meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Following volatile and weak conditions in May, markets have settled down again during the last quarter with equity and bond prices generally drifting higher. Markets have absorbed well the conflagration in the Middle East and reacted well to the cessation of hostilities and retreat in the oil price as well as the relatively benign economic situation qualified though it is by some concerns about inflation.

The tables below detail relevant movements in markets.

International Equities 31.05.06 – 31.08.06

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+3.6	+3.3	+5.0	+5.4
Finland	+1.4	-0.6	+1.1	+1.4
France	+5.8	+3.7	+5.4	+5.8
Germany	+2.9	+0.9	+2.6	+2.9
Hong Kong, China	+8.3	+6.3	+8.0	+8.4
Italy	+5.7	+3.6	+5.3	+5.7
Japan	+4.5	-1.7	-0.1	+0.3
Netherlands	+8.7	+6.5	+8.3	+8.7
Spain	+8.3	+6.2	+8.0	+8.3
Switzerland	+7.3	+4.0	+5.7	+6.1
UK	+4.2	+4.2	+5.9	+6.3
USA	+3.0	+1.3	+3.0	+3.4
Europe ex UK	+5.7	+3.4	+5.1	+5.4
Asia Pacific ex Japan	+3.8	+1.7	+3.4	+3.8
Asia Pacific	+4.2	-0.3	+1.3	+1.7
Latin America	+3.9	+7.6	+9.4	+9.8
All World All Emerging	+4.5	+2.5	+4.2	+4.5
The World	+3.9	+1.8	+3.5	+3.8

Source FTSE World Indices

FT Government Securities Index (capital movement) +0.6%

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

Currency	31.05.06	31.08.06
Sterling	4.58	4.51
US Dollar	5.07	4.74
Yen	1.82	1.63
Germany (Euro)	3.96	3.75

Sterling's performance during the quarter ending 31.08.06 (%)

Currency	Quarter Ending 31.08.06
US Dollar	+1.7
Canadian Dollar	+2.5
Yen	+6.3
Euro	+2.0
Swiss Franc	+3.2

Other currency movements during the quarter ending 31.08.06 (%)

Other Currency	Quarter Ending 31.08.06
US Dollar/Canadian Dollar	+0.8
US Dollar/Yen	+4.6
US Dollar/Euro	+0.3
Swiss Franc/Euro	-1.1
Euro/Yen	+4.3

Significant Commodities (US dollar terms) 31.05.06 – 31.08.06 (%)

Significant Commodities	31.05.06 – 31.08.06
Oil	-0.2
Gold	-3.6

Markets

Equity markets have edged higher during the quarter. The total return on the FTSE World Index in local currency terms was 3.9%, in sterling terms 1.8%, in US dollar terms 3.5% and in euro terms 3.8%. In local currency terms, there was not a wide divergence of performance between the major individual markets or regions with the FTSE Europe ex UK performing the best of the major areas with a return of 5.7%. However, currency movements made a significant difference with the weakness of the Yen causing sterling and US dollar based investors to see a slightly negative return in their respective indices as measured by the FTSE Japanese Index. Of particular note elsewhere was a strong recovery by Latin America. A fairly average 3.9% total return on the FTSE Latin America Index became a 7.6% return in sterling terms, 9.4% in US dollar terms and 9.8% in euro terms.

Bond markets, as measured by ten year government bond yields, also improved. Gross redemption yields declined across the board. Sterling bond yields fell by seven basis points to 4.51%, US dollar ones by thirty basis points to 4.74%, Yen ones by nineteen basis points to 1.63% and German ones by twenty-one basis points to 3.75%.

In the foreign exchange markets, sterling was strong but the particular feature was the weakness of the Yen against which sterling appreciated by 6.3%. The carry trade looks as if it was at work here with some investors borrowing Yen to invest in higher yielding currencies.

In the commodity markets, notwithstanding a further rise within the quarter, oil ended the quarter almost unchanged against the level at the end of May. Gold eased modestly over the quarter.

Economics

- *Despite the high oil price and geopolitical events generally economic conditions are relatively benign*....growth rates are more in line following a slowdown in the USA and a strengthening eurozone economy.

- *Markets took the fighting in the Middle East in its stride*....the paradox is that markets were volatile and weak in May when there was no significant event to precipitate this but remained calm when a war was taking place.

- *The interest rate cycle is showing variations*....the peak of this cycle may have been reached in the USA but further rises are highly likely in the eurozone and probable in the UK. Major central banks are on close inflation watch.

- *The oil price recedes, at least, temporarily*....after the cease fire in the Lebanon, the price eases back to leave the price little changed over the quarter.

USA

- *Second quarter growth is revised upwards*....the first estimate of 2.5% is revised to 2.9%.

- *Interest rate increases put on hold, at least for the time being*....the Federal Reserve pauses at 5.25% at its August meeting after seventeen straight quarterly increases. It will be watching inflation carefully with the headline CPI still over 4%, year on year.

