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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Having held up well in the first six months of 2011, international equity markets reacted badly to the U.S. debt ceiling wrangle and, when that was temporarily settled, to the worsening eurozone sovereign debt crisis. We cover this issue in detail in our review. High quality bond markets reflected a flight to safety from perceived riskier credits, driving yields down to extraordinarily low levels. In currency markets, the yen and U.S. dollar were seen as the safest havens. Gold, although off its peak, ended the quarter higher but the oil price fell.

The tables below detail relevant movements in markets :

International Equities 30.06.11 - 30.09.11

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-12.0	-17.7	-20.1	-13.7
Finland	-21.4	-25.0	-27.2	-21.4
France	-23.5	-27.0	-29.2	-23.5
Germany	-25.9	-29.3	-31.4	-25.9
Hong Kong, China	-22.7	-20.3	-22.7	-16.5
Italy	-25.8	-29.3	-31.4	-25.8
Japan	-10.3	-3.1	-6.0	+1.6
Netherlands	-20.2	-23.9	-26.2	-20.2
Spain	-15.8	-19.7	-22.1	-15.8
Switzerland	-11.2	-15.2	-17.7	-11.1
UK	-13.0	-13.0	-15.6	-8.8
USA	-14.0	-11.3	-14.0	-7.1
Europe ex UK	-20.2	-24.3	-26.5	-20.6
Asia Pacific ex Japan	-14.8	-18.0	-20.4	-14.0
Asia Pacific	-12.8	-11.7	-14.3	-7.4
Latin America	-11.5	-22.2	-24.6	-18.5
All World All Emerging	-14.4	-19.2	-21.6	-15.3
The World	-14.6	-14.7	-17.3	-10.6

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +8.2%

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

Currency	30.06.11	30.09.11
Sterling	3.38	2.42
US Dollar	3.16	1.93
Yen	1.14	1.03
Germany (Euro)	3.01	1.89

Sterling's performance during the quarter ending 30.09.11 (%)

Currency	Quarter Ending 30.09.11
US Dollar	-2.6
Canadian Dollar	+5.0
Yen	-6.7
Euro	+5.1
Swiss Franc	+4.6
Australian dollar	+7.3

Other currency movements during the quarter ending 30.09.11 (%)

Currency	Quarter Ending 30.09.11
US Dollar/Canadian Dollar	+7.9
US Dollar/Yen	-4.2
US Dollar/Euro	+7.9
Swiss Franc/Euro	+0.5
Euro/Yen	-11.2

Significant Commodities (US dollar terms) 30.06.11 - 30.09.11 (%)

Currency	Quarter Ending 30.09.11
Oil	-8.6
Gold	+6.8

Markets

Significant negative returns have been seen almost everywhere in international equity markets. In fact, the only positive return in our table on the front page came from the FTSE Japanese Index in euro adjusted terms. Every other return was negative.

The FTSE World Index showed negative returns of 14.6% in local currency terms, 14.7% in sterling terms, 17.3% in US dollar terms and 10.6% in euro terms. The least bad area in local currency terms was Japan where the FTSE Japanese index showed a negative return of 10.3%. The worst area was Europe ex UK with the FTSE Europe ex UK index showed a negative return of 20.2%. Within that area, the worst performers were Germany (-25.9%), Italy (-25.8%) and France (-23.5%) whilst the least bad performers were Switzerland (-11.2%) and Spain (-15.8%) as measured by the relevant FTSE indices.

Against the FTSE World Index, there were small outperformances from the FTSE Australia index (-12.0%), the FTSE UK index (-13.0%) and the FTSE USA index (-14.0%). The FTSE Asia Pacific ex Japan index performed fractionally worse than the FTSE World Index at -14.8% but the FTSE Latin American Index (-11.5%) and the FTSE All World All Emerging Markets Index (-14.4%) performed slightly less badly.

Because of quite significant currency movements, a different picture emerges when the indices are looked at in sterling terms. Whilst there is hardly any difference in the performance of the FTSE World Index in local currency and sterling terms, just 0.1%, we see the negative performances from the FTSE Europe ex UK index expand to 24.3%, from the FTSE Australia Index to 17.7%, from the FTSE Asia Pacific ex Japan index to 18.0%, from the FTSE Latin American index to 22.2% and from the FTSE All World All Emerging Markets index to

19.2%. On the other hand, the strength of the yen reduced the negative return on the FTSE Japanese index to just 3.1% whilst the negative return on the FTSE USA index reduced to 11.3%.

The high quality government bond markets performed very strongly in contrast to the perceived weak credits of some eurozone countries. Taking ten year government bonds as a benchmark, the gross redemption yield on UK government bonds fell by an astonishing 96 basis points to 2.42%, on US Treasuries by 123 basis points to 1.93% (this despite an S&P downgrade of its long term sovereign debt from AAA to AA+), on Japanese government bonds by 11 basis points to 1.03% and on euro denominated German government bonds by 112 basis points to 1.89%.

