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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

Following weakness in international equity markets the previous quarter, a pleasing upward movement was seen this quarter as markets reacted well to generally good economic news including a substantial fall in the oil price. Bond yields also moved lower. Optimists will see this as a "Goldilocks" scenario where the world sees a "soft landing" to enable markets to continue to experience benign conditions for a further improvement. A more pessimistic interpretation of market movements is that either bond or equity investors have misinterpreted the situation.

The tables below detail relevant movements in markets.

International Equities 31.07.06 – 31.10.06

Total Return Performances (%)

Country	Local Currency	£	US$	€
Australia	+9.1	+7.8	+10.2	+10.1
Finland	+4.4	+2.2	+4.4	+4.4
France	+7.3	+5.0	+7.3	+7.3
Germany	+10.4	+8.1	+10.4	+10.4
Hong Kong, China	+9.0	+6.6	+8.9	+8.9
Italy	+8.5	+6.2	+8.5	+8.5
Japan	+3.7	-0.8	-1.3	+1.3
Netherlands	+9.8	+7.5	+9.8	+9.8
Spain	+17.0	+14.5	+17.0	+17.0
Switzerland	+7.9	+4.6	+6.9	+6.8
UK	+4.6	+4.6	+6.8	+6.8
USA	+8.5	+6.2	+8.5	+8.4
Europe ex UK	+9.8	+7.2	+9.5	+9.5
Asia Pacific ex Japan	+8.5	+6.8	+9.1	+9.0
Asia Pacific	+5.6	+2.2	+4.4	+4.4
Latin America	+8.8	+8.4	+10.7	+10.7
All World All Emerging	+8.4	+6.4	+8.7	+8.7
The World	+7.8	+5.5	+7.8	+7.7

Source FTSE World Indices

FT Government Securities Index (capital movement) +1.6%

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

Currency	31.07.06	31.10.06
Sterling	4.60	4.52
US Dollar	4.99	4.61
Yen	1.94	1.73
Germany (Euro)	3.92	3.74

Sterling's performance during the quarter ending 31.10.06 (%)

Currency	Quarter Ending 31.10.06
US Dollar	+2.2
Canadian Dollar	+1.3
Yen	+4.6
Euro	+2.1
Swiss Franc	+3.2

Other currency movements during the quarter ending 31.10.06 (%)

Other Currency	Quarter Ending 31.10.06
US Dollar/Canadian Dollar	-0.9
US Dollar/Yen	+2.4
US Dollar/Euro	N/C
Swiss Franc/Euro	-1.0
Euro/Yen	+2.4

Significant Commodities (US dollar terms) 31.07.06 – 31.10.06 (%)

Significant Commodities	31.07.06 – 31.10.06
Oil	-21.7
Gold	-4.3

Markets

During the quarter equities moved higher. The total return on the FTSE World Index in local currency terms was 7.8%, in sterling terms 5.5%, in US dollar terms 7.8% and in euro terms 7.7%. In local currency terms, as measured by the relevant FTSE World Index, there was little to choose in performance between Europe ex UK and the USA with respective returns of 9.8% and 8.5%. Asia Pacific ex Japan (8.5%), Latin America (8.8%) and emerging markets (8.4%) showed almost identical movements in local currency terms. The UK and Japan lagged with respective returns of 4.6% and 3.7%. The strength of sterling pulled down overseas returns in sterling terms but they were still generally good. The only significant negative return in sterling terms came from Japan where the Yen's weakness meant that the FTSE Japan Index returned –0.8% in sterling terms. Returns from all the other markets mentioned above were higher in sterling terms than from the UK with the FTSE USA index returning 6.2%, Europe ex UK 7.2%, Asia Pacific ex Japan 6.8%, Latin America 8.4% and emerging markets 6.4%. Australia is also worthy of note. It continues to perform well with the local currency return at 9.1% and the sterling return at 7.8%.

Bonds, as measured by ten year government bond yields, enjoyed a positive quarter. Gross redemption yields on sterling bonds fell by 8 basis points to 4.52%, US dollar bonds by 38 basis points to 4.61%, Yen bonds by 21 basis points to 1.73% and German euro denominated bonds by 18 basis points to 3.74%.

In the currency markets, the feature was the weakness of the Yen against which sterling rose by 4.6%. Sterling was also stronger against the other major currencies but not nearly as markedly.

In the commodity markets, the 21.7% fall in the oil price in US dollar terms provided some welcome relief for consumers. Gold fell by 4.3%.