- *The housing market continues to weaken*....bears worry that a sharp correction will cause a recession. On the other hand, a soft landing will help to quell inflationary concerns and enable the economy to grow at a sustainable pace.

- *US companies buy back their shares aggressively*....S&P estimates that large US companies repurchased US$116 billion of shares in the second quarter, 43% more than in the same period a year ago.

- *Corporate spending is strong*....Thomson Financial reports that S&P 500 companies raised capital spending in the second quarter compared with the same quarter last year. This indicates confidence in the economic outlook.

Japan

- *Just a probably temporary sign of a slowdown*....second quarter growth of 0.2% was lower than expected. Increased domestic demand was the driving factor. Net exports were weaker.
- *But the economy ministry still expects growth to be on course for the year*....the government's target is 2.1%.
- *Inflation remains very subdued causing some to wonder whether interest rates were raised prematurely*....the domestic demand deflator for the second quarter was just 0.1% higher over the year and consumer price inflation in July was 0.2% higher than a year ago.
- *The outlook still appears to be encouraging*....private sector machinery orders are strong and bank lending has risen with smaller companies borrowing to finance their capital investment programmes.
- *An encouraging prospect for structural reform*....a law came into effect in July which will allow public services to be market tested to see if they can be done more efficiently in the private sector.
- *The Yen has been the weakest of the major currencies*....it looks as if the carry trade is at work. Japanese companies' exports are very competitive.

China

- *The economy continues to grow very rapidly*....second quarter growth was 11.3% higher than a year earlier.

- *The authorities are trying to restrain growth*....they are using monetary and administrative measures to check over investment in fixed assets, for example.

Europe Ex UK

- *The eurozone's growth rate has been good*....first quarter growth was revised upwards to 0.8% and second quarter growth was 0.9%. The ECB's mid point forecast of its range for 2006 is 2.5%.

- *Inflation remains a problem for the ECB*....it raises its inflation forecast with a mid point of 2.4% in 2006 and the same for 2007.

- *Further interest rate increases are almost certainly on the way*....the ECB President says he expected "a progressive withdrawal of monetary accommodation".

- *In Germany, the Chancellor comes under pressure*....business is unhappy with lack of consultation and she is criticised by both wings of the CDU, one part wanting less reform, another part more reform.

- *Whilst the German economy is performing quite well at present, there are worries for the future*....next year's 3% VAT increase appears to be bringing forward spending to this year.

- *Despite the government's political difficulties, the French economy is performing well*....Insee estimates, in preliminary figures, that the French economy grew between 1.1% and 1.2% in the second quarter. Unemployment at 9% is at its lowest level for four years.

- *Italy's new coalition government is already backtracking on spending cuts*....the left partners, in the face of better than expected tax receipts, have forced the government to reduce planned expenditure cuts.

UK

- *The Bank of England moves on interest rates*....after a long period of stability they rise by 0.25% in August to 4.75%. We think it likely that there will be a further rise soon.

- *The housing market appears to be strengthening*....house price increases and the level of lending suggest as much. The Bank of England will be concerned.

- *Second quarter growth confirmed at 0.8% by the ONS*....GDP grew by 2.6% compared with the same period last year. The Bank of England forecasts growth in 2006 of 2.8% and 3.1% in 2007.

- *Sterling has risen during the quarter making life more difficult for the UK's manufacturing sector*....one possible reason for the rise, given the UK's current account deficit, is the substantial number of overseas acquisitions of UK companies for cash. Net foreign acquisitions of UK companies amounted to £15.1 billion.

Summary

- *It is still a reasonable background for equities*....moderate ratings particularly against bonds with the prospect of continued, albeit more modest, earnings increases as world economic growth continues but cost pressures rise on companies.
- *Bond yields appear too low*....some are artificially depressed for regulatory reasons but the shape of some countries' yield curves suggests a recession which we think unlikely. Yields appear vulnerable to increased inflation.

Markets have experienced a stable quarter having shrugged off the volatility and weakness of May. As we indicated at the time, there appeared to be no fundamental rationale for the sudden bout of turbulence which occurred at that time but we have to accept that sudden market movements, apparently lacking rationale, will occur from time to time as those with a very short time horizon make their presence felt. This is not a pleasing situation for long term investors but the main lesson to be learned is that it is wrong to be influenced into making wrong investment decisions by such volatility. As always, the media will accentuate the negative whilst good news finds it hard to make the headlines. Of course, pundits will rationalise a movement in the market after the event, in this case rising US interest rates and inflation were blamed, but the point is that nothing occurred which could not reasonably have been foreseen. A more plausible answer might be that hedge funds, influenced by a long period of rising equity prices and finding fewer anomalies from which to benefit, had become more long only in their outlook. Relying on short term performance, the lead of a small number of funds may quickly have caused matching action elsewhere, precipitating a fall in equity prices. This is speculation, of course, but it is plausible given the lack of any new issue in the economic background. After markets had experienced their fall, a partly unforeseen geopolitical event occurred in the Middle East with the conflict in Lebanon. That might have been expected to affect markets not only because a war, however localised, is not good news but, in the Middle East, oil supply concerns always loom. Paradoxically, markets stayed relatively calm and, at the time of writing, are drifting upwards, helped by better news from the Middle East. The point of this, in part somewhat speculative appraisal of what has happened over the past four months, is that markets sometimes do unexpected things. It makes it very important to keep one's eye on the fundamental issues which drive markets and to try to avoid being influenced by "noise" in markets. So, whilst May has not been forgotten, the markets have returned to the calmer and less volatile atmosphere which obtained before May.