There were some quite sharp moves in the currency markets. Against the Canadian dollar sterling rose by 5.0%, against the euro by 5.1%, against the Swiss Franc by 4.6% (this after the Swiss Central Bank pegged the Swiss Franc to the euro following a dramatic rise in the Swiss Franc) and against the Australian dollar by 7.3%. On the other hand, sterling fell by 2.6% against the US dollar and 6.7% against the yen. In other cross rates, the euro fell by 11.2% against the yen, hence the positive return on the FTSE Japanese index in euro terms mentioned above.

In the commodities markets, the turbulence affected oil with Brent crude falling by 8.6% in US dollar terms but the US dollar, except against the yen, was generally a strong currency. Gold, although off its peak level, rose by 6.8%.

Economics

A thoroughly dispiriting quarter for investors has resulted from the lack of political leadership in the USA and eurozone. At the end of the first half of this year, markets had held up well in the face of bad news but, in the third quarter, political issues related to US government and eurozone finances unnerved investors.

The first issue was the US debt ceiling stand off. So partisan have become US politicians that they were prepared to put at risk the USA's credit standing to score petty political points. It is frightening how little many politicians, not just in the USA, seem to understand about the real world of economics and finance, in this case the consequences of the stand off. At the eleventh hour, a short term fix was agreed but not before considerable damage was done to the USA's credibility and a subsequent downgrade of the USA's long term credit rating by S & P to AA+ from AAA. In its reasoning, S & P referred to the political issues in the USA and who can quarrel with this judgement? The checks and balances in the Constitution are not suited to quick and effective decision making, especially when there is a split Congress. The virulence of the antagonism shown by the various parties towards one another has made rational decision making almost impossible. It is difficult to know if many US politicians do not understand the consequence of their actions or lack of action or whether they just do not care, preferring instead to try to gain some short term political advantage. But whatever the reason, the debt ceiling saga caused much damage in the markets and was one of the contributors to the poor performance of international equity markets in the third quarter. Before we leave the USA temporarily, we have another example coming up in the USA of proposed legislation which, if enacted and not vetoed by the President if he is able to, could cause serious economic damage. When the world economy is facing difficult times, countries often veer in a protectionist direction and a bill before Congress is aimed at putting tariffs on Chinese goods related to an estimation of the level of undervaluation of the Chinese currency. In past reviews, we have referred to the latent protectionism which abounds in the USA with politicians influenced by the particular constituency to which they feel obligated rather than wider considerations. As a general rule, protectionism works against most people's interests and is a threat to world growth because of the effect of trade barriers. It is sadly true that most politicians look no further than the next election, promoting policies that they believe will help their re-election cause. A much longer time horizon is required for good decision making. The problem in the USA is that next year is election year and it would be an optimist who expected appropriate rather than populist economic policies to be put forward. The bill regarding China is particularly crass. It is true that China manages its currency and, in the absence of this, the yuan would be higher. But the USA is the world's largest debtor and antagonising your creditors is not sensible. China does not respond to threats and the views of those proposing these protectionist measures are depressing. Leadership and realism are in very short supply in the USA.

The stand off over the US debt ceiling, whilst highly damaging, has its roots in an important issue for the USA, the size of government. The very serious level of the budget deficit and long term projections for its course and the overall level of public debt in relation to GDP, means that the present situation has to be addressed, as it is unsustainable. Either taxes have to rise or public expenditure has to be cut or some combination of the two has to occur. The increasing polarisation of the Democrats and Republicans means that there is not much centre ground. The USA has been able to sustain the unsustainable as far as its deficits are concerned because the US dollar is the world's largest reserve currency, which gives it some sway over its creditors because they do not wish to damage the value of their US dollar assets by dumping dollars. Also, crucially, the USA is able to print its own currency and is not hamstrung like troubled countries within the eurozone.

The US debt ceiling stand off was the catalyst for the fall in equity prices in the third quarter but the temporary compromise has meant that it has now been replaced as the major concern by the eurozone sovereign debt crisis. The USA's fiscal position remains very serious but, for the moment, it is on the back burner. All things are relative and, for the moment, nothing approaches the eurozone sovereign debt crisis in seriousness. We may be about to witness the break up of a monetary union.

The design flaws, which were clear at the outset of European Monetary Union and which were pointed out by many people, have come back to haunt the eurozone. The performance of the politicians has been mostly abject. Most of those involved in the establishment of the euro are still around and so, politically, it is difficult for them to admit that the project is flawed. The number of stakeholders in the project is large and, as everyone knows, management by committee is hardly ever effective. In the case of the euro, the politicians are always behind events and nobody appears to be in charge. They all profess undying support for the euro but what is not clear is whether that is actually true or whether they do not understand that the eurozone is not an optimal currency zone and, so, believe, that it is sustainable or whether they are so frightened of the consequences of the euro's break up that they feel they must remain in denial because they want to sustain confidence in the banking sector. We are all guilty of using the benefit of hindsight but it must be emphasised that there is no hindsight here. The "one size fits all" monetary policy and the inability to transfer funds within the eurozone such as occurs in the USA, for example, were fatal flaws.

