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ASSET MANAGEMENT (C.I.) LIMITED



## Investment Memorandum

A benign economic background, encouraging corporate earnings growth and a continuing high level of M & A activity have contributed to strong returns from international equities during the last quarter. By contrast, bonds have experienced a poor quarter as more realism creeps into yield levels.

The tables below detail relevant movements in markets :

### International Equities 28.02.07 – 31.05.07

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+8.8	+13.2	+14.3	+12.2
Finland	+20.4	+21.5	+22.7	+20.4
France	+12.6	+13.7	+14.8	+12.6
Germany	+17.4	+18.5	+19.6	+17.4
Hong Kong, China	+7.8	+6.8	+7.8	+5.8
Italy	+7.5	+8.5	+9.5	+7.5
Japan	+1.1	-2.5	-1.6	-3.4
Netherlands	+13.4	+14.4	+15.5	+13.4
Spain	+8.6	+9.7	+10.7	+8.6
Switzerland	+10.0	+8.6	+9.6	+7.6
UK	+8.9	+8.9	+9.9	+7.9
USA	+9.1	+8.0	+9.1	+7.1
Europe ex UK	+12.4	+13.1	+14.1	+12.0
Asia Pacific ex Japan	+9.5	+10.8	+11.9	+9.8
Asia Pacific	+4.7	+3.1	+4.1	+2.2
Latin America	+17.4	+24.4	+25.6	+23.3
All World All Emerging	+12.1	+14.6	+15.6	+13.5
The World	+9.1	+8.9	+10.0	+7.9

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): -2.2%

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

Currency	28.02.07	31.05.07
Sterling	4.80	5.25
US Dollar	4.56	4.90
Yen	1.64	1.76
Germany (Euro)	3.96	4.41



### **Sterling's performance during the quarter ending 31.05.07 (%)**

<b>Currency</b>	<b>Quarter Ending 31.05.07</b>
US Dollar	+0.9
Canadian Dollar	-8.0
Yen	+3.8
Euro	-0.9
Swiss Franc	-1.3

### **Other currency movements during the quarter ending 31.05.07 (%)**

<b>Other Currency</b>	<b>Quarter Ending 31.05.07</b>
US Dollar/Canadian Dollar	-8.8
US Dollar/Yen	+2.8
US Dollar/Euro	-1.8
Swiss Franc/Euro	-2.2
Euro/Yen	+4.7

### **Significant Commodities (US dollar terms) 28.02.07 – 31.05.07 (%)**

<b>Significant Commodities</b>	<b>28.02.07 – 31.05.07</b>
Oil	+9.9
Gold	-1.1

### **Markets**

International equity markets rose strongly during the last quarter. The total return on the FTSE World Index in local currency terms was 9.1%, in sterling terms 8.9%, in US dollar terms 10.0% and in euro terms 7.9%. With the exception of Japan, all areas performed strongly. In local currency total return terms, as measured by the relevant FTSE World Index series, the USA returned 9.1%, Europe ex UK 12.4% and the UK 8.9%. Japan returned just 1.1%. Within the Europe ex UK section, Finland and Germany were outstanding with respective returns of 20.4% and 17.4%. Latin America, emerging markets, Asia Pacific ex Japan and Australia all experienced excellent quarters returning respectively 17.4%, 12.1%, 9.5% and 8.8%. Looking at sterling returns, there are some significant differences to the local currency returns because of currency movements. The strength of the Australian dollar raised the sterling return to 12.3% on the Australian index. Currency movements in Latin America, in particular, and emerging markets raised the returns to 24.4% and 14.6% respectively. On the negative side, weakness in the yen meant a negative return of 2.5% in that market.

Bonds had a poor quarter and we still think that they are dear. Taking the ten year government bond as a benchmark, the sterling bond's gross redemption yields rose by 45 basis points to 5.25%, US dollar bond yields by 34 basis points to 4.9%, yen bonds by 12 basis points to 1.76% and German euro denominated bonds by 45 basis points to 4.41%.

In the currency markets, the main feature was extraordinary strength in the Canadian dollar against which sterling fell by 8.0% and the US dollar by 8.8%. Canada's strong position in natural resources attracted attention to the currency. The yen continued to perform poorly on the back of "carry trade" activity and sterling showed a rise of 3.8% against the currency whilst the US dollar rose by 2.8% against it.

In the commodity markets, oil, as measured by Brent crude, rose by 9.9% but gold fell by 1.1%.



## Economics

- *The economic background remains generally benign* ..... the OECD forecasts 2.7% growth for this year and next amongst its members whilst the IMF forecasts 4.9% growth for the world economy this year and next.
- *The biggest threat to the world economy is, we feel, protectionism* ..... the changed complexion of the US Congress means the threat is greater. The EU remains a repository of protectionism.
- *China is so powerful economically that any retaliation by it could have serious economic consequences* ..... the same would be the case if China were destabilised internally.
- *China prepares to diversify its policy on its vast foreign exchange reserves* ..... it is looking at a fund, perhaps US\$300 billion, which will invest in higher risk assets overseas. A US\$3 billion stake in a private equity house is a start. It is also making a start in allowing Chinese banking clients to invest indirectly overseas.
- *M & A activity continues at a frenetic pace* ..... moderate share valuations, still relatively cheap money, ample liquidity and a benign economic background provide the background for this activity.
- *A de-equitisation process is under way in many markets* ..... besides takeovers, share counts are being reduced through share buy backs and returns of capital.
- *Although commodity prices overall have changed little over the quarter, oil has risen nearly 10% as measured by Brent crude* ..... OPEC supply constraints, a buoyant world economy and shortages of refinery capacity have helped to cause this situation.
- *Whilst equities have enjoyed a successful quarter, bonds have weakened* ..... yields have been unrealistically low given the rise in inflation in some countries and the buoyant world economy.
- *Although the outlook for the world economy is good, the OECD has some warnings* ..... these are on economic overheating, large current account imbalances and lack of action in these good economic times to address structural budget deficit problems.

