meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The feature of the quarter has been the problems in the credit markets arising from the US sub prime mortgage loans which have turned sour. For those with direct or indirect exposure, the experience is proving painful but for equity investors, whilst there has been volatility, the negative performance for the quarter has been relatively mild. Top quality bonds have benefited from the move to safety.

The tables below detail relevant movements in markets:

International Equities 31.05.07 – 31.08.07

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+0.8	-2.8	0.9	-2.2
Finland	+8.2	+7.5	+9.6	+8.2
France	-6.7	-7.3	-5.5	-6.7
Germany	-2.7	-3.3	-1.4	-2.7
Hong Kong, China	+15.3	+13.3	+15.5	+14.0
Italy	-5.6	-6.3	-4.4	-5.6
Japan	-8.5	-5.6	-3.8	-5.0
Netherlands	-4.3	-4.9	-3.1	-4.3
Spain	-4.5	-5.1	-3.2	-4.5
Switzerland	-6.3	-6.8	-5.0	-6.2
UK	-3.9	-3.9	-2.0	-3.2
USA	-3.2	-5.1	-3.2	-4.4
Europe ex UK	-4.9	-5.5	-3.7	-4.9
Asia Pacific ex Japan	+6.7	+3.9	+5.9	+4.6
Asia Pacific	-1.7	-1.3	+0.6	-0.7
Latin America	+2.9	-1.2	+0.7	-0.6
All World All Emerging	+7.5	+4.5	+6.6	+5.2
The World	-3.2	-4.2	-2.3	-3.6

Source FTS E World Indices

FT Government Securities Index All Stocks (total return): +2.9%

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

Currency	31.05.07	31.08.07
Sterling	5.25	5.04
US Dollar	4.90	4.53
Yen	1.76	1.61
Germany (Euro)	4.41	4.25

Sterling's performance during the quarter ending 31.08.07 (%)

Currency	Quarter Ending 31.08.07
US Dollar	+2.0
Canadian Dollar	+0.9
Yen	-3.0
Euro	+0.7
Swiss Franc	+0.5

Other currency movements during the quarter ending 31.08.07 (%)

Other Currency	Quarter Ending 31.08.07
US Dollar/Canadian Dollar	-1.0
US Dollar/Yen	-4.8
US Dollar/Euro	-1.3
Swiss Franc/Euro	+0.1
Euro/Yen	-3.6

Significant Commodities (US dollar terms) 31.05.07 – 31.08.07 (%)

Significant Commodities	30.04.07 – 31.08.07
Oil	+6.6
Gold	+1.6

Markets

Equity markets have given back some of the gains achieved earlier this year but, for the year to date, remain in positive territory overall. Although the indices have mostly declined this quarter, the movements are quite modest and put into perspective recent events in the credit markets. In local currency terms, the FTSE World Index has shown a total return of -3.2%, in sterling terms -4.2%, in US dollar terms -2.3% and in euro terms -3.6%. In local currency terms, there has been little difference in the return from the USA (-3.2%), Europe ex UK (-4.9%) and the UK (-3.9%). Japan was the worst performer at -8.5%. As so often in recent times, the best performers were Asia Pacific ex Japan (+6.7%), Latin America (+2.9%) and emerging markets (+7.5%). Within the Europe ex UK section, Finland was a notable performer with a positive return of 8.2%, thanks to an excellent performance by Nokia. Australia showed a small positive return in local currency terms of 0.8%. If we look at currency adjusted returns to sterling, the US return moves to -5.1%, the Europe ex UK return to -5.6% but, unusually in recent quarters, the Japanese return improves to -5.6% because of a strengthening yen. The sterling return for Asia Pacific ex Japan fell to 3.9% and for emerging markets to 4.5% whilst Latin America turns negative at -1.2%. All these returns reflect the relevant FTSE World indices.

Turbulence in the credit markets was reflected in a move to quality in the international bond markets as represented by ten year government bonds. The gross redemption yield on sterling bonds fell by 21 basis points to 5.04%, on US dollar bonds by 37 basis points to 4.53%, on yen bonds by 15 basis points to 1.61% and on euro denominated German government bonds by 16 basis points to 4.25%.

The feature of the currency markets was a recovery in the yen against which sterling fell by 3.0%. The partial recovery of the yen was due to some unwinding of the carry trade. Elsewhere, sterling drifted upwards, particularly against the US dollar against which it rose by 2.0%. In other cross rate movements, the US dollar declined by 4.8% against the yen.

In commodity markets, oil rose by 6.6% whilst gold was just 1.6% higher.

Economics

- *August has been dominated by credit market problems with their origin in the U.S. sub-prime mortgage market* .... this has resulted in a seizing up of credit markets and significant open market and some lender of last resort operations by central banks.
- *The resulting problems have ended up in surprising places* ...... because these loans have been packaged up into asset backed securities and "sliced and diced", some financial institutions and hedge funds have been affected, not only in the USA.
- *Some structured vehicles holding these assets have experienced severe financing problems* .... short term finance has been used to finance longer term assets and commercial paper borrowing opportunities have evaporated.
- *Some of these vehicles and hedge funds have become forced sellers of assets* ...... because some of them were unmarketable or impossible to price, good quality highly liquid assets, such as "blue chip" equities, were dumped. However, share buy backs have absorbed some of these sales and prices have shown some recovery.
- *Central banks have reacted calmly but in different ways* ...... the Federal Reserve has cut its discount rate by 0.5% to 5.75% but not its target federal funds rate, the ECB has expanded its open market operations and one senses that the expected interest rate increase in September will not take place, the Bank of Japan one senses is not likely to increase interest rates and the Bank of England has adopted a "hair shirt" attitude by lending to banks in its lender of last resort role at its penal discount rate.
- *Just prior to the problems in the credit markets, the IMF, in July, had raised its forecast for world economic growth* ...... for both 2007 and 2008, it had raised its estimate to 5.2% from 4.9%. One feels, intuitively, that economic growth will be affected by what has happened in August but, unless something unexpected develops, probably not seriously.
- *There will be some areas where a negative wealth effect is felt but these should be localised* ...... hedge fund and bonus fuelled property markets in London, for example, together with associated up market spending.
- *Ultimately, if there is a sensible re-pricing of risk, the world economy will benefit* ...... it could be argued that current problems in the credit markets started with ultra low interest rates and excess liquidity which encouraged dangerous risk taking. Ultimately these could, in some circumstances, but probably not these, lead to major economic problems. A sensible re-pricing of risk could help to obviate this.

USA

- *The Federal Reserve acts quickly to provide liquidity to the financial system* ...... it reduces the discount rate to 5.75% from 6.25% and indicated that it will do what is necessary to keep the system running smoothly.
- *Earlier, in August, after its meeting, the FOMC had emphasised its concern about inflationary risks* ...... its change of tone towards the end of the month reflected conditions in the credit market and its determination that credit worthy clients should be supported. However, it does not want to be seen underwriting moral hazard.
- *Meanwhile, the U.S. economy enjoyed a strong second quarter* ...... the second estimate of GDP growth shows an annualised figure of 4.0%.
- *Corporate earnings growth has been encouraging, too* ...... Thomson Financial estimates, quoted in the Financial Times on 30 August, suggest that with 96% of companies having reported second quarter profits, earnings were up a better than expected 7.7% on the same period a year earlier.
- *Although the Federal Reserve remains concerned by inflation, recent news is more encouraging* ...... the core personal consumption expenditure index, which the Federal Reserve monitors closely, rose just 0.1% in July and 1.9% year on year.
- *The current credit market problems started in the housing market and this remains weak although not all indicators are negative* ...... the President, at the end of August, announces a package of measures to help U.S. homeowners to keep up with mortgage payments but ruled out a bail out.