Although the eurozone is split on how to deal with the crisis, all participants are agreed that the eurozone must not fail. They may be saying this for a number of reasons. Firstly, they may believe it. Secondly, they may be too proud to admit that it is flawed. Thirdly, they may feel that it is imperative to say this to maintain confidence. Fourthly, they may believe that although the eurozone project is in deep trouble, to unravel the euro may be even worse. Whatever happens, there is going to be no happy ending to this project.

Let us see where we are now. The "one size fits all" monetary policy was never going to work. Rather than lead to convergence, it has led to divergence. Countries like Germany and Greece have very little in common in terms of economic structure. To believe that one interest rate could be suitable for both was incomprehensible. The same goes for all of the southern members of the eurozone and, also, Ireland. With their higher rates of inflation compared to Germany, they became increasingly uncompetitive leading, in the troubled eurozone members (except Ireland), to a wide current account deficit. Crucially, the credit markets, until it was too late, did not distinguish between the various members of the eurozone. There was at the end of 2006, for example, almost no difference in the yield between German and Spanish bonds and only a modest premium for Greek bonds. A euro was considered to be a euro whichever country was behind it. The economic discipline which a monetary union entails was lacking in many spheres, notably the Stability and Growth Pact which imposed limits on budget deficits and overall public debt as a percentage of GDP. Early on, France and Germany exceeded these limits so, if the two largest eurozone countries break the rules, it is very unlikely that others will adhere to them.

Had these troubled eurozone countries remained outside the monetary union and retained their former currencies, markets may not have let them follow the economic policies which they did because they would have experienced depreciating currencies, even higher relative inflation and higher interest rates. Countries like Ireland and Spain which had property booms on the back of interest rates set by the ECB, largely for Germany, would have set interest rates higher to suit their domestic needs, an example of the insidious effect of a single interest rate for such a disparate group of economies. Now, whilst the troubled countries remain in the eurozone, they will not be able to re-establish their competitiveness through the normal channels of a devaluation. So what is being forced upon them by their creditors is a vicious programme of cost reduction and deflation to achieve an internal devaluation to move their costs back into line with when the euro started or when they joined the eurozone. Greece is the author of its own problems but with various governments having colluded with policies which have brought the country to its present state, it is not difficult to see why there is so much hostility in Greece to the bail out programme. The programme of public sector redundancies, pay and pension cuts and tax rises condemn Greece to a state of economic contraction making it certain that the country will be unable to repay its debts and default. In these sort of circumstances and with tight fiscal policy in most of the eurozone, it is hard to see where growth will come from in a country with the economic profile of Greece. Yet somehow, through smoke and mirrors, those who run the eurozone want to keep the show on the road. This is because of concerns about the banking sector. Whilst some banks have recognised a 21% haircut on their Greek sovereign debt, we can have a high degree of belief that such a haircut does not in any way recognise the level of write off which is going to be needed for Greek sovereign debt. They are desperate that other countries do not default because of the threat particularly to the eurozone's banking sector.

So, what is going to happen and what may be the investment consequences of the eurozone crisis? As well as the economics of the situation, we have to look at the politics. All along, those politicians have made the running with relatively little consultation with their electorates. There is little doubt that the eurozone's voters do not share the views of most of their political leaders. In the relatively strong countries like Germany, the Netherlands and Finland, there is growing resentment at the money going to the weaker eurozone members. It is not just amongst the electorate, it also manifests itself in the rise of eurosceptic parties like the True Finns in Finland. The more guarantees these countries give, the weaker will be their credit in markets so that, far fetched as it may seem now, they, too, could end up in trouble. In Germany, the Chancellor, Angela Merkel, has got an expansion in the European Financial Stability Facility (EFSC) through the Bundestag. But this increase was agreed last July and the €440 billion agreed then is quite inadequate now. Germany's guarantee in relation to this runs to nearly €130 billion. Given the unhappiness in Germany at this amount, imagine what the feeling would be if it was a multiple of this and this is just one parliament out of 17. At some stage, there will come to power politicians who will not feel the same affinity to the euro. So expanding the EFSC into the trillions of euros seems impracticable and Germany is always bound by the limits of its Constitutional Courts where angry economics professors are always willing to challenge the government.

However, the anger of the debtor eurozone's voters is likely to be even greater. Riots and strikes in Greece are commonplace and must be affecting the economy in a negative way. The regular increases in austerity imposed by the troika of the ECB, EC and IMF must surely have passed their population's limit of its tolerance and it is difficult to see any Greek government being able to govern effectively in such circumstances.

