meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

International equity investors have seen satisfactory returns over the last quarter as the benign economic environment and low volatility levels have increased investor confidence. Bond investors have generally experienced a disappointing quarter as the UK and ECB raise interest rates and concerns about inflation increase slightly despite a weaker oil price.

The tables below detail relevant movements in markets :

International Equities 31.10.06 – 29.01.07

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+7.6	+4.9	+7.7	+5.8
Finland	+7.7	+6.8	+9.6	+7.7
France	+5.6	+4.8	+7.5	+5.6
Germany	+8.3	+7.4	+10.2	+8.3
Hong Kong, China	+15.6	+12.2	+15.2	+13.1
Italy	+6.0	+5.2	+7.9	+6.0
Japan	+6.8	+0.8	+3.4	+1.6
Netherlands	+4.5	+3.6	+6.4	+4.5
Spain	+6.7	+5.9	+8.6	+6.7
Switzerland	+7.0	+3.9	+6.6	+4.7
UK	+1.8	+1.8	+4.5	+2.7
USA	+5.1	+2.4	+5.1	+3.2
Europe ex UK	+7.1	+6.1	+8.9	+6.9
Asia Pacific ex Japan	+8.1	+5.6	+8.4	+6.5
Asia Pacific	+7.3	+2.8	+5.5	+3.6
Latin America	+15.7	+11.9	+14.8	+12.8
All World All Emerging	+10.5	+8.4	+11.3	+9.3
The World	+5.9	+3.3	+6.1	+4.2

Source FTSE World Indices

FT Government Securities Index (capital movement) -2.4%

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

Currency	31.10.06	31.01.07
Sterling	4.52	4.98
US Dollar	4.61	4.83
Yen	1.73	1.71
Germany (Euro)	3.74	4.10

Sterling's performance during the quarter ending 31.01.07 (%)

Currency	Quarter Ending 31.01.07
US Dollar	+2.6
Canadian Dollar	+8.1
Yen	+6.0
Euro	+0.8
Swiss Franc	+3.0

Other currency movements during the quarter ending 31.01.07 (%)

Other Currency	Quarter Ending 31.01.07
US Dollar/Canadian Dollar	+5.3
US Dollar/Yen	+3.2
US Dollar/Euro	-1.8
Swiss Franc/Euro	-2.0
Euro/Yen	+5.1

Significant Commodities (US dollar terms) 31.10.06 – 31.01.07 (%)

Significant Commodities	31.10.06 – 31.01.07
Oil	-2.8
Gold	+7.8

Markets

During the quarter, international equities drifted higher. The FTSE World Index, in local currency terms, showed a total return of 5.9%, whilst the respective sterling, US dollar and euro adjusted returns were 3.3%, 6.1% and 4.2%. In local currency terms, there were excellent performances from Europe ex UK, Japan and the USA with respective returns of 7.1%, 6.8% and 5.1%. The UK lagged at 1.8%. Latin America, Emerging Markets and Asia Pacific ex Japan continued their outstanding performances with total returns of 15.7%, 10.5% and 8.1%. Australia also did well with a total return of 7.6%. If we then look at sterling adjusted returns, the picture changes particularly because of the weakness of the yen where the return falls to just 0.8%. The returns for Europe ex UK and the USA fell to 6.1% and 2.4% respectively, still ahead of the UK. The returns from Latin America, Emerging Markets and Asia Pacific ex Japan fell to 11.9%, 8.4% and 5.6% respectively, still excellent figures. Australia was very satisfactory with a 4.9% return.

International bond markets, as measured by ten year government bonds, experienced a poor quarter. The gross redemption yield on sterling bonds rose by 46 basis points to 4.98%, on US dollar bonds by 22 basis points to 4.83% and on euro denominated German government bonds by 36 basis points to 4.10%. The exception was Japan where the yield fell by 2 basis points to 1.71%.

In the currency markets, sterling remained firm. Against the yen it rose by 6.0%, against the Swiss franc by 3.0%, against the US dollar by 2.6% and against the euro by 0.8%.

In the commodities market, oil fell by 2.8% and gold rose by 7.8%.

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Economics

- *A benign economic background still exists*....markets have demonstrated very low levels of volatility and an increased appetite for risk. A pursuit of high returns with the attendant risk might lead to problems in certain areas of the market.

- *The background for equities has been good*...steady economic growth has been responsible for pleasing corporate earnings growth which, in some cases, has been above share price growth leading to a downrating of shares thus providing a stable platform for this year's performance.

- *Bonds have performed poorly*....in absolute terms yields look too low and, in relative terms, bonds look expensive against equities.