Japan

- *Low Japanese interest rates have been blamed for the problems in credit markets* ...... the line of thinking is that they have provided cheap money for the carry trade or investment in overvalued assets.
- *Much as the Bank of Japan may want to have a more normal monetary policy, recent events and figures have conspired to work against an early increase in interest rates* ...... with credit markets disturbed, raising interest rates would not be sensible.
- *In any case, recent inflation figures militate against an early increase* ...... the Cabinet Office revises its forecast for inflation in the current fiscal year to March to nil against an earlier forecast of 0.5%.
- *Average earnings figures provide a puzzle* ...... they decline 1.1% year on year to June yet unemployment falls yet again to 3.6% in July.
- *Second quarter growth was unexpectedly weak at 0.1%* ...... but the IMF, in its latest forecast, still expects growth of 2.6% this year and 2.0% next year.
- *Because of the LDP's political difficulties the pace of reform is uncertain* ...... the loss of the upper house has presented the Prime Minister, Mr Abe, with a problem.

China

- *The authorities continue to try to curb excessive growth* ...... interest rates are raised again with the benchmark lending rate at 7.02%, up from 6.84%.
- *Food price inflation has contributed to a general increase in inflation* ...... in July, it rises to 5.6%.
- *China looks to open up investment opportunities overseas which could have great long term significance for overseas stock markets* ...... US$200 billion of foreign exchange reserves are earmarked for investment in higher return overseas markets and restrictions on individuals' ability to invest overseas are gradually being lifted.

Europe Ex UK

- *It now seems unlikely that the ECB will raise interest rates in the very near future* ...... although the President of the ECB gave a strong hint through the use of the words "strong vigilance" in early August that September would see an increase, that no longer seems to be the position as events have overtaken the ECB.
- *Current headline inflation of 1.8% is within the ECB's target range* ...... although it is expected to rise above 2.0% shortly.
- *Economic growth in the eurozone in the second quarter slows down* ...... growth falls to 0.3% compared with 0.7% in the first quarter and 0.9% in the fourth quarter of 2006.
- *However, the ECB will be watching money supply growth carefully* ...... M3 was up 11.7% in July and business lending was up 13.6% on a year previously although lending for house purchase slowed slightly to 8.1%.
- *Germany's finances improve dramatically* ...... in the first half of the year there is a surplus of 1.2 billion.
- *France risks confrontation with fellow eurozone countries* ...... President Sarkozy's efforts to kick start the economy through tax cuts means a slippage in the agreed timetable towards a balanced budget.

United Kingdom

- *The Bank of England maintains a hard line in the financial markets* ...... lending in its lender of last resort role is at a penal rate.
- *However, the long expected interest rate increase to 6% may be deferred* ...... a big margin of inter bank rates over base rates itself indicates a tightening and an increase would not seem sensible in current circumstances.

- *Second quarter U.K. economic growth is robust* ...... growth is confirmed at 0.8% in the second quarter and 3% year on year.
- *Inflation has fallen quite sharply* ...... the consumer price index for July falls to 1.9% from 2.4% within the Bank of England's range. It is likely to rise again although cost push pressures from earnings are modest. Average earnings growth, excluding bonuses, in the year to June is 3.4%, the lowest level since July 2003. The second quarter GDP deflator was, however, 3.8%.
- *As in the USA, house prices are an important economic indicator* ...... if prices were to fall in the UK, there would be serious economic problems. Various measures still show prices rising with some tentative indicators of a slowdown in the rate of increase.
- *Companies use the turbulence in financial markets to buy back more shares* ...... there are many share buy back programmes in operation and many companies take advantage of attractive prices to buy back stock. Not only does this support prices but it enhances earnings per share by more than it would have done at higher prices.

Summary

- *Long term equity investors should not be unduly influenced by volatility in markets* ...... share ratings still look attractive and corporate balance sheets are strong. Investors should be aware of the potential opportunity cost of selling shares as a result of being intimidated by short term market movements.
- *Whilst economic growth prospects have probably been affected by events in financial markets there is still good momentum* ...... Asia provides an increasingly important source of growth.
- *If necessary, central banks will change their policies to ensure that economic prospects are not too badly affected by what has happened in credit markets* ...... this should, however, be differentiated from immediate action to bale out imprudent borrowers and lenders.

Without doubt, the most important event of this last quarter has been the upheaval in credit markets which originated with the problems in the US sub-prime market. Perhaps the first time that the issue really came to the attention of investors outside the USA was when HSBC announced late last year an increase in provisions relating to this type of business. Even then, although the news temporarily affected the HSBC share price, investors may well have regarded this as a localised issue if not just to HSBC but also perhaps companies in the USA involved in the sub-prime lending market. A period of cheap money and no financial crises engendered a state of overconfidence amongst lenders. With hindsight, lending standards fell dramatically in the drive to put extra business on the books. Furthermore, at a time of cheap and easy money, borrowers were tempted by "teaser" loans, loans with very low introductory interest rates which ratchet up over the life of the loan. As servicing of these loans has become more expensive, delinquencies have risen leading to defaults and foreclosures. There the problem may have stayed but for new structured vehicles which have come into existence which spread the problem as they derived from the original delinquent loans. In the past, one would have expected these poorly performing loans to have stayed on the books of the lender and the area where the problems lay would have been clear to investors. But, no longer is this the case. Loans are packaged up and sold on in the form of asset backed securities which might comprise all sorts of receivables, other than mortgages, such as credit card receivables. Investors, who buy these asset backed securities, rely on the strength of principal and interest repayments. Their value can, therefore, be affected by defaulting borrowers. The problem has been magnified again by the use of leverage to buy these securities. Whilst, in normal times, this should magnify the gains for investors if the underlying investment is successful and provide a nice source of income for lenders, in current circumstances it is providing a major worry for some investors who face losses, in some cases, total, and for lenders who may see an increase in loan defaults. It was this type of situation that caused credit markets to seize up in August. Nobody could be quite sure where the next problem might show up and, as a result, banks were unwilling to lend to each other and users of commercial paper found they could not roll over maturing paper. To provide a temporary fix for this serious problem, the central banks used their open market operations and lender of last resort role to provide liquidity for the markets and, at the time of writing, this seems to have calmed down markets. The list of casualties is likely to grow. Those who borrowed short and invested long on the assumption that they could roll over short term borrowings may have a problem if they cannot obtain bank finance, or the cost of it rises, as credit risk is re-priced. They may become a forced seller of assets to raise money to pay off borrowings. Two problems could arise here. Firstly, they may only be able to sell assets at a distressed price; secondly, they may not be able to sell them at all, resulting in a collapse. As lenders to funds seek repayment of loans, so this situation increases the number of forced sales at depressed prices, creating a spiral effect. We should expect more pain in the hedge fund area. By their nature, some hedge fund investors are very short term in their outlook and rush for the door at the first sign of trouble. It is likely that hedge fund redemption requests will rise, leading to the forced sale of assets with a consequential effect on prices as, even if the underlying securities hedge funds hold are of good quality, the prices achieved may not reflect this position.

So, the issues which have affected financial markets are: bad loans, the uncertainty of the names of institutions and funds where they will end up, forced sales due to further cash requirements, de-leveraging, the difficulty of valuing assets and hedge fund redemption cash requirements.

As a result of the forced sale of assets, some of the best quality ones came on to the market and temporarily depressed their prices. "Blue chip" equities are one example and, temporarily, some of them suffered more than lesser quality ones which could not be sold so easily. Unusual patterns of movements in securities' prices caused problems for some quantitative strategies as computer models, based on large amounts of data from previous relative movements of assets, did not work well on this occasion. As a result, some quantitative funds have performed badly.