The narrow trading range of markets, which has been a feature for some weeks, probably owes itself to the tug of war which is going on between those who believe the world economy will slow down sharply and perhaps move into recession and those who believe that economic growth will continue at a satisfactory rate. The bears focus on the signs of weakness in the US housing market and much slower second quarter growth and point to the fall in bond yields as evidence that investors expect an economic slowdown at best. The bulls argue that, after a very strong first quarter when the US economy grew at nearly 6% annualised, a slowdown in the second quarter was inevitable and desirable because an economy growing above its sustainable stable inflation rate by definition risks a rise in inflation. They will also point to the fact that the Federal Reserve has, at least for the moment, halted its programme of interest rate increases. Elsewhere, growth remains satisfactory to strong to give buoyancy to the world economy, the oil price notwithstanding.

An encouraging feature of the world economy is a closer grouping, at least in the short term, of economic growth rates. There is, at present, much less divergence between the USA, regularly the best performer amongst the major economies, and the eurozone and Japan. That should make a very modest contribution towards narrowing the economic imbalances in the world economy. The major imbalance is the large current account deficit in the USA which finds it counterpart in the large surpluses in Asia and the Middle East. A coming together of economic growth rates would be very helpful in this respect. Growth forecasts for the eurozone are being raised and the Japanese economy remains relatively buoyant even if there are some, hopefully temporary, weaker signs at the moment. If the savings ratio in these surplus countries were to decline, it would represent an important contribution towards a better balanced world economy. Whilst the US economy runs a large current account deficit, some fear that this will ultimately lead to a world recession if confidence in the USA weakens.

The, at least temporary, merging of growth rates has implications for the direction of interest rates. Slower growth in the USA at least gives the Federal Reserve the opportunity to consider a further pause in the series of seventeen interest rate increases since their low point of 1%. In the eurozone, where inflation has consistently been above forecast and growth has strengthened, further increases are undoubtedly in the pipeline. In the UK, after a long period of unchanged interest rates, the Bank of England raised interest rates by 0.25% to 4.75% at its August meeting. In Japan, the Bank of Japan has raised interest rates from nothing as the economy strengthens and it tries to move towards normality in monetary policy. China has raised interest rates in an attempt to cool down the rapidly expanding economy. Australia, where growth has consistently been strong, has raised interest rates again as have a number of other countries. So perhaps where the USA, as well as Australia, led the way in the current cycle of interest rates rises some time ago, the USA, at least, might be the first to call a halt because growth has slowed down. Although it may not be the case this time because of the very rapid growth of countries like China and India, growth which is not synchronised can be beneficial for inflation as demand is not maximised. In an extreme and unlikely theoretical position where a major economy or region was in recession and another major region was growing rapidly, world inflation would be likely to be lower than under a scenario where all economies or regions were growing rapidly together. But, in a more realistic example, where the US economy slowed down but others were growing quite strongly, the inflation picture would be likely to be better than if the USA and every other major economic power were growing strongly at the same time.

We mentioned earlier that one of the post event rationalisations of May's equity market weakness was a fear about rising inflation at a time when the oil price had risen strongly and other commodity prices were firm on the back of strong industrial demand. It is important to pay full attention to the inflationary effects of an oil price increase but it is also important not to over react. Although consumption of oil has increased over the years, its importance in relation to GDP is about half of what it was in the early 1970's, the time of the first oil shock. There is no cause for complacency but this statistic goes some way towards explaining the resilience of the world economy in the face of a rising oil price. The rise in the oil price has not on this occasion been due to a supply shock but, rather, to strong demand particularly in countries like China and India. An economy which is growing rapidly is more easily able to absorb rising prices than one which is not. Were a supply shock to occur and growth be stunted or reduced by a lack of oil, the costs and adverse effects would be much more severe. Fortunately, the world economy is not in that position at present and, hopefully, it will not be. Even with oil at around US$70 a barrel, in real terms it is below its all time peak in the early 1980's and, as mentioned earlier, the relative importance of oil has declined since then. Whilst investors must always be aware of the threat of inflation, the issue must be kept in perspective.