- *In the absence of unforeseen events 2007 should be a satisfactory year for the world economy*....the IMF, in January, expressed hope that global growth will remain "solid" at close to 5% in 2007.

- *Some assistance has been given to the world economy from the fall in the oil price*....although it has risen recently, it is still about US$20 a barrel lower than its 2006 peak level.

- *The ECB President warns about the danger of protectionism*....this is an issue which we have often mentioned and, to us, has the potential to be one of the biggest threats to the world economy. We are not at this stage at present but a close watch needs to be kept on populist politicians.

USA

- *Recent economic news has been quite positive*....a string of data suggests the economy finished 2006 in good form and has started 2007 well.

- *Fourth quarter annualised growth was 3.5% on the first estimate, faster than expected*....personal consumption and exports (a good quality driver of growth) were behind the better than expected figure which is subject to later revision.

- *The latest Beige Book survey was moderately positive*....manufacturing and services were generally expanding in the Federal Reserve's various districts and the labour market was tightening although it was not too concerned about the effect on wage growth.

- *The Federal Reserve appears slightly more positive about economic prospects*....at its late January policy setting meeting, it was slightly more sanguine about inflation and the housing market.

- *Bears of the US economy cite the recent sharp fall in the housing market, fearing that it will spill over into the rest of the economy*....but it has not done so far, apart from reducing economic growth last year, and various items of recent data tentatively suggest some stabilisation although these are by no means conclusive.

- *Most recent items of economic data have been positive*....the ISM's manufacturing and service sector indices, employment figures, industrial output, durable goods orders and consumer confidence point in the right direction.

- *But the US political scene needs watching*....the change of control in Congress may not be good news for businesses and investors. It is not a market factor at present but may be in the future.

Japan

- *The Bank of Japan leaves interest rates unchanged in January*....a split decision has led to fears of political pressure, denied by the Governor. The Bank of Japan gives its reasoning as the economy being weaker than expected compared with its expectations in last October's Outlook Report.
- *Deflationary pressures remain stubborn making it more difficult for the Bank of Japan to justify an interest rate rise*.... there is really no inflation in the economy.
- *Retail sales have been weak*....they declined by 0.2% in December.
- *Corporate Japan remains quite confident*....December's Tankan survey was reasonably positive and private sector manufacturing orders remained strong in November, rising by 3.8% over October.
- *The yen remains very weak*....the "carry trade", whereby investors borrow in cheap yen to invest in higher yielding currencies, continues to be a feature although it carries risk. But currency weakness has not caused inflation and makes Japanese exporters very competitive.

China

- *Economic growth has been faster than expected*....it came in at 10.7% for 2006 helped by strong consumption and rising exports.
- *The authorities are trying to manage growth*....they want to ensure that inflation does not become a problem (it rose to 2.8% in December) and that investment is restrained to avoid bad debts in the banking system.
- *The growing Chinese trade surplus remains an irritation to the USA and EU*....in 2006, it rose by 74% to US$177.5 billion. Foreign exchange reserves exceed US$1,000 billion, rising by 30% over the year.

Europe Ex UK

- *Eurozone growth has exceeded expectations*....the OECD, for example, believes it will have achieved 2.6% growth in 2006 and is forecasting growth of 2.7% in 2007.
- *Although the ECB did not raise interest rates in January, it will almost certainly do so again soon*....it is concerned about the fast rate of growth of M3 money supply which showed a 9.7% annual rate of growth in December. Banking lending remained strong. Money supply growth is an important pointer for the ECB in determining its interest rate policy.
- *More buoyant growth has reduced unemployment*....the December figure of 7.5% in the eurozone was the lowest since records began in 1993
- *So far, the effects of Germany's 3% VAT increase in January seem to have been reasonably well contained*....January's eurozone inflation figure is 1.9%. For 2006, the average rate was 2.2%, above target.
- *Some encouraging news from Germany*....the German government raises its economic growth forecast for 2007 to 1.7% compared with its previous estimate of 1.4%. Although unemployment is very high, it has been falling, with the January rate at 9.5%.

- *There could be problems on the industrial relations front*....economic recovery and high profits will encourage large pay claims, supported by some politicians. The ECB will be watching progress.

- *France is consumed by pre-election politics*....not much is likely to get done before the election but, interestingly, President Chirac talks about the need to reduce corporate taxes.

UK

- *A surprise increase in interest rates in January to 5.25%*....most observers expected an increase in February. The decision was a close one, with the hawks seeing enough evidence and no reason to delay the rise and the doves concentrating on the expected fall in inflation later this year with the attendant risks of excessive monetary tightening now.