Economics

- *A mixed pattern of economic growth*....the USA slows down but Europe, the UK, the Far East and Australia grow quite strongly. China and India continue to power ahead. Overall, the position is satisfactory.

- *Some relief on inflation*....oil falls sharply over the quarter helping to reduce headline, but not core, rates of inflation.

- *Geopolitical events, although significant, have not noticeably affected markets*....the conflict in Lebanon and the North Korean nuclear test have not impacted on markets.

- *Interest rates are at different stages of the cycle*....they have probably peaked in the USA but further rises are expected in the eurozone, UK and probably Japan (next year).

- *Corporate earnings continue to grow pleasingly*....this is providing significant support for equity valuations and the background for shareholder friendly measures such as rising regular dividends, special dividends, returns of capital and share buy backs.

- *A buoyant economic situation and still relatively cheap money provides the background for a high level of M&A activity*.... this is likely to continue as companies seek economies of scale. It should continue to support share prices.

- *The weakness of the Yen remains a feature of currency markets*....despite a large current account surplus, low Yen interest rates continue to encourage the "carry trade", one reason for the currency's weakness although it could snap back sharply if Japanese interest rates rise further.

- *Italy's credit rating is downgraded by Standard & Poors and Fitch*....this is symptomatic of Italy's worsening economic position but has implications for the eurozone itself.

- *The Dow Jones Industrial Average goes through its all time high*....this is not a representative index of the US stock market but, psychologically, it is important.

USA

- *The weakness of the housing market is affecting US economic growth*....the first estimate of third quarter growth is 1.6%. However, as yet, there is no real evidence that housing market weakness is spreading to the rest of the US economy.

- *Short term interest rates have probably, but not certainly, peaked*....weaker growth, as indicated above, may influence the FOMC but it is still watching inflation which remains above its target range with the core personal consumption expenditure deflator at 2.4%, above the Federal Reserve's preferred upper limit of 2.0%.

- *In a generally positive assessment of the world economic outlook, the IMF points to the US housing market as being one risk to its forecasts*....but one Federal Reserve President points to the automatic stabilisers of lower US bond yields which could be helpful as mortgage rates are tied to bond yields.

- *An upward revision to employment numbers complicates policy making decisions*....employment numbers to March 2006 were revised upwards by 810,000, an increase of 0.6%.

- *The Federal Reserve's Beige Book indicates an economy experiencing weakness in the housing market but satisfactory elsewhere*....its report characterised growth overall as "moderate or mixed".

Japan

- *Inflation remains very low*....core consumer prices were up just 0.2% in September, year on year, whilst the headline number, affected by weaker oil prices, was 0.5% lower year on year.
- *Nevertheless, the Bank of Japan will be mindful of the Yen's weakness*...even if inflation does not seem a problem now, it might be later on if currency weakness continues.
- *A further reason why the Bank of Japan may be concerned about inflation down the line is increasing tightness in the labour market*....the recruitment company, Hudson, was reported in the Financial Times as saying that 63% of companies were planning to increase staff over the next three months. The Bank of Japan says every business sector is now suffering from staff shortages.
- *The above factors are likely to boost Japanese growth*....but they will also raise inflation so the Bank of Japan may raise interest rates in the early part of next year.

China

- *Growth is still very rapid but it is slowing down*....the National Bureau of Statistics reports that the economy expanded by 10.4% in the third quarter compared with 11.3% the previous quarter.
- *The authorities will be pleased to see a slight reduction in growth*....monetary and administrative measures to rein in over investment in fixed assets, property speculation and local government spending appear to be having some success.
- *Inflation remains well contained*....in September, it was 1.5% year on year.
- Employment regulations are raising costs for foreign investors....these will make the production of goods more costly in China and the era of ultra cheap Chinese exports may be drawing to an end.
- *Chinese exports are booming*....the third quarter's trade surplus was 70% higher than a year previously.

Europe Ex UK

- *The ECB raises interest rates for the fifth time in this cycle*....they rise by 0.25% in October to 3.25% and the wording of the President of the ECB's statement suggests at least one further rise to come.
- *The ECB pays significant attention to money supply growth and bank lending probably more than other central banks*.... private sector loans rose by an annual rate of 11.4% in September whilst lending to business grew at 12.7%. The ECB will be concerned by these figures.
- *Although headline inflation fell in September as oil prices retreated, cost pressures remain*....the eurozone Purchasing Managers Index showed that manufacturers' output prices rose for the fourteenth consecutive month. In January, the consumer price index will be adversely affected by the 3% rise in German VAT.
- *Political problems begin to surface in Germany*....the compromises involved in coalition government satisfy very few. Business is becoming disillusioned with the government and healthcare reform proposals are heavily criticised.
- *Germany raises its growth forecast for this year*....the economics minister confirms that the economy should grow by 2.3% this year compared with the earlier forecast of 1.6%. Next year's growth is now expected to be 1.4% against the previous forecast of 1.0%.

