not something which comes easily to many politicians. They would rather spend money in the hope that this would make them popular. Unfortunately, there is a strong correlation between this lack of prudence and the countries which have serious public debt problems, such as the USA, UK and a number of eurozone countries. One might also add Japan where, although there is no immediate crisis, the figures look very bad. Budget deficits fall into two parts, cyclical and structural. The former is a function of economic cycles, and proper use of the automatic stabilisers should ensure that budgetary problems do not occur. The second type of deficit, structural, is undesirable. It occurs when public finances are chronically in deficit as spending consistently outpaces revenues. Thus, as has happened in many countries recently, cyclical deficits have been piled on structural deficits, to leave a very ugly situation and, in countries like Greece, Portugal and Ireland, it has led to a crisis as investors worry about these countries' ability to discharge their debt obligations. We will return to this, suffice it to say that the levels of budget deficit and, by extension, the ratio of public debt to GDP in some countries could simply not have been imagined before the onset of the financial crisis.

If anything, the profile of the monetary policy being followed since 2008 is even more startling. Near zero interest rates in many major economies would have been scarcely believable and the printing of money, described as "quantitative easing" (QE), literally unbelievable. In the latter case, the USA and UK have the advantage of controlling their own currency, so are in a position to do this. Countries tied into the euro cannot, of course, do this independently so have been at a disadvantage.

So, investors, for nearly two years, have faced an extreme fiscal situation, very large budget deficits, and extreme monetary policy, negligible interest rates and money creation in some countries. It is self evident that the deficits being run by the USA, UK, Japan, and a number of eurozone countries like Greece, Ireland, Portugal, Spain and Italy, are unsustainable. This statement may relate to current budget deficits as a percentage of GDP, the overall level of public debt in relation to GDP or both. Although all of these countries are in a bad situation, the degree of urgency with which they have to be dealt with varies. As the issuer of the largest reserve currency, the USA has an advantage because, if holders of US dollars decided to dump them, they would damage the value of their remaining US dollar assets. A country like the UK, where foreign holdings of sterling are much less important, has no such advantage. For eurozone countries like Greece, Ireland and Portugal, there is nowhere to hide and, although the eurozone governments and central banks will do everything they can to avoid any member defaulting or having to restructure their debt, there is only so far that they can go. Greek bond yields already tell us that investors do not expect Greece to honour its debts in full and, although Irish and Portuguese government bond yields are not at Greek levels, they are signalling investors' serious concerns about these countries' ability to repay their debt in full.

Therefore, in surveying the investment landscape, investors are making judgements against a background which they could never have believed possible. Amongst other questions which they have to consider is whether the severe fiscal retrenchment which has to occur in many economies will lead to a "double dip" recession or whether the prospect of falling budget deficits will give confidence to the private sector, on which economic growth depends, to invest. Will very low interest rates, although bank lending margins may be rising, encourage activity or, at least, alleviate financial stress for borrowers? Will very low interest rates for savers, who have traditionally relied on interest income, adversely affect consumer spending? Will robust economic activity in China, India, much of Asia, parts of the Middle East and Brazil offset slow growth or recession in some deficit ridden western economies and Japan? Is deflation a serious threat? The answer to questions such as these informs investment policy.

If investors are facing very unusual economic circumstances, then markets are sending out a confused message. In the top quality AAA rated government bond markets, as our table at the beginning of this review shows, yields are extraordinarily low. These yields tell us one of two things, or both. They tell us that deflation is a real prospect so that, whilst nominal yields are very low, real yields, because of negative inflation, may be higher in the future than nominal yields. They may also tell us that so called risk assets are just that, so risky that even a very low yield on government bonds is better than the risk of losing money on equities or property, for example. They may tell us both of these things. Traditionally, since the 1950s, in the case of the UK, gilts have yielded more than equities, but now we have a situation in markets like the UK, France, Germany, Switzerland and Japan where equities yield more than these countries' ten year government bonds. In the USA, the S&P 500 Index yields less than the ten year US Treasury bond, although the Dow Jones Industrial Index yields more. This may tell us that a "double dip" recession is coming and that current dividend levels are not safe. Then, again, if investors are fearful of deflation, why is gold so strong? It is normally thought of as a store of value in inflationary times, but inflation is not generally a problem at the moment. More plausible, at the moment, is the explanation that some currencies may be risky because of the possibility of further quantitative easing. But, if the economic outlook, as suggested by bond yields, is so poor, why have share prices held last year's gains and even advanced?

So, we can see that markets are full of contradictions and we still try to work our way through these conflicting signals.