- *The economy ends 2006 on a strong note*....0.8% growth in the final quarter and estimated growth by the ONS of 2.7% in 2006.

- *The MPC is watching asset prices closely*....housing is the key and there is tentative evidence that the market may be cooling down, although not in London. It is too early to be sure, though.

- *Inflation is of concern*....The Consumer Price Index is 1.0% over target at 3.0% and the Retail Price Index, which many people consider more relevant and which is often used for wage negotiations, stands at 4.4%. There is evidence of companies having more pricing power.

- *Most short term indicators are positive*....The CIPS/RBS manufacturing and service sector surveys, the CBI's January retail sales survey, one from the BCC and the CBI's industrial trends survey, are all quite positive.

- *Public borrowing is building up to a potentially big problem*....at this stage of the economic cycle, finances should be in much better order. Tax increases and/or stringent public spending curbs are on the horizon. This year's public sector pay round will be difficult.

Summary

- *In the absence of unforeseen circumstances the equity market outlook should be satisfactory for this year*....modest corporate earnings growth on the back of an expanding world economy should provide solid support for equities.

- *Bonds still look expensive*....yields do not price in risks and bonds look less attractive than equities.

In a quarter which has seen stability or even further growth in equity values, a feature has been the continued very low level of volatility in nearly all markets. In terms of what an equity investor wants to see, this is about as good as it gets. That may seem a strange thing to say because a number of quarters in the past have seen double digit returns. But such rises, whilst very pleasing in terms of pure numbers, do give rise to an anxiety that there may be a significant setback just because prices have moved up so far so quickly. If one is, realistically, expecting average long term total returns from equities of 7% - 9% per annum (some years better, some years worse), then the achievement of such a return in one quarter far exceeds long term expectations. If, with low volatility, prices move upwards steadily, in line with the long term expectations mentioned above, investors' comfort level should be high. This is what we have seen during the last quarter. However, when equity markets are experiencing these sorts of conditions, sceptics can say that they are too good to last and that something must go wrong.

That may or may not be the case. One argument the sceptics could reasonably use is that low volatility implies that investors' risk appetite has increased and that, in the chase for spectacular returns, the seeds of their own destruction are sown as problems with the riskier investments emerge. It is, unfortunately the case that some investors become greedy and regard regular returns of, say, 20% as normal. That is not the case. An average long term real, inflation adjusted, return of around 5% should be a pleasing result. So, if a problem arises in markets because the pursuit of high risk comes unstuck, then markets generally may be adversely affected. But, equally, a gentle rise in equity prices on the back of continued growth in corporate earnings which leaves ratings unchanged or lower, as happened last year, can provide a sound base for continued growth.

Investors will remember that equity markets had a sudden period of weakness last May and June for no good fundamental economic reason. This squall came from nowhere and, whilst one can always try to rationalise an event after it has occurred, there was no real satisfactory explanation for the sudden movement. However, the sound investment principle of stepping back and examining the fundamentals to see if they have changed, rather than following the short term trend and being led to a poor investment decision (in this case, to follow the trend) should lead to better results. Therefore, so far, those who stood firm during last summer's squall have been well rewarded, whilst those who bailed out in response to temporary weakness are likely to have had a poor result for the year. Probably the biggest danger from the present benign equity market conditions is that some investors become over confident and greedy in the pursuit of above average returns leading to problems in the market which may or may not spill over generally. In this respect, it is comforting that the problem with the Amaranth hedge fund last year was contained. This might not always be the case.

Equity returns over the past year have been broadly in line with what might be expected as a long term average and, as these returns were generally achieved without multiple expansion, and, in many cases, with multiple contraction, they were soundly based.

On the other hand, as expected, the bond market performed poorly although, in the search for extra return by taking higher risk, lower quality issues performed better than top quality issues, an example of what we have just been talking about. Yield premiums do not seem sufficient for the extra risk taken. Our view for some time has been that bonds were overvalued in absolute terms and in relative terms against equities. Except in Japan, we have seen a significant rise in yields in top quality bonds but, even at the yield levels on ten year bonds, the outlook appears unpromising. The real yields look unattractive at a time when inflation is certainly not dead. An extreme example is the UK where the latest Retail Price Index shows a rise of 4.4%, year on year, giving ten year UK government bonds a real yield of less than 60 basis points. On the official measure of inflation, the Consumer Price Index, which stands 3.0% above a year ago, the real return is still too low in our view. Many will think that the RPI is a more realistic measure of inflation. The rise in bond yields, which we have seen during the last quarter, is overdue and has, in our view, further to go.