Whilst inflation concerns were blamed for May's market volatility, a look at bond market yields tells us what investors are really thinking. If we take ten year government bond yields at the end of August in the USA at 4.74%, the UK at 4.51% and Germany at 3.75%, it is difficult to believe that investors have serious concerns about inflation. It is true that the yield curve in the UK is downward sloping throughout the maturities and in the USA to the ten year maturity before edging up to the thirty year maturity. Sometimes, but not always, this predicts a recession. On the evidence which we currently have, a recession appears unlikely. We should also qualify our remarks about bond markets not showing a concern about inflation by saying that, in the UK for example, pension funds are under pressure to buy longer dated bonds for regulatory rather than investment reasons which is artificially depressing yields.

What drives shares higher over time is rising corporate earnings, dividends and other manifestations of shareholder value. Over recent reviews, we have emphasised the positive drivers to markets which these have been presenting and this continues to be the position. By way of example, Thomson Financial is reported as forecasting that, in the USA, S&P 500 companies' profits are expected to rise by 14.7% in the third quarter compared with the same period a year ago and to continue to rise strongly after that, albeit at a declining pace. This would represent the thirteenth quarter of double digit growth. Standard & Poors estimates that large US companies repurchased US$116 billion worth of shares in the second quarter, a figure 43% higher than a year ago. Worldwide, the strong trend of corporate earnings growth continues to give companies' boards the confidence to pursue mergers and acquisitions, again a positive development for markets in the short term even though doubts persist on the effect of acquisitions on shareholder value in the longer term.

Nowadays, in any review of a quarter, significant attention must be paid to China which continues to grow at a rapid pace. Its influence on the world economy is increasing and, as we discussed above, just one manifestation of this is the rise in commodity prices, including oil. Whilst rapid Chinese economic growth has generally been beneficial for the world economy, over rapid growth could promote higher inflation in China and cause problems for the banking system. There would be overspill effects on the rest of the world economy so there is a balancing act going on there which, again, needs watching closely. We will be looking in more detail at the Chinese economic picture later on in this review.

The above, then, are some of the main themes of the last quarter and we will touch on some of the issues in the remainder of the review which covers individual countries and regions of the world, starting with the USA where second quarter economic growth has been revised upwards to an annualised 2.9% from the earlier estimate of 2.5%. It will be recalled that the first quarter's growth was an exceptional and unsustainable 5.6% reflecting post hurricane recovery in the US economy. The new upwardly revised estimate is closer to the sustainable stable inflation growth rate potential of the US economy. Catalysts to the upward revision of growth were consumer spending, exports, non residential building, private inventory investment and state and local government spending. On the other hand, there was a downward revision to residential fixed investment. The upward revision of the second quarter growth estimate gives comfort to those who do not believe that the USA will fall into recession and a little ammunition to those who believe that growth may be strong enough to exert further upward pressure on inflation. In present circumstances, we would describe this as a comfortable growth rate.

The big news in the USA in August was that the Federal Reserve paused in its series of seventeen interest rate increases with the rate remaining at 5.25%. We know from the FOMC minutes, published at the end of August, and which related to the meeting at which the decision to leave interest rates unchanged was taken, that it was a finally judged decision. Most FOMC members thought that inflationary pressures would "ease gradually" and that current policy could prove "consistent with satisfactory economic performance". Options were left open on the risks of inflation and further interest rate rises. At the time of the announcement of unchanged interest rates on 8 August, the FOMC said that "economic growth has moderated from its quite strong pace earlier this year, partly reflecting a gradual cooling of the housing market and the lagged effects of increases in interest rates and energy prices". In taking a relatively sanguine view on inflation when it talked about "contained inflation expectations", it was reflecting the cumulative effect of past interest rate increases on demand. But it did hedge its bets, so nothing can be taken for granted. For the time being, the interest rate level seems stable in the USA with some commentators speculating on the timing of the first interest rate cut. It is a positive point for US equities (and, indirectly, those of other countries) if interest rates have peaked.

Another big issue in the USA is the state of the housing market. As in the UK and countries such as France and Spain, prices in recent years have risen rapidly engendering confidence amongst consumers and contributing to significant economic growth in at least the USA, UK and Spain to name three of the countries mentioned above.

A reversal in the housing market in countries where it has been strong could lead to a negative wealth effect. So those who are bearish about the US economy point to trends in the housing market there. The latest pieces of data suggest continuing weakness in the housing market. In July, home construction fell to its lowest level in almost two years. As far as sales of existing homes are concerned, annualised sales in July were 4.1% lower than in June. The supply of unsold homes was a record 7.3 months of sales in July, nearly double the level of early 2005. Sales of existing homes were at their lowest level since January 2004 and the median sale price just 1% higher than a year ago. New home sales were also weak in July, down 4.3% on the previous month. Private residential activity showed a 2% fall in July pulling down construction activity by 1.2%. The National Association of Realtors pending home sales index fell by 7% in July. The supply of unsold homes, according to the US Census Bureau and the Department of Housing and Urban Development was at its highest for over ten years. As with all important economic statistics, the movement up or down in the data needs to be at the right trajectory to achieve the optimum result. In this case, a "soft landing" for the housing market is the desirable position, one where the decline is sufficient to allay inflationary concerns without the fall being precipitous enough to cause a sufficiently large negative wealth effect and a recession. Our judgement at this time is that the position is manageable for the US economy and, of course, a weaker housing market will be one of the indications at which the Federal Reserve looks when deciding interest rates.