- *The wisdom of next January's German VAT rise is being increasingly questioned*....tax revenues for the federal government and regional states are up 7.8% in the first three quarters of the year. The deficit should be within EU rules this year, one year earlier than expected.

- *The current economic news from Germany is generally good*....manufacturing orders in August rose by 3.7% over the month, industrial production rose by 1.9% in August. The German economy grew by 0.9% in the second quarter and the Ifo business climate index rose from 104.9 in September to 105.3 in October.

- *As well as the current buoyancy of the German economy, it is becoming increasingly competitive within the eurozone*.... German wages and salaries are growing much less quickly than in some other major eurozone economies such as France. Relative figures show French wages and salaries growing at 2.9% in France in the second quarter compared with the previous year against 1.2% in Germany. The Italian story is the same with a significant loss of Italian competitiveness against Germany since the introduction of the euro.

- *France is engaged in pre-election political manoeuvring and the situation is depressing*....there seems no real sense of urgency about trying to change attitudes to work and business and some of the individual politicians' proposals hark back to previous decades.

- *Symptomatic of France's problems is a ruling on maximum working hours in the hospitality industry*....it has been ruled that an agreement for a 39 hour working week must be overturned in favour of the standard 35 hour working week. This will raise costs and threaten jobs in the industry. The lack of realism is frightening.

- *A report by McKinsey is instructive in this respect*....it reports that a fall in French productivity has lost the opportunity to create 700,000 French jobs and that France is losing its share of global exports twice as fast as the USA and three times as fast as Germany.

- *Italy's coalition government becomes unpopular and weak*....it is difficult to see how meaningful reforms can be made and the emphasis on reducing the budget deficit by raising taxes rather than cutting spending is depressing. It is difficult to be optimistic about Italy's economic prospects. This has longer term implications for the euro.

UK

- *Economic growth is strong in the third quarter*....the ONS reports that it grew by 0.7% and, against the same quarter the previous year, growth was 2.8%. Services and manufacturing were well balanced with respective quarterly growth rates of 0.8% and 0.7%.

- *But public finances remain a concern*....a period of steady growth, such as the UK has experienced, should be used to strengthen public finances perhaps by running a surplus or, at least, a balanced budget. What we see is a large deficit which is structural in nature and which threatens to become a major problem when the economy turns down. The figures for the first half of this financial year are poor although the trend has time to change.

- *Interest rates seem very likely to rise to 5% in November*....The Bank of England is concerned by inflationary pressures. The Consumer Price Index showed a rise of 2.4% in September, year on year, compared with 2.5% in August. The Retail Price Index, which is more recognisable to many as it includes housing costs and which wage negotiators still use as a bargaining tool, was up 3.6% which is the highest level since June 1998.

- *The Bank of England's Monetary Policy Committee will also be watching the housing market closely for pointers to its interest rate policy*....The evidence is that it is quite strong with the Halifax index up 1% in September and the FT House Price Index up 0.5% for the same month. The Council of Mortgage Lenders reported that gross mortgage lending set a September record.

Summary

- *On balance, the economic outlook remains satisfactory*....growth should continue at a reasonable pace and the fall in the oil price is helpful. If the USA can withstand, as is probable but not certain, the weakness in housing then it can continue to contribute to a reasonable level of international growth.

- *Corporate activity should keep investors interested*....we think there is plenty more M&A activity to come and, whilst it may not benefit investors in the long term, it should be supportive of markets in the shorter term.

- *We think equity valuations look reasonable*....even if price/earnings multiples do not expand, prospective earnings growth should support a modest further uplift in equity prices. Relative to bonds, which we continue to think overvalued, we believe then to be attractively priced.