It is not only the debt issues which are the problem, it is also that a number of these countries have proved resistant to supply side reforms which, if enacted, could increase the country's growth potential. Rigid labour markets and closed professions (Italy comes to mind) have condemned some eurozone members to low growth and low growth potential. But vested interests have resisted reforms and, certainly in Italy, the government does not seem to have the stomach to try to liberalise the economy preferring instead to rely on tax increases which will negatively impact on the potential growth rate of the Italian economy.

We therefore think it unlikely that the politics will be helpful to eurozone governments, the EC and ECB as they try to stabilise the eurozone's sovereign debt crisis. This provides a further uncertainty.

By its very nature, decision making is cumbersome in the eurozone. As this is written, the €440 billion EFSF has still not been approved by all 17 parliaments. As this is a fast moving drama, the main participants are well behind the crisis.

We think that the short term solution lies with the ECB which has been turned on its head in terms of what it is supposed to stand for. Originally considered the most orthodox of the central banks, it has taken steps which are quite out of keeping with its previous image and, in doing so, has caused unhappiness in its ranks. The ECB's inflation target has been well exceeded. In the spring and summer it raised interest rates in two stages to 1.5%, well below the eurozone's current rate of inflation of 3.0%. It now looks as if it might have to reverse these rises because of the eurozone's problems. Secondly, in order to try to limit the damage to sentiment and credibility of Spain and Greece, it started to buy Spanish and Italian government debt to keep ten year bond yields below 6%. It now has approximately €160 billion of eurozone government bond debt on its balance sheet, the other debt belonging to Greece, Ireland and Portugal. This action has been particularly controversial because it could be seen to providing fiscal help to these countries, which is not allowed. If these purchases are not sterilised, then debt could be monetised and this is likely to be the short term fix. Additionally, because some eurozone banks are finding it difficult to raise funds, having been shut out of money markets, the ECB is providing the necessary liquidity. The problem arises when the collateral becomes of uncertain value but the ECB cannot afford to let a major bank go under so will, if necessary, print money. This is how we see the short term picture unfolding.

One idea gathering pace seems to be that of leveraging up the EFSF assuming it is agreed in its present form by all the parliaments of the eurozone. As mentioned just now, the politics are becoming difficult, yet €440 billion will be totally inadequate to meet the needs of the situation. It will be almost impossible to get a larger figure through all 17 parliaments. By gearing up the €440 billion and leaving that slice as equity to absorb losses on troubled government debt purchased in the markets or from bank losses, the plan would be to arrive at an equivalent situation to beef up the EFSF without having to gain parliamentary approval. This would be effectively a money printing exercise to provide the extra funds for purchases.

It is an irony of the situation that the desperate measures being undertaken or mooted by the authorities strengthen the position of the debtor countries in a paradoxical way. As the eurozone's leaders become more and more desperate to maintain its integrity, the debtor countries know that threats to withhold support are, if not quite empty, lacking in credibility because, if they were to default, the other eurozone members' banks would suffer serious damage. Because eurozone banks stocked up with "safe" assets such as eurozone government bonds and did not distinguish sufficiently between credits, they have very large holdings of eurozone sovereign debt on their balance sheet. According to a table in the Financial Times on 21 September 2011, the total sovereign debt outstanding of Greece, Ireland, Portugal, Spain and Italy is €3.116 trillion, a significant amount of which is held by foreign banks.

If the worst came to the worst and there were significant eurozone sovereign debt failures (Greece should be manageable), the experience of the 2008 financial crisis should come in useful with major troubled banks being nationalised and deposits guaranteed again, and because the individual eurozone countries are unable to print their own money, some mechanism through the ECB would presumably be found. This sounds easy. It certainly would not be and the inflationary consequences down the line would be likely to be serious. It is sticking plaster applied as a temporary expedient.

What we have described is the third way forward, the "muddle through" way. In truth, it is not a way forward. There are only two. One is to go for a full fiscal transfer union so that, as in the USA, there would be monetary union between the eurozone countries and fiscal transfers as necessary. Will the electorates of the richer eurozone countries stand for this? Almost certainly not. The other alternative is the complete or partial break up of the eurozone because, for different reasons, creditor and debtor eurozone nations find the situation they are in to be intolerable. A break up of the eurozone would be extremely disruptive and cause immense financial damage.

The plus point for the debtor countries is that, with their own currency, the ensuing devaluation gives them a chance, through increased competitiveness, to grow again. The alternative, years of austerity and deflationary measures, is likely to prove intolerable and the electorates would not stand for it.

So we think that, at some stage, the eurozone will either fragment or completely break up. A structure with such a fatal flaw cannot last indefinitely. In the short term, every possible measure will be taken to shore it up and we have described some of these above. The unpleasant volatility in markets, which we are currently seeing, reflects the uncertainty and lack of any leadership. No one seems to know what they are doing, especially the politicians, and it does not engender any confidence. The fact that those in authority in the eurozone are in denial about the currency does not help. Ultimately, it makes matters worse.