Apart from the very pleasing rise in corporate earnings which was seen in 2006 and which has helped to provide solid support for share prices, other developments provided positive drivers for equity markets. The abundance of still cheap money, despite a trend towards higher interest rates, made cash acquisitions attractive in an environment where shares were not expensive. Companies also found that the combination of relatively cheap money and modest share ratings made the mathematics of buying in shares appealing. Large amounts of equity were withdrawn from the market. Apart from increases in regular dividends, special dividends and returns of capital were other features. Investors like these actions which are supportive to share prices. Ironically, and this is a UK issue, the regulatory pressures on some institutions to sell equities and buy bonds has contributed to the number of cash takeovers for UK companies from abroad last year. Companies' shares were left looking cheap by these sales and foreign investors, recognising value, were quick to respond. The takeover of BAA is just one example but there are others.

Cementing these positive features, and being a cause of some of them, has been the sound state of the world economy which, last year, weathered the rise in the oil price remarkably well. On the information currently available, 2007 looks like being another satisfactory year even if growth in many economies does not match that of last year. In January, IMF officials expressed confidence that global growth will remain "solid" at close to 5% in 2007. The IMF's Managing Director reported hopefully on the US housing market which has been a concern to bears of the US economy and he said that a soft landing for the US economy seemed more assured. What he described as "spillovers to other economies from slower growth have, so far, been minimal". He referred to a broadening of the economic recovery in Europe, Japan as being broadly on track and to vigorous emerging market growth, particularly in India and China.

Economic and market sentiment has been helped by the fall in the price of oil which, from its 2006 peak, has fallen approximately US$20 a barrel. Oil has proved to be a very hard market to predict. OPEC is currently trying to support the price through output cuts but, undoubtedly, a lot of speculative positions have been unwound. It is obviously helpful that the oil price has fallen but, because the relative use of oil is less than it used to be, economies should be able to withstand a moderate recovery in the oil price from this level. It is much easier to cope with a rising oil rice when economic growth is solid, as is the case now, than when there is a supply shock and oil availability is limited. Oil has always been available recently although at a high price, which is still below previous peaks in real terms.

We now move to look at individual countries and regions, starting with the USA. The latest Beige Book Survey from the Federal Reserve's regions paints a moderately upbeat picture of the state of the US economy. The labour market appears to be strengthening. It reports a "tightening" in most parts of the USA and that businesses had "difficulty finding qualified workers". This is a stronger stance than in its previous report. Although hinting at some knock-on effect on wages, it was not generally alarmist about the situation. Manufacturing "continued to expand in most districts" and services "generally expanded in most districts". The Beige Book reported uneven growth in retail sales over December and January.

The uncertain signals from the US economy also inform the thinking of the FOMC whose minutes of the December meeting were published in early January. It was trying to draw a conclusion from evidence of continuing strength in the labour market with spending and production data which possibly pointed the other way. Which of these conflicting signals is more representative of the state of the US economy and its prospects? Are some of the figures inaccurate? In terms of what is likely to happen to US interest rates in the foreseeable future, the conflicting evidence suggests no change in US interest rates. As we shall see shortly, the news in the US housing market looks slightly more encouraging and that was, and perhaps is, the most likely source of difficulty for the US economy. It is unlikely that the US economy will put in a poor performance this year and there are enough pointers of strength, for instance in the employment market, to suggest that a near term cut in interest rates might be too risky. However, if there is enough evidence to suggest that the economy is likely to have a growth rate below its long term potential consistent with inflation, say 3.0% to 3.25%, then the Federal Reserve is likely to start the process of cutting interest rates. The best estimate is that interest rates will remain unchanged for the foreseeable future until the conundrum is sorted. After the Federal Reserve's policy making meeting at the end of January at which interest rates, as expected, remained unchanged, a slightly more confident view on the outlook for the US economy was apparent. It came against the background of the first estimate of final quarter of 2006 growth of 3.5% annualised, a faster rate of growth than expected, although the figure is subject to later amendment. Drivers of growth in the final quarter were personal consumption, up 4.4%, and a 1% rise in exports. The Federal Reserve was slightly more confident on growth, the housing market and inflation although it remains very vigilant on the latter.

As we have indicated, the housing market in the USA is showing some tentative signs of stabilisation. Housing starts were up 4.5% in December compared with November. There was also a fall in the inventory of unsold homes in December. New home sales rose by 4.8% in December compared with November. This was the largest rise since last April. On the other hand, the National Association of Realtors reported that the pace of existing home sales had fallen by 0.8% in December. Overall, there is enough in these various sets of data to point to stabilisation in the market, but more data will be required to establish this view with more certainty.