Because the bank loans, originating in the USA, have been "sliced and diced" and been sold on, it would, at first sight, seem that the pain had been shared around and no institution should be affected too badly. This is simplifying the theory but that is what intuition tells one. However, because, in some cases, these loans have been leveraged, the losses have been magnified.

With a background such as has just been described, it is obvious that there are going to be some big losers. Apart from financial institutions which have seen loans go bad, investors in artificially contrived securities, say geared ones, risk crystallising bad losses. This is quite a different position to that of investors who invest in quality shares or bonds, for example, who do not become forced sellers when markets turn adverse. They are investing in businesses which provide needs and which will continue in existence whatever the turmoil in financial markets. They will probably continue to pay dividends and should benefit from economic growth which will lead to increased earnings and dividends. It is said that fear and greed move markets. In the case of the latter emotion, the search for super normal returns has led to excessive risk being taken with the results which we now see in certain securities.

But long term investors who do not have to respond to conditions like these because they are not under pressure to sell, can take into account wider issues which can influence markets. The main one concerns what the authorities will do in a situation such as we are experiencing now. The central banks are key to the situation. None of them will want their country's economy to implode and there is action which they can usually take to help matters. Rather than indiscriminately sell securities because of media hysteria, long term investors can consider more fundamental issues.

So, in current conditions, highlighted by the seizing up of the credit market, the central banks can provide liquidity to the market by expanding their open market operations or by acting as lender of last resort to banks which find they cannot attract enough funds to finance their operations. In this respect, the decision of the Federal Reserve to lower the US discount rate from 6.25% to 5.75%, provided relief to the market on 17 August which helped it to recover some of its poise. The discount rate is the rate at which the Federal Reserve will lend funds directly to banks. But it did not alter the target for the federal funds rate which stands at 5.25% and which is the one which would affect interest rates generally. At this stage, even though the USA is enjoying sub-par growth, the world economy is performing well and a premature reduction in interest rates could lead to inflationary problems later on. Furthermore, central banks do not want to bale out imprudent borrowers and lenders by cutting rates to help them out. That, too, would store up trouble for the future. It is important to price risk correctly, otherwise an inflationary bubble could develop because interest rates were too low.

Investors can take comfort from appropriate measures being taken. With the world economy performing well, there seems, for the moment, no need to stimulate it through lower interest rates but a continued need to ensure that the financial system works properly so that day to day business can continue. At the time of writing, this has been done.

In July, the IMF raised its forecast for world economic growth for this year and next to 5.2% from 4.9%. At the time, it did not, of course, know the full effect of the seizing up of credit markets and it seems inconceivable that growth will be unaffected by what has happened. But Asia is the main driver of growth at present and there is a reasonable chance that the world economy will not be too badly damaged. However, if it does look as if growth has been damaged more than is acceptable (we should remember that growth generally is above its long term trend consistent with stable inflation), central banks will be able to reduce interest rates.

In our reviews over the years, when an unexpected event has occurred, we have always emphasised that investors should consider the authorities' action in such circumstances which will be to attempt to counteract, usually successfully, the potentially malign effects of the unexpected event. This time is no different.

Life for many of the businesses in which we invest on behalf of clients goes on much as normal. The corporate sector is in a strong financial position and there is evidence that it has used the opportunity arising from forced sales of shares by some investors to buy back shares at more favourable prices which will increase the benefit to earnings per share. There are many large buy back programmes which have been authorised by shareholders and we would expect to see that some companies have accelerated their share re-purchases as a result of what has happened. Sovereign Wealth Funds have been much in the news recently and we note that Singapore's state investment fund, Temasek, has raised its holding in Standard Chartered Bank by 1.3% to 15.3% which probably would not so easily have been accomplished had market conditions at the time not been abnormal.

As we see it at present, the central banks, by their actions, have averted a crisis in the financial system caused by the non-availability of credit to good quality borrowers. That would represent a credit crunch in the true sense. The world economy, which is in good shape, should be able to absorb the recent turbulence in credit markets and still get by with lower, albeit satisfactory, growth. The corporate sector is in good condition and should continue to deliver increased earnings and dividends and to increase shareholder value in some cases by continuing to repurchase shares which produces an earnings enhancing effect, as mentioned above. Merger and acquisition activity is likely to continue, albeit at a reduced rate because private equity deals will be more difficult because of lack of finance or more conservative terms set by lenders.

Earnings growth has been stronger than expected in the second quarter. According to Thomson Financial, as quoted in the Financial Times of 30 August, U.S. companies' second quarter earnings growth is 7.7% compared with the same period last year. That was with 96% of companies having reported.

With share valuations very reasonable in most markets, in our view, we see no reason for long term investors to abandon their equity strategy. As we have mentioned on a number of occasions in the past, one of the most dangerous things a long term investor can do is to be intimidated by volatility into selling good quality shares. If they are not able to be bought back at the price they were sold because the shares have subsequently risen, the loss of profit will be permanent if the shares do not fall back to the level of the sale. Reacting to short term dips in the market rather than remaining focused on fundamental issues can have a very damaging effect on long term performance. Fundamental issues of valuation or economic prospects can, of course, determine a change in asset allocation but changes made in reaction to short term volatility, such as we have just seen, can often be very costly in terms of lost performance. A very simplistic and highly over-generalised model to consider for equity investors is of two lines, one representing the capital movement of a portfolio and the other representing the trend of dividend income and, for simplicity, let us assume that this is represented by an exchange traded fund covering a particular index, say the FTSE100. The dividend line will represent what companies think that they should be paying out to shareholders and that will reflect the view they take of present trading conditions and prospects for the future. If, as happens most years, the economies in which they do business grow, then the probability is that companies' profits will rise, leading to increased dividends. As has happened in the past and is likely to happen in the future, the dividend line shows a steady rise, reflecting dividend increases. This is the line that long term investors should be concentrating on because, irrespective of short term market movements, a rising dividend income line would push the capital value line upwards although obviously not in a straight line. We said that this is a generalisation. If the equity market is very overvalued (which we do not think to be the case at the moment), then the capital value line may go down for a while before resuming its long term upward trend. But, at the end of the day, the success or otherwise of most companies will depend upon there being a favourable economic environment and that is why, although economics may seem a very dry subject, it is important to concentrate heavily on macro economic prospects.

We should also emphasise that we do not invest in structures which hold asset backed securities. Our only indirect exposure would be through holdings in high quality financial institutions which have exposure, perhaps through loans, but none has given any indication of significant problems. It is important to draw a distinction between artificially created structures and real businesses. The latter continue from day to day and, if their shares temporarily fall for either market or individual reasons, the probability is that most of them will recover and move on ahead. An artificial structure, where losses are crystallised, cannot easily recover in many cases.

Returning to the importance of considering macro economic prospects, mentioned two paragraphs above, we can perhaps consider what the international prospects may look like following the problems which have emerged in credit markets and which have spread to some structures.

Clearly, there will be a negative wealth effect in some areas. Investors who have direct exposure to failed or weakened structures will not feel so wealthy and will probably pare their spending if they have suffered a material loss. Some people, who work in financial institutions which have developed these structures may see their bonuses cut and employment prospects may have been damaged. Redundancies may occur. The hedge fund industry will be affected to some extent. These are areas where huge fortunes have been earned. An obvious area which can be expected to be affected is the property market. Manhattan or the West End of London come to mind as two obvious areas. London is almost an economy of its own in the UK, driven by the enormous success of the financial sector. As a result, house prices have risen more strongly than elsewhere and have continued to do so as interest rates have risen. Some effect is likely to be felt, not only in the property market but in all those businesses which have fed off this boom, such as top end restaurants. Provided London continues to be a magnet for wealthy foreigners, the effect may be mitigated to some extent. But because the London economy will lose some buoyancy, there may be a benefit to inflation as it is more difficult to make price rises stick. New York is also a similar example.