That leads on to a look at the USA's inflation situation, obviously a key indicator for the Federal Reserve. The bond market took some comfort from weaker than expected producer price figures. The headline figure rose by just 0.1% in July whilst the core producer price index fell by 0.3%. Twelve month rises were 4.2% for the headline figure and 1.3% for the core rate. At the consumer price index level, the core index showed a 0.2% rise in July with the headline figure up 0.4%, driven by higher energy prices the year on year increase. Since then, gasoline prices have been falling so a better figure may be expected for August. The Commerce Department's Personal Consumption Expenditure deflator for June showed a core rise of 0.2% for an annual rate of 2.4% and, annualised, the last three months' data shows a rate of 2.9%. On the other hand, with possible implications for the rate of growth of corporate earnings, unit labour costs in the second quarter rose at an annual rate of 4.2% and productivity growth was below recent trends at 1.1% in the non farm business sector. With the economy operating at around full capacity utilisation, these type of figures are to be expected. Average hourly earnings in August were up just 0.1%. Whilst it is a fairly balanced judgement, the carefully worded optimism of the Federal Reserve seems justified and, for the moment at least, the threat to interest rates seems limited.

Positive items of news from the US economy over the last month included a rise in the ISM's July manufacturing index from 53.8 in June to 54.7 in July. The Commerce Department reported that personal incomes rose by 0.5% in June with disposable income up 0.7% and with spending up by 0.8%. Retail sales have also been quite strong with the Commerce Department reporting that sales rose by 1.4% in July although there was a downward revision of June's figure to –0.4% from 0.1% figure. On the other hand, there was a sharp fall in the Conference Board's consumer confidence index from 107.0 in July to 99.6 in August so there is some ambiguity there. Unemployment in August fell from 4.8% to 4.7% with the economy creating 128,000 jobs.

The overall impression of the US economy is one which is moving along at a satisfactory pace but probably slightly below its long term stable inflation growth level. This should provide the background for continued satisfactory growth in corporate earnings albeit at a slower rate than hitherto. Certainly, companies seem to be quite optimistic. For example, Thomson Financial reports that S&P 500 companies raised capital spending by 20.6% in the second quarter of 2006 compared with a year ago. It is unlikely that they would do this if they did not feel confident about the future. In the absence of an unforeseen economic slowdown, US equities appear to be attractively valued.

We turn now to Japan where second quarter real GDP grew by 0.2% over the previous quarter. This was lower than expected although the economy minister said the economy was on course to meet the government's target growth figure of 2.1% in the year to next March. Growth in the second quarter was driven by domestic demand which added 0.3% to growth, more than offsetting the –0.1% contribution of net exports. Inflation was barely positive over the year with the domestic demand deflator rising by 0.1% over the previous year. Another measure of inflation, core consumer price inflation, rose by 0.2% in July compared with a year earlier.

Individual items of news pointing to a better outlook include a rise in bank lending by 2.9% in July compared with a year previously, adjusting for write offs. Demand for loans from small companies has been rising as they crank up their capital investment programmes. Private sector machinery orders rose by 8.5% in June which bodes well for future capital spending.

In our reviews on Japan in recent years, we have often talked about the need for and benefits of structural reform in Japan. Japanese companies started the ball rolling some years ago out of necessity and many are lean and profitable businesses. At the state level, where there are enormous vested interests, progress has been more difficult. That is why it is very encouraging to note that a law which came into force in July will allow public services to be market tested to see if they could be done more efficiently in the private sector. Lists of services to be put out to tender will be published shortly. If this reform is carried out rigorously, it will be hugely significant for the Japanese economy and be a major supply side reform which should help to promote faster long term growth.

Apart from benefiting from growth in the domestic economy, Japanese companies are well placed to benefit from the very competitive level of the Yen in export markets. The Yen appears to be depressed by being borrowed at negligible rates for carry trades to be invested in higher yielding securities. Coupled with the cost cutting and efficiency exercises which many Japanese companies have put into place over the years, we see some formidably competitive companies. Japan remains a market in which to be invested.