Inflation signals will provide a pointer to the likely course of US interest rates. The latest signals were disappointing in that they were worse than expected, but several sets of figures will be necessary to establish if a trend has been confirmed. After a rise of 1.3% in November, core producer prices rose 0.2% in December. The consumer price index rose by 0.5% in December, whilst core consumer prices rose 0.2% in December over November. There was also a rise in wages with a 4.2% increase in average hourly earnings.

Most of the individual items of news from the US economy in the past month have been positive, confirming the belief that, so far at least, weakness in the housing market has not spilled over into the rest of the economy. Indeed, if the housing market confirms the more optimistic trends noted above, it may give a further stimulus to the economy.

Individual items of news pointing to a sound economy were numerous in January. The ISM's index of manufacturing activity moved into positive territory in December, rising from 49.5 in November to 51.4. The ISM's service sector index of activity, whilst it fell slightly in December to 57.1 compared with 58.9 in November, was still strongly in positive territory (any reading over 50). The only reason the index fell slightly was the negative fallout from the housing market.

The employment market remained strong. December's non-farm payrolls reading was far higher than expected at 167,000. Retail sales numbers were also strong. They rose by 0.9% in December. Industrial output rose by 0.4% in December compared with November. Durable goods orders were 3.1% higher in December against November and, excluding transportation, the increase was 2.3%, the largest increase since last March. The Conference Board's consumer confidence index rose from 110.0 in December to 110.3 in January, the highest level since May 2002.

So, from the evidence available, the US economy seems to have ended 2006 on quite a strong note with some reasonable, but not certain, hope that problems in the housing market have been contained and that, subject to confirmation from further data, it may recover later this year. Although US corporate earnings growth has been strong and profits are mostly at record levels, the economic background and prospects for 2007 suggest that satisfactory, although more modest, earnings growth is in prospect.

An interesting statistic in the flows of funds into and out of the USA is that, in November, foreign investors bought US$63.9 billion worth of corporate bonds. Earlier in this review, we touched upon the issue of investors' heightened appetite for risk, and this is one manifestation of this phenomenon. Although US Treasury bond yields have risen, they are still low by historical standards and, in the search for additional return, foreign investors are prepared to trade down the quality ratings. At an overall net inflow of US$74.9 billion, the USA comfortably covered its current account deficit with capital inflows.

Whilst the economic position of the USA looks satisfactory, despite the very large current account deficit, the political background has changed, given the Republicans' loss of control of Congress. Whilst not apparently a significant stock market issue at the moment, investors need to watch developments closely as the Democrats' policies are unlikely to be so favourable to investors and the corporate sector.

As far as Japan is concerned, the dog that did not bark in the night in January was interest rates. There had been quite a widespread belief that the Bank of Japan would raise interest rates from 0.25%, but it did not do so, raising fears in some quarters that it had been susceptible to political pressure. As with the Bank of England's recent decision to raise interest rates, the vote was split, this time 6-3 in favour of no change. The government had made no secret of its belief that interest rates should remain unchanged to support its growth policy and the absence of meaningful inflationary pressures added support to its view. The Governor of the Bank of Japan sought to refute the view that the Bank had been under pressure, saying that "as always, today's decision is based on our careful assessment of the economy and prices. There is no room for factors other than economic and price conditions to wield clout over monetary policy".

The Bank of Japan indicated, in its reasoning behind an unchanged interest rate, doubts about the strength of the Japanese economy, indicating that it was not as strong as envisaged in last October's Outlook Report. Despite inflationary pressures from rising interest rates, Japanese prices have remained stubbornly low. December's core consumer price index, excluding fresh foods, was 0.1% higher than a year earlier and, if energy is excluded, there is deflation with core consumer price inflation at -0.1% in December compared with November. Excluding food and energy prices, the nationwide consumer price index fell by 0.3%, the twelfth monthly decline in a row. The Bank of Japan said that private consumption had been weaker than expected and it noted that energy prices had recently fallen, saying that domestic prices "are expected to be somewhat weak or stay flat in the immediate future due to the drop in international commodity prices". Latest figures for retail sales show a 0.2% decline in December, adding support for the Bank of Japan's reasoning.

Currency weakness has been a feature in Japan with the yen now hitting a four year low against the US dollar. Keeping interest rates at minimal levels is not helpful to the yen, especially when interest rates have been rising elsewhere. As we have seen with the inflation figures above, a weak yen has not been able to put Japan back into a position of modest inflation, so one of the arguments against a weak currency does not stack up on this occasion. The "carry trade" whereby investors borrow in yen to invest in higher yielding currencies is still alive and flourishing. It can be a dangerous ploy for investors and, once sentiment changes, the currency could reverse itself quickly. Lack of volatility in markets and benign conditions have made investors complacent. Whilst this should not be an issue for equity investors, given the reasonable ratings of equities, it could be for currency speculators or bond investors, for example.