This current problem in credit markets started in the US sub-prime mortgage market. As lenders seek to recover their loans, increased foreclosures may temporarily accelerate the downturn in property prices in some areas of the USA. Looking at US property prices, it is noticeable how wide the divergence of price performance is. Some areas continue to be strong but others have seen big price falls. This further development may weaken the housing construction sector further. This sector has acted as a drag on US economic growth at a time when the rest of the US economy has been performing well. Mortgage lenders will be affected. Already, we are seeing lay offs in the sub-prime mortgage sector as financial institutions cut back or eliminate their sub-prime operations. Mortgage lenders have suffered badly with some going into Chapter 11. Large well capitalised banks may well take a hit as loans turn non-performing but it is unlikely, on the evidence currently before us, that any major bank will get into difficulty. That, however, may not be the case lower down the line. We have seen German public sector banks getting into trouble because of their involvement in the fall out from the sub-prime loan problem. Problems will turn up in unexpected places and we must expect to see this continue for many months. Banks will certainly become much more cautious in their credit policies. Hopefully, this will not impact on credit-worthy borrowers because, if that did happen, it would be damaging to economic prospects. Central banks have probably done enough to ensure that there is liquidity to avoid a credit crunch but banks, at least for the time being, will certainly reconsider their credit policies and the areas of business in which they become involved. Providing good quality borrowers can continue to have access to funds, the economic consequences of what has happened are not likely to be too damaging.

Indeed, there could be beneficial consequences involving the sensible re-pricing of risk. After events, such as, say, the savings and loan crisis in the USA in the 1980's or the crisis in the UK property market when banks made heavy losses in the 1980's, one says "never again". But it has happened again. Why is this? The availability of cheap money, distance from previous problems, people involved who have not seen it before, low volatility in markets and greed for returns which are above what reasonably can be expected to be obtained, have all contributed to the present position. Risk has not been priced correctly and has led to troubles in certain areas of the financial markets, some of which we have repeatedly mentioned in previous reviews. Whilst cheap money may have fuelled economic growth in certain areas, in some countries and regions, growth has been at a level which is above that consistent with stable inflation. Apart from central banks setting short term rates at levels consistent with the current economic position and outlook, the re-pricing of risk by lenders to an appropriate level relative to general interest rates will help to ward off over-speculation and maintain a more stable and sustainable growth rate for an economy.

Business and customer confidence is an important determinant of the short term economic outlook. Inevitably, it is affected by the headlines even if individuals and companies do not have exposure to sub-prime mortgages, asset backed securities or hedge funds which have been affected.

It may make people and business more nervous and this influences their spending decisions which could affect economic performance. Our instinct at the moment, and it can be no more, is that outside the areas directly affected, it will not be greatly influential although it is almost bound to continue showing up in weaker consumer and business confidence levels.

Although many individuals have high levels of indebtedness and will be affected by movements in interest rates, most companies have strong financial positions developed as a result of large increases in profits in recent years of economic expansion. Apart from specific areas, US housebuilders for example, most companies are in a comfortable position. With economic growth continuing, albeit at a lower level than expected, and profits rising modestly, we would expect to see continued dividend growth and measures to enhance shareholder value such as share buybacks.

But overriding all of this is the continued shift of power in the world economy to the east and countries like China and India, in particular. If we talk about Asia very generally as a region, and in contrast to the position at the time of the Asian financial crisis about ten years ago, it is in a strong financial position with large current account surpluses and foreign exchange reserves and some very profitable companies. The IMF reports that, for the first time, China is the driver of world economic growth this year. In its World Economic Outlook update, published towards the end of July, it predicted economic growth from the Newly Industrialised Asian economies at 4.8% for both 2007 and 2008. For China, it predicts growth of 11.2% this year and 10.5% next year and, for India, the figures are, respectively, 9.0% and 8.4%. The IMF's forecasts for advanced economies are 2.6% this year and

2.8% next year. It is quite probable that the recent turmoil in financial markets may cause the IMF to reduce the figures for growth in absolute terms but, in relative terms, the picture will not change. Asia is a big driver of world economic growth and, in the current environment, that is positive for the world economy and gives some reassurance that recent events will not greatly change international economic prospects.

This is the key to actions which central banks might take. None of them will want to underwrite moral hazard. In other words, if financial institutions or individuals do imprudent things, they should not be bailed out by central banks cutting interest rates to accommodate them as opposed to taking actions which are in the interests of the economy as a whole. Prior to the recent problems in the credit markets, the expectation was that the Bank of England and ECB would raise interest rates further whilst US rates were probably at their peak in the current cycle. It was also clear that the Bank of Japan would like to raise interest rates from their current rate of 0.5% in order to have a more normal monetary policy but that the lack of inflation made raising interest rates very difficult. So far, in either open market operations and/or lender of the last resort mode, the central banks, in varying degrees, have acted to stabilise the credit markets after their recent seizure. However, apart from the Federal Reserve's cutting of the discount rate, a tactical measure rather than cutting the general level of short term interest rates, there has been no hurry to cut rates. Indeed, the ECB was, until the last few days, still giving every indication of raising interest rates again at its September meeting. The unanimous vote by the MPC to maintain UK interest rates at 5.75% at its last meeting probably indicates a reluctance to raise interest rates in the immediate future and recent events may have stayed its hand. However, when prospects look clearer, and assuming no major damage is done to the economy, inflation fears could still lead to at least one more rise to 6%.

Central banks are probably right in being cautious about how they react to recent events. The world economy has proved to be resilient to shocks in the past, sometimes stimulated by interest rate reductions. They will not want to act prematurely to cut interest rates because this could raise the rate of inflation. We have not mentioned fiscal easing amongst the possible policy reactions. A fiscal stimulus would almost certainly be more slow working and the fiscal condition of most advanced countries is such that they could not really afford it since budget deficits are already too large in many countries.

One thing is almost certain, however, and that is that, at some stage in the future, another excess will occur. Although everyone involved vows to learn from the mistakes of the past, after a suitable passage of time, another bubble emerges. Furthermore, this one has been evident for some time as it has been clear that risk has been under priced and strategies like the yen carry trade into high yielding currencies were highly dangerous. But, even as this is written, the yen is starting to weaken again as investors take on more risk. There is always the feeling that this time it is somehow different.

Obviously, it has been necessary to spend some time discussing the problem in the credit markets but we should not be distracted from looking at the regular economic data and the relevant information which comes out on a regular basis.

We touched upon the latest IMF forecasts for economic growth this year and next. It was revised upwards in July to 5.2% for both years. In early August, the First Deputy Managing Director said that the IMF would not revise downwards that forecast. He described the global economic outlook as "very favourable" despite what had happened recently although he did acknowledge that there were "downside risks" to the global economy. He also added that the realignment of risk … is not necessarily unsettling". This is something we touched upon earlier when we were discussing the repricing of risk. We went into some of the detail of the IMF's growth forecast earlier on, noting the strong stimulus to world growth given by China and India. The comments by the First Deputy Managing Director were made in early August and instinct makes us feel that the forecasts will be trimmed back but it is obviously sensible not to make sudden downgrades until the situation becomes clearer. What we can say, though, is that there is still significant momentum in the world economy which is likely to contine.

