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ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

Equities and bonds have both performed well this quarter. Whilst investors in both classes of asset have reason to be cheerful about their returns, it does raise the question as to whether one of them has made a mistake i.e. whether bond investors are too pessimistic about world economic prospects or equity investors too optimistic. There is a third, more appealing, possibility which is that they are both right. We will look at the issues in the course of our review.

The tables below detail relevant movements in markets.

International Equities 30.06.06 – 30.09.06

Total Return Performances (%)				
Country	Local Currency	£	US\$	€
Australia	+2.5	+1.9	+3.0	+3.9
Finland	+1.6	-0.3	+0.7	+1.6
France	+6.2	+4.1	+5.2	+6.2
Germany	+5.7	+3.7	+4.7	+5.7
Hong Kong, China	+8.7	+7.3	+8.4	+9.4
Italy	+5.8	+3.8	+4.8	+5.8
Japan	+2.4	-1.8	-0.8	+0.1
Netherlands	+13.2	+11.0	+12.1	+13.2
Spain	+13.3	+11.1	+12.3	+13.3
Switzerland	+10.1	+6.5	+7.5	+8.5
UK	+3.2	+3.2	+4.2	+5.2
USA	+5.4	+4.4	+5.4	+6.4
Europe ex UK	+8.0	+5.6	+6.7	+7.7
Asia Pacific ex Japan	+5.2	+4.1	+5.1	+6.1
Asia Pacific	+3.5	-0.5	+1.5	+2.5
Latin America	+5.0	+4.9	+6.0	+6.9
All World All Emerging	+5.9	+4.2	+5.2	+6.2
The World	+5.3	+3.7	+4.7	+5.7

Source FTSE World Indices

FT Government Securities Index (capital movement) +2.0%

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

Currency	30.06.06	30.09.06
Sterling	4.70	4.52
US Dollar	5.15	4.65
Yen	1.93	1.68
Germany (Euro)	4.06	3.71



Sterling's performance during the quarter ending 30.09.06 (%)

Currency	Quarter Ending 30.09.06
US Dollar	+1.0
Canadian Dollar	+1.3
Yen	+4.3
Euro	+2.0
Swiss Franc	+3.4

Other currency movements during the quarter ending 30.09.06 (%)

Other Currency	Quarter Ending 30.09.06
US Dollar/Canadian Dollar	+0.3
US Dollar/Yen	+3.3
US Dollar/Euro	+0.9
Swiss Franc/Euro	-1.4
Euro/Yen	+2.3

Significant Commodities (US dollar terms) 30.06.06 – 30.09.06 (%)

Significant Commodities	31.05.06 – 31.08.06
Oil	-16.5
Gold	-2.7

Markets

Equities and bonds have both performed well this quarter. The total return on the FTSE World Index in local currency terms was 5.3% whilst in sterling terms it was 3.7%, in US dollar terms it was 4.7% and in euro terms it was 5.7%. Looking at individual markets in local currency terms, we note that the FTSE USA Index returned 5.4%, very close to the return on the FTSE World Index. Europe ex UK produced an above average performance, returning 8.0%. Within that area, Spain and Netherlands were strong features with respective returns of 13.3% and 13.2% but Finland under performed with a return of 1.6%. Japan produced a below average return of 2.4%. The UK under performed this quarter with the FTSE UK Index showing a return of 3.2%. Elsewhere, Emerging Markets, Asia Pacific ex Japan and Latin America showed pleasing returns of 5.9%, 5.2% and 5.0% respectively. If we look at sterling adjusted returns, the relative performances change somewhat. The weakness of the euro places the total return on the FTSE Europe ex UK Index at 5.6% against 4.4% for the FTSE USA Index. Although the Japanese market, as measured by the FTSE Japanese Index, showed a modest return in local currency terms, weakness in the Yen caused the sterling return on this index to showing a negative performance of 1.8%. The US dollar adjusted performance was also a negative 0.8%.

Bonds also performed well as measured by ten year government bonds. Sterling bonds showed a fall in gross redemption yields of 18 basis points to 4.52%, US dollar bonds a fall of 50 basis points to 4.65%, Yen bonds a fall of 25 basis points to 1.68% and euro denominated German government bonds a fall of 35 basis points to 3.7%.