A number of interesting background factors are worthy of discussion in relation to the performance of markets over the last quarter. The oil price is one. Its sharp fall in price, down 21.7% over this period, has assisted sentiment, temporarily at least, for it has taken some pressure off business costs and some consumers' pockets. We have mentioned in previous reviews that oil's relative importance has declined since the oil shocks of the 1970's and 1980's and, so, with a growing world economy, businesses have been better able to absorb the rising costs of oil. There is a significantly different economic effect between a supply shock, where there is some sort of interruption to supplies, and a price rise without a supply interruption, essentially the position we have seen this year. OPEC has now announced a reduction in output amongst its members in order to try to stabilise the oil price, albeit at a level far above that which OPEC members had earlier considered to be reasonable. The rising oil price has raised OPEC's aspirations for an acceptable price. Although the world currently seems well supplied with oil, the uncertain geopolitical situation in a number of important oil producers always poses a risk to supplies. For the moment, however, the fall in the oil price over the quarter has been a positive factor for markets.

Oil is never far from geopolitical tensions. The paradox of markets is that, whilst markets endured a significant bout of volatility and weakness in May for no apparent economic or political reason, they hardly registered concern when the conflict in Lebanon flared up later on and they continued to recover from that weakness in May. Whilst the Lebanon situation is less prominent now, although, of course, never far below the surface, the North Korean nuclear test has become the latest focal point of global tension. It goes without saying that this is potentially a very serious threat, yet markets have not really registered concern. They appear to be taking the position that it is not a serious long term threat to stability. It is true to say that investors have to balance up the probabilities and possibilities when assessing geopolitical risk as they do with the economic outlook as well. There are always risks around in the market but it is not a practicable proposition to dwell on them to the exclusion of positive factors, otherwise no investment policy could be seriously formulated and, as experience has so far shown, positive factors have usually been in the ascendancy.

A milestone this quarter has been the breakthrough by the Dow Jones Industrial Average into new high ground. This iconic index is not representative of the market and the way it is calculated pays no attention to market capitalisation but, rather, to the share prices of its components. Nevertheless, its importance is psychological because its break through its previous peak does represent confirmation of the return of confidence to markets and, perhaps, to show that it is the turn of the large capitalisation stocks to find favour with investors. The S&P 500 is still below its all time high and the NASDAQ is well below that level.

But one reason why the Dow Jones Industrial Average has broken through its previous peak is that corporate earnings growth continues to provide strong support for share prices. This is true not only in the USA but almost everywhere else. As the world economy continues to grow quite strongly so do corporate earnings and dividends. In many countries, corporate profits in relation to GDP are at record levels. Although equity markets have recovered very strongly since 2003, so, too, have corporate earnings, leaving shares, in our view, still looking reasonably valued. The strong financial and profitability positions of businesses and the reasonable economic outlook have encouraged significant merger and acquisition activity which is good for market sentiment. Even though interest rates have risen, in some cases quite substantially, from their lowest levels, money is not dear. In most markets, earnings yields exceed bond yields, in some cases by quite a margin. There is ample liquidity around and areas such as the Middle East have substantial funds for investment overseas. UK companies have been popular targets for cash bids because of the UK's liberal attitude to foreign investment. We see this situation continuing and remaining a supportive factor for shares.

Interest rates remain the focus of attention. One reason why the US and other stock markets have been performing well is because of the belief, shared by many observers, that short term US interest rates have reached their peak. We will discuss this in more detail when we come to look at the USA. This view obviously helps other markets as well given the size of the US economy. The expectation is that eurozone interest rates will rise further and, in the UK, most people feel a second rise in interest rates at the next meeting of the MPC is a certainty. At some stage, perhaps in the early part of next year, Japanese interest rates will probably be raised. Whilst headline rates of inflation will benefit from the fall from peak levels in oil prices, there remains a concern about core inflation rates. Inflation and interest rates will be an important consideration for investors.

In the currency markets, the weakness of the Yen has been a feature. Yen interest rates remain minimal so the carry trade of borrowing in Yen to invest in higher yielding currencies remains appealing. There is some evidence that foreigners, who were influential in the Japanese equity market's good performance last year, have retreated this year whilst Japanese investors' appetite for overseas securities has increased. The Bank of Japan will be concerned about the direction of the Yen for currency weakness could stoke up inflation (a strange worry in view of Japan's recent deflationary problems). A rise in interest rates might help to support the Yen.