## USA

- *The US economy showed surprising weakness in the first quarter* ..... the third estimate of growth has been revised down to an annualised rate of 0.6%.
- *The Federal Reserve has become more pessimistic on the effects of the housing slowdown* ..... nevertheless, it expects the economy to recover for the remainder of the year helped by an end to inventory rundowns in the manufacturing sector and an increase in business investment.
- *The housing picture is not all gloomy* ..... for example, housing starts rose in April and the sales of new homes rose strongly.
- *The Federal Reserve's main concern is inflation* ..... at the moment, it is an issue but not a serious problem. The latest consumer price index shows an annual rise of 2.3% whilst the Federal Reserve's favoured personal consumption expenditure measure is at 2.0%, the top of its comfort range.
- *In May, there were a number of encouraging economic statistics* ..... the ISM's April manufacturing index and service sector index, rising factory orders, encouraging export figures, good employment figures for May (after a disappointing April) and better productivity numbers.
- *Corporate earnings growth in the first quarter was better than expected* ..... it is estimated that earnings on the S & P 500 index were 8.2% higher than a year previously.



## Japan

- *First quarter growth was 2.4% annualised compared with 4.8% in the final quarter of 2006* ..... both the IMF and the OECD see growth well in excess of 2% for 2007.
- *The currency remains weak* ..... still very low interest rates have made it the currency of choice to borrow and convert into higher yielding currencies.
- *The Japanese continue to invest heavily overseas* ..... the country's net external assets rose by 19% in 2006. For the moment, Japan's large current account surplus counts for nothing in terms of the yen's movement.
- *Despite the weak currency, inflation is slightly negative* ..... the core consumer price index for the year to April was -0.1%.
- *A puzzle is that the tight jobs market has not translated into higher take home pay* ..... unemployment is at a nine year low of 3.8%, the ratio of jobs to job seekers is 1.05, yet household disposable income fell 0.4% in the year to May.

## China

- *The authorities try to restrain stock market exuberance* ..... stamp duty on shares is trebled, exhortation having failed.
- *Further measures are taken to try to restrain the economy* ..... interest rates and banking reserve requirements are raised again.

## Europe Ex UK

- *Europe is performing well and growth forecasts have been raised* ..... for example, the EU monetary affairs commissioner raises his forecast for economic growth this year and next by 0.5% for both years to 2.9% this year and 2.7% next year.
- *The EU monetary affairs commissioner, like the OECD, is concerned that complacency is creeping into domestic finances* ..... he urges this strong period of economic growth to be used to address structural financial deficits.
- *The ECB is likely to raise interest rates again* ..... although inflation at 1.8% is within target, excessive money supply growth, strong lending and rising house prices are regarded as symptoms of a potentially inflationary problem.
- *The German economy is buoyant* ..... it has weathered this year's 3% VAT increase better than expected. First quarter GDP growth was a higher than expected 0.5%.
- *State finances are improving rapidly* ..... The finance minister estimates that Germany will deliver its first balanced budget in forty years by the end of the decade.
- *The ECB will be watching German pay settlements* ..... after years of restraint, pay increases in key sectors like engineering and metals have increased. The estimated settlement of just under 4% over a year is probably just about manageable to the ECB.
- *In many ways France is the most interesting eurozone country at present* ..... can President Sarkozy implement his reforms without social unrest? France badly needs supply side reforms and he will need to act whilst he has momentum from his election victory.
- *French consumers have become more confident* ..... the EC reports a significant increase in consumer confidence since the Presidential election.



## UK

- *Interest rates are likely to rise again* ..... inflation and rapid money supply growth are likely to influence the MPC's decisions. The Bank of England's latest inflation forecast is predicated on interest rates 0.25% higher by the summer.
- *The MPC will be watching closely the housing market* ..... there is some tentative evidence that rising interest rates are beginning to make an impression. London, however, remains a special case with house prices continuing to rise strongly.
- *In a generally positive view of the UK economy, the OECD warns about the size of the budget deficit* ..... adjusted for the economic cycle, it estimates it at 2.9% of GDP. Should things go wrong for the UK economy, it will be difficult for the government to use fiscal policy to stabilise the economy.
- *Buoyant M & A activity and share buybacks continue to give support to the UK equity market* ..... according to the Financial Times, Morgan Stanley estimates that 56% of UK companies had active buyback programmes in 2006.
- *Bonds continue to look unattractive* ..... the sharp downward slope of the yield curve means to us real danger of bad losses out longer on the curve. Artificial demand for longer dated issues does not reflect attractive fundamentals.

## Summary

- *The economic background remains supportive to equities and unhelpful to bonds* ..... reasonable equity valuations, continued corporate earnings growth, more M & A activity and share buybacks are helpful to equities.
- *Unless shares are to be up-rated this year, which is possible, it may well be that the majority of the year's gains have already been seen* ..... the rise in the first five months has been significant.
- *We do not advocate raising liquidity* ..... we do not consider shares to be expensive and are aware of the opportunity cost of selling shares against a background which we still believe to be favourable.

There have been a number of interesting economic and political issues for investors to consider over the last quarter, some of which may have important long term implications for investors and international stock markets.

Each quarter, the importance of China to international politics and economics seems to grow. This is not really surprising considering its size and annual growth rate which exceeds 10%. We consider China to be a big positive for the world economy and stock markets but its very success, if one measures it in terms of having the world's largest foreign exchange reserves and a vast current account surplus, is causing political opposition which is manifesting itself in ugly protectionism which takes little or no account of economic realities. In a generally benign economic environment, which is supportive to equities, this is perhaps the biggest threat to the macro economic outlook and, hence, the stock market. The threats come mainly from the USA and Europe. The Democrats, who now control Congress, are more protectionist than the Republicans and they are now raising the stakes with China. It is worth considering just what are the dangers of protectionism manifested in, say, a trade war with China or discriminatory actions taken against it or pressure placed upon it to allow the currency to rise.

Firstly, the USA and Europe no longer produce many of the manufactured goods made in China. China and many other countries have a comparative advantage in low value added manufactures (although China is rapidly rising up the value added chain). The ability to produce goods now ceded to China has gone. Tariffs, quotas or success in getting China to allow its currency to rise, are going to raise costs for western consumers and companies and reduce purchasing power. The inflationary effects would almost certainly lead to higher interest rates with negative economic consequences. The effects would help to destabilise China which needs to grow at a rapid rate to absorb the flow of people from the countryside. If China's purchasing power was diminished as a result of trade sanctions then one of the important drivers of world economic growth would be weakened. No one would



benefit from that. With the world's largest foreign exchange reserves, China could, if it wished, make life very difficult for the USA by rebalancing its foreign exchange reserves. With a large current account deficit, the USA is consuming vastly more than it produces. That is not China's fault. It is disturbing how some US politicians seem to believe that the USA holds all the economic cards in this issue with China. In practice, it holds very few, yet some choose either to ignore this fact or fail to grasp it. It is the same in parts of Europe and the new French President mixes economic liberalism with some protectionist traits.