We turn now to look at individual areas of the world, starting with the USA where we noted that on 17 August the Federal Reserve cut the discount rate from 6.25% to 5.75%. This is not normally the rate which captures the headlines – that is the federal funds rate which currently stands at a target of 5.25%. The discount rate is the one at which the Federal Reserve lends to banks and, by bringing it nearer to the federal funds rate, it was providing assistance to the banks to withstand the problems in the money market. Whilst there may seem to be a stigma attached to banks for having to borrow from the central bank in its role as lender of the last resort, the reduction in the discount rate made it less penal. In fact, as this is written, four major US banks – Bank of America, Citigroup, JP Morgan Chase and Wachovia have borrowed US$500 million each as a symbolic gesture to show the value of the facility at the Federal Reserve. Citigroup said in a separate statement that it was "pleased to inject liquidity into the financial system during times of market stress and to support creditworthy clients."

In a statement accompanying the decision to reduce the discount rate, the Federal Reserve said that financial market conditions had deteriorated to the point where "the downside risks to growth have increased appreciably". It said that it was monitoring the position and was "prepared to act as needed to mitigate the adverse effects on the economy arising from disruptions in the financial markets". Investors sometimes underestimate the ability of central banks through changes in monetary policy or the use of tools at their disposal to influence the economy or change sentiment. In this case, the surprise announcement of the discount rate cut worked well for it changed sentiment, leading to a sharp recovery in share prices, yet it preserved its financial integrity by not cutting the federal funds rate target and seeming to underwrite moral hazard. It looks to have struck just the right chord. Of course, depending upon how events unfold, it may find it prudent to cut the general level of interest rates but this will reflect economic conditions and prospects rather than a knee jerk reaction to the seizing up of the credit markets. Indeed, in its statement on 7 August, the Federal Reserve, whilst accepting the risks to growth had increased, was still concerned about inflationary risks. It accepted that recent inflation figures had "improved modestly" but said again that a "sustained moderation has yet to be convincingly demonstrated."

Recent USA data on inflation is reasonably encouraging. The core personal consumption expenditures price index, which the Federal Reserve monitors closely, rose by 0.1% in July to show a year on year increase of 1.9%. This is the best result since March 2004. The upper end of the Federal Reserve's comfort level is believed to be 2.0% so the latest figure is encouraging. At the producer price level, core prices, excluding volatile food and energy prices, rose by just 0.1% in July whilst the headline figure, boosted by food and energy prices, rose 0.6%. The annual rate for core producer prices showed an increase of 2.3% whilst the rate for the headline figure was 4.0%. The consumer price index rose by 0.1% in July compared with June whilst the core rate rose by 0.2%. Annual inflation rates were 2.4% for the headline rate and 2.2% for the core rate. So the figures are teasingly near where the Federal Reserve would like to see them but it is right to be cautious and, despite the problems in credit markets, the Federal Reserve is surely right not to be bounced into cutting the target for the federal funds rate.

The problem in the credit markets sprung from the US housing market and it had been hoped that, as 2007 progressed, there would be signs of stabilisation which would be reflected in a run down in the levels of housing inventories towards more normal levels. What has happened recently must have damaged confidence and put back the time when the market returns to a normal condition. Apart from anything else, it is going to be more difficult for some potential buyers to find the necessary finance. The National Association of Realtors reports that the national median price for an existing family home fell by 1.5% to US$223,800 from the second quarter of 2006. A report from S&P/Case Shiller showed a decline of 3.2% in second quarter house prices although another report said they rose by 3.2%. The annualised rate of existing home sales stayed at a 5.91 million annual rate in the second quarter, 11% down on the same quarter the previous year. A survey amongst the National Association of Homebuilders has only once recorded a worse mood than the current one. July's housing starts fell by 6.1% compared with June and the annualised starts were at their lowest rate since January 1997. On a brighter note, the National Association of Realtors pending home sales index rose 5% to 102.4 in June. It may be, of course, that subsequent developments will reverse this trend. There was an improvement in home sales in July of 2.8%, a better figure than expected although housing starts, as mentioned above, and building permits fell in July. The supply of unsold homes rose to a 16 year high in July. Inventories rose by 5% compared with June. Sales of existing homes were 9% lower than a year previously.

Leaving aside the problems in the credit markets and the housing markets, other individual items of news have been mixed. We know that momentum built up in the second quarter from the Commerce Department's second estimate of annualised growth of GDP at 4.0% compared with 0.6% in the first quarter. Amongst positive indications over the last month have been new factory orders which were up 0.6% in June although that figure was flattered by transport orders. Durable goods orders rose a strong 5.9% in July. Productivity growth in the second quarter was reasonably good at a 1.8% annualised rate. Encouragingly, and to be expected after the U.S. dollar's decline, demand for US exports is strong. June's exports were a record at US$134.5 billion, 1.5% higher than the figures for the previous month. This helped to reduce June's trade deficit to US$58.1 billion from US$59.2 billion in May. Industrial production rose by 0.3% in July against 0.6% in June. Manufacturing itself showed a 0.6% increase in output in July with vehicle production particularly strong. The Conference Board's leading indicator of economic prospects showed a 0.4% rise in July following a 0.3% fall in June. Personal spending in July was up 0.4% compared with a revised 0.2% in June. Recent strong economic growth in the USA has considerably improved the USA's deficit figures. The Congressional Budget Office now forecasts a US budget deficit of US$158 billion in the year to 30 September 2007 compared with its March estimate of US$177 billion. In the next financial year starting on 1 October 2007, the CBO forecasts a figure of US$155 billion. Although the figures should be at least in balance at this stage of the economic cycle, they still represent significant progress in improving domestic finances. Unfortunately, however, spending pressures are building up which are likely to cause the figures to worsen in future years.

On the negative side, the ISM's index of manufacturing activity for July declined from 56.0 in June to 53.8, although still in positive territory. Payrolls in July grew at their slowest pace since February, rising by 92,000 compared with an increase of 126,000 the previous month. The ISM's service sector activity index declined from 60.7 in June to 55.8 in July. Not surprisingly, given the news background, consumer sentiment has been affected. The Reuters/University of Michigan consumer sentiment index showed a preliminary reading for August of 83.3 compared with July's figure of 90.4 and the Conference Board's confidence index fell nearly seven points to 105.0.

With news headlines such as we have had in the USA, it is easy to feel gloomy. If one is involved in the financial world, it is all too easy to get caught up in the euphoria and depression of news and markets. Bullishness and bearishness tend to become exaggerated and do not fully reflect realities of the economy as a whole. In the short term, the consumers who are affected by the weakness in the housing market are the ones whose spending patterns will be changed. Given the low level of unemployment in the US economy, the majority, who are not directly affected by problems in the housing market, are not likely to change their spending patterns noticeably. As we have noted before, the Federal Reserve is, quite rightly, very reluctant to tailor its monetary policy to benefit those who have been imprudent, otherwise it would be unleashing moral hazard which could contribute to economic problems in the future. Its immediate attention will be focused on ensuring that the credit markets operate as smoothly as possible and that good quality borrowers have access to funds. Should economic conditions deteriorate and inflation be at levels which do not concern the Federal Reserve unduly, then it may well reduce its target for the federal funds rate from its current level of 5.25%, But it would need to be satisfied that it was taking the correct decision for the economy rather than to bale out a section of borrowers and lenders who have been imprudent. Markets do have effective correcting mechanisms. Already, we see some financial institutions closing or reducing their sub-prime businesses. A move towards repricing risk correctly in the USA and elsewhere (because this has become a global problem) would lead to a more sustainable base for future economic growth.