For followers of the eurozone, the downgrading of Italy's debt in October should be seen as a significant event. Standard & Poors lowered Italy's debt rating to A+ from AA- and Fitch reduced it to AA- from AA. Italy's public finances remain in a poor state and we have long seen Italy as a weak link in the eurozone because it appears almost impossible to implement the reforms necessary to put Italy back on course. As credit downgrades occur, borrowing becomes relatively more expensive and the yield margin of Italian ten year government bonds over equivalent German ones has risen to about 28 basis points and on thirty year government bonds to 40 basis points. Not only is the present position bad but, if interest rates were to rise, the cost of servicing Italy's debt would put an even greater strain on its current budget deficit. It is difficult to see the exit strategy for Italy in this worrying financial situation. Whilst, in the past, it could devalue its currency, membership of the euro now precludes that option. Each year, Italy is losing competitiveness as its costs rise faster than those of, say, Germany. The new coalition government's attempts to introduce supply side reforms through deregulation have met with strong opposition and have had to be watered down. Similarly, attempts to rein in the budget deficit have met with opposition from left wing members of the coalition and the emphasis on increasing the burden of taxation rather than cutting spending has angered business. How the Italian financial situation might unfold is uncertain but it looks unlikely to have a happy ending and may ultimately have implications for the eurozone. One has the feeling that, in the past, a country's membership of the eurozone has made some feel that credit ratings have become less meaningful because the risk had been removed. That is not the case.

We turn now to look at the USA where the first estimate of third quarter growth came in at a lower than expected 1.6% dragged down by weakness in house building and imports and where the Federal Reserve, as expected, has left interest rates unchanged at its October meeting. Its accompanying statement referred to slowing economic growth over the course of the year which it partly attributed to a cooling in the housing market. It expected the economy to expand at a moderate pace. But it continued to warn about inflation risks and left itself with the option of raising interest rates later on as it characterised the core inflation rate as "elevated" although it appeared less concerned about commodity and energy prices. It also appeared to be relatively sanguine about the housing market. The tone of the FOMC statement appeared not greatly different from the impression given by the minutes of the September meeting which were released in the early part of October. The Federal Reserve's Beige Book, which is a useful snapshot of the US economy, reported that growth in its districts was "moderate and mixed". It continued to report weakness in the housing market and did not see much evidence that it might be near its low point. It was relatively sanguine about inflation and it noted some areas where there was tightness in the labour market although it described wage growth as "generally modest". The services sector strengthened across all districts and it described manufacturing as "generally strong".

The attention paid to housing in the FOMC statement with the October rate decision and in the minutes of the September meeting, together with the reference to the housing market in the Beige Book, highlights one of the perceived risks to the US economy. This is also a risk highlighted by the IMF in its September edition of the World Economic Review. Housing starts in September were 5.9% higher than those of the previous month but, compared with the same month the previous year, they were down 17.9%. Sales of new houses rose by 5.3% in September compared with August. According to the National Association of Realtors, home sales fell by 1.9% in September. But house prices continue to fall. As measured by the median price of a new home, they were 9.7% lower than a year ago and average house prices fell by 2.1%. In the minutes of the FOMC's September meeting, the members did not appear unduly concerned about the effects of the housing market's weakness on other areas of the US economy and the President of the St. Louis Federal Reserve referred to the automatic stabilisers of lower bond yields which would be helpful to the housing market. At the time of writing, it is not evident that weakness in the US housing market is spreading to the rest of the economy although the weakness itself will adversely affect GDP growth until it recovers. However, the situation needs constant monitoring.

One of the issues which has complicated the Federal Reserve's task was a substantial upward revision in employment statistics to March 2006. The numbers shown as employed were revised up by 810,000. So the Federal Reserve has been working off figures which, according to the latest revision, under recorded the position. So, although the September non farm payroll figures rose a less than expected 51,000, it was off a much larger existing number. The two previous months' figures were revised upwardly by 61,000 and the overall unemployment rate was 4.6% in September, 0.1% lower than in August. The employment market appears robust.

We have noted above that the Federal Reserve is still concerned about inflation describing the core rate as "elevated". In September, the core rate rose by 0.2%, the same as in each of the previous two months. The three month annualised rate stands at 2.7%. The headline inflation figure for September fell by 0.5% reflecting lower energy prices. The core personal consumption expenditure deflator was 2.4% higher than a year ago in October above the Federal Reserve's preferred ceiling of 2.0%. There has been some reduction in the trend of core price inflation but it is still clearly of concern to the Federal Reserve and, should the data take a turn for the worse, the Federal Reserve may raise interest rates again. However, on the facts as we know them now, the probability is that short term interest rates have reached the peak of the current cycle.

It is some time since we discussed US politics but with the mid term elections approaching and the Republicans, who control both houses of Congress, in some trouble, it is worth considering that the political climate for investors may be turning. For investors, the US tax background has been benign but the political weather may be turning less favourable and investors should keep this at the back of their mind although we do not yet consider it to be a market factor.