In the short term, the eurozone is performing well. Eurostat reports that second quarter growth was 0.9% which is faster than in the USA and UK, a very unusual situation. First quarter growth was revised upwards to 0.8%. The European Commission has revised its forecast for third quarter growth to between 0.5% and 0.9% compared with 0.3% and 0.7% previously. The eurozone may grow by 2.5% this year which, if it happens, would be the best performance since 2000. This is the ECB's mid point forecast of its range.

Quite strong growth and inflation above target is likely to encourage the ECB with its series of interest rate increases. At the beginning of August, it raised rates by another 0.25% to 3.0%, only a mildly positive real rate with headline inflation at 2.4% in July since down to 2.3% in August. It said in August that it would "monitor very closely all developments to ensure that risks to price stability do not emerge". We can be fairly sure that further monetary tightening will occur especially in the light of remarks by the ECB President at the end of August when he said that strong vigilance was warranted by the Bank to defend price stability and expected "a progressive withdrawal of monetary accommodation". The ECB raised its inflation forecast for 2006 to a mid point of 2.4% in 2006 and 2007 as well. One of the problems for the ECB, which was always foreseeable when the euro was introduced, is the wide divergence of inflation rates amongst members of the eurozone. For instance, 3% is far too low a rate for a country like Spain which has a 4% inflation rate. Such a low rate of interest will only encourage further inflation and make the country more uncompetitive.

There are some interesting developments within the eurozone, some of a political nature. In Germany, for example, the political honeymoon of Angela Merkel has ended quickly. Not only is a grand coalition very unsuitable for a country which badly needs reform because every decision is a compromise but there are splits within her own CDU party about reform. Some want to go faster, some slower. German businesses are unhappy about government policy and lack of consultation and even the German President has voiced his opinion on the need for continued reform. Whilst Mrs Merkel favours change, she is hamstrung by her coalition partners.

Meanwhile, the economic news has been mixed to good in Germany but, in the background, is the spectre of the 3% rise in VAT next year which might distort economic statistics as consumers stock up ahead of such a large rise. Behind the fastest quarterly growth rate for five years, 0.9%, were a number of domestic drivers, domestic demand, construction and machinery and equipment orders. This is of some encouragement because the reluctance of consumers to spend and a high rate of savings has meant that Germany has run a large current account surplus. If domestic spending strengthens, it will be of some help to the eurozone growth rate and internationally as well given the size of the German economy. The latest consumer confidence survey shows confidence to be at its highest since 2001 but the cause is the bringing forward of spending before the VAT rise, not the best quality of rise. One good result of the strong economic growth now being recorded is a better than expected result for public finances. In the first half of 2006, net government borrowing fell by 12 billion because of buoyant tax revenue. The steep rise in VAT is being effected next year to bring Germany's finances in line with its eurozone obligations on public borrowing.

In terms of items of news from Germany in the last month, the Chief Executive of Hochtief made a moderately positive statement on the construction industry outlook suggesting that this important sector was slowly turning off its lowest levels of activity. The Bundesbank reported that German employment grew by 0.3% in the second quarter. There has also been an easing of inflation with the latest annualised rate down from 2.1% in July to 1.9% in August.

Perhaps suggesting that the peak of economic growth has been reached, there have been a number of negative signals coming from the German economy. The ZEW Economic Institute's economic sentiment index fell 20.7 points to –5.6 in August. Factors contributing to the fall were a slowing US economy and a stronger euro which would adversely affect German exports. Not surprisingly, the forthcoming VAT was mentioned as a factor as well as oil prices and changes to corporate taxation which is causing a lot of concern amongst German owned and foreign owned companies. The Ifo business climate indicator for August fell slightly but was still at a level which reflected confidence. However, we again see that future expectations are not so positive. The reading for six months' ahead is much less good. Again, we must assume that this is the spectre of the forthcoming VAT increase.

One would expect that the German economy will be adversely affected by next year's VAT increase, at least at the beginning of 2007, and overall growth will depend on the robustness or otherwise of exports. Because the VAT increase has been flagged well in advance, one would expect markets to be discounting the effect. However, if it proves more damaging to the economy than expected, it is likely to be a market factor.

Although the political decision making in France is paralysed by the weakness of the present government and the jockeying for pole position in the race to be the candidate for the next presidential election, the economy is, at present, performing well. It beat Germany's growth rate by posting a 1.1% to 1.2% increase in the second quarter according to preliminary figures from Insee. The stronger economic performance has helped France's chronically bad unemployment situation with second quarter job creation almost matching that for the whole of last year. Unemployment at 9% is at its lowest level for four years and compares with a recent peak of 10.2% in May 2005.

Stronger economic numbers and, consequently, more buoyant tax receipts paradoxically have a malign side effect in that they give non reform minded politicians an excuse to backtrack on much needed structural reforms. Europe is a prime example of this problem and it has recently become evident in Italy which has chronic problems with its public finances. The recently formed coalition government has used the excuse of higher than expected tax receipts to reduce the public spending cuts to 30 billion from the previously announced 35 billion. Given the extent of Italy's public sector debt and the threat it ultimately poses to the Italian economy, caving into members of the coalition is a retrograde step.