Firstly, what could justify such low bond yields like the ones shown in the table at the beginning of this review? It could be that within the bond markets, and the eurozone is a good case in point, investors are so concerned about some of the weaker credits, like Greece, Ireland and Portugal, that they are paying for quality and prepared to accept very low returns. That situation does not look likely to go away and it may get worse. The second argument, which we touched upon earlier, is that the world economy is likely to experience deflation and, that being the case, even nominal yields of below 3% on ten year government bonds, as a benchmark, would provide acceptable real returns. Is this going to happen? We think it is unlikely. Whilst inflation may remain low for a while, other than for individual quarters, cost pressures from commodities (food is getting much attention at the moment) are likely to remain. We think that it would take a collapse in demand worldwide which would reduce companies' pricing power dramatically for deflation to take hold on an international basis, as opposed to an individual country basis. We do not see this happening. In countries such as the UK, inflation is obstinately high and has regularly exceeded the Bank of England's forecasts. Thirdly, and this is linked with the issue just raised, do we see a world recession so severe that dividends would be so slashed that current top quality bond yields, often, as we said earlier, below those on equities, would look attractive against equity yields? We do not see this happening. When the financial and economic crisis blew up in 2008, companies quickly battened down the hatches, reducing discretionary spending where possible and becoming very lean in the process. Many companies are now in a good financial position and are starting to raise their dividends again. A dramatic reduction in dividends looks unlikely and our expectation is that dividend levels will continue to recover. To give an example of economic growth expectations, we show below excerpts from the International Monetary Fund's World Economic Update of July 2010.

IMF Projections (world output year over year % change)

	2009 (actual) %	2010 (estimate) %	2011 (estimate) %
World output	(0.6)	4.6	4.3
Advanced economies	(3.2)	2.6	2.4
USA	(2.4)	3.3	2.9
Eurozone	(4.1)	1.0	1.3
Germany	(4.9)	1.4	1.6
France	(2.5)	1.4	1.6
Italy	(5.0)	0.9	1.2
Spain	(3.6)	(0.4)	0.6
Japan	(5.2)	2.4	1.8
UK	(4.9)	1.2	2.1
Canada	(2.5)	3.6	2.8
Newly industrialised Asian economies	(0.9)	6.7	4.7
Emerging & developing economies	2.5	6.8	6.4
Russia	(7.9)	4.3	4.1
China	9.1	10.5	9.6
India	5.7	9.4	8.4
Brazil	(0.2)	7.1	4.2

Other significant economies straddling the above definition			
	2009 (actual) %	**2010** (estimate) %	**2011** (estimate) %
Australia	1.3	3.0	3.5
Hong Kong SAR	(2.8)	6.0	4.4
Korea	0.2	5.7	5.0
Singapore	(1.3)	9.9	4.9
Taiwan Province of China	(1.9)	7.7	4.3
ASEAN - 5			
Indonesia	4.5	6.0	6.2
Malaysia	(1.7)	6.7	5.3
Philippines	1.1	6.0	4.0
Thailand	(2.2)	7.0	4.5
Vietnam	5.3	6.5	6.8

Consumer Prices			
	2009 (actual) %	**2010** (estimate) %	**2011** (estimate) %
Advanced economies	0.1	1.4	1.3
Emerging & developing economies	5.2	6.3	5.0

Source IMF World Economic Outlook Update - July 2010 (excerpt)

Of course, forecasts can be wrong, as 2008 forecasts made for 2009 show most recently, but, in the absence of unforeseen circumstances, the direction of the IMF's projections tie in with what we know of the current economic circumstances. Because of a return to growth by the advanced industrialised countries and a very strong performance from the BRIC countries (Brazil, Russia, India and China), as well as other Asian economies, it seems highly likely that the significant recovery in world economic output which is, by now, guaranteed for this year, will follow through to next year. Their growth will help to provide some offset to the cumulative effects, particularly in relation to the UK and the eurozone, of the fiscal squeeze aimed at restoring order to public finances. So, coming back to the question of dividend yields compared with high quality bond yields, we should note that many companies with an international aspect to their businesses which are based in the USA, UK, Europe and Japan, are benefiting from exposure to these much faster growing economies even if their domestic economies are subdued. This international exposure should help to protect profits and dividends and makes the relationship between government bond yields and dividend yields hard to justify. We would say that the anomaly lies with bond yields, rather than dividend yields, with the former being too low. We then come to the enigma of gold. If investors are concerned about the ogre of deflation which, as we have just said, we do not believe, then why has the gold price been so strong? One could expect that, if inflation was expected to be an issue, it would be seen as a store of value, but that is not the case at present. A more plausible explanation is that investors are losing confidence in currencies, in itself an issue indirectly connected with the inflation/deflation argument. Whilst most people are not immediately worried about inflation, the extremely loose and unorthodox monetary policy being followed by countries and regions such as the USA, UK, Japan and the eurozone carried with it an inflationary threat for the future if not correctly exited. Negative real interest rates (using official rates as the benchmark for this statement) are a possible threat to inflation and quantitative easing, effectively money printing, is certainly a threat to inflation and the relevant currency. Those buying gold may be looking ahead to the future possibility of currency debasement and inflation. Because interest rates can hardly fall any lower, they lose their power to influence economic developments so quantitative easing is the last lever, but it is a very dangerous one so it is vital that it is exited as soon as it is possible to do so.