But in the ways which we have mentioned above, the authorities do have the power to keep the show on the road, albeit that the measures taken can only be a temporary expedient. To recap, the ECB would keep buying the bonds of troubled eurozone countries and provide unlimited liquidity for banks shut out of the markets. If significant eurozone government defaults occurred, the banks which would be badly affected could be nationalised. The UK's example with RBS is a precedent and now the Franco-Belgian bank, Dexia. The EFSF could be leveraged up and money printed to keep it going. This all sounds very easy. In fact, these are the desperate measures necessary when a monetary union is on the verge of breaking up. If these measures restore some short term confidence, markets may well stabilise. Notwithstanding a very poor quarter for equities, it is noticeable that when there is any lull in the flow of bad news or things look slightly better, markets do recover. The balance of news has obviously been negative but the pattern of market movements noted above is established.

The authorities will encourage the banks to build up a cushion against the losses which will hit them so that eventually they can absorb losses from the sovereign debt crisis. As mentioned above, state involvement in the banking sector is likely to increase whilst this crisis works itself out. Hopefully, somewhere in the eurozone, work is being done on how to handle departures from the euro. Something like this would never be admitted but it would be irresponsible not have a plan. Reciting some of the measures that may be taken in the short term to stabilise the position sounds rather easy. It is not, of course, and further down the line the measures seem sure to spark off inflation. But, such is the seriousness of the situation, that the problem has to be put to one side whilst attention is focused on the short term problems.

However, a sense of balance is important. Yes, things look awful in the west and Japan and particularly in the eurozone area and we tend to be influenced by the events around us rather than further afield. The truth is that around half of the world, as measured by its share of GDP, is doing much better than the west and Japan and growth in these areas provides some important support for the troubled part of the world economy. As things stand at present, these growth regions should prevent the world economy slipping into recession.

The latest economic forecasts inevitably reflect the damage to confidence which events in the third quarter have caused. With so much uncertainty, who can blame companies and individuals if they hold on to their money? Whilst households in some countries like the UK and USA are highly leveraged and are trying to pay off debt, many companies which battened down the hatches after the 2008 financial crisis are cash rich but do not have the confidence to spend. Growth forecasts are understandably being reduced.

For example, the IMF, in its latest economic projections from its September "World Economic Outlook", has reduced its forecast for world economic growth to 4.0% for each of 2011 and 2012, reductions of 0.3% and 0.5% respectively, compared to its June 2011 forecasts. This would compare with growth of 5.1% in 2010. This forecast is not disastrous and it does not project a recession. Amongst advanced economies, growth is forecast at 1.6% this year and 1.9% next year, quite sharp reductions of 0.6% and 0.7% respectively from its June forecasts. The forecasts for US growth have been cut sharply to 1.6% and 1.9% respectively, reductions from its June forecast of 1.0% and 0.9% respectively. Not surprisingly, the eurozone's growth forecast has also been reduced sharply to 1.6% and 1.1% respectively, reductions of 0.4% and 0.6%. Germany, the best performer of the major eurozone economies which grew by 3.6% in 2010, is forecast to grow by 2.7% this year but just 1.3% next year, not much different to the projected average eurozone growth rate. These projections represent downgrades of 0.5% and 0.7% respectively on last June's forecasts. Japan, in the aftermath of March's earthquake and tsunami, is forecast to contract by 0.5% and to grow by 2.3% next year. This year's forecast in fact represents an upgrade of 0.2% from June although next year's forecast represents a reduction of 0.6% in its projection. The UK, too, has suffered a downgrading of its prospects. The IMF now projects growth at 1.1% for this year rather than 1.5% as previously and 1.6% next year as against 2.3% previously. For the Newly Industrialised Asian Economies, the adjustment has been relatively minor for this year, 4.7% against the June forecast of 5.1%. Next year's forecast remains at 4.5%. If we look at its forecast for Emerging and Developing economies, the IMF's forecasts are still quite robust, notwithstanding a modest downgrade by the IMF from its June estimates. It projects growth of 6.4% this year against 6.6% previously and 6.1% next year against 6.4% previously. Within that, China and India are still projected to show strong growth at 9.5% and 7.8% this year and 9.0% and 7.5% next year, all of these forecasts showing modest downgrades from June but, if they are achieved, still helpful levels of growth for the world economy. The other two members of the BRIC area, Russia and Brazil, are forecast to show growth this year of 4.3% and 3.8% respectively and for next year, 4.1% and 3.6% respectively.

The European Commission has also published revised forecasts for EU growth. For the EU27, its Spring forecast of 1.8% has been downgraded to 1.7%. Within the EU, its forecast of 1.6% actually remains unchanged but there is a sharp downgrading for the UK, 1.7% down to 1.1% for this year.