Unless there is some geopolitical event which we cannot presently foresee, latent protectionism seems to us to be one of the greatest threats to the international economic outlook.

But recent news from China also provides room for optimism for long term investors. It is reported that consideration is being given to having a proportion of China's vast foreign exchange reserves, currently over US\$1,200 billion, set aside for management in foreign markets. This could be a very significant move for international stock markets, if it occurs. Very recently, on a much smaller scale, but still significant, China has agreed to invest US\$3 billion in the US private equity house, Blackstone, which is launching an IPO. This will give it a 9.9% stake though it has agreed to give up its voting rights. Whilst the sum is not large in relation to the size of China's foreign exchange reserves, it is a highly symbolic investment. It shows a much more aggressive policy in terms of managing parts of its foreign exchange reserves. Both of these measures, are aimed at resisting the upward movement of the renmimbi which arises from the large current account surplus and flows of foreign direct investment. A further measure which excited the Hong Kong stock market when it was announced, was the introduction of new rules to enable Chinese banking clients to invest in overseas stock markets. This would be done through foreign equity funds which are authorised by overseas regulators. This is on top of a Qualified Domestic International Investors scheme introduced last year which opened the door to overseas investment for the first time.

Gradually, therefore, the door is being opened for a major expansion of Chinese investment in foreign markets. The tentative start we have described above is likely to develop into something much more significant and has the potential to be a major investment factor. We have already seen the significant effect of Middle Eastern money in the UK, in takeovers, partial stakes in companies and the property market. China promises to be the same. Diverting part of China's foreign exchange reserves to international equities, to name one class of asset, means that they will not be invested in another class of asset, such as US Treasury bonds, so there could be consequential effects there in terms of higher yields or currency movements. Nevertheless, the potential importance of China's move could be very significant.

Undoubtedly, a positive factor for international equity markets during the last quarter and before then has been the frenetic pace of merger and acquisition activity which continues unabated. Even though interest rates have been rising, they are not high by historical standards and liquidity is plentiful. Notwithstanding that equity markets are starting their fifth year of growth, corporate earnings, too, have been rising very rapidly to leave equity markets reasonably valued with earnings yields well in excess of bond yields and short term interest rates in many markets. The mathematics of acquisitions still stack up favourably. As well as conventional takeovers by quoted companies, private equity continues to attract vast sums of money and the targets are becoming ever larger. A political backlash is beginning to occur although it remains to be seen whether this translates into any action.

A further support to equity markets has been the very high level of share buy back activity. The strength of corporate balance sheets and share ratings low enough to make buy backs earnings enhancing have made this activity possible and, together with a large number of takeovers, have contributed to the phenomenon of de-equitisation. Whilst some investors would prefer companies to raise their dividends more sharply (they are moving up well in any case), share buy backs hold the advantage for companies of being able to turn them on or off depending upon what alternative options there are for the funds available.



Although commodities overall have moved little over the quarter, oil has been a firm feature. Perhaps because the move upwards has been fairly gradual, it has not attracted enormous attention in markets. Even though it is not at a level which is particularly troublesome, it could become an issue at a higher level, pushing up inflation. The ability of the world economy to absorb higher oil prices is improved by its good growth. Were there to be a supply shock, however, there would be a problem. The present situation looks manageable against the promising international economic background but it is important not to be complacent.

The rise in the oil price has had a modest effect on inflation but it has not been significant. Strong monetary growth is beginning to worry central banks, with the ECB probably the most concerned about the rate of money supply expansion. Apart from the USA, the trend is towards higher interest rates as central banks try to ensure that inflation is contained. The process has a little further to go but, in our judgement, on the information currently available, not to a level that seriously threatens equity prices. Although we are here talking about short term interest rates, we expect the yield curve to shift upwards as bond yields across the spectrum, and particularly at the long end, continue to look unrealistically low. In the last quarter, for example, we have seen central banks raising interest rates in the UK, eurozone, Switzerland, China and New Zealand to give some examples.

European politics have been centre stage during the last quarter, dominated by the French Presidential election with the centre right candidate, Mr. Sarkozy, winning a comfortable victory on a turnout of over 85%, a remarkably high figure. The economic implications and, therefore, those for the stock market, could be very significant. Although the eurozone economy is performing well at the moment, further longer term progress to increase its potential growth rate consistent with stable inflation depends upon structural reforms. Mr Sarkozy's policies, from pronouncements which he has made, are a mixture of economic liberalism and traditional French protectionism. National champions and barriers to trade are indications of the latter whilst a loosening of the employment market regulations, lower taxes and a reduced public sector are symptoms of the former. Radical measures like loosening the 35 hour week, less onerous employment contracts and minimum service levels during public sector transport strikes are best taken early whilst the momentum is with him. He obviously needs to win the forthcoming parliamentary elections if he is to achieve his objectives but, at this stage, it is likely that the centre right will do so. He has the advantage of having set out his policies clearly and achieved a decisive victory on a very high turnout. Whilst protectionism is a retrograde step and economically damaging, progress in the areas of economic liberalism, which he espouses, will be positive if enacted, helpful to the French economy and almost certainly to the stock market, too. As the second largest eurozone economy, signs of progress in the domestic economy send out good signals elsewhere. In terms of the protectionist side of his policies, the European Commission has had some success in facing down protectionism (i.e. its intervention in the takeover bid for Endesa which the Spanish authorities tried to thwart). Creations of national champions, immune from foreign takeovers, will present the EC with a significant challenge. If they succeed, besides the direct and indirect economic benefits, merger and acquisition activity in the eurozone is likely to reach an even higher level which is likely to prove a further boost to eurozone stock markets.

Within the last two months we have had two sets of encouraging economic forecasts from the IMF in April and the OECD in May. The IMF forecasts world economic growth at 4.9% in 2007 and the same for 2008. This compares with 5.4% in 2006. The OECD sees growth amongst its thirty members this year at 2.7% and the same next year against 3.2% in 2006. China, India and Russia are not OECD members and, of course, growth is much faster in these countries.