From these conflicting signals, our view, on the information currently available to us, is that bond yields are anomalously low and that a dangerous bubble exists which could leave holders of bonds, other than those of short duration, with some nasty losses as yields rise to more realistic levels. In these circumstances, we rate bonds as very expensive compared to shares. We can also have sympathy with investors in gold. There are big economic risks still prevailing and significant inflation is a possibility later one. There are reasons to be negative on any of the major currencies but, as it is a zero sum game, they cannot all go down against each other.

As we focus on the international economic outlook, the immediate centre of attention must be the eurozone, where the troubles mount. As an area of monetary union, it is dysfunctional, which was always going to be the case with a monetary union that was driven by political ambition to the detriment of any sound economic underpinning. That there was going to be trouble down the line, we knew. It was built on sand. How the first major test would emerge for it, we could not know. But now it has emerged, the eurozone is ill equipped to deal with the crisis which has arisen. For a currency union to work, its members have to have a marked degree of similarity. This covers areas such as economic profile and cultural issues as they relate to work and economic attitude. The similarities have to be such that, although there is no political union in the sense that there is a government for the whole area, one can envisage the union as being similar enough as to be regarded as one country in the eyes of investors. But looking at the economically strongest country in the eurozone, Germany, and the weakest, Greece, it is difficult to see what, if anything, they have in common, other than being part of Europe. The idea that the eurozone would lead to the necessary economic convergence was far fetched at the time the eurozone came into being. It is now incredible. Without the underpinning of a eurozone government, a eurozone economic and monetary policy cannot work but that would be a step too far even for the most federalist minded politicians who managed to avoid asking their electorates if they were happy to be part of a monetary union. The inevitable consequence of this eurozone crisis is that it is every country for itself, with Germany, naturally, very sceptical about helping countries like Greece which have demonstrated economic indiscipline for a long time.

The depth of the eurozone's problems can be gauged by what the eurozone bond markets are telling us. If we take the gross redemption yield (2.22%) on the ten year bond of the best eurozone credit, Germany, equivalent Greek bonds are standing at a premium of 784 basis points, those of Ireland of 435 basis points and those of Portugal of 416 basis points. They tell us that investors do not expect a full repayment on Greek bonds and there are serious doubts about Ireland and Portugal. It was not meant to be like this. Convergence should have led to a seamless movement towards a common yield. A euro was to be a euro whichever eurozone country issued the debt. The truth is, of course, quite the opposite. The "one size fits all" interest rate of the euro has been completely inappropriate. With countries unable to run their own monetary policy, the common interest rate has caused immense damage. For example, in countries like Ireland and Spain, too low an interest rate caused a property bubble which has now burst and, in the case of Ireland, the troubles of the banks, particularly Anglo Irish, have taken the country into a critical state. Different inflation rates have led to countries like Greece, Spain, Portugal and Italy becoming less competitive against Germany. Severe overregulation of labour markets has left some eurozone economies without the flexibility to adopt to current circumstances. Over the years, much of Europe has been self indulgent, awarding itself more and more benefits without asking how they are to be paid for and what will be the consequences for public finances. Embarrassment about the possible demise of the euro has emboldened some eurozone countries to raise pension ages and contributions in the public sector, policies which one could not have imagined them to have the courage to take had circumstances been less dire. So far, these measures have led to strikes in Greece, Portugal, Spain and France. Governments have been backed into a corner by their need to take serious measurers to reduce their deficits and, if there is one good thing to come out of this crisis, it is that long overdue measures to reform their rigid economies are having to be taken.

There is no doubt that the sovereign debt crisis in the eurozone is a threat to the project. If Greece defaults, or comes to an agreed debt restructuring, then attention will turn to Ireland and Portugal and so on. The critical policy option which these countries would have outside a currency union would be devaluation. That no longer exists and this is why it is difficult to see the eurozone avoiding fragmentation or a break up. Apart from the political embarrassment of this happening, one of the major worries for eurozone members is the exposure of their banks to sovereign debt, which is currently under suspicion. In May, a €750 billion rescue package for Greece was announced. In our June review, we quoted Bank for International Settlements' figures for the end of 2009, showing that European banks' exposure to Greece, Portugal, Ireland and Spain was €188.8 billion to Greece, €240.7 billion to Portugal, €638.3 billion to Ireland and €856.0 billion to Spain. Of these amounts, French banks' exposure was €399.8 billion and that of German banks was €514.2 billion. That of UK banks was €341 billion, with over half of that to Ireland. Spain is not without concern. Its ten year government bond yields 182 basis points more than the equivalent German one, but there appears to be less concern about Spain than there was in the summer. However, banks in the weaker eurozone countries are finding it difficult to attract deposits and still rely to an important extent on the ECB. The ECB would like to exit this support.