Japan has been blamed in some quarters for current problems in financial markets. The reasoning is indirect, the line of thought being that minimal Japanese interest rates have encouraged speculation via the carry trade. The critics say that cheap Japanese funding has encouraged speculation in financial markets and created an asset bubble in certain areas. This seems rather a harsh judgement on Japan. In a deflationary or flat price era, any positive nominal interest rate is a higher or same real rate of interest. Higher nominal interest rates, say at even Swiss interest rate levels, would have imposed a real interest rate on the Japanese economy which could have put it back into recession. As it is, Japan has seen four years of economic growth and, as the second largest economy in the world, this is positive for the world economy as a whole. During the past month, the yen has seen large swings in value against other currencies as carry trades have been unwound against high yielding currencies like the Australian and New Zealand dollars although, as this is written, the yen is weakening again with some commentators suggesting that risk appetite is increasing again. Despite its problems in the recent past, the Japanese economy is still a strong one with the world's second largest foreign exchange reserves, now eclipsed by those of China, and a large current account surplus. Speculating against it by investing in currencies like those of Australia and New Zealand where the countries have large current account deficits is a dangerous policy. We should emphasise here that we are keen on Australian shares, rather we are talking about currency speculation. The costs of unwise speculation in currencies, such as some borrowers most recently have suffered as yen carry trades were unwound, should be a more effective way of dealing with excesses rather than the Bank of Japan following a monetary policy which could push the country into recession and threaten a deflationary spiral. The effect of recent events in financial markets is likely to be a postponement of the next rise in Japanese interest rates. The Bank of Japan has been keen to follow a more normal monetary policy but its hands are tied now by internal events, no inflation, and external events, problems in the financial markets. August's vote on interest rates at the Bank of Japan was 8-1 in favour of keeping them at 0.5%. A revision in the Cabinet Office's expectations on inflation to nil against an earlier forecast of 0.5% for the current fiscal year to next March increases the likelihood of a delay in the timing of the next interest vote increase. Average earnings are also weak, despite falling unemployment with a year on year decline of 1.1% in June. Given that unemployment fell from 3.8% in May to 3.7% in June and again to 3.6% in July, the earnings figures are surprisingly weak. In terms of macroeconomic news in Japan, second quarter growth was just 0.1%, much lower than recent experience. Growth was restrained by weak exports and housing and public investment expenditure. On the other hand, consumption and corporate investment were strong to provide a counter balance to the area of weakness. Export growth fell to 0.9% in the quarter compared with 3.4% the previous quarter. Public investment fell by 2.1% and residential investment by 3.5%. Household consumption, although down, rose by 0.4% (0.8% in the first quarter) and private sector investment increased by 1.2%. July's retail sales were weak, partly because of the earthquake in Japan. They were down 2.4%, month on month, on a seasonally adjusted basis and 2.2%, year on year. Household spending in July was down 0.1%, year on year and industrial production fell 0.4% on the month, again an earthquake affected figure. However, the purchasing managers' index for August showed a more positive picture. On the inflation front, core consumer prices were down 0.1% in the year to July.

Notwithstanding the slowdown in economic growth in the last quarter, economic conditions look set fair for Japan. In its latest update in its World Economic Outlook, the IMF is forecasting growth of 2.6% this year and 2.0% next year. China is an important trading partner of Japan and with China likely to continue to grow at a rapid rate, Japanese growth should be well supported. There is perhaps more uncertainty on the political front with the LDP's loss of the upper house to the opposition. It is possible that economic reform will become more difficult. Although progress has been made, considerably more needs to be done.

Until the recent turbulence in credit markets, the most hawkish central banks, and the ones most confidently expected to raise interest rates again, were the ECB and the Bank of England with the ECB favourite to raise them first. It is possible, judging by Mr Trichet's remarks on 27 August, that the ECB is having a change of mind because of what has happened in financial markets. The ECB has been active in providing liquidity to the markets when they threatened to seize up. It was in early August that, at a press conference after the ECB kept interest rates unchanged, Mr Trichet described the ECB's stance as one of strong vigilance. Even as late as 22 August, the ECB was saying that its monetary policy remained as set out on 2 August. Intuition suggests that, whilst financial markets are unsettled, it would not be sensible to take the risk of raising interest rates. Once things have settled down, the ECB could review the position. One senses that its view is changing.

Indeed, there is some economic evidence to support a "wait and see" attitude by the central bank. In the second quarter, Eurostat reported that growth in the eurozone had slowed down to 0.3% compared with first quarter growth of 0.7% and 0.9% in the fourth quarter of 2006. For the three biggest economies in the eurozone, Germany, France and Italy, growth rates were respectively 0.3%, 0.3% and 0.1%. This slowdown could represent the effects of the series of interest rate increases which the ECB has introduced and provides a reason to stay its hand on further interest rate increases apart from reasons to do with the fragility of financial markets at present.

The ECB's aim is to keep inflation "below but close" to 2% and the headline rate for August is 1.8% so it would seem to be within range although not comfortably so. The ECB's caution on interest rates is because it expects headline inflation to rise above 2% towards the end of the year as a result of stronger growth in the eurozone, notwithstanding a slowdown in the latest quarter. Individual items of data from the eurozone have been mixed over the last month. On the negative side, manufacturing activity fell to a seventeen month low in July. The eurozone's NTC purchasing managers index fell to 54.9 in July from 55.6 in June although that reading is, of course, in positive territory. Retail sales have not been particularly buoyant. Over the year to June, they were up just 0.9%. There was a slight fall in the EC's eurozone economic sentiment indicator for August which fell from 111 in July to 110. On the positive side, industrial orders in the eurozone have been strong. June's orders were 4.4% higher than in May and 13.8% up on a year on year basis. Whilst the NTC Purchasing Managers' Index for manufacturing activity was weaker in July, the flash corporate index for manufacturing activity for August was only slightly down at 57.9 compared with 58.3 in July. If there is no significant revision, these figures suggest an economy holding up relatively well. The ECB will be watching closely money supply and bank lending figures. In July, business lending was up 13.6% on a year previously, the fastest rate of increase since the start of the euro. M3 continues to grow at a rapid rate up 11.7% in July compared with a year previously. On the other hand, there has been a reduction in the rate of increase of lending for house purchases, up 8.1% in July, the lowest rate of increase for nearly four years.

Looking into the individual economies of the eurozone, it is interesting to note that the views of the Bundesbank and the German government are quite bullish. August's bulletin from the Bundesbank saw no reason to change its optimistic view of the German economy although it did say that inflationary pressures were building. Perhaps characteristically, given its financial orthodoxy, it did not seem unhappy about the reappraisal of risks in the financial markets. The Finance Ministry expected growth to accelerate in the second half of this year after slowing slightly in the first half of the year. Otherwise, the news from Germany over the last month has been mixed. Manufacturing orders were strong in June, up 4.6% over May. However, industrial output was weak in June, down 0.4% compared with May, but it should be future orders which are more relevant. Perhaps not surprisingly, given the background in financial markets, the ZEW economic expectations index came in at -6.9 points in August compared with +10.4 in July. Such surveys are bound to be influenced by background news which was full of the problems in credit markets at the time it was taken. Subsequent surveys of consumer and business confidence have shown some weakness and retail sales have been disappointing. But one landmark has been reached. In the first half of the year, the public sector, the federal and regional governments and the social security system has shown a 1.2 billion surplus. This is the first time for twenty years. Apart from the desirability of following a prudent fiscal path in a period of economic growth, it is very desirable for the euro project and the poor state of public finances in some of the eurozone countries is a reason to remain concerned about the long term viability of the euro.