With the economic outlook as benign as it appears to be, it is only prudent to guard against complacency by pointing out negative factors which may be at play. The OECD mentions economic overheating and the continuation of large current account imbalances. The OECD mentions inflationary concerns and suggests a further tightening of monetary policy in a number of countries but not Japan. The OECD is concerned that many countries are not using better economic conditions to address structural budget deficit problems. With its latest





Economic Outlook, the OECD produces research suggesting that better outcomes on this issue arise from fiscal consolidation occurring after a fiscal crisis and that action on the expenditure side is more effective. Of course, governments are usually rather keener to spend money than to curb expenditure and, in relatively good times, ignore the necessity to act to curb structural deficits. This means that, in bad times, the automatic stabilisers are less able to come into play as the ability of a government to loosen fiscal policy is weakened by the size of its budget deficit.

All these words of caution are valid to consider alongside the positive view which the OECD expresses on the world economy. To quote from the introduction to the Economic Outlook, it says “our central forecast remains indeed quite benign” a soft landing in the United States, a strong and sustained recovery in Europe, a solid trajectory in Japan and buoyant activity in China and India. In line with recent trends, sustained growth in OECD economies would be underpinned by strong job creation and falling unemployment. This is fairly bullish stuff. For the USA, it expects gradually increasing momentum after a weak first quarter and it expects the overhang of housing supply gradually to work itself off. In Europe, it notes that economic recovery in Germany and Italy is likely to be much stronger than expected. Very strong Chinese growth is expected to boost Japan.

An abridged summary of the OECD’s latest projections are as follows:

<b>Real GDP Growth (%)</b>			
	<b>2006</b>	<b>2007</b>	<b>2008</b>
USA	3.3	2.1	2.5
Japan	2.2	2.4	2.1
Eurozone	2.8	2.7	2.3
UK	2.8	2.7	2.5
Total OECD	3.2	2.7	2.7
China	10.7	10.4	10.4
India	9.0	8.5	8.0
Russia	6.7	6.5	5.8

<b>Inflation (%)</b>			
	<b>2006</b>	<b>2007</b>	<b>2008</b>
USA	2.9	2.6	2.2
Japan	(0.9)	(0.4)	0.2
Eurozone	1.7	2.0	2.0
Total OECD	2.2	2.1	2.0



### Current Account Balances as a % of GDP

	2006	2007	2008
USA	(6.5)	(6.1)	(6.2)
Japan	3.9	4.8	5.4
Eurozone	0.1	0.4	0.4
Total OECD	(1.9)	(1.5)	(1.5)
China	9.5	10.2	10.6
India	(1.3)	(1.8)	(2.0)
Russia	9.8	6.2	3.8

### Cyclically Adjusted Fiscal Balance as a % of GDP

	2006	2007	2008
USA	(2.5)	(2.8)	(2.8)
Japan	(2.2)	(2.7)	(3.2)
Eurozone	(1.0)	(0.8)	(0.7)
Total OECD	(1.7)	(1.8)	(1.9)

Turning now to individual countries and areas of the world, we start with the USA where economic growth is temporarily lagging that of most other large industrialised countries although most observers believe that it is suffering from a mid-cycle economic pause before growth accelerates again. Growth for the first quarter has been revised down again to 0.6%. The Federal Reserve is running a tightrope between concerns about economic growth and excessive inflation levels. Hence, interest rates, as set by the Federal Reserve, have not changed since June last year. The statement accompanying its announcement of unchanged interest rates in May still expressed concern about the level of inflation, whilst acknowledging that growth had slowed down in the first quarter of the year, and also the continued weakness in the housing market. The language seems to suggest an unchanged interest rate policy for some time until either inflation or growth shows a significant break out to justify a change in interest rates either way. When the minutes of the meeting were released at the end of May, it became clear that members of the FOMC had become more pessimistic about the housing market and suggested that weak residential investment would affect economic activity throughout the year. On the other hand, the FOMC expected growth to pick up after the weak first quarter with the manufactory inventory run down unwinding itself and business investment increasing. The concerns about inflationary pressures were clearly expressed.

The main factor holding back economic growth has been weakness in the housing construction market and the FOMC's concerns are detailed above. Solid improvement is only likely to occur when the inventory of unsold homes reverts to more normal levels. But the situation is not entirely gloomy with some of the statistics released being encouraging. On the negative side, the National Association of Realtors reported that pending home sales in March had fallen by 4.9% to their lowest level since March 2003. Also, building permits fell by 8.9% in April to their lowest level since June 1997. On the other hand, housing starts in April rose by 2.5% against March and sales of new homes in April rose by 16.2% which was the biggest increase in fourteen years. This increase in sales reduced the supply of unsold homes to 6.5 months worth of sales which is close to what is considered the equilibrium level. So, it is not all bad news from the sector.

Although inflation is above the level that the Federal Reserve would like to see, it is not seriously so. April producer prices increased by 0.7%, month on month, but the core rate, excluding food and energy, was unchanged. April's consumer price index rose by 0.4% but the core rate rose by 0.2%. The year on year consumer price index



was up 2.3% compared with a peak of 2.9% last September. The Federal Reserve's preferred index of inflation, the personal consumption expenditure measure, is down to 2%, the top of its comfort zone. Wage inflation is moderate. In April, hourly wage rates rose by 0.2% compared with 0.3% the previous month. On the other hand, the ISM manufacturing report in early May indicated that the employment and prices paid elements of the survey rose at their highest rate since last August. So, there is some mixed news on the inflation front but there is, at present, nothing serious enough in the data to warrant a further increase in the very near future. With the oil price having resumed its upward trend, a wide difference has opened up between the headline price indices and the core indices.

Despite weak first quarter growth, there is evidence to suggest that the US economy will pick up some pace over the remainder of the year. Over the past month, there have been quite a number of positive items of news from the USA. The ISM's manufacturing index for April rose to 54.7 compared with 50.9 in March and it was higher again in May. Factory orders rose by 3.1% in March compared with February. ISM's service sector index rose to 56.0 in April compared with 52.4 in March. Although the trade deficit rose in March because of the cost of oil imports, the export figures were encouraging. Compared with February, exports rose by 1.8% in March with strength in exports to the EU and China. Orders for durable goods, excluding aircraft orders, rose by 1.5% in April. Productivity figures have been more encouraging with a 1.7% increase in the first three months of the year. In the employment market, job creation in May was a higher than expected 157,000 after a disappointing increase in April. Unemployment remained at 4.50%. Retail sales were weak in April. According to the Commerce Department, they fell by 0.2% compared with March.