Because the eurozone represents a monetary union, individual countries cannot print their own money through quantitative easing. They have to rely on the ECB, perhaps by it providing unlimited access to funds for banks. But the result is the same. It threatens currency debasement.

As we mentioned earlier, the USA enjoys the advantage of having the world's largest reserve currency. This means that, because it is held in very large amounts by some countries and they realistically have to hold the US dollar, they are constrained in the action they can take, being mindful of the effect on the rest of their US dollar holdings if they started to sell the currency aggressively. Furthermore, although the euro has risen recently against the US dollar, the woes of the eurozone have diverted attention from the USA's problems. At the end of 2009, the USA's general government balance as a percentage of GDP was over -11%. The Administration does not seem seriously exercised about coming to grip with its appalling deficit position. The US public appears to care more about its deficits than electorates elsewhere and there is notable resistance to the Administration's tax and spend policies which, if the opinion polls are correct, may result in the Democrats losing control of the House of Representatives and even the Senate in November's mid term elections. If that happens, not much is likely to get done in the final two years before the next Presidential election in 2012. The US political system with its checks and balances makes it difficult for decisive action to be taken as quickly as, say, in the UK. But action will have to have taken, at some stage, to tackle the USA's budget deficit, otherwise there will be long term damage to the US dollar. Meanwhile, the Federal Reserve may increase the level of quantitative easing if the economy looks as if it needs a further stimulus. It recently took the half way house measure of maintaining the size of its balance sheet by using the proceeds of the repayments of mortgage backed bonds to buy Treasury bonds in the market. It could go one step further and increase the size of its balance sheet if it felt it necessary.

Although the UK does not have the advantage any longer of being a major reserve currency, it has been rewarded since the General Election in May with a sharp fall in gilt edged yields so that, at the time of writing, the ten year gilt yields 2.89%. This is the down payment by buyers of UK gilts on the Coalition's policy of eliminating the structural deficit by the end of this parliament in 2015, if it lasts its full course. The UK has taken one of the toughest lines on restoring its public finances and the market likes it. The IMF, in its Concluding Statement of the Mission following its review of the UK economy, is fulsome in its praise for what is being done. To quote part of the Overview "The UK economy is on the mend. Economic recovery is underway, unemployment has stabilised and financial sector health has improved. The government's strong and credible multi-year fiscal deficit reduction plan is essential to ensure debt sustainability. The plan greatly reduces the risk of a costly loss of confidence in public finances and supports a balanced recovery. Fiscal tightening will dampen short term growth, but not stop it, as other sectors of the economy emerge as drivers of recovery ...." The Coalition government could hardly have put it better. We feel that the IMF has got it right. There are those, including ministers who were in government prior to May, who think the UK should go much more slowly on its deficit reduction plans in order to avoid public spending cuts, in particular, causing a "double dip" recession. Whilst this approach is seductive, we think it is dangerous because it relies on theory rather than practice and, crucially, ignores the markets. The UK's public finances are in a horrendous condition with the budget deficit the Coalition inherited at 11.6% of GDP. With this sort of deficit, which would previously have been thought of an unimaginable, there was the risk of a collapse of sterling and/or the gilt market. Prior to the General Election, the markets probably gave the UK the benefit of the doubt, but they would have not have been as tolerant if decisive action was not taken after it. As we have seen in Greece, Ireland and Portugal, markets have taken matters out of the hands of the politicians and they are no longer masters of their own house. This could easily have happened to the UK if decisive action had not been taken and why we disagree strongly with those who want to take their time over deficit reduction. There is going to be a large campaign, as we know, against the public spending reductions and widespread strike action, as we are seeing elsewhere in Europe, is probable. Life will get very difficult for the Coalition, which will become very unpopular and it is possible that it will fragment. But opinion polls appear to show that the reason for the deficit reduction action is well understood, so those advocating less dramatic action may not have it all their own way. The UK has therefore already received the benefit of its robust structural deficit elimination plans in terms of lower interest rates which will help to moderate the growth in its debt servicing charges. It now has to deliver against the background of every special interest group complaining about the effect of the cuts and the near certainty of a significant number of public sector strikes. If the Coalition were to go back on its plans to eliminate the structural deficit over the life of this parliament, the bond and foreign exchange markets would punish the UK severely and, quite possibly, as is happening with the weaker members of the eurozone, matters will be taken out of their hands. To our way of thinking, those who call for a more gradual approach to deficit reduction in the UK are not facing reality. At any time, the markets could regard the UK as too risky and matters, in such a case, would be taken out of the hands of the government. That should not be a position in which any government would want to find itself. That the UK's deficit cutting plans now have credibility is shown by the fact that, in August, international investors bought £8.6 billion of gilts, 55% more than in July. The six month rolling average rose to £8 billion in August, the highest ever level since the data was recorded in the 1980s.