Despite weakness in private consumption, corporate Japan still appears reasonably confident. Private sector machinery orders in November were strong, showing a rise of 3.8% over the previous month. December's Tankan survey was reasonably positive. Of course, with a weak currency and really no inflation, Japanese companies are very competitive. This ideal combination of factors augurs well for Japanese company profits in the foreseeable future although, in a steady international equity market performance in 2006, Japan was the one real disappointment, but investors should recall the stellar performance in 2005. Our experience is that investors are influenced by poor past performances from the Japanese stock market in their views on Japan, but we would argue that with reform under way in the Japanese economy, and with companies being much more lean and efficient, Japan should retain an important minority position in international equity portfolios.

We now move on to discuss the eurozone where January's meeting of the ECB left interest rates unchanged, although the expectation is that there will be an interest rate increase shortly. The ECB pays more attention to money supply growth than most central banks and it remains concerned about its fast rate of growth. December's M3 broad money supply grew at an annual rate of 9.7% compared with 9.3% in November. This represents the fastest rate of increase since the euro was introduced. Some respite for the ECB might be provided by the fact that the rate of growth of lending for house purchases has slowed down. It is still fast, but December's growth of an annual rate of 9.7% compares with November's figure of 10.2%. Lending growth to business was almost unchanged at 13.5% in December, compared with 13.1% in November. That the ECB or, at least parts of it, are concerned by the pace of monetary growth, is illustrated by a comment by the President of the Bundesbank which refers to strengthening internal pressures on price increases taking over from external pressures. Very interestingly, the OECD, early in January, queried the importance which the ECB paid to monetary growth in terms of its importance as a guide for policy. It urged the ECB to indicate what current rates of money supply growth mean for future inflation. For the moment, though, this is one of the pillars of the ECB's interest rate policy. The latest unemployment figure for the eurozone in December was 7.5% which is the lowest since records began in 1993. Whilst still high by international standards, the ECB will be watching out for any inflationary wage pressures which a stronger employment market might bring.

Since the start of the euro, inflation has constantly exceeded the ECB's target. For 2006, the average inflation rate was 2.2% compared with the ECB's target of "below but close to" 2.0%. This is something that has understandably bothered the ECB. Now, with eurozone growth, by its standards, quite buoyant, it fears that inflationary pressures will build up. In Germany, for example, where the economy performed well in 2006, some politicians and trade unions are pressing for employers to concede pay rises well above inflation. The ECB is not likely to look favourably on this pressure which will be inflationary. The current rate of eurozone inflation in January was 1.9%. Early indications are that the VAT increase in Germany has had less effect on inflation than feared.

The latest OECD forecast for eurozone growth in 2006 is 2.6% and 2.2% for this year. This accompanied the usual calls from a wide range of sources for the eurozone to speed up supply side reforms in the labour market. If growth does turn out in line with the OECD's forecast for 2007, that can be considered a satisfactory result in view of Germany's substantial increase in VAT.

The short term question of interest in Germany is the extent of the economic effect of 1st January's 3% VAT rise. As we noted, 2006 was a good year for the German economy, far better than most had expected. Most of the short term news has been positive. The unemployment situation has been improving. There were 106,000 fewer job seekers in January and the German unemployment now stands at 9.5%, still a dreadful figure, but better than it was. Industrial production rose by 1.8% in November. Over the year, investment spending rose by 5.3%. This is an encouraging figure suggesting increased confidence by German businesses. Stronger than expected economic growth meant that Germany's budget deficit fell to 2% of GDP in 2006, well within the Maastricht limits of 3%. As we mentioned earlier, the feeling is that the effect of the 3% VAT increase in January may not be as adverse as first feared. For example, investors seem reasonably confident. The ZEW survey of investment sentiment, revealed in January, showed sentiment to be at its highest for six months. However, the industrial relations climate could become much more difficult as a result of the economic recovery in Germany. The country has increased its competitiveness against its EU partners because real wages have been held down. Now, some big pay demands are likely to come in from IG Metall, for one, and they will be more difficult to resist. As we noted earlier, the ECB will be very interested in the course of German pay negotiations and their outcome could well have an effect on its interest rate policy. At the end of January, the German government raised its forecast for economic growth for 2007 to 1.7% compared with a previous forecast of 1.4%.