However, crucial to supporting current market levels on Wall Street is the health of corporate America and this remains excellent. According to Standard & Poors, operating earnings of the S & P 500 rose by 8.2% in the first quarter compared with a year earlier, a better outcome than expected. Corporate balance sheets are in excellent health, facilitating the large share buyback programmes which we have seen. The combination of these factors, plus still satisfactory economic prospects, is conducive to the continuation of significant M & A activity. A prospective P/E ratio for current year earnings of just over 16 on best estimates, with the likelihood of further earnings growth next year, should support US shares which look attractive when compared with ten year US Treasury bonds yielding 4.86% and thirty year bonds yielding 5.0%.

The Japanese economy remains an enigma in many ways. Whilst other countries are mildly worried about inflation, Japan is struggling to achieve any inflation. Not even a weak currency has helped here. Whilst other countries like the USA and, to some extent, the UK struggle with a large current account deficit, Japan runs a very large current account surplus yet has a weak currency. With its very low interest rates, the yen remains the favourite currency for "carry trades" with yen being borrowed and sold to invest in higher yielding currencies. An extreme example is seen against the New Zealand dollar where the official short term administered rate is 7.75% against 0.5% in Japan. But the potential risk is shown by the fact that Japan's current account surplus is around 4% of GDP whilst New Zealand's deficit is around 9%. It is quite a frightening comparison. With the Japanese investing heavily overseas, government statistics reveal that the country's net external assets rose 19% in 2006 to the equivalent of around £900 billion. It is rather a bizarre situation and, of course, it is a source of friction with overseas trading partners. For exporters, the combination of nil domestic inflation and a weak currency is a dream and it is not surprising to see Japan's already large trade surplus increasing. March's current account surplus of the equivalent of £89.2 billion was a record. As might be expected, this is causing friction in the USA where car manufacturers are suffering from the success of Japanese car manufacturers. However, it would not be fair to accuse Japan of manipulating its currency. It has not been intervening in the foreign exchange market and it is difficult to argue with an interest rate of 0.5% when there is no inflation. Whilst this level of interest rate, which is so different from the levels of other major currencies, attracts the carry traders, it cannot be said that the government or central bank is responsible for this. The latest figure for the core consumer price index for the year to April shows a decline of 0.1%.



Following annualised growth of 4.8% in the final quarter of 2006, the rate slowed down in the first quarter of 2007 to 2.4%. The expectations of both the IMF and the OECD are for a very modest slowdown in 2008, compared with 2007. The IMF expects growth in 2008 of 1.9% compared with 2.3% in 2007, whilst the OECD sees growth in 2008 of 2.1% compared with 2.4% in 2007. The Japanese jobs market is tight. The unemployment rate has fallen to a nine year low of 3.8%. The ratio of jobs to jobs seekers is 1.05. Surprisingly, however, wage rates have not yet (but surely will) reflected this tightness. In the year to April, household disposable income fell by 0.4%.

Although it is purely speculation at this stage, it might be expected that Japan would benefit from any move by China to diversify the type of assets in which its foreign exchange reserves are held. Important trading links make Japan an obvious investment area. In the shorter term, although the Japanese stock market has been relatively out of favour at a time when shares generally have been moving upwards and there has been substantial overseas investment by Japanese investors, economic conditions are still favourable for Japanese companies. Many have responded by raising dividends sharply and, although dividend yields are low by international standards, some look very good domestically compared with what is available on deposit. Japan is a relatively out of favour market which still merits a place in an international portfolio.

Moving on to Europe ex UK, we see a eurozone which is performing well. After strong growth in 2006, the IMF forecasts growth this year and next year of 2.3% whilst the OECD forecasts growth of 2.7% this year and 2.3% next year. For the EU as a whole, the EU monetary affairs commissioner raised his forecast for economic growth to 2.9% in 2007 and 2.7% in 2008, in both cases a rise of 0.5% on his previous forecast. The forecast for EU unemployment is that it will fall to below 7% in 2008 after the creation of almost nine million new jobs between 2006 and 2008. But, like the OECD, the EU monetary affairs commissioner is concerned about complacency creeping into the effort to improve EU members' domestic finances. A period of relatively strong growth should be used to address structural problems with domestic finances.

In the short term, most observers expect a further increase in eurozone interest rates in June with the President of the ECB emphasising that the ECB will do what is necessary to ensure price stability, against the background of quite strong growth in the first quarter of 2007 of 0.6%, following on from growth of 0.9% in the final quarter of 2006. This rate of growth, combined with still fast growing money supply and some concern about the level of pay increases in Germany, will keep the ECB vigilant. The latest inflation rate for April in the eurozone was 1.8% which is within its target of "below but close to 2%". The EU monetary affairs commissioner is forecasting inflation in the EU of 2.1% this year and, for the eurozone, 1.9%, but these figures may be dependent on appropriate interest rates being set by the ECB for the eurozone. The ECB will certainly be watching money supply growth very carefully. More than most central banks, it pays attention to money supply data. In March, the broad measure, M3, grew at an annual rate of 10.9%, an acceleration on February's 10.0%. Monetary growth has been helping to fuel the dramatic rise in house prices in some parts of the eurozone although rising interest rates appear to be having some effect, with lending for house purchases slowing down from an annual rate of 8.9% in March to 8.6% in April. M3 money supply, although well above target levels, slowed to an annual rate of 10.4% in April from 10.9% in March. Eurozone loans to non financial corporations slowed slightly in April from an annual rate of 12.4% in March to 12.2% in April.

Short term items of data continue to be positive in the eurozone. The European Commission's eurozone economic sentiment index remained almost unchanged in April at the very high level of 111.0 against 111.1 in March. NTC Economics' service sector survey of European companies was very positive. Companies reported rising optimism about prospects for sales, profits, employment and investment compared with a year previously. As one might expect from such positive results, costs are expected to rise. Within the EU more than 60% of companies surveyed expected staff costs to be higher in the next twelve months than the current rate. This goes back to the concerns the ECB will have about rising wage levels in the eurozone. Even though eurozone growth is quite strong, the trade figures provide further encouragement. March's figures showed the largest surplus for nearly three years.