In the currency markets, the main feature was the weakness of the Yen against which sterling rose by 4.3%. The euro was also weaker with sterling showing a 2.0% gain against it over the quarter. The Swiss Franc was weaker still with sterling rising by 3.4% against it over the quarter. The US dollar also weakened slightly but by less than the other major currencies. Sterling rose by 1.0% against it over the quarter.



In the commodity markets, there was at least some temporary good news on oil which fell by 16.5% over the quarter. Gold eased by 2.7%.

Economics

- *The pattern of economic growth changes...*the USA slows down after unsustainable first quarter growth, Japan temporarily pauses, but the eurozone, UK and Asia ex Japan are buoyant.
- *On present evidence, the outlook for 2007 is satisfactory...*the IMF, in its latest World Economic Outlook, predicts only slightly lower growth than for 2006 and is quite sanguine on inflation. It does, however, emphasise risks on the downside.
- *Some, at least temporary, respite for inflation prospects...*over the quarter oil falls about 16.5%.
- *Interest rate prospects appear mixed...*there is a reasonable chance that the Federal Reserve has stopped tightening but further increases are likely in the eurozone, UK and, perhaps, Japan.
- *Short of some very serious geopolitical event which we cannot foresee, protectionism is one of the main dangers to the world economy...*the threats of two US Senators to have tariffs placed on Chinese imports if the currency is not allowed to appreciate significantly is alarming.

USA

- *US growth slows down in the second quarter...*following the post hurricane influenced first quarter, when growth was an annualised 5.6%, revised second quarter figures show a 2.6% annualised rate.
- *The IMF points to the US housing market as a possible risk to its forecast...*it fears that, if the decline is greater than expected, it could spill over to the rest of the economy. According to the Chairman of the White House Council of Economic Advisers this is not happening at present although it will affect third quarter growth.
- *The Federal Reserve has not raised interest rates at its last two meetings...*with the US economy slowing down, gasoline prices much weaker and headline inflation falling, there is a reasonable chance that the peak of this short term interest rate cycle has been reached. The Federal Reserve has left open its options.
- *The worst of inflation may be over...*year on year CPI stood at 3.8% in August, down from 4.1% in July. The index was up 0.2% over the month but the core rate fell by 0.4% in August.

Japan

- *Although there have been some temporary signs of a slowdown, the prognosis for next year still looks quite good...*annualised growth in the second quarter was 1%. The IMF forecasts growth of 2.1% next year against 2.7% this year. The Bank of Japan board paints a satisfactory picture of a well balanced economy.
- *Despite the fundamentals, the Yen continues to be weak...*there are several reasons for this including the carry trade but the Bank of Japan will not be happy to see this weakness continue indefinitely because of the inflationary consequences, an unlikely concern given the deflation experience of recent years but one which could become reality.
- *Business is upbeat...*the latest Tankan survey shows a high level of business confidence at large manufacturers.



China

- *Continued strong growth forecast...*the IMF forecasts growth of 10.0% for 2006 and 2007.
- *But exceptional economic growth carries concerns...*there is over investment in certain industries which could lead to problem bank loans and inflationary pressures, currently low, could rise.
- *The Chinese authorities are taking measures to restrain the economy...*these are of an administrative and monetary nature.
- *Foreign exchange reserves will soon reach US\$1,000 billion...*apart from causing excess liquidity at home, it sounds a warning to any country which tries to pressurise China into acting faster than it wishes on its currency or imposes tariffs to try to further this end. China has a strong retaliatory weapon.