US companies continue to turn out excellent corporate results and one wonders how long it can go on. This is one area where political issues come into play but, for now, with the US economy seemingly set for satisfactory but not stellar growth next year, corporate earnings and dividends should continue to move ahead. M&A activity is likely to remain strong. Short term interest rates do not look like posing a great threat to equities, especially with the possibility that they might move lower next year. The yield curve in the USA is relatively flat at present and it may well become more conventionally shaped. We think that, as in other countries, longer term bond yields are too low. Should they rise substantially, which does not look likely at present, that would pose a threat to equities but, if they rise modestly, the earnings yield on US equities is likely to remain comfortably above longer term bond yields and, on the basis of satisfactory US economic growth, US shares remain reasonably valued.

Moving on to Japan, the weakness of the Yen remains an issue. It has been suggested that one of the reasons for the weakness of the currency has been the lack of volatility in foreign exchange markets which reduces the obvious risks from making a bad bet in highly volatile markets. Therefore, the more obvious deals, such as borrowing in a low yielding currency like the Yen to invest in a higher yielding one, are being done. However, even though inflation is very low in Japan, with core consumer price inflation up just 0.2% year on year in September, a continued slide in the currency could cause alarm at the Bank of Japan so the currency is not a one way bet. Rising Japanese interest rates could reverse the currency situation even though a further rise is not thought to be imminent.

An interesting survey from the recruitment company, Hudson, quoted in the Financial Times, surveying the jobs market in Asia, said that 63% of Japanese firms which it surveyed planned to increase full time staff in the next three months. This was the strongest result in its country surveys. According to the Bank of Japan, all business sectors are suffering from staff shortages. The economic consequences of this are that wages are likely to be pushed higher as employers compete for staff and consumers will become more confident. Stronger growth should ensue and, if that happens, Japan should be able to make some contribution towards rectifying global imbalances.

Supply side reforms remain very important in establishing a faster growth rate potential for Japan and one very encouraging piece of news relates to government proposals to expose local government to market forces in the debt market. The plan is to end government guarantees on local government debt. If this happens, the effect on local government should be bracing. Paying market rates on loans should encourage prudent spending and the risks the lender would face would encourage a stringent evaluation of the credit risk. It should lead to better economic decisions. The implications could be enormous and it is the type of reform which Japan badly needs so it is to be hoped that it will be implemented. It should produce a more level playing field in the borrowing market and help to remove some economic distortions. In many ways, it has some of the benefits which the privatisation of the Japanese Post Office will have for the economy in the form of better allocation of assets.

The Japanese market remains some way below its peak, lagging other markets. Fears about a temporary slowdown, such as Japan seemed to experience recently, and a weaker yen may have deterred some investors but Japanese companies remain in generally good health and reporting encouraging profits growth. For those Japanese companies exposed to overseas markets, the weakness of the Yen has provided a competitive advantage.

Within the eurozone, interest rates, as expected, have been raised again. In early October, the rate was raised by 0.25% to 3.25% and this from the original low point of 2.0%. The expectation is that there will be a further increase. The ECB said that it would "monitor very closely" future developments. Interest rates were described by the President of the ECB as "low" and policy was "accommodative". Business still seems to be quite buoyant in the eurozone. In the third quarter, the eurozone manufacturing purchasing managers index was comparable with the strong figures in the previous quarter. It did give a hint of inflationary issues in the pipeline for it showed that manufacturers' output prices had risen for the fourteenth consecutive month. Industrial orders in the eurozone in August rose by 3.7% according to Eurostat and this followed a 1.9% rise in July.