Because, next door in France, the fiscal levers are being loosened by President Sarkozy as he attempts to kick start the French economy which has lagged behind Germany in recent times. The tax cuts introduced by President Sarkozy are expected to cost about 11 billion in 2008. Tax cuts are desirable in France as the country's high tax rates make it less competitive against lower tax competitors. Rather than expand the fiscal deficit compared with what had been planned, public spending cuts would be more desirable, difficult though they are to achieve in France. The plan of moving to a balanced budget, as pledged by eurozone governments earlier this year, has now moved to 2012 at the latest. President Sarkozy's plan is to stimulate the economy through tax cuts. In a clever plan to dismantle the 35 hour week, one of the poorest pieces of economics imaginable and which was introduced by a previous government, overtime will be exempted from tax. This should enhance the popularity of longer hours, increase consumer spending and bring cost benefits for employers and, ultimately, competitiveness. It is the sort of legislation which is difficult for opponents of the 35 hour week to complain about because it will be popular with many people. The government plans to reduce the budget deficit to 2.3% of GDP in 2008 compared with 2.4% in 2007 and its forecasts are predicated on growth of 2.5% in 2008 and inflation of 1.6%. But officials are being more cautious about their growth forecasts for this year. The Bank of France is not happy about the state of government finances. In a letter, the Governor of the Bank of France described public finances as "fragile" and demanded "great vigilance". He referred to the country's credibility under the eurozone's stability and growth pact, to which we referred above and a structural deficit of 2% of GDP. For countries with a large structural deficit, apart from the constraints which those in the eurozone accept under the stability and growth pact, the danger is a lack of fiscal weapons to fight an economic downturn because of the danger of public finances deteriorating dangerously. The risk which France is running is that, if economic conditions deteriorate, it will not have the fiscal weapons to stimulate the economy and risks running an unacceptably large budget deficit.

That France needs to increase its competitiveness is illustrated by just one important example, the trade deficit. Although the trade deficit narrowed slightly in June against May, it was 16.5% higher in the first half of 2007 at 15 billion compared with the first half of 2006. France has fallen behind Germany in growth and competitiveness and the new French government recognises this. It is very difficult to make reforms in France but, with a strong mandate, this present time is the major window of opportunity for the new French government.

Far from converging, the eurozone is diverging and this could bring problems for the management of monetary union. Italy is one area of weakness for the eurozone with a very large level of public debt in relation to GDP at over 100%. The nature of Italian politics makes it a very hard to achieve meaningful reforms. If growth slows down, it will worsen the fiscal position and it is a concern that, in the second quarter, growth was only 0.1% compared with 0.3% in the first quarter. With very low growth, it could be that Italy will suffer the problem of the "one size fits all" interest rate of the euro. Elsewhere, in the eurozone, Ireland has suffered a sharp dip in consumer sentiment as measured by the IIB/ESRI Irish Consumer Sentiment Index. It fell from 93.1 in June to 74.7 in July. Ireland, partly as a function of it being a fast growing economy, experienced a housing boom and strong rise in prices. Had the Central Bank been able to set interest rates, they would undoubtedly have been higher than ECB rates in the past. If the property market slips badly, it might have wanted to lower interest rates. Spain was another eurozone country where interest rates were set at an inappropriately low level. The Spanish economy, although it has performed well, if judged by the level of economic growth, has grown above its ability to do so consistent with stable inflation. It has become less competitive and a current account deficit of nearly 10% of GDP reflects this. It is also an economy heavily dominated by the construction sector. Although interest rates have been inappropriately low in the past for Spain under the eurozone interest rate regime, there may soon come a time when they become inappropriately high if the construction and property sectors suffer too badly.

There continue to be interesting developments coming out of China as events move fast in the economy. One of our biggest concerns for the world economy is the growth of protectionist tendencies in the USA and Europe and the main target is China. We believe that there is a considerable amount of wrong thinking behind the protectionist thinking and, notwithstanding the merits or demerits of such arguments, the proponents of protectionism should consider that they are not in the strong position they might think. For example, the USA, as we all know, has a large current account deficit, around 6% of GDP, and relies on foreign capital to finance this deficit. Although it may be self defeating, given the size of China's US dollar holdings in its reserves, a rearrangement of currencies by China could cause the US big economic problems. In the early part of August, there were some mildly threatening noises coming out of China, although it has since stepped back but it is a warning of things to come if protectionist pressures keep increasing. China is not a country which will easily give in to overt pressure and it has big economic clout.

Although China needs to grow fast to absorb those coming in from rural areas, it also needs to keep inflation under control. The only concern about the rate of economic growth, forecast by the IMF, for example, to reach 11.2% this year and 10.2% next year, is that it may be too rapid and be one cause of excessive inflation. In July, the year on year rate of inflation reached 5.6%, largely caused by food price inflation, partly as a result of a shortage of pigs following an outbreak of disease which killed vast numbers of pigs. The Central Bank has been acting to try to control inflation by steadily raising interest rates for borrowers and savers and raising banks' reserve requirements. The benchmark lending rate of the People's Bank of China has been raised to 7.02% from 6.84% towards the end of August whilst the deposit rate has been raised to 3.60% from 3.33% in an attempt to increase savings.

But perhaps the most interesting development in China is on the external front. China, as we have mentioned before, is attempting to put its vast foreign exchange reserves to work to earn a higher return and is earmarking US$200 billion for this purpose in what have become known as Sovereign Wealth Funds. Although this development, too, is raising protectionist hackles in certain countries, the more liberal countries, like the UK, should benefit in terms of equity purchases which should be positive for markets in the long term. China is also liberalising the rules to encourage individuals to invest overseas. As a start, investors will be able to open accounts at the Bank of China branches across China to trade securities listed in Hong Kong. China's State Administrator of Foreign Exchange said that these investments, once approved, would be exempt from the US$50,000 limit of foreign currency Chinese citizens could buy or sell each year. These moves, one would expect, would be expanded gradually as China integrates itself more into the financial system. The implications for foreign stock markets could be significant. So, apart from the phenomenal growth which China continues to show, and which is an important driver of international economic growth, these investment developments are also of great importance for world securities' markets.

If we turn to look at the UK, it is noticeable that the Bank of England has followed a fairly unsentimental policy with regard to problems in the credit markets. It has lent funds, in its lender of the last resort role, at penal rates but only in a modest way and has stood back from the problems in the credit market. There is obvious pain for some structured vehicles and hedge funds but the Bank of England would not see its role to underwrite moral hazard. At the time of writing, there have not been problems with financial businesses such as have been apparent in the USA and Germany.

Prior to any economic effect which problems in the credit markets might have had, the UK. economy enjoyed robust second quarter growth. The ONS estimates that the UK economy expanded by 0.8% in the second quarter and 3% over the year, confirming an earlier forecast. During the quarter, manufacturing was estimated to have expanded by 0.7%, construction output by 1.1% and business and financial services by 1.5%. This environment provided a good background for company profits which rose by 4.4% over the quarter and 16.2% compared with the same quarter last year.

At its meeting in early August, the Bank of England's Monetary Policy Committee voted unanimously to keep interest rates unchanged at 5.75%. Most members had "no firm view on whether rates would need to rise further". Until the difficulties in the credit markets surfaced, observers had little doubt that UK interest rates would rise to at least 6%. In its latest quarterly Inflation Report, the Bank of England forecast that, if interest rates were left at 5.75%, it would expect inflation to stay above its target and commented that strong demand had cut the amount of slack in the economy. It also cast doubt on official figures for economic growth, believing that it may be above 3%. The Bank of England's report showed that central inflation projection falling to 2% in two years' time provided interest rates rose by a further 0.25% which would take them to 6%. The Governor of the Bank of England was concerned about the lack of slack in the economy and that the oil price increase meant that consumer price inflation would not fall as much as expected last May. The Governor also welcomed, in the context of unsettled credit market conditions, the repricing of risk and had fairly hawkish comments for unwise lenders.