Whilst structural reform in Europe, which is so badly needed, remains slow, the impressive corporate results from many European companies reflect streamlining undertaken during the very difficult economic times. With demand conditions now more buoyant, there has been, for many companies, a disproportionately good benefit to results. Despite the good performance of European equities, ratings remain modest and further progress can be expected. Takeovers can be expected to feature prominently (for example, the Italian bank market is now more open to rationalisation). If the EC manages to make progress against protectionist barriers (such as the conditions put on E.ON's bid for Endesa in Spain), it will further help the process.

The major piece of recent economic news in the UK was the Bank of England's decision at its August meeting to raise interest rates by 0.25% to 4.75% after a long period of stability. We now know from the publication of the minutes that there was near unanimous support for the interest rate increase, the vote was 6-1. The members agreed that "it was most likely that interest rates needed to rise in order to bring inflation back to target in the medium term". At the time of the interest rate rise, the Bank of England gave as its reasons "firm economic growth, limited spare capacity, rapid increases in credit and the money supply" and a forecast of continued above target inflation as the reason for its pre-emptive rate increase. It said that consumer price inflation is "expected to remain above the 2.0% target for some while because, as rises in energy prices fade over the next two years, some recovery in profit margins and pay growth is likely to mean that consumer price inflation will move only gradually back to target". With the UK economy performing more strongly than expected, it is likely that interest rates will rise to 5% by the end of this year. For example, the Bank of England is forecasting growth in 2006 at 2.8% and, in 2007, at 3.1%. The ONS has confirmed that GDP grew by 0.8% in the second quarter of the year compared with the first quarter and by 2.6% compared with the same period in 2005.

For many, the consumer price index is unrecognisable as their own personal measure of inflation. For example, council tax is not included and this has been a fast rising item of expenditure for those who pay it. If people believe that inflation is higher than currently indicated by the CPI and, given relatively tight conditions in the economy, there may well be upward pressure on wages.

The signs of inflationary pressures in the economy are there to be seen. Even though the CPI dropped slightly in July from June, 2.4% against 2.5%, the short term pressures will be upwards. For example, besides rises in utility bills, the introduction of university tuition fees is expected by the Bank of England to add 0.25% to inflation. These will be included from October. The Governor of the Bank of England said in August that there was a "50-50" chance of inflation rising above 3% during the next six months. In its latest quarterly inflation report, the Bank of England's new central inflation forecast shows it to be rising sharply in the next few months, peaking close to 3% by the year end and remaining above 2% if interest rates were to stay at 4.75%. The Bank of England's forecast showed that only if interest rates were raised by another 0.25% would inflation fall back close to target. The Governor of the Bank of England said that the Bank had changed its view on inflation because it now believed UK companies had less spare capacity. Although companies are still having some difficulty passing on price increases, input prices have risen significantly and may eventually make themselves felt in final prices if companies' pricing power strengthens. Producers' input prices were 1.1% higher in July than June and the annual rate of increase was 9.7%. However, reflecting the difficulty which companies have in passing on cost increases, year on year output prices only rose by 2.8%. With the economy growing moderately strongly, it may be possible that companies will have greater pricing power in the next few months particularly as import prices are rising. To areas where this is relevant to competition with UK companies, it may make domestic price rises easier to implement.

As in the USA and parts of Europe, the strong rise in house prices has created a positive wealth effect which has spurred consumer spending and growth of the relevant economies. House price increases show signs of accelerating in the UK and this could raise difficult issues for the UK economy because they would increase the risks to the economy. If house price rises do accelerate, the Bank of England is likely to raise interest rates further and with the large amount of debt in the UK economy this would risk a significant downturn in the economy if the cost of servicing debt affect people's spending or if it led to a sharp fall in house prices and negative equity problems. In this context, it is worth looking at the various measures of house price inflation which have recently been published. The Land Registry reported that house price increases in England and Wales in the second quarter were 7.7% higher than in the same period last year. The RICS reported that house prices in July rose at their fastest pace in more than two years. The Department for Communities and Local Government, on the other hand, reported house price increases running at an annual rate of 5.2% in June compared with 5.6% in May. The Nationwide's index of house prices for August showed a month on month rise of 0.8% in August to give an annual price increase of 6.6%. The latest FT House Price Index showed an annual rise of 5.4% in July. Early indications are that the 0.25% rise in UK interest rates has had little effect. If the Bank of England feels that the rate of house price increases is posing a threat to the UK economy, more aggressive rises in interest rates will be necessary. Another signal of a still strong property market is growth in the "buy to let" market. Loans for this sector were 17% higher in volume terms and 20% higher in value terms compared with the record levels of the second half of 2005. The British Bankers Association reported that banks lent a net £5.7 billion in July. It reported that "the robust nature of mortgage lending continues, with recent monthly net increases not far short of the movement seen when lending peaked in 2003/4. Its July mortgage approvals were down 20% on June but 5% higher than in July 2005. Council of Mortgage lenders' figures showed gross lending reached £30.4 billion in July, the second highest on record. Finally, the Bank of England reported that the number of mortgages approved for house purchase in July was at its highest level for six months.