Germany has been much in the news recently. The political honeymoon of the coalition government has quickly ended and the government and, in particular, the CDU, has lost significant support. Inevitable compromises in a grand coalition have caused much disappointment, particularly on the side of business. The health reforms have also been heavily criticised and there is a lack of impetus to reform which is necessary in Germany but is very difficult when two partners in the coalition have such different fundamental views. In front of the much criticised 3% VAT increase coming in on 1 January 2007, the German economy appears to be performing quite well at the moment. In the second quarter, the German economy grew by 0.9% which was helped by strong activity in the construction sector. Overseas demand for German goods and domestic investment spending have helped but there is some evidence that demand from overseas for its products is easing off. In August, exports from Germany showed a 0.1% fall over the previous month. However, industrial production in August rose by 1.9% and this was the fastest monthly increase for almost three years. The previous month's rise had been 0.8%. Industrial orders rose by 3.7% in August, a further strong reading after the 2.1% rise in July. We mentioned above the 3% VAT increase coming in next year. One of the reasons for the criticism of this rise has been that the more buoyant state of the German economy has increased tax receipts. It was announced, in October, that tax receipts for the federal government and regional states were 7.8% higher than in the same three quarters of the previous year, a rise of €23 billion. Whilst this will improve the budgetary position, it does invite criticism about the large VAT increase. The strength of the German economy was emphasised by the economics minister's forecast that Germany will grow by 2.3% this year. The previous forecast had been 1.6% and, with the VAT increase next year, growth is expected to slow down to 1.4% in 2007. Finally, in another sign of the present confidence in the German economy, the Ifo business climate index staged a recovery to 105.3 in October from 104.9 in September. But, as we have mentioned before, there is a difference in perception between the current view of the economy and future expectations. Although there was a mild increase in optimism about future prospects, it was markedly less than about current prospects.

In France, the main interest arises from the electoral situation in front of next year's presidential elections. Whilst nothing much can be done in a pre-election period, the proposals put forward by the various candidates do not significantly address France's major economic weaknesses caused by over-regulation and an oversized French state. Some of the ideas put forward would undoubtedly make the French position worse. In an interesting report, McKinsey reported that, because of a sharp drop in French industrial productivity gains, the opportunity to create more than 700,000 jobs had been lost and the country could be vulnerable to a large amount of low cost imports. It found that France is rapidly losing competitiveness. We have commented in previous reviews about the falling share of French exports in the world market. This report suggested that France was losing its share twice as fast as the US and three times faster than Germany and this because of the country's declining competitiveness. McKinsey reported that tentative labour and education reforms could go faster and be deeper. In fact, the absurdity of the French situation is shown by a recent ruling that the 35 hour week must apply in the hospitality industry where there had been an agreement for 39 hours before. This ruling threatens businesses and jobs but is symptomatic of a mindset that does not recognise global trends. It is difficult to be optimistic that France will make the necessary changes.

We discussed the situation in Italy at the beginning of this review. It is hard to see how Italy is going to make significant progress with its economic problems in view of the fractious political situation. The downgrade in Italy's credit rating is a warning but there are very few grounds for optimism about future economic progress. Besides its steady loss of competitiveness, the Italian economy does not have the profile of businesses that fit so well with world demand as that of, say, Germany. It is undoubtedly a weakness in the eurozone and could well lead to problems with monetary union later on.

Turning now to the UK, the economy has shown robust growth. In the third quarter the ONS reported that the economy had grown by 0.7%. Compared with the same quarter in 2005, growth was 2.8%. In the quarter, services grew by 0.8% and the manufacturing sector by 0.7%. However, although growth at this level would normally be considered to be good news, it does highlight the growing problem with public finances which are showing significant structural deficit problems. At a time when the economy is growing quite rapidly, it would be normal practice to aim for a budget surplus or at least a balanced budget to allow for the possibility of a cyclical deficit when the economy slowed down. Should the economy slow down from now on, and with public finances in a relatively poor state, there could be significant decisions ahead for the Treasury. This is an issue which has concerned us for some time but, although it has not been highlighted to the extent that it perhaps should, there is bound to be a time shortly when difficult decisions have to be made. Borrowing figures have been disappointing for the Treasury. Public sector net borrowing in the first half of the financial year to the end of September was at a level of £25.4 billion compared with £21.4 billion in the same period the previous year. The forecast by the Treasury was for lower borrowing over the whole financial year. Things can, of course, change but it is right at least to highlight this problem. The current deficit, which excludes capital investment, was £13.1 billion in deficit for the first six months of the year which compares with a deficit of £13.4 billion for the same period the previous year. The Treasury's forecast was for the current borrowing level to be about half the level of £14.8 billion which it was in 2005/6. The problem at the moment is on the expenditure side where public expenditure growth in the first half of the year was 7.5% whereas the budget estimate for the whole year is 4.5% although the Treasury has emphasised that the expenditure is forward loaded. Interestingly, the Treasury is trying to ensure that public sector pay is strictly controlled next year. The Chancellor of the Exchequer has told pay review bodies that settlements should not breach the government's inflation target of 2%. For doctors, dentist and nurses, the government has indicated basic pay rises of 1.5% next year with anything over that hitting patient care. The pay round could be very difficult for the government next year particularly as inflation is above target. Although headline CPI figures fell to 2.4% in September, down from 2.5% in August, this was because of lower petrol prices but the retail price index, the previously used measure, which is used as a yardstick for salaries and pensions and which is regarded as a more accurate barometer of prices since it includes housing costs, rose by 3.6%. One has to go back to June 1998 for a higher figure. Other evidence of rising prices comes from the retail sales price deflator, which rose by 0.6% in the year to September, the first time it has risen for a long time and the CBI, in its latest quarterly industrial trends survey, reported that the balance of manufacturers expecting to raise prices over the next three months rose from six in July to twelve in October. The squeeze on manufacturers margins is shown by the fact that the ONS reported that manufacturing output price inflation for the manufacturing sector was 1.8% in September against 2.8% in August.