Obviously, the MPC will be watching inflation and conditions in the housing market. Pricing power is on the MPC's closely watched list of indicators and the latest CIPS/NTC purchasing managers' survey for the manufacturing sector showed the index of output prices being at its highest level since the survey started in 1992. On a more encouraging note, producers' input prices fell by 0.5% in July on a seasonally adjusted basis as metal prices fell. Output prices rose by 0.2%. The relevant figures for core prices were 0.2% and 2.3%. There was good news, at least temporarily, on the consumer price index. In July, the year on year rate fell to 1.9% from 2.4%. The more valid Retail Price Index fell to 3.8% from 4.4% in June. One reason for slight optimism on inflation is that headline average earnings growth is at a three year low in the three months to June at 3.3%. Excluding bonuses, the figure is 3.4% which is the lowest level since July 2003. So there is not a great deal of cost push pressure on inflation from the pay front. However, not such good news came from another measure of inflation, the GDP deflator, which, in the second quarter, rose at its highest level since 1996, 3.8%.

The inflation figures carry mixed signals but the fact that the economy is growing above trend suggests that inflationary pressures are evident and that the Bank of England is right to be concerned. It remains to be seen whether the turmoil in the credit market will restrain inflation but it is doubtful if the Bank of England will be taking any risks on this front unless, as is unlikely, the economy looks as if it is going to be so badly affected that it has to cut interest rates.

In setting interest rates, the housing market will remain a closely watched indicator. As we discussed towards the beginning of this review, events in the financial markets may hit a specific area particularly hard, albeit from a high level, namely certain parts of London. This market has increasingly distanced itself from the rest of the country as the financial services sector has boomed. If bonuses are cut or employees laid off or, as is probable, the numbers employed in the hedge fund industry decreases, then the more expensive parts of London, where prices have seen particularly sharp rises, may be significantly affected. So the particular effect of this event may be felt here as opposed to the general effect of the series of interest rate increases which may be felt across the rest of the country.

If we look at the various indicators of house prices, the Halifax reported an acceleration of house price increases in July, +0.7% as against +0.4% in June. The three months on three months series, however, showed its lowest rate of growth since last April. The FT House Price Index showed an annual increase of 9.0% in July, slightly lower than June's 9.0%. It showed house prices had increased in London by 15.2% over the past year. The Department of Communities and Local Government reported house price increases, year on year, of 12.1% which was the highest rate for two years. The monthly RICS survey showed some caution amongst respondents. The property website, Rightmove, reported asking prices up 0.6% in August compared with July but did note minor weakness in London. The Land Registry reported just a small increase in prices in July, 0.1%, compared with June with year on year prices up 8.8% in July compared with June. At the end of August, Nationwide reported a 0.6% rise in house prices for August compared with 0.1% in July to give an annual rate of increase of 9.6% compared with 9.9% in July.

In terms of activity within the sector, as measured by mortgage activity, the British Bankers Association reported a rise in net mortgage lending of £5.7 billion in July compared with an increase of £5.4 billion in June.

The Building Societies Association reported net mortgage approvals of £3.6 billion in July compared with £3.9 billion in June. The British Bankers Association also reported that new loans for mortgages in July stood at 67,000, 0.7% lower than a year ago. Gross mortgage lending was 12% higher than a year previously at £21.3 billion, boosted by a higher level or re-mortgaging activity. The Council of Mortgage Lenders reported gross mortgage lending of £34.4 billion in July, 13% above the level of the previous year. It, too, noted an increase in re-mortgaging. The Bank of England reported that 115,000 new loans for house purchase were taken out in July, the same as June. These figures do not yet signify a marked change in conditions and activity in the housing market.

For the time being, the good days in the commercial property market appear to be over. Relative movements in yields have been unfavourable and are now beginning to affect returns and sentiment. According to the Investment Property Databank, prices for retail property fell by 0.6% in July and by 0.3% in industrial property. The office market was stronger, rising by 0.3%. The figures quoted for yields and cost of money are instructive with the boom in the commercial property market pushing yields down to 4.56% whilst the cost of money, as evidenced by five year swaps, rising to 6.1%.

As the robust GDP growth figures suggest, there are areas of strength in the UK economy. The purchasing managers' indices for both the manufacturing and services sector remain strongly in positive territory even if the one for the services sector fell slightly in July. Manufacturing, although now a relatively small part of the economy at 15% of GDP, rose by 0.2% in June and was 0.7% up, second quarter on first quarter. The latest CBI survey shows that manufacturers' orders books are at their largest for twelve years. In the retail sector, sales volumes have been strong although this has been at the expense of heavy discounting. July sales volumes rose by 0.7% against June and the annual rate of increase rose to 4.4% compared with 3.7% in June but the volume of sales fell by 0.2% in the month and rose 4.1% for the year, showing the effect of heavy discounting. The British Retail Consortium's figures were less strong. It reported that sales were up 3.1% in July compared with the same month the previous year and a lower increase than in previous months. The CBI reported a poor August for retailers. One disappointing pointer to the future is the modest increase in business investment in the second quarter which the ONS put at just 0.8%. This suggests a certain lack of confidence in future prospects.

One interesting and expected consequence of the volatility of stock markets has been that companies have taken advantage of share price weakness to progress with their share buy back plans. This is likely to be a worldwide phenomenon as financially strong companies accelerate their plans and, of course, the lower is the share price at which they buy back stock the more advantageous it is for earnings per share. According to the Financial Times, Mergermarket reported that, in the five trading days between August 14 and August 21, 34 FTSE100 companies bought back their shares compared with 22 in the week before the turmoil, spending £764.3 million on doing so compared with £618 million in the week of July 10 to July 16. We expect this kind of activity occurred in most markets where share buy backs take place and will have acted as a support to the markets when distressed sellers were having to raise money by selling good quality shares. Long term investors will benefit from this evidence of strong companies taking advantage of the situation to add shareholder value.

Notwithstanding solid growth in the UK, there remain issues which could become problematical in the future. These are the potential dangers to the economy if serious weakness in the housing market develops, perhaps because relatively high inflation has caused the Bank of England to tighten monetary policy further, the poor state of public finances which, if there is economic weakness, will limit the ability to use fiscal policy to take offsetting action and the current account imbalance which always has the possibility to cause problems for sterling which looks overvalued.

In Australia, which has been a successful area of investment, consistent strong economic growth has provided an inflationary stimulus and, in August, the Reserve Bank of Australia raised interest rates to 6.5% in the face of inflationary pressure. In the quarter to the end of June, inflation rose by 1.2%. Although the Australian economy has performed outstandingly well for a long time, the continual rise in interest rates may be unhelpful to the government which shortly faces re-election and is lagging in the opinion polls. Investors will need to monitor the situation and the opposition's economic policies to see how they may affect the Australian stock market if it replaces the present government.

The sentiments which we expressed in our special note to clients on 17 August, remain valid. For equity investors, high quality companies with good earnings and dividend growth prospects remain reasonably valued. The fact that they were hit, at one stage, by forced selling should not influence long term investors. They should not be intimidated by short term market conditions into selling good quality assets. Even if they fall temporarily, they will still continue to pay dividends and, in time, recover and move ahead. Selling good quality equities in response to short term pressures could prove very costly. Even if economic growth is affected, as is likely, the economic prospects still look quite good and shares reasonably rated. If conditions deteriorate unacceptably, central banks will act to offset the danger. Whilst there is no room for complacency, there are a number of powerful supportive factors for international equities.