Although not receiving as much attention as the deficits of the USA, UK and some eurozone members, Japan, in some ways, has the worst position of all, with gross government debt approaching 200% of GDP. Because most of the debt is held internally, it has been less of a problem. There have been plenty of domestic buyers, although the drop in the savings rate, as the demographics change, points to a less comfortable trend in future. Because of its strong external position as a result of its very large foreign exchange reserves, investors do not tend to worry about Japan too much. But the constant comings and goings on the political scene and the hot potato of the consumption tax and whether to increase it and, if so, when, give the impression of indecision and, sometimes, an unwillingness to face the facts. With negligible interest rates and deflation, monetary policy has lost its ability to be effective. Not now, but in the future, the markets may turn on Japan but, for the moment, the problems of others are worse.

When countries are facing difficult problems and the electorates are restless, politicians are inclined to engage in diversionary tactics to deflect blame from themselves or to try to garner populist support. This leads to the risks of accidents happening which could lead to long term economic damage. We see several examples of this at present. Over the years, we have often commented that one of the greatest dangers to the world economy is an outbreak of protectionism. Whilst it may seem good politics to erect trade barriers in order to protect local business, it is very poor economics since it involves an economic loss to consumers and ultimately the world economy. With the US midterm elections coming up, some US politicians are ramping up the pressure on China to allow its currency to appreciate significantly. They consider that China is manipulating its currency to keep its exports competitive and cite the trade surpluses which China continues to run and, therefore, the foreign exchange reserves which it accumulates. All of this may be true, but politicians have to live in the real world and reflect on the consequences of ill judged actions. In this case, the stakes are very high. Should tariffs be imposed on Chinese imports to reflect what the proponents of legislation judge to be the level of the undervaluation of the renminbi, they would invite retaliation and, when a country is the world's largest debtor nation, it is in no position to provoke the world's largest holder of foreign exchange reserves, namely China. That these US politicians believe that China will not retaliate, beggars belief. In a trade war, nobody wins, and many lose. In current circumstances, it could lead to a significant curtailment of economic activity and a rise in unemployment. The momentum for action of this type is building up in Congress, although it is not clear if legislation would pass or what is the attitude of the President. The Administration appears to prefer persuasion. Whatever the justification for complacency about the undervaluation of the renminbi, this potential action is particularly crass. So an increase in protectionism is one risk to the world economy.

In Europe, protectionism is never far from the surface, and the USA and others have every reason to complain. The proposed Alternative Investment Fund Managers Directive is a purely political project masquerading as a directive for preventing another financial crisis. As a firm, we have a policy of not investing in hedge funds, but it is wrong to blame the financial crisis on hedge funds and other structures which could be caught up in the draft directive. This is a protectionist measure dressed up as something else, because it could make it very difficult for non EU based firms to sell their products in the EU and the restrictions on funds will make life difficult for those within the EU which could be badly affected by this directive. It is still not agreed, but is another damaging idea thought up by politicians who have not thought through or, it seems, understood the issues. The UK could be a big loser here, given the importance of fund management to the UK financial services industry.

In some ways related to this, is the "banker bashing" game being played by many politicians. To be critical of politicians who are involved in this is not to defend many of the practices which went on or the remuneration packages which many bankers received but, in an attempt to ingratiate themselves to their relevant electorates, they have lost touch with the practicalities of the real world. In the real world, parts of the Middle East and Asia are seeing significant growth in their financial service activities and are actively encouraging financial businesses to establish themselves there. The risk is that banks or, more likely, part of their activities, will move to more benign areas. This is really cutting off one's nose to spite one's face. In the UK, there are already murmurings from banks like Standard Chartered and, perhaps, HSBC. If the Banking Commission recommends that banks be split between retail banks and investment banks, there could be an exodus. This is on top of bankers' bonus taxes, balance sheet levies and increasingly uncompetitive personal tax rates. This is particularly relevant to the UK with its large financial services industry. The politicians who drive policy, in many cases, do not seem to be in touch with reality and risk damaging their countries' tax base to score political points. The UK, particularly, comes to mind here.