Europe Ex UK

- *Growth has been pleasingly robust...*the IMF forecasts growth in the eurozone this year of 2.4% and the OECD 2.7%. The ECB has a mid point growth forecast of 2.5%. For the EU as a whole, the EU Commissioner has raised the growth rate forecast from 2.3% to 2.7%.
- *However, there are economic clouds on the horizon...*the 3% VAT increase in Germany next year is likely to distort growth patterns in Germany and have an indirect effect elsewhere in the eurozone. Spending will be brought forward. German sentiment indicators reflect current situation buoyancy but concern about the future.
- *Economic buoyancy is helping budget deficit reductions, one of the eurozone's largest problems....*, the German finance minister forecasts a deficit of 2.8% of GDP this year, France's deficit is forecast to be 2.7% this year and 2.5% next year whilst the Netherlands has seen its first budget surplus for seven years.
- *Although the headline rate of inflation has fallen sharply, interest rates are likely to rise further...*headline inflation in the eurozone has fallen to an annual rate of 1.8% in September from 2.3% in August, below the ECB's target. But money supply growth and bank lending, which the ECB watches closely, are rising rapidly.

UK

- *It is probable that interest rates will rise to at least 5%...*an error in the ONS's estimate of the cash value of national income in the second quarter overstated its growth and therefore may have raised inflationary concerns unnecessarily. However, a year on year rise in CPI of 2.5% in August and 3.4% in the RPI as well as signs of a strengthening in house prices are likely to influence the Monetary Policy Committee.
- *The IMF forecasts growth of 2.7% in 2006 and 2007...*but it is concerned about borrowing trends and it again urges restraint on public spending. In the short term, although it is only five months into the current financial year, borrowing trends are not looking encouraging.
- *The UK's competitive position appears to be slipping...*a combination of increasing regulation and uncompetitive tax rates threatens micro and macro economic problems in the medium and long term. More lowly rated large internationally orientated companies are likely to cope better.



Summary

- *Relatively stable stock market conditions and much lower volatility suggest investors are quietly becoming more confident....the volatility of May appears due to short term operators in the market at a time when nothing unexpected happened on the economic front. Long term investors must be careful not to be intimidated by such movements.*
- *Although there are well documented risks to the international economic outlook, we believe the balance of probability is that the IMF economic forecasts for next year are realistic....should that be the case, equity investors can expect further satisfactory corporate earnings and dividend growth. M&A activity is likely to remain strong.*
- *There is, therefore, a reasonable possibility that it is a "Goldilocks" scenario....however, although bonds have experienced good returns this quarter, we remain concerned about their absolute levels of yield.*

By way of background, we can start with recent economic forecasts from the IMF and OECD which portray a reasonably encouraging outlook but with words of caution to temper any over optimistic assessment.

Salient features from the recent IMF's World Economic Outlook are as follows:

	2006 (%)	2007 (%)
World Output	5.1	4.9
Advanced economies	3.1	2.7
USA	3.4	2.9
Euro area	2.4	2.0
Germany	2.0	1.3
France	2.4	2.3
Italy	1.5	1.3
Spain	3.4	3.0
Japan	2.7	2.1
U.K.	2.7	2.7
Canada	3.1	3.0
Newly industrialised Asian economies	4.9	4.4
Developing Asia	8.7	8.6
China	10.0	10.0
India	8.3	7.3

Consumer Prices

	2006 (%)	2007 (%)
Advanced economies	2.6	2.3
Other emerging market and developing countries	5.2	5.0

Source: IMF World Economic Outlook



An interim assessment from the OECD, also in September, forecast growth for this year with implied year average projections for 2006 as follows:

	2006 (%)
USA	3.6
Japan	2.5
Euro area	2.7
Germany	2.2
France	2.4
Italy	1.8
UK	2.8
Canada	2.8

Source: OECD – interim assessment – September 2006

With nearly three quarters of the year having gone, projections for this year from the two organisations are understandably quite close.

The deceleration in growth in 2007 foreseen by the IMF is really very small and the inflation forecast is quite encouraging. If these growth and inflation forecasts are close to the eventual outcome, investors will be pleased for they provide an encouraging background to securities' markets. However, we should emphasise the risks which the IMF and OECD believe exist and which could, if they come to fruition, alter the good outlook.

The IMF believes the risks to its forecast are slanted to the downside. IMF staff estimates suggest a one in six chance that growth could fall to 3.25% or less in 2007. The risks which they detail include a tighter than anticipated monetary policy resulting from intensified inflationary pressures, rising oil prices (although they have eased since the forecast was published) and a rapid fall in the US housing market leading to a more abrupt slowdown of the US economy. The perennial concern about global imbalances is also mentioned although the IMF believes these will probably be unwound through the market. The OECD's assessment of the risks is similar.