Of course, helping to drive the strong growth in the eurozone is its largest member, Germany, which has weathered January's 3% VAT rise much better than expected. A whole host of positive data has been reported in May. The VDMA engineering association reported that March orders were 47% higher than a year ago. This was attributable to strength both at home and abroad. German unemployment in April has fallen to its lowest level in four years. March's manufacturing orders were 2.4% higher in March following a 4.3% increase in February. Investor confidence is strong. The ZEW economic research institution said that its economic sentiment indicator rose for a sixth month running to 24 for May. The IFO business climate index remained at a high level in May, unchanged at 108.6 and very close to a record level. Retailers had become less optimistic but exporters were more optimistic. GDP grew by 0.5% in the first quarter, a figure that was much better than one might have expected after the big VAT increase. Strong investment offset a 1.4% fall in private consumption.

Very encouragingly, domestic finances are improving as a result of better than expected growth. The finance minister estimates that Germany will deliver its first balanced budget in forty years by the end of the decade. He said that, based on this estimate, the total state deficit, including the social security system, federal, regional and local government budgets, could reach zero by 2010 whilst the federal government could achieve its first surplus since 1969, a year later. These estimates are based on much higher than expected revenue. Despite the VAT increase, economic growth is not expected to be much lower this year but the OECD, in its latest forecast, is particularly bullish about growth prospects this year, forecasting growth of 2.9% against 2.7% last year. The EC for example, forecasts growth of 2.5% this year whilst the government's latest estimate is 2.3%.

Within the eurozone, and particularly against Italy, Germany has gained significant competitive advantages since the advent of the euro by holding down relative wage costs. Now that business has improved so much, German trade unions are looking for much more substantial pay increases, with the ECB keeping a careful watch for their inflationary implications. So far, there is nothing to give the ECB major concerns although there is enough for them to be very watchful. The significant deal was in the engineering and metals industries where business is strong as a result of strong export growth. The deal that was agreed, and likely to become the national norm, is for a 4.1% increase for the next twelve months, followed by a further 1.7% for the following seven months. There is a one off payment of 400 per employee for April and May. It is estimated that the overall effect of the deal is a pay rise of just under 4% over a year. Depending upon the level of productivity growth in the sector, this is probably manageable as far as the ECB is concerned but it will not be relaxed. It is somewhere on the edge of acceptability in terms of the inflation consequences for which it will be watching.

In many ways, in the short term, France is the most interesting country to observe following the election of Nicolas Sarkozy as President. If the centre right obtains a majority in the forthcoming parliamentary elections, then he will be able to move forward with his reforms designed to make France more competitive, which it needs to be since it has lost ground to Germany and is growing more slowly, a reversal of the trend of the most recent past. Labour market reform and a reduction of taxation, plus a reining in of the very large public sector in France, are seen as necessary prerequisites of faster economic growth. Notwithstanding the strong mandate which he achieved in the Presidential election, he will face determined opposition from special interest groups. How he fares in any confrontation will dictate investment sentiment towards France. But, whilst being economically liberal in some respects, he is protectionist in others and French protectionism is the most strongly entrenched in Europe. In particular, the espousal of "national champions" and sectors which are off limits to foreign purchasers will exercise the EC greatly. We can expect some strong clashes and how they end up will also be a stock market factor. If the EC is successful in any trial of strength and French companies are more able to take part in consolidation, it should be a positive for eurozone stock markets. What happens in France over the coming months will be very important for investors. Meanwhile, the EC reports a significant increase in consumer confidence in France following the Presidential election.



Earlier in this review, we have discussed the potentially very significant implications of Chinese overseas investment through several channels. One of the advantages, short and long term, is that it will help to take the pressure off the domestic economy, the rate of growth of which is causing concern to the Chinese authorities. The most immediate concern is the high valuation of domestic “A” shares, available to Chinese investors, which have been pushed up by a surge of speculation which has been driven by the easy availability of money. Interest rate increases and steadily rising banking reserve requirements, as well as administrative orders in bank lending, have been used by the Chinese authorities to try to cool down the economy. Its latest measure to restrain the domestic Chinese stock market has been a tripling of stamp duty, exhortation having failed. Although it may have psychological importance in other markets, particularly Asian ones, it should not have international implications as the affected shares are domestic ones. In terms of efforts to rein in bank lending, the latest measures taken by the Chinese authorities were to raise the benchmark deposit rate by 0.27% and the lending rate by 0.18%, and to increase the bank reserve requirement ratio by 0.5% to 11.5%. The worry about excessive bank lending is that it will be inflationary and lead to problems within the banking sector as some loans to finance fixed asset investment turn sour because of over investment. First quarter annualised growth was running at 11.1%, above the level with which the Chinese authorities are comfortable. Nevertheless, most forecasts are for growth this year not much below that. China remains an enormous force for economic growth in the world economy with investors able to benefit in a number of different ways but perhaps the indirect one that will ultimately be the most important is the effect on overseas stock markets of Chinese investment interest in the ways we discussed earlier in this review. The need to find an outlet for the vast current account surpluses being built up is shown by the fact that the trade surplus for the first four months of the year reached US\$63.3 billion, an 88% increase over the same period of 2006. These figures provoke anger with China’s trade partners but, as we said earlier, retaliatory and protectionist measures are not the way to react because of the dangers they would pose to international economic growth.

One of the currencies which is favoured for investment by the “carry trade” is the New Zealand dollar. It is an interesting economy in that the country runs a very large current account deficit, about 9% of GDP, whilst running a significant budget surplus. The problem for New Zealand is the very low level of private savings which finds its counterpart in the very large current account deficit. New Zealand is very vulnerable to a change in sentiment in the foreign exchange markets especially as its interest rates at 7.75% are exceptionally high by international standards. The finance minister has announced measures to try to encourage saving and investment to reduce the reliance on foreign capital which has been fuelled by a consumer boom. Were some of this money saved, it would improve the country’s current account position and hence reduce its need to import capital. So, for companies, corporate tax is to be cut to 30% to align it with Australia and individuals are to be given incentives to save. Cutting taxes, although the government could theoretically afford to do so, could risk exacerbating the consumer boom and, hence, current account deficit. So these are sensible measures to try to reduce the disequilibrium in the New Zealand economy between saving, investment and consumption.