These are three examples of actions being driven by politicians to buttress their standing with their respective electorates, which threaten economic damage and are relevant to investors as they determine their investment strategy. None has, so far, developed as far as to cause serious damage but they could well do so and, in this case, could have investment implications.

We now turn to look at different areas of the world, starting with the USA, where the final estimate of second quarter GDP shows annualised growth of 1.7%, confirming the slowdown in the rate of growth in the world economy that is currently being experienced. This 1.7% annualised growth rate compares with 3.7% in the first quarter and 5.0% in the final quarter of 2009. The second quarter growth figure ties in with the report in the latest Beige Book issued by the Federal Reserve. Although the economy continued to expand, there were "widespread signs of a deceleration". The Federal Reserve regional banks reported that consumers continued to increase their spending but are avoiding non essential purchases. Some regions reported that manufacturing demand had weakened but farmers and miners were enjoying growth. Home sales were weak. The slowdown in the rate of growth of the US economy was enough to make the US Federal Reserve indicate that it was prepared to take further quantitative easing measures to boost the economy, if necessary. In its policy statement, after its September meeting, the Federal Open Market Committee said that it "was prepared to provide additional accommodation, if needed, to support the economic recovery". In keeping the federal funds target rate in its range of 0% to 0.25%, it went on to say "economic conditions ..... are likely to warrant exceptionally low yields of the federal funds rate for an extended period". This is as close as it possible to say that short term interest rates will remain very low for the foreseeable future. As one might expect with an economy which is growing only modestly, there was a mix of good and bad news in September but, of course, that balance is much better than in late 2008 and 2009, when most of the news was unremittingly bad, so the trend is better, and this is something that investors had noted. On the positive side, the Conference Board's consumer confidence index rose 2.5 to 53.5 in August compared with 51 in July. In another measure of sentiment, the IBD/TIPP economic optimism index rose from 43.6 in August to 45.3 in September. The ISM manufacturing index rose from 55.5 in July to 56.3 in August. The US trade gap narrowed in July because of a rise in exports. With the trade deficit falling by 14% to US$42.77 billion, the improvement was helped by a 1.83% increase in exports to US$153.3 billion and a 2.1% decline in imports to US$196.1 billion. Earlier in the year, in the second quarter, rising imports had been a drag on US economic growth. US retail sales rose by 0.4% in August, following a 0.3% rise in July. News from the housing and construction market was mixed. On the positive side, construction of homes reached the highest level in four months in August. They rose by 10.5% at an adjusted annual rate to give a rise over the last year of 2.2%. US home sales rose in August for the first time in four months to an annual rate of 4.13 million units, compared with 3.84 million units in July. Finally, the S&P/Case-Shiller index of house prices in twenty US cities rose by 3.2% in July compared with one year ago. On the other hand, the Federal Housing Finance Agency reported that US home prices fell by 3.3% in July compared with a year earlier, with the time it would take to clear the market of homes for sale being 12.5 months in July, the highest in more than a decade of data, according to the National Association of Realtors. Prices in July were 0.5% lower than in June. As consumers in the USA retrenched, US consumer borrowing declined by US$3.63 billion in July, following a drop of US$1.02 billion in June. This is part of the necessary deleveraging which is taking place in the economy, which, in the short term, has a negative impact on demand.