In making broad asset allocation decisions, we have to deal in probabilities and possibilities. We cannot make decisions based on the possibility of there being a major problem round the corner unless it is fairly obvious that there is one. In today's uncertain world, there are always geopolitical issues which can arise but we cannot say that we will not invest in shares because of this. Many of them can be accommodated without doing great damage to the market. Equally, however, we can say that market squalls might arise for no obvious reason. We have recent examples of both of these phenomena. Market turbulence during May was due to no obvious economic reason. There was a rationalisation after the event i.e. US inflationary and interest rate worries but, in truth, these were not reasons for the market to fall. Rather, the weakness was almost certainly due to the actions of short term operators rather than long term investors. On the other hand, a subsequent geopolitical event, the conflict in Lebanon, which might have been expected to be a market influence, did not affect the market in a significant way. Investors expect that there will be regular geopolitical issues and factor in their likely impact into their investment decision making. Such an issue might be continuing tensions in the Middle East and the effect which this may have on the oil price. Something truly unforeseeable would impact on markets but investors also need to factor in what governments and monetary authorities might do to offset the situation. Monetary policy, post 9/11, would be such an example. It would have seemed scarcely believable that the Federal Funds rate could be lowered to 1% but that is what happened as the Federal Reserve attempted to restart economic growth.



In this context, and going back to the IMF staff's assessment of risks where it is suggested that there is a one in six chance that growth could fall to 3% or less in 2007, that assessment, bearing in mind its mainstream forecast, does not seem to call for any significant change in investment policy. Were growth to fall to that level, it would not be a disaster, but were investment policy to be predicated on the one in six scenario and the five in six scenario turned out to be the correct assessment investors in, say, shares could suffer a significant opportunity cost.

Quite naturally, media attention will be concentrated on negative economic or political news. That is much more interesting than good or routine news. Thus, the continuation of good corporate earnings and dividend growth, the bread and butter of long term market performance, does not attract the headlines which a big fall in the stock market might occasion. Only when companies in politically sensitive areas like oil, utilities and banking show strong profits growth do the headlines occur and they are normally negative because of the political slant.

So, we would say that, if the IMF forecasts for 2007 are reasonably accurate, equity investors should be in line to benefit from the growth rates envisaged because they should ensure that companies continue to perform well financially.

Looking back over the last quarter, we mentioned the absence of a market effect from the conflict in Lebanon. In a steady quarter for equities, the sharp decline in the oil price has provided some relief for hard pressed businesses and consumers. This will have supported market sentiment. We have noted before that the world economy has coped well with the sharply increased price of oil, this for a number of reasons including the fall in its relative importance as an input in relation to GDP and, importantly, because it is easier for the world economy to absorb rising oil prices when there is strong growth. Were a supply shock to occur, that would be a different matter. A further source of relief to markets was the pause in the series of rises in US interest rates, increasing the chance that they have now peaked in this cycle. The happy coincidence of a fall in oil prices and a large drop in gasoline prices in the USA should help to reinforce this belief given that it will take some pressure off the inflation figures. Clearly, that is for now. We cannot count on oil prices remaining at current levels. They could just as well go up as down.

The economic phenomenon which is China continues to dominate international economic headlines. As we see from the economic forecasts of the IMF, economic growth expectations for next year are similar to this year's at 10.0%. China's foreign exchange reserves are soon expected to reach US\$1,000 billion. The emotions which the latter evoke amongst some western politicians remain a cause for concern. Mindless protectionism advocated in some quarters in the USA and Europe is a threat to the world economy. Pressing China to allow its currency to rise significantly by threatening tariffs on Chinese imports as, for example, two US senators are trying to do does not pass any economic test. Firstly, many of the goods China exports to the USA (the same could be said of Europe) are not candidates for import substitution, US factories simply do not make these goods any more. So the result would be higher prices stoking inflation and probably leading to interest rate increases. The resulting slower US growth would affect employment and the effect on the Chinese economy, of lower growth domestically would affect its appetite for US imports (aircraft, for example, where Boeing has made major sales to Chinese airlines). China could also be expected to retaliate. As the owner of the world's largest foreign exchange reserves and, given the USA's large current account deficit, it does not seem sensible to antagonise China. The newish US Treasury Secretary, Hank Paulson, seems to have a realistic view of the situation, which is encouraging. As we have often mentioned in previous reviews, protectionism is one of our major economic concerns and a close watch will have to be kept on developments in the USA and EU. Protectionist measures could backfire horribly.