In France, attention is focused on the forthcoming Presidential election. France's economic policy is particularly distinctive and ill suited for the age of global competition. This is realised by some politicians but change is not easy to achieve in France. There is concern about how far behind Germany, France has fallen. Its share of world exports has fallen and it has lost competitiveness to Germany. Interestingly, although it may not count for much, President Chirac said in January that the French corporate tax rate should fall from 33% to 20% over five years. The relative economic success of Germany has given a wake up call to some French politicians. Germany's move to tilt the incidence of tax more towards consumption and away from labour has been noted.

The French Finance Minister said that France had to be "very attentive towards what is happening in Germany". The VAT increase in Germany will help to fund cuts in social charges on employers and employees. One suspects that one of the Presidential contenders, Mr Sarkozy, realises that France needs to change. He has said as much, but with an electorate hostile to globalisation, private businesses and in protectionist mode, not to mention being wedded to a large state sector, he has his work cut out, and he may have to nod in favour of policies and sentiments which independent observers feel do not serve France well.

Having done well last year, we would expect another satisfactory performance this year from European shares based on the probability of further moderate earnings growth arising from decent economic growth (by the standards of the eurozone where the long term potential growth rate of the economy is less than that of the USA). Mergers and acquisitions may play an important part in sentiment towards European shares. If the EC can succeed in blocking protectionist measures against takeovers, and therefore make takeovers more likely, the market could be boosted. Because of overt and covert protectionism by some countries in the EU (for example, the battle waged by Spain against the takeover bid by E.ON of Germany for Endesa), it is not a certainty that the EC will prevail. One way or another, it will be a market issue in 2007.

The major item of economic news in the UK was the Bank of England's surprise decision to increase interest rates by 0.25% in January to 5.25%. The surprise lay not in the direction of interest rates, but the timing. Most observers felt that February was the most likely month for the MPC to announce an interest rate increase. At the time of the announcement on 11th January, the Bank of England referred to strength in demand, growth and the international economy. At the time, the latest inflation rate, as measured by the Consumer Price Index, was 2.7%, with the expectation that it would rise further above the Bank of England's 2.0% target. In the event, we now know that December's inflation rate rose to 3.0% and, for many, the more relevant Retail Price Index was 4.4%. It is the latter index which is widely used as a guide in pay negotiations. We now know from the minutes of January's MPC meeting that the decision to raise interest rates was finely balanced with a 5 to 4 vote in favour. The Governor of the Bank of England voted in favour of the increase. The majority felt that there was enough evidence to support an increase and no reason to delay it. Those supporting the rise felt that asset prices were unlikely to fall soon and an early move might prevent a larger movement later. Other reasons cited in support of the decisions were the increased pricing power of companies as a result of the robust global economy, diminishing spare capacity and rising inflation. The minority, who opposed an immediate rise, felt that attention should be paid to the probability of inflation falling later this year and did not want to run the risk of excessive monetary tightening. In a later statement, the Governor of the Bank of England also referred to the probability of a sharp fall in inflation later this year. The majority who voted for an interest rate increase would have felt a further vindication for their view following news of the ONS's estimate of growth in 2006 of 2.7%, including a 0.8% growth rate in the final quarter of the year.

The reference in the MPC's minutes to asset prices will largely relate to the housing market since the equity market, despite its recovery, does not look overstretched. The various pointers of information on house prices are giving a slightly conflicting picture of what is happening. On the most positive interpretation, as far as the Bank of England is concerned, interest rate rises are starting to have some effect. For example, the Halifax suggested that prices fell by 1.0% in December to reduce the annual rate to 9.9%. It has the most pessimistic estimate of house price inflation for 2007 at 4.0%. The Financial Times house price index for December showed a 0.6% increase over November and a rise of 6.8% for the year. The Land Registry's figures show a 0.7% rise in December and a 7.8% rise for the year. Rightmove shows a 13.5% increase for the year to January. The latest figures from Nationwide show house prices rising by 0.3% in January and 9.3% in the year to January. The Nationwide is forecasting house price increases of 5% to 8% in 2007, whilst the RICS forecasts 7.0%. The evidence from these various pieces of data is certainly not conclusive but there is just enough in some of the figures to suggest that the interest rate increases may be having some effect. They may be one of the factors staying the hand of the MPC in raising rates again in the very near term, although we may not have seen the peak of the current interest rate cycle. Evidence supporting the buoyancy of the housing market in 2006 can be seen from figures from the Council of Mortgage Lenders. At £29.4 billion in December, gross mortgage lending was at a record for the month. It was 11% lower than in November but 8% higher than the previous December. There was a 20% increase in total lending in 2006 at £346 billion.