Intuitively, one would expect the risks to be on the downside, as most forecasters are now saying. The ongoing crisis in the eurozone hardly engenders any confidence. But the point is worth making that, as these projections show, even if the magnitude of the growth forecasts may be too optimistic, the increasingly important developing and emerging markets are a positive influence on world economic activity and investors have a number of ways of benefiting from this trend. There is a further reason to take a more balanced view of events as far as economic activity is concerned. The financial crisis of 2008 came so quickly that businesses were not prepared for it and carried what turned out to be excessive levels of stocks. When the crisis struck, it was as if the world economy came to a halt as production fell as stocks were drawn upon. So, in 2009, we saw a contraction in world output of 0.7%, as the IMF tables show, with advanced economies recording a contraction of 3.7% whilst Developing and Emerging Economies still managed to grow by 2.8%, with China growing by 9.2% and India by 6.8%. As we mentioned earlier, companies have been very cautious since that economic shock and have been conserving cash and keeping stock levels lean. The effect of the stock cycle is unlikely to be as sharp this time and, in this environment, this is a positive offset.

Obviously, most of this review so far has concentrated upon the sovereign debt problems of the eurozone which is the main issue for markets and investors at the moment but we do not want to ignore issues in other countries. Normally, we would often put some detailed economic and statistical information on various countries and regions in this review but, against the background of such economic anxiety, it seems sensible to concentrate on a small number of high level points from each area and we will start with the USA.

Earlier in this review, we touched upon the US debt ceiling stand off. For the moment, that issue has moved to the back of investors' minds and the eurozone has taken front stage. The problems for the USA are a high level of budget deficit and the need to take significant action in future to restrain the level of overall public debt, the level of unemployment and the need to try to accelerate growth which is currently low. In early September, the Office of Management and Budget, in its mid year review, issued a number of forecasts. That for the budget deficit showed an improvement because of a combination of the spending cuts which have been agreed and higher than expected revenues. The OMB's June forecasts for the 2011 deficit will be US$1,316 billion compared with its February estimate of US$1,645 billion, which reduces the deficit as a percentage of national output from 10.9%

to 8.8%. There has been a deterioration in the outlook for unemployment with the OMB's forecast rising from 8.3% in 2012 to 9% and it does not fall to 7% until 2015. The OMB's forecast for economic growth this year has been reduced to 1.7% from 2.1%.

Although there was a slight upward revision in the annualised rate of second quarter GDP to 1.3% from the previous estimate of 1.0%, the latest Federal Reserve Beige Book showed an economy that was sluggish and, in fact, two regions reported falling activity. Against such a background, President Obama has proposed US$447 billion in tax cuts and new spending to try to provide a boost to the US economy. This sum amounts to just over half of the amount of the stimulus applied in 2009 in the aftermath of the financial crisis of late 2008. This plan tries to stimulate employment. It includes a reduction in the social security payroll tax in 2012 from 4.2% to 3.1%, the usual rate being 6.2%. There is a proposed 50% cut in payroll taxes for businesses with a cap of US$5 million of wages. If companies can show that they have hired new employees with increased wages, then they would gain an exemption from payroll taxes, this being capped at US$50 million in additional payroll. This part would cost approximately US$235 billion. There is a call for a new infrastructure bank and US$80 billion in spending on new building projects. He also wants Congress to approve aid for states so that they can hire again laid off employees and there is a proposed extension of unemployment insurance which would be worth US$49 billion and a tax credit for those who have been out of work over a long period. He has also asked a team to work with Fannie Mae and Freddie Mac to find ways of translating current low mortgage rates into help for borrowers.