The interest rate cycle is not synchronised. As mentioned above, it is possible that US interest rates have peaked. The last increase in Federal Funds rate was to 5.25% on 29 June. On the other hand, euro interest rates were raised to 3.0% by the ECB on 3 August and are expected to rise further. UK rates were raised to 4.75% on 3 August also with the possibility that they might rise again. In Japan, the first interest rate rise from effectively zero took place on 14 July when the overnight call rate rose to 0.25%. Nowhere can monetary policy be considered tight, however. The possible peak in short term US interest rates has been of some encouragement to the US equity market and, despite the prospect of interest rate increases elsewhere, is helpful to these markets as well given the size of the US economy.

One significant issue for investors to untangle is the investment validity of both bonds and equities performing quite strongly during the quarter. Can bond and equity investors both be right or has one of them got it wrong? Why should bond yields have fallen during the quarter when inflation poses a modest threat to monetary policy? The answer would normally be that investors are expecting either a major economic slowdown or a recession which will lower inflation to justify current longer term bond yields and perhaps offer the prospect of capital gains if yields fall further. The UK, for example, has a downward sloping yield curve with the 30 year government bond yielding about 90 basis points less than the one year bond. That might, but not necessarily does, presage a recession. In fact, it probably reflects regulatory pressure on pension funds to buy longer dated bonds to reflect their asset/liability position. Equity investors might have been buying shares because they expect that the period of monetary tightening may soon be coming to an end with it possibly having already done so in the USA and because they think that there will not be many more rate rises in the eurozone or UK. They may be anticipating, for example, a fall early next year in US interest rates as the Federal Reserve provides a more accommodating monetary background to help the US economy to raise its economic growth rate towards its sustainable long term trend consistent with stable inflation. Overall, in their assessment of the world economic outlook, they may feel that the outlook is for one of satisfactory growth at low inflation levels supporting continued growth in earnings and dividends whilst valuations are supported by low bond yields. Of course, this latter prospect points to the “Goldilocks” scenario where growth is not too hot and not too cold and inflation is contained. So it is possible that bond and equity investors are correct. We will be considering the outlook as we go through this review. We do, however, consider the absolute level of international bond yields to be too low.

We turn now to look at individual areas of the world, starting first with the USA where the estimate of second quarter GDP growth has been revised downwards from the preliminary estimate of 2.9% to 2.6%. This followed a post hurricane affected 5.6% rate of growth in the first quarter. This growth rate is below the trend rate of growth of the US economy consistent with stable inflation and is one reason why the Federal Reserve may feel more comfortable about at least instituting a pause in the upward interest rate trend. The Federal Reserve’s Beige Book of trends within its different areas is a useful piece of background information about the state of the US economy. It did not detect increased pressure in the employment market and it suggested that companies were absorbing increased commodity prices. Weakness in residential construction and housing markets was neutral unlike the position in the current construction market. Consumer spending was rising only slowly, the service industry sector was mixed but manufacturing was generally expanding. At its September meeting, the Federal Reserve, which, as indicated earlier, left interest rates unchanged for the second month running, kept its options open in the event of inflationary risks increasing.

With respect to US inflation, the Personal Consumption Expenditures index, excluding food and energy, which the Federal Reserve watches closely, rose at a 2.7% annual rate, following a 2.1% rise in the first quarter. The Federal Reserve’s upper target is usually held to be 2.0% which is one reason why there was a long series of 0.25% interest rate increases. On other measures of inflation, the CPI index increased by 0.2% in August to leave the year on year figure at 3.8% compared with 4.1% in July. The core producer price inflation index, excluding



volatile food and energy prices, fell 0.4% in August. The index was influenced by price falls for passenger cars and trucks. Excluding those from the equation would have left the index unchanged. One possible concern, although this does not appear to have shown up in the price indices, is that unit labour costs have been accelerating. The annualised rate of increase for the second quarter was 5.0% following revisions to the figures. Subject to this caveat, cautious optimism, but no more, is in order and the sharp fall in gasoline prices, referred to earlier will be helpful in this context.