Lead by Germany, the eurozone has performed better than expected but this, of course, covers a wide range of outcomes given the severe financial conditions and some of the peripheral eurozone countries. Quarter on quarter, eurozone GDP grew by 1% in the second quarter compared with the first and this is the fastest rate of growth for four years following an upwardly revised increase of 0.3% in the first quarter. Both the European Central Bank and the European Commission raised their forecast for economic growth in the eurozone this year. The current ECB expectation for growth this year has a midpoint of 1.6% in its range compared with 1%, which it has anticipated in June and, for 2011, the respective figures are 1.4% and 1.2%, although it did qualify its forecast with a warning that its projection could be overoptimistic. The reason for the upward revision was the exceptional recent growth spurt, which we have noted in the second quarter figures. The President of the ECB said they expected a slowdown in the second half, but said he expected "positive underlying momentum". According to the EC, eurozone growth would be 1.7% in 2010 compared with its 0.9% growth forecast last May. It forecast "a moderation of growth" in the second half of this year, with forecast quarter on quarter growth for the third quarter at 0.5% and 0.3% for the fourth quarter, down from the 1% noted above in the second quarter. The contrast is made between the strongest economy, Germany, which is seen as growing at 3.4% in 2010, compared with the previous year, and Spain, showing a contraction of 0.3% at the end of 2010 compared with the year earlier. There was a slight improvement in consumer confidence in the eurozone in September, compared with August, at -11.2 compared with -11.4. The purchasing managers index of activity for services in the eurozone sector fell to 53.6 in September from 55.9 in August while that for manufacturing fell to 53.6 from 55.1. Both are in positive territory, but suggest a slowdown in the rate of growth in economic activity, which is consistent with the ECB's and EC's projections. There was a pickup in the rate of growth of eurozone money supply in August to 1.1% at an annual rate compared with 0.2% in July. On the negative side, there was no change in eurozone industrial production in July. It had fallen 0.2% in June. Industrial orders in the eurozone fell by 2.4% in July, to leave them 11.2% higher than a year earlier. Within the eurozone, the German economy has performed very strongly, although the rate of growth is expected to slow down in the second half. Amongst items of positive news was one on unemployment in Germany, which fell to 3.193 million, its lowest level since November 2008, to give an unemployment rate of 7.6%. German business sentiment also continues to improve. The Ifo business climate index rose in August to 106.8 from 106.7, a fourth consecutive monthly rise. Consumer confidence is also improving. The GfK market research index said that its consumer climate index had risen from 4.3 in September to 4.9 in October. On the negative side, in Germany, and consistent with a slowdown in the rate of growth, we note that industrial orders fell by 2.2% in July compared with the 3.6% rise in June. The ZEW index of German economic sentiment fell to -4.3 in September compared with 14 in August. The German purchasing managers index fell to 55.3 in September from 58.2 in August and for services to 54.6 from 57.2. Again, both are in positive territory, being above 50, but indicate a slowdown in the rate of economic growth.

France has struggled compared with Germany and has a significant budget deficit. Its latest plan to reduce the deficit has just been announced, which is aimed at cutting the deficit by 1.7% in 2011. France has consistently failed to observe budget discipline and has not run a balanced budget for twenty five years. The plan is to cut the deficit from 7.7% of GDP this year to 6% in 2011, to 2% in 2013 and 2% in 2014. Its additional measures are aimed at raising taxes by €11 billion, imposing a nominal freeze on government spending and end economic stimulus measures and rely on higher tax revenues from stronger economic growth. This latter is particularly difficult and often relied upon by governments to give credibility to forecasts. Sometimes the growth does not emerge. As we have seen from strikes, largely in the public sector in France, measures to restore a semblance of order to France's public finances by, for example, raising the pension age from 60 to 62, have been met by mass public sector strikes and demonstrations. In previous times, the government has given way but perhaps the severity of the economic situation, with France being at the weaker end of the AAA credit rating spectrum, will stiffen the government's resolve.

The main news from Japan in September has been intervention by the Bank of Japan to weaken the yen because its strength was threatening economic activity. For the first time in six years, the Bank of Japan intervened in the currency markets to sell the yen and, furthermore, it did not sterilise the intervention because it did not effectively mop up the yen by issuing yen denominated debt. This intervention displeased Japan's trading partners, most of which are happy with weak currencies to try to stimulate their growth but they cannot, of course, all be weak at the same time. The latest Tankan survey from the Bank of Japan showed manufacturers to be optimistic about business conditions in September but more gloomy about what lies ahead. Large manufacturers are expecting business conditions to worsen in the final quarter of 2010. The Tankan headline sentiment indicator, comparing the number of larger manufacturers reporting positive conditions compared with those reporting negative news, rose to 8 in September from 1 the previous quarter but, looking ahead, that index falls to -1. Two factors have made them more negative, the first being the slowdown in some of the bigger export markets for Japanese manufacturers and the second being the high yen to which we have just referred. To try to ease conditions, the government plans a US$55 billion equivalent supplementary budget.

The USA, UK, eurozone and Japan can, of course, only look on with awe at the growth rate in China. Chinese industrial production in August was 13.9% higher than a year earlier, compared with a figure of 13.4% in July. Retail sales rose by 18.4%, year on year, compared with 17.9% in July. Fixed asset investment rose by 24.8% in the first eight months of the year compared with the same period a year before. M2 money supply growth increased to 19.2% year on year in August compared with 17.6% the previous month. Fixed asset investment is something that the Chinese authorities are concerned about, because of the possibility that it will not be economic and will cause problems for Chinese banks because of the loans which they have advanced. The HSBC purchasing managers index in China rose to 52.9 in September from 51.9 in August. This mainly reflected faster increases in production and new business. Another economy where the west can only look on with envy, at least in terms of economic growth, is India, where the June quarter saw an 8.8% year on year growth. India has economic problems with inflation and deficits, so there are problems there, but the growth rate reported was the fastest since the beginning of 2008. Another BRIC economy, Brazil, reported an annualised growth rate of 8.9% in the first half of 2010. It indicated that the 7% growth for the year, which had been forecast, might be exceeded.