One of the difficulties for the manufacturing sector, now only a small minority part of the UK economy, is the strength of sterling which is an overvalued currency. The UK runs a significant trade deficit, reduced somewhat by a surplus on invisibles, but one should not be complacent about the currency. Unlike some other countries, which show protectionist tendencies, the UK is, rightly, a liberal country when it comes to allowing foreign acquisitions of UK companies. There has been a substantial number of significant acquisitions, the largest recent one being BAA and, before that, O2. Figures released by the ONS show that, in the second quarter of 2006, foreign acquisitions of UK companies were valued at £18 billion compared with UK acquisitions of foreign companies valued at £2.9 billion. The respective figures for the first quarter were £24.1 billion and £6.8 billion. Depending upon how these acquisitions were financed is the extent to which sterling has been buoyed by these foreign takeovers of UK companies. One reason why so many UK companies have been taken over is obviously that foreign buyers see much more value in them than UK investors do. We have noted before in our reviews that UK pension funds, partly for regulatory reasons, have been selling UK equities to diversify into overseas equities and longer dated sterling bonds. Whilst geographical diversification of equity exposure is sensible, some of the reasons for switching from equities to bonds are of a regulatory nature but, in terms of investment returns, are not likely to match the returns of equities over the long term. This has left UK companies vulnerable to foreign takeovers, in particular.

Although interest rates have been rising they are still relatively low compared with interest rate levels of the past and, even though there are some clouds on the UK's economic horizon, we may expect more takeovers to support the UK market. We maintain our relatively neutral stance on the UK market with our caution towards it tempered by the reality of significant overseas interest in UK assets.

The main concern of Chinese economic policy at present is to place some restraint on economic growth (11.3% year on year in the second quarter) to prevent inflationary trends developing and to try to curb over investment in certain sectors of the economy. At present, inflation is not a major issue for China – for example, the latest annual producer price inflation index is 3.6% for July. Monetary and administrative measures are being used to achieve the authorities' objectives. On the monetary front, the People's Bank of China raised benchmark lending and deposit rates by 0.27% in mid August. The banking regulator, in an administrative measure, has put limits on new lending by state banks. The authorities in China have a difficult balancing act to perform. They need to keep the economy growing at a rate which can absorb those coming from the rural areas yet need to keep inflation under control and ensure that over investment which cannot provide a commercial return is discouraged because of the danger it poses for the quality of bank loans. There is some tentative evidence that this is happening. If it is successful in slowing down growth to a sustainable but still fast rate of growth by the standards of the west or Japan, for example, it is probably the right result for everyone. For our view is that, notwithstanding that there will always be losers from what has happened in China, its rapid growth has been beneficial for the world economy mainly because its exports have enabled inflation to be subdued, interest rates to be below what they would otherwise have been and economic growth faster, with the benefits which this brings to individuals and companies.

The Australian market is one we have liked for some time on the back of its exceptionally good economic performance over the years. Many shares have looked interesting, offering surprisingly high yields. The central bank, in the light of continued strong growth and low unemployment, is likely to tighten monetary policy further to avoid inflationary risks developing. With the strength of the natural resources industry, unemployment has fallen to 4.8% leading to a rise in wage growth. Although consumer confidence has weakened, the Reserve Bank is unlikely to take risks with inflation. It successfully managed a soft landing in much of the housing market which has shown significant strength in the past. With takeover activity evident (a tentative approach for Coles Myer and speculation about Fosters), the market is likely to be able to absorb further interest rate increases. If there were to be a sharp fall in commodity prices (unlikely for the moment but possible if China slows rapidly), the market would be affected.

In conclusion, we think the balance of advantage lies with equity markets. One has to judge the conflicting forces at work in the world economy and also politically. Will the US housing market weaken so much as to pose a recessionary threat to the US economy? On the other hand, has the Federal Reserve finessed its interest rate rises correctly so that the US economy, after its very rapid first quarter growth, enjoys the much sought after soft landing? Will inflation be sufficiently restrained so as not to represent a threat to continued satisfactory international economic growth? Will China, presently growing very rapidly, have a hard landing or will the various measures being taken by the Chinese authorities have the desired effect? And, then, there are the geopolitical issues some of which may affect the price of oil. In our review, we have tried to deal with some of these issues and conclude that in the absence of unexpected geopolitical events economic growth should continue at a rate which will provide acceptable corporate earnings growth which will continue to validate ratings of shares in most markets. As before, we continue to believe that shares have the edge over bonds where we believe that yields are unrealistically low in view of the risks to that market.