But, of course, the President can only propose and he cannot necessarily dispose. With very bad feeling between the Administration with the Democrat controlled Senate, on one hand up, against a Republican controlled House of Representatives on the other, any agreement is very difficult and this package would have to be paid for since there is no money available. The Republicans are set against any tax increases, in most cases, and the President is trying to raise the tax for the wealthier section of the population. According to the White House Budget Director, the President wants to cover the cost of the short term stimulus with US$467 billion in additional revenues over the next ten years. The President proposes that about US$400 billion of the stimulus would be funded by savings arising from the limits on the ability of households earning over US$250,000 a year to deduct certain items like mortgage interest and charitable donations from their taxes. The rest would come from private equity executives, hedge fund managers and property investors by taxing their carried interest at income tax rates rather than capital gains tax rates. There are also plans to raise more money from oil companies and corporate jet owners. The Republicans are not likely to approve of these measures and, therefore, there is serious doubt about whether this stimulus will occur. There also has to be a conclusion to the discussions on how to reduce the threat to the budget deficit ceiling which caused the stand off and agreeing the cuts will be very difficult although the mechanism is in place to make them happen. These proposed measures represent the fiscal side of the equation but it is monetary policy which has been used as the real driver to try to stimulate the US economy with practically zero interest rates. Notwithstanding the downgrading of the USA's long term credit rating by Standard & Poor's to AA+, US government bond yields, as our table at the beginning of this review for ten year benchmark issue shows, have fallen to extraordinarily low levels. Furthermore, the US Federal Reserve through its "Operation Twist" plans to try to keep down longer term bond yields by selling short term government securities to reinvest at that end of the market and thereby make an impression on borrowing costs, mainly for companies but also for those taking out mortgages. The Federal Reserve has already given an indication that it is likely to keep interest rates at negligible levels for nearly the next two years and so we can be fairly sure what monetary policy will be. However, as the US economy is growing only slowly, the Federal Reserve has indicated that it is open to further measures which might entail another bout of quantitative easing although one would expect each new measure of quantitative easing to be less effective than the original one but it does have some weapons in its armoury. All of the time, however, we have to remember that quantitative easing threatens inflation down the line unless it is withdrawn and the more quantitative easing that is applied to an economy, the more difficult it will be to withdraw. However, this is likely to be the next significant economic initiative in the USA. With the pressure off the USA now that the debt ceiling stand off has been resolved, albeit temporarily, and the eurozone has taken front stage, the US dollar has been strengthening. There are reasons why all of the major currencies should be weak but they cannot all be weak against each other and, just at the moment, it is the US dollar and yen which are the favourites. The debt situation in the USA is horrendous but it is unlikely to destabilise the markets in the short term whilst this bigger crisis plays out in the eurozone.

Turning to the eurozone, which we have discussed at length, it is clear that the area is slowing down and, as the economic projections shown earlier in this review demonstrate, Germany, the powerhouse of the eurozone in 2010 and the early part of 2011 is slowing down. At the same time, substantial fiscal consolidation is happening not only in Greece, Ireland, Portugal and Spain but also in Italy and France, so that the chances of growth accelerating from within the eurozone are small and it will depend upon demand from outside. The finances of many of the eurozone's members had deteriorated substantially as a result of long periods of overspending and the consequent adjustment is going to be dramatic. At the same time, the rating agencies are looking closely at the economies and Italy has suffered a downgrade in September from Standard & Poor's and Moody's.

In Europe, but not in the eurozone, September saw dramatic action by the Swiss National Bank to try to curb the value of the Swiss Franc, which has been seen as a safe haven in these troubled times against the problems of the euro. The sharp rise in the value of the Swiss Franc was causing very serious problems for Swiss manufacturers, threatening to price them out of markets, so the Swiss National Bank took the dramatic step of pegging the value of the Swiss Franc to the euro and being prepared to use massive intervention in the foreign exchange markets to ensure that this happened and, so far, it has. This is not a measure to be taken lightly because it carries great risks. Firstly, as has happened before, the Swiss National Bank could suffer heavy losses if it does not manage to make the peg stick because of the amount of euros it will have held on its books. Secondly, the resulting monetary expansion, as Swiss Francs are created to be sold in the market, could threaten inflation further out, but the Swiss National Bank will have reckoned that this is a lesser risk in the short term. This is another example of the misalignments of currencies causing countries to take what might normally be called protectionist measures, although one cannot blame the Swiss given that they are the innocent party in this eurozone problem.

For Japan, the issue is how to pay for reconstruction. There are plans mooted to increase taxes on the wealthy and to sell shares in Japan Tobacco. At present, although Japan has the highest level of gross debt to GDP of the industrialised nations of over 200%, it does largely finance this deficit internally and benefits from very low interest rates. Whilst the yen is regarded as a safe haven at present as its strength over the last quarter shows, Japan cannot rely on this situation indefinitely, particularly with its demographics. The performance of the economy is likely to be atypical this year because of the negative effects of the tsunami and earthquake last March and some of the growth lost in the first and second quarter will be pushed forward to the latter part of 2011 and into 2012 as the latest IMF projections suggest. Attempts to intervene in the foreign exchange market have not been successful as problems in the eurozone increase the attractions of Japan and the USA, at least for the moment.

Another country which has been relatively successful because of its mining industry and close links with China, is Australia, and it was pleasing to note that second quarter GDP quarter on quarter growth was 1.2% compared with their contraction the previous quarter of 0.9%. The year on year increase to the end of June was 1.4%. The fortunes of China, a major export market for Australian commodities, will weigh very heavily on Australia but, as far ahead as one can see, even if the Chinese economy slows a little, Australia will remain very well positioned.