One of the concerns raised about the US economy is the weakness of the housing market. The IMF mentioned this point in its World Economic Outlook to which we referred earlier and the concern is that this localised difficulty will have a knock on effect on the rest of the US economy. To give some idea of what has been happening, home construction had its biggest fall in the second quarter since 1995. It declined at an annual rate of 11.1%. The National Association of Home Builders reported in September that the average new home sale price in July was up 0.3% on the year before whereas in January it had been 9.8%. For existing homes, the National Association of Home Builders estimates that the rise in July was 1.5% year on year whereas, in January, the figure had been 12.6%. Another measure from the Office of Federal Housing Enterprise Oversight shows that, whilst second quarter year on year gains were running at 10%, the annualised rate of increase in the second quarter was only 4.7%. So the trend in the housing market is clear and the question is whether it can do serious damage to the economy. In one sense, of course, it is a positive, for weakness in the market is bound to influence the Federal Reserve in its interest rate decisions. If interest rates seem more likely to stabilise or fall as a result, that is likely to be helpful to markets. At the end of September, the Chairman of the White House Council of Economic Advisers told the Senate budget committee that weakness in the housing market does not appear to be spreading to other areas of the economy. That does appear to be the case at present but, should a further substantial fall in house prices occur, a negative wealth effect is inevitable. But with interest rates stable, one's instinct is that the housing market will stabilise. With mortgages tending to be tied to bond yields, the recent fall in yields is a positive driver for the housing market.

Although the housing market will affect third quarter GDP growth, much of the rest of the economic news is positive for the US economy. Unemployment remains low. It fell slightly in August to 4.7% from 4.8% in July. 128,000 jobs were added in August against 121,000 in July. Retail sales appear to be responding to lower gasoline prices. August's retail sales were up 0.2% over July and July had shown a 1.4% rise over June. August's consumer confidence figures were encouraging with the index rising from 100.2 in August to 104.5 in September.

As we have just said, what investors in US stocks and bonds are fervently hoping for is a "Goldilocks" scenario where growth settles down at a sustainable rate which does not threaten inflationary pressures. This will depend on so many variables, some outside the control of the authorities and some within its control. There will be some element of judgement, some of luck if this scenario is to unfold. For instance, has the Federal Reserve done enough on interest rates, has it done too much or has it got in just right by stopping, at least temporarily, at 5.25%? But own goals can also be scored and we refer to our earlier comments on protectionism in the USA. If the USA places tariffs on Chinese goods because China does not move fast enough on its currency adjustment, the USA stands to lose more than China. We have already seen a nasty piece of protectionism dressed up as a security issue in the USA when it effectively forced Dubai to sell some ports acquired through the P&O takeover. If own goals can be avoided, there is a reasonable chance that there will be a continuation of the series of good annual growth rates posted by the US economy.



Looking now at Japan, the prognosis continues to appear quite good although there have been some pieces of evidence of a slowdown but not enough to establish a trend. The IMF forecasts growth of 2.1% next year, a modest slowdown from this year's forecast of 2.7%. As we mentioned earlier, the Bank of Japan raised interest rates to 0.25% in July and recent indications suggest that the board members think that will do for the time being. Their assessment of conditions, given in mid September, did not suggest any indication that a second rate rise was on the way, although it said it had no predetermined view. A downward revision to the inflation figure to a minimal figure has reduced any pressure for a further increase for the time being. The board members noted a slowdown in the economy in the second quarter where the annualised rate of growth was just 1%. To quote from its statement it said "the economy was expanding moderately with domestic and external demand and also the corporate and housing sectors well in balance".