Inflation is obviously one of the issues that the Bank of England will be looking at when setting interest rates and it will also be very interested in the latest news from the housing market. House prices appear to be on the rise again. The Halifax reported that the average house price in September was 1% up on August. The year on year rate had fallen back slightly to 8.0% in the year to September. The FT house price survey showed that the annual rate of house price inflation by its measure had risen to 6.1% in September from 5.8% in August after a rise of 0.5% in September which was led by a strong housing market in London. Although off peak levels the Council of Mortgage Lenders reported a September record figure for gross mortgage lending of £29.5 billion. The evidence on inflation and house prices strongly suggests that 5% interest rates will be reached in November with the possibility of at least one further rise later on. It was noticeable that the Governor of the Bank of England in October reported that falling oil prices, which has been the experience of the last quarter, would not necessarily lower inflation in the medium term.

The employment figures are showing a contradictory figure for the UK economy. Unemployment has been rising steadily but so has the number in employment. As a result of an increase in the workforce, because of the number of people entering the country, the number of people in employment rose to an all time high of 29.02 million whilst the number of people claiming unemployment benefit rose to its highest level since December 2001 at 962,000 with unemployment at 5.5%. The rise in unemployment figures is unlikely to influence the MPC in its interest rate decision.

In China, where the authorities have been trying to rein in growth in order not to exacerbate inflationary tendencies or to cause problems in the banking sector through excessive investment in fixed assets, there is some sign that the measures are working. Third quarter economic growth was still a substantial 10.4% but it was slightly lower than in the second quarter when it was 11.3%. For the first three quarters of the year, growth was an annualised 10.7%. Investment in fixed assets rose substantially at 23.6% year on year in the third quarter but this was lower than the 27.3% recorded for the first nine months. Chinese exports remained very strong and the trade surplus was 70% higher in the third quarter compared with the same period the previous year. Encouragingly, because of competition in industrial goods of which there was an over supply and a good harvest, inflation was low at 1.5% in September, year on year. If China can maintain low inflation and successfully control growth, that would be a benign result for the world economy. However, China is increasing the regulation of the employment market which will affect overseas companies investing in China and will make doing business more expensive. There are early signs that the era of very low cost Chinese imports may gradually be coming to an end. There will still be much lower costs than can be experienced in advanced industrialised countries but, whereas low cost Chinese imports have helped to keep down inflation in the past, the influence may now be beginning to wane and, if there is any upward pressure on the Chinese currency, that position will be exacerbated. It remains very unwise for industrialised countries to put undue pressure on China since it has powerful retaliatory weapons which could cause problems for the world economy.

Australia remains an economy for which we have a high regard. It has performed exceptionally well for many years and has been a profitable place in which to invest. In its latest survey of the Australian economy, the IMF is forecasting 3.1% growth this year, rising to 3.5% in 2007. It said that the economy was well placed to deal with any further fall in commodity prices but believes that interest rates may have to rise further because of accelerating inflation. In the second quarter, inflation ran at an annual rate of 4%. These may be seen as slight problems of success and the Australian economic position would be envied by most industrialised economies. There is no domestic debt, something that is most unusual. It remains an area that we favour.

All in all, in the absence of any unexpected geopolitical event, we remain quietly optimistic for equities. This is based on the fact that valuations do not seem excessive and economic growth is likely to continue to provide impetus for corporate earnings and dividend growth and provide an environment in which mergers and acquisitions still flourish. Interest rate rises that will probably occur in the eurozone, the UK and, probably, Japan are not likely to be at a level which will seriously threaten markets but we still expect weakness in the bond markets where yields are too low. But, again, any rise in bond yields should not be to a level which threatens equities. As always, with the operation of many short term players in the market, volatility could develop at any stage but investors would be well advised to concentrate on the fundamentals and, providing they do not deteriorate, resolve to maintain their policy in order not to damage long term investment performance.