For China, the issue is to deal with inflation. As we saw from the figures earlier, China is expected to continue to grow strongly, albeit at a slightly lower rate. The main issue for China is to deal with inflation and the latest inflation figures show a slight reduction in August, down to 6.2% year on year compared with a three year high of 6.5% in July. China has had some success in bearing down on property price increases and it also needs to deal with the high level of overinvestment in fixed assets and to try to stimulate consumption. On the international scene, we touched earlier on protectionist moves in the USA and this is a potentially dangerous situation since

China is very unlikely to take any measures lying down. It is to be hoped that wiser counsels prevail in the United States but increasing protectionist sentiment is a threat to world trade overall and, therefore, to world economic growth. China is always very aware of the possibility of social unrest which high inflation might cause and some big increases in minimum wages have been awarded in various parts of China. Nevertheless, China obviously remains in a very strong position relative to most countries because of its financial strength and continues to be an increasing influence on the world economy and one which should enable it to avoid a recession, notwithstanding what has been happening in the west. In terms of managing the currency, the major gripe of the USA and other countries, the renminbi has been allowed to rise modestly against the US dollar this year.

At the time of writing, it has appreciated by about 3.3% against the US dollar. Finally, we turn to the UK which has been following perhaps the most robust path towards structural deficit reduction of any major country and this has been rewarded by very low government bond yields, as the table at the beginning of this review shows, and the maintenance of its AAA rating, again confirmed, an absolutely vital prerequisite of recovery and something that those who advocate a less austere policy ignore. The UK has had a very solid down payment for its robust approach to its structural deficit and, under no circumstances, must this be lost. The lessons to be learned from the eurozone, where fiscal profligacy has been rife, should be a warning to any country that thinks it can borrow its way out of trouble. It cannot and, say, UK gilt yields doubled because of concern about the will of the government to deal with the problem, debt servicing payments would rise, the currency fall and the country would be threatened with a sovereign credit downgrade. It is not a sensible policy even to consider at these times because although, in theory, it might seem fine to slow down the pace of adjustment, in practice, debtor countries are at the mercy of markets and politicians cannot ignore them, much as many would like to. As our tables at the beginning show, growth forecasts have been reduced and the problems in the eurozone, Europe being the UK's largest trading area, are very unhelpful. Although we do not believe the eurozone can last in its present form, in the short term, the disorder which would arise from a break up would be hugely damaging to the UK economy. The Bank of England has authorised a further £75 billion of quantitative easing with very serious warnings from the Governor of the Bank of England about this financial crisis. This policy is likely to weaken sterling, perhaps something that would not be unwelcome as it should make UK goods more competitive although the manufacturing sector is a small part of the UK economy now and trading partners in the west, if not in the east, are weak. Quantitative easing is only a policy to be undertaken in the most extreme circumstances and these are what we are facing at present. The UK economy grew by just 0.1% in the second quarter, hence this further measure. Nevertheless, the UK does have some advantages. Crucially, it runs its own currency, can control interest rates and has a policy for dealing with the deficit. In addition, important as well for other areas like the USA and Europe, the UK has many high quality multinational companies with significant exposure to faster growing areas of the world and this type of company remains a suitable way to play the developing and emerging market story with relatively low risk. With UK short term interest rates almost certain to remain very low for a long time and government bond yields being where they are, although we do think they are unrealistically low, the yield attractions of UK equities (and the same applied to other markets) should be an important source of support and there are a number of companies with high dividend yields, which look relatively safe, which make a very positive case for holding them against much lower yielding bonds.

As we survey this extraordinary economic scene which is undoubtedly extremely serious, we have no close precedent to examine. Dealing with a vast currency union in danger of breaking up, where its fatal structural flaws are now becoming more apparent by the day, is not in most economists' and central bankers' text books. In this review, we have indicated how the position may be stabilised in the short term, even though it will leave vast problems later on. The sharp volatility in securities' markets shows how nervous and uncertain investors are. We feel that we can be fairly confident about certain things. It is difficult to see how bonds can offer any proper value. If we look at high quality government bonds, such as those detailed in our table at the beginning of this review, the yields look totally inadequate in the face of current rates of inflation. It might be different if one were confident that inflation would fall to very low levels but one cannot be. These bonds have benefited from the flight to quality and, where it has been used, quantitative easing, but there appears to be no investment value at all. As for cash, it is almost certain that monetary policy is going to remain very loose and that, therefore, short term deposit rates will remain very low, so it is certain that cash deposits will lose value in real terms for the foreseeable future. Notwithstanding that it has been a poor quarter for international equity markets, this is where value seems to lie. Ratings are modest and dividend yields attractive. Companies have been very cautious since the 2008 financial crisis and balance sheets are generally strong in the non financial sector. As we have pointed out, many parts of the world economy are performing well and it is possible to gain exposure to these areas directly and indirectly through good quality companies. It is noticeable how many good quality defensive companies' shares have held up well during a very difficult quarter. Business will go on and companies will still make profits and pay dividends. If one is a long term investor, undue attention to short term performance is undesirable. The dividends will still be coming in and the markets will recover. Reacting to a falling market by selling good quality stocks risks being left exposed to poor relative performance when markets recover. We cannot forecast short term market movements but we can say there appears to be plenty of value around in good quality equities.