Turning to the UK, the UK economy grew by 1.2% in the second quarter and this was its fastest rate of growth since 1999. The figure comprises inventory rebuilding, adding 0.4% to the headline growth number, and business investment, rising 0.7%. Looking at a number of forecasts which have been made in September for the UK economy, the OECD is forecasting growth to slow to 0.7% in the third quarter and about 0.4% in the fourth quarter. The European Commission has raised its forecast for UK growth this year to 1.7% compared with its previous forecast of 1.2%. Its forecast for the third quarter growth is 0.5% and 0.6% for the final quarter of 2010. The CBI has raised its forecast for growth in 2010 to 1.6% compared with 1.3% with growth expected to be 0.3% in the third quarter and 0.6% in the final quarter. It has reduced its growth forecast for 2011 to 2.0% from 2.5% because of the cuts in government expenditure.

There is evidence, as expected, of a slowdown in the rate of growth of the economy. The housing market is one indicator. According to the Nationwide's house price index for August, house prices recorded their first back to back decline since February 2009. According to its data, the average house price fell by 0.9% in August following 0.5% in July. On the other hand, data from the Halifax showed a slight rise in August of 0.2% in house prices compared with July, following a 0.7% rise in July over June. The RICS said that, amongst its members, 38% thought prices were falling, while 7% saw rising prices to give a seasonally adjusted balance of -32% compared with -8% in July. The Council of Mortgage Lenders reported that mortgages granted to first time buyers fell to 19,400 in July, from 19,700 in June and 20,100 a year earlier. According to the Department for Communities and Local Government, house prices rose by 8.4% on the year in July compared with a 9.9% gain in June. For the month of July, prices fell by 0.3% after rising 0.4% in June. The Bank of England reported that the number of mortgages granted to buy homes in August fell from 47,000 to 45,000, and approvals have not been this low since April 2009. British Bankers Association figures showed that the number of mortgages approved by high street banks fell to a sixteen month low in August at 31,167 against 34,219 in July, the lowest level since April 2009. As a sign of general deleveraging, the Bank of England reported that lending to private non financial companies rose by 0.9% in August at £2.3 billion, although much of that reflected loans in foreign currencies. Bank lending in sterling fell by £400 million. The various purchasing managers indices also indicate growth, but at a lower rate. The index for the manufacturing sector in August fell to 54.3 from 56.9 in July. The index for the construction sector fell to 52.1 in August from 54.1 in July and that for the services sector from 53.1 in July to 51.3 in August. This evidence chimes in with that of outside observers that the economy is growing but at a slower rate than in the second quarter and this is replicated in many other countries. Official figures showed that output rose by 3% in July, the same rate as in May and June, lifting the annual growth rate to 4.9%, which is the highest since December 1994. The Nationwide's headline gauge of confidence rose to 61 in August from 56 in July and its index measuring confidence over the economic outlook rose from 77 to 84. According to a survey of British manufacturers, they expect production to grow solidly in the next quarter, even though orders are weakening. The balance of manufacturers expecting to raise production over the next quarter improved to 12 in September from 10 in August. The CBI reported that retail sales were strong in September with its index rising to 49 from 35 in August, the highest level since May 2004.

In terms, of monetary policy, there appears to be perhaps a three way divergence of views in the Monetary Policy Committee which sets interest rates but, overall, the latest minutes show that the Bank of England may be moving towards more quantitative easing. The MPC agreed that "it was quite likely that the recovery in the United

Kingdom would not be smooth and that growth in some quarters would be relatively slow". Some members felt that "the probability that further action would become necessary to stimulate the economy …. had increased". It looks possible, therefore, that the UK and US central banks will engage in another round of quantitative easing to try to resurrect economic growth, which still continues, albeit at a more modest rates.

Encouragingly for the international economy, the Head of the World Trade Organisation said that the Organisation had raised its expectation of growth in world trade to 13.5% this year, which is a third higher than its previous estimate. Mr Lamy put this increased forecast down to success in warding off protectionism although, as we have discussed earlier, there is no reason to be complacent because it is never far from the surface in the USA and Europe. In the developing world, trade volumes are expected to rise 17%, whilst the developed world will still show a still respectable 11% rate of growth. This would reflect the fastest year on year expansion recorded in annual figures since 1950, albeit that they were from a depressed level in 2009.

Against the background which we have described in this review, it is not surprising that investors' and investment managers' views are so polarised on the market. There are many conflicting signals. Although we must expect setbacks, and the path has not been smooth this year, we believe, for the reasons given, that shares offer the best value of the major asset classes and it is always important to remember that a stock market cycle can diverge from an economic cycle. Nobody can deny that the world's economic problems are serious but it does not mean that all investments are expensive.