Over in Australia, a market we favour, the government enjoys an abundance of riches with its domestic finances as Australia has no domestic debt and, despite tax cuts, continues to run a budget surplus. Additionally, by acting early on the pensions issue which is haunting many industrialised economies, it has secured a much better future position. Substantial inflows of money are available for investment and this has contributed towards the Australian stock market’s excellent performance. The danger the Australian economy faces is one of overheating. The Reserve Bank of Australia was one of the first central banks to raise interest rates in this economic cycle on the back of a sharp rise in property prices. With a booming economy, unemployment is very low at 4.5% and there are labour shortages. For this reason, although the fiscal position is exceptionally strong, excessive tax cuts would risk stoking up inflation. As it is, taxes have been cut in five successive budgets. This budget unveiled tax cuts and other measures amounting to AUD31.5 billion. Furthermore, it is estimated that the underlying cash balances over the next three years will amount to AUD37.2 billion. The one potential issue for the Australian economy is that, like New Zealand, it runs a large current account deficit, around 6% of GDP. With confidence high in the Australian



economy on the back of its excellent growth record and rich natural resources, financing the deficit is not likely to be a problem in the foreseeable future. Like the New Zealand dollar, the Australian dollar is a recipient of “carry trade” funds. Corporate activity, notwithstanding the failure of the Qantas bid, also remains a feature of the Australian market, helping to de-equitise it. Despite its good performance, the Australian stock market is still well supported by earnings. An election is due soon and, with the opposition under its new leader ahead in the polls, attention needs to be paid to the implications of opposition policy announcements before the election.

Probably the issue gaining most attention in the UK at present is interest rates as a result of inflation having moved well above target. It is confidently expected that short term interest rates will rise at least once more from their present level of 5.5% to 5.75% and a number of observers expect them to rise eventually to at least 6%. When raising interest rates to 5.5% on 10 May, the Bank of England referred to strong investment and more pricing power by companies. It stated that it raised interest rates again because “relative to the 2% target, the risks to the outlook for inflation in the medium term consequently remain tilted to the upside”. It also referred to rapid money supply growth and the robust international economy. At the time this interest rate decision was taken, the consumer price index stood at 3.1%, against its 2.0% target, and the Retail Price Index at 4.8%. This latter index, reflecting housing costs, is considered by many, including wage negotiators, to be a more realistic index of inflation than the CPI. The April figures, when they were announced a few days after the MPC meeting, showed a 0.3% month on month rise in the CPI to give an annual inflation rate of 2.8% whilst the annual rate of increase for the RPI was 4.5%. The MPC expects inflation, as measured by the CPI, to fall further towards its 2% target but is still concerned by inflationary pressures within the economy. In its latest inflation forecast, the Bank of England suggests that for inflation to settle around target it will be with interest rates 0.25% higher this summer. Should interest rates stay at the present level of 5.5%, the Bank of England’s central forecast is for inflation to be above target and rising sharply in two years’ time with a much higher than usual probability that consumer price inflation will be above target. The Governor of the Bank of England said that “strong growth prospects appear to be continuing in the second quarter of this year”. The Governor said that interest rate rises since last August reflected the Bank’s best guess of past inflation “once energy prices have settled down”. The Governor repeated the observation about companies’ increased pricing power although, interestingly, the latest CIPS/RBS Survey of the services sector revealed input and output price inflation falling to a four month low with price competition lowering output cost increases to well below the level of input cost increases. Manufacturers’ output prices rose 0.5% in April compared with March to give a year on year increase of 2.5%, a level higher than the Bank of England would like to see. If one measures inflation by the former measure, the Retail Price Index, one sees that average earnings are not keeping pace with its current 4.5% level. During the three months to the end of March, average earnings, excluding bonuses, rose by an annual rate of 3.7% whilst, including bonuses, the figure was 4.5%. Therefore, although these figures are above the CPI, most wage negotiators would look at the RPI and the figures do not suggest significant wage pressure at this stage. There is, however, some evidence that food price inflation is increasing. High street inflation, as measured by its particular index, rose by 1% the year to April compared to 0.4% the previous month, driven up by higher food prices. The Bank of England, although it may not emphasise money supply growth as much as, say, the ECB, will be concerned about its rapid growth in the UK. For the year to April, the Bank of England reported that it had grown by 13.3%.

In making its judgement on interest rates, the Bank of England will be looking closely at the housing market for signs of a slowdown. More than most, the housing market is important for the UK economy and too sharp an increase in interest rates could cause serious economic problems. With many mortgages at fixed rates, the effect of the current series of interest rate increases has not been fully felt but when re-fixing comes due, it will prove painful for some borrowers. The rapid rise in house prices in recent years has helped to fuel the consumer boom but a fall in the housing market, such as has been seen in the USA, could prove highly damaging for the UK economy. It is a fine judgement that the MPC may have to make at some stage.



The various measures of house prices can give a confusing picture of what is happening. Rarely do they converge that closely. The following are examples of figures issued in May referring to previous months. For March, the Land Registry reported that the average house price rose by 1% compared with February. The annual rate of house price inflation was 8.3% which, on the Land Registry's figures, was the highest level for two years. On the other hand, the Halifax, in its data for April, reported house prices increasing at their slowest pace this year. Its index showed house prices rising by 1.1% in April compared with March, and year on year, the rate of increase declined slightly over the previous month to 10.9%. The Financial Times house price index for April showed an annual increase of 8.4%. The RICS was the most bullish on house prices. It reported that house price inflation gathered momentum in April. It reported that 28.9% more of its members experienced price increases in April rather than a fall, a much higher percentage than normal. Hometrack, whose data is the latest and covers May, reported an increase in house prices for the month of 0.6% compared with 0.7% in April. Annual house price inflation fell to 6.7% in May compared with 6.8% in April.

In terms of the mortgage market, the British Bankers Association reported that underlying net mortgage lending was £5.0 billion in April compared with the recent monthly average of £5.4 billion. The Bank of England reported that March's mortgage approvals were at their lowest level in a year.