Most of the recent economic news for the UK has been positive. The two CIPS/RBS indices of manufacturing and service sector activity were in positive territory at 51.9 and 60.6 respectively, suggesting that the dominant service sector is performing particularly well. The CBI's January retail sales survey was quite positive with a balance of 30% reporting higher sales volume compared with a year ago. The ONS reported an increase in the volume of retail sales of 1.1% between November and December, with a 3.7% increase for 2006. The British Chambers of Commerce survey covering the final three months of 2006 painted a generally positive picture which also suggested more pricing power, something which might interest the Bank of England. On the other hand, despite general buoyancy, not so many businesses in the manufacturing or service sectors were operating at full capacity.

The CBI's industrial trends survey for the manufacturing industry was also positive. It said that, in the three months to January, total new orders grew at their strongest since the Spring of 2004 with domestic demand being the main driver. As for the BCC, it hinted at more pricing power for manufacturers.

But, apart from concerns about inflation, the main problems for the UK economy are the size of the budget deficit and persistent deficits on the current account. Although the problems of the structural internal deficit are not so obvious when the economy is growing quite rapidly, trouble is being built up for the future. The rising tax burden in the UK, in contrast to what is happening in many other countries, will hinder the economy. Public finances, about which the Treasury has been consistently too optimistic, should be in a much better state at this stage of the economic cycle. Should there be an economic downturn, public finances could take a nasty turn for the worse. Anticipating that inflation will fall back later this year, the Treasury is talking very tough on the public sector pay round. Once the taps of public spending have been turned on, it is very difficult to turn them off.

On the external account, the deficit in goods and services at £4.7 billion in November remains large although, as a percentage of GDP, much lower than in the USA. Whilst sterling remains strong, the deficit has not attracted much attention. Foreign governments and central banks have been diversifying their reserves and raising the sterling content. There has also been a big inflow of money from cash takeovers of UK companies by foreign investors. But it is not a healthy situation and, if foreign sentiment towards the UK should change, sterling could be vulnerable.

China has recently reported stronger than expected economic growth for 2006 at 10.7%. Propelling growth in 2006 was investment, helped by strong consumption and rising net exports. The Chinese authorities are trying hard to manage growth so that it does not lead to excessive inflation (it rose to 2.8% in December), or bad banking debts arising from over-investment. To quote from the Chinese Prime Minister who said "from the beginning of the year we will reasonably control investment growth, enhance monetary and credit management .... and prevent any investment rebound and excessive lending growth".

The trade imbalances with the USA and Western Europe continue to be a source of discontent in those areas. In 2006, the Chinese trade surplus reached US$177.5 billion, an increase of 74% over 2005. Export growth at 27% outpaced import growth of 20%. Chinese foreign exchange reserves rose over 30% over the year to end at US$1,066 billion, larger than those of Japan.

There has been only a very gradual rise in the renmimbi since its fixed exchange rate was relaxed. The unnaturally low value of the currency, which is deemed to give China an unfair competitive advantage, has been a major source of tension with the USA and EU. However, as we have often said before, it is a dangerous tactic to threaten China, given the enormous economic power which it wields. In practical terms, many of the items which China now exports to the West are no longer made in those countries, so there is no possibility of import substitution. Therefore, a rise in the value of the renmimbi would stoke inflation. One of the reasons why the world economy has performed so well is the impetus to demand given by China and India. Both countries are expected to continue to grow strongly, a positive prospect for the international economy. China needs to be able to accommodate in the workforce those coming from the rural economy, so its fast rate of growth, and the opportunities which this growth provides, is a stabilising influence and ultimately helpful to the rest of the world economy.

Indeed, the protectionist tendency which arises from Chinese success and globalisation is one of the major threats to the world economy. In the absence of any key serious geopolitical event, the magnitude of which we cannot foresee at present, protectionism is perhaps the greatest threat. It was interesting and relevant that Mr Trichet, President of the ECB, gave a strong warning against the dangers. To quote, he said that "it would be very, very damaging if this risk would materialise and so we warn very much against protectionism in all respects". He noted that this was the first time that he had mentioned protectionism first among the risks facing the world economy.

But Mr Trichet, in spite of the warning given against protectionism above, was bullish about prospects for the world economy and, as we have suggested earlier, this informs our thoughts on the outlook for the stock market in 2007. International economic growth, even at slightly below last year's level, should provide the background for further moderate corporate earnings growth. Although equities have performed well in recent years, the substantial rise in corporate earnings has left ratings still looking acceptable, so our best estimate, on the information presently available, is that further modest progress should be made in equity markets this year, perhaps high single digit growth. In our view, equities continue to offer better value than bonds where, despite the rise in yields, the risks look greater.