So, the picture from the housing market is mixed but there are signs that it is responding to the rise in interest rates, providing some comfort to the Bank of England.

Elsewhere, the majority of the short term news is positive. GfK's consumer confidence survey shows a slight improvement in April with the index rising by two points. News from the retail sector is broadly positive. The CBI's distributive trades survey showed 64% of retailers reporting higher sales than a year ago with only 20% reporting that they were lower. The three month moving average was also buoyant. Although the ONS reported that there was a 0.1% decline in the volume of retail sales between March and April, the three months' figures to April showed sales volumes 1.2% higher than in the previous three months. The figures show an accelerating three months' improvement over previous series. The latest CBI survey of business confidence shows all regions to be more confident, the first time this has occurred for twelve years. The survey also indicates evidence of increased pricing power. A CBI/Grant Thornton survey of the service sector was strongly positive. The survey reported strong demand which was enabling prices to be raised. Consumer services companies reported that demand was at a three year high in the quarter ending in May and expectations for the next three months remain positive. Business services demand increased, albeit at a slower rate than in the previous three months. Companies are optimistic about profits' prospects. Although the reading has fallen slightly in April to 57.2 from March's 57.6, the CIPS/RBS survey of the service sector is still showing a positive figure. The news on the labour market was mixed. During the first quarter of the year, the number of people in work fell by 55,000 to 28,900,000. Unemployment rose by 13,000 to 1,700,000 over the quarter but the numbers claiming unemployment benefit fell by 2,800 to 890,000. Job vacancies are 51,000 higher than a year ago. The figures are not really conclusive at this stage.

There have also been items of negative news for the UK economy. Insolvencies reached a record level in the first quarter. Rising interest rates will exacerbate the position here. The trade deficit remains at very high levels and the current account deficit is forecast by the IMF to run at 3.1% of GDP both this year and next. Whilst the UK has been able to finance this deficit easily enough and the performance of sterling testifies to this, it does serve as a warning signal about imbalances in the UK economy which could easily lead to currency problems at some stage. It certainly cannot be taken for granted that sterling will remain a strong currency indefinitely. It looks overvalued at present. Although business investment has been strong on a year on year basis, it was weaker in the first quarter of 2007 falling by 1.3% over the previous quarter. Business investment is a high quality component of economic growth and, with corporate profitability at record levels, one would hope to see it recover.





If business did not feel the need to invest, it would indicate a cautious approach to future economic prospects. One quarter's figures are not, of course, conclusive. But one straw in the wind may be a fairly cautious survey from the British Chambers of Commerce. It predicted that economic growth would decelerate from 3% to 1.9% in the first half of 2008. It warned that the slowdown could be sharper. This would reflect the cumulative effect of interest rate increases with the realistic prospect that they might rise further. It cited the squeeze on disposable incomes with weakening household consumption, a dampening of investment expenditure and exports hampered by the strong pound.

On the surface, the good level of economic growth and low unemployment levels paint an encouraging picture for the UK economy but there are imbalances which could cause problems in the future and to which we have often alluded in the past. We have just talked about the current account deficit running at around 3% of GDP. Whilst that figure is not in the same league as the USA and Australia, around 6%, or New Zealand and Spain, around 9%, it does point to a dependence on foreign capital which, if confidence in the UK were to diminish for any reason, could cause economic problems. Internally, government borrowing is running at too high a level given the strength of the economy. In its April "World Economic Outlook", the IMF estimates that the structural deficit will be 2.2% of GDP this year. This is too high. Ideally, after a long period of growth, there should be a surplus to give a cushion for action should economic conditions deteriorate and the government needs to use fiscal measures to stabilise the economy. At the moment, the UK would be hard pressed to be able to take such measures without running a high risk strategy. In a generally positive review of the UK economy, the OECD warns about the size of the budget deficit which, adjusted for the economic cycle, it estimates at 2.9% of GDP. It said it "looks large by European standards" and called on the government to cut back on spending growth to reduce the budget deficit.

Although it is important to note the potential problems which are looming for the UK economy as a result of the internal and external imbalances, the stock market, as elsewhere, continues to be supported by earnings growth, takeovers and shareholder friendly actions by companies. It was reported in the Financial Times in May that Morgan Stanley had estimated share repurchases at £46 billion in 2006, up from £28 billion in 2005. Morgan Stanley reported that 58% of UK companies had active buy back programmes in 2006 which was almost double the level of 2004. Although there is discussion on the value of share buy backs versus increasing regular dividends, a relative scarcity of shares is developing. These buy backs have helped to offset UK institutions' sale of UK equities to buy overseas equities and bonds. One of the most astonishing investment decisions surrounded some investors' willingness to buy 50-year UK government bonds on redemption yields of around 3.75% last year. Given that, at the end of May, the gross redemption yield on the 2055 gilt had risen to 4.37%, some serious losses are being shown. Such is the distortion in the UK gilt market that a 2007 gilt, maturing in December, is currently on a gross redemption yield of 5.84%. Bonds are often favoured because of their supposed lack of volatility. It is important to emphasise that they can be more volatile than equities and, at the moment, longer dated issues look very poor value compared with equities.

The first five months of 2007 have produced good returns for equity investors and poor returns for bond investors. For reasons we have given, we continue to think that equities are attractive, particularly relative to bonds. However, unless equities are going to be up-rated, which is quite possible, it is probable that the majority of the gains have been seen for this year. Even if there were to be no further advance in equities this year, it will still have been a satisfactory year. In our investment policy, we have a presumption that equities will rise over the long term, as they have done in the past, and, for that reason, especially with the economic outlook apparently benign, we consider it highly risky to increase liquidity because of the potential opportunity cost of doing so. Providing that investors have the right time horizon for their investments, they can weather downturns in the markets that do not obviously have anything to do with a deteriorating economic position. After all, shares will still pay dividends and are most likely to recover and exceed previous peaks. A good example of the dangers



of being intimidated into selling shares by market conditions can be seen in May/June 2006 and, to a much lesser extent, in February this year, when shares fall back. Those who abandoned the long term perspective and sold shares will now regret it because share prices have advanced. Unless shares come back to these lower levels, the loss of profit will never be recovered. Because we see more positive drivers for equities than negative ones, we see a change of stance as unwise and would retain equity positions.

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