We mentioned that indicators had turned mixed. The latest Tankan survey shows business confidence at large manufacturers at 24 in September, a two year high. This compares with 21 in June. The Ministry of Finance's latest corporate survey showed that Japanese companies' investment in the second quarter was up 18% over the same period the previous year. The figure for corporate sales was up 9%. These were the strongest figures for some time. On the other hand, and this may be a statistical aberration, core private sector machinery orders fell by 16.7% in July compared with June. The series is a volatile one.

We have, in the past, often talked about structural reform in Japan. Companies have certainly carried out much self help which is why they are generally doing well again but the Japanese economy, like much of Europe, needs supply side reforms to raise the potential long term growth rate of the economy which lags well behind the USA. Apart from what has already been done, some further encouragement has been derived from the potential outsourcing of government services to the private sector. The cabinet has approved such plans and, initially, such services as the collection of national pension premiums and state run employment agencies will be put out to competitive tendering. These are very significant moves for Japan and, hopefully, they will lead to further outsourcing projects. But we must also remember that vested interests in support of the status quo are strong in Japan and that the new Prime Minister, Mr Abe, is probably more conservative in his outlook than Mr Koizumi.

As we can see from the currency tables at the beginning of this review, the Yen has been the weakest of the major currencies. The carry trade is a factor whereby, because interest rates are so low relative to other major currencies, investors borrow to invest in higher yielding currencies. Foreign investors, who were so influential in pushing the Japanese stock market up so strongly last year, are now less in evidence and Japanese investors are investing more overseas. Japanese goods are very competitive because of the currency's weakness but the Bank of Japan, whilst pleased for economic reasons that there is a little bit of inflation in the Japanese economy, will not be happy to see sustained weakness in the currency because of its effect on inflation. The current influences on the Yen, in whole or part, will reverse themselves at some stage and there will be a move back into the currency.

Moving on to the eurozone, we note the IMF forecasting a fairly robust 2.4% growth rate for this year and the OECD one of 2.7%. We already know that first quarter GDP growth was 0.8% and 0.9% in the second quarter. The ECB expects 2006 growth with a mid point of 2.5%. For the EU as a whole, as opposed to just the eurozone, the EU Commissioner has raised this year's growth forecast from 2.3% to 2.7%. It is good news that the eurozone has accelerated its growth because this is necessary if world economic imbalances are to be reduced. Europe has not pulled its weight for a long time, lagging behind the USA. However, whilst improvement is welcome, Europe needs large scale structural reform if it is to be able to raise its long term growth rate, consistent with stable inflation. This is difficult to achieve in much of Europe. But sentiment is quite good at present. The EC's economic sentiment index, which covers businesses and consumers, rose to 109.3 in September from 108.3 in August.



All the indications are that interest rates will rise further in the eurozone despite a sharp fall in headline inflation in September. The headline rate of inflation fell from 2.3% in August to 1.8% in September. But the ECB also watches money supply, more so than many central banks, and this has been accelerating. In August, it accelerated to 8.2% growth from 7.8% in July. Bank loans also accelerated with figures to the private sector showing 11.3% growth in August, up from 11.1% in July. The ECB will be mindful of these figures when setting interest rates but it is almost certain that interest rates will be raised at least once more in this cycle.

However, whilst current economic activity figures in the eurozone are generally good, the future is more problematical because of the 3% VAT increase in Germany from next January. This is a large increase and bound to affect consumers' spending actions. A rational consumer will bring forward spending on expensive items which will boost activity this year and depress it next year. Because Germany is the eurozone's largest economy, its fortunes will be relevant to activity elsewhere in the eurozone and beyond. The IMF forecast for Germany, suggesting growth this year of 2.0% and 1.3% next year, reflects the likely effect of the VAT increase on the economy. The same kind of pattern in Germany is suggested by the recently published Ifo business climate indicator. There was very little difference in the reading in September compared with that in August. It dipped to 104.9 from 105.0, still a good overall reading. Its composition is interesting. The component measuring the current business situation is at its highest level for fifteen years but the forward looking component fell to its lowest level since last November. That reflects the post VAT increase outlook. The irony of the situation is that the strength of the German economy has boosted government finances to the extent that the budget deficit is likely to fall to 2.8% of GDP this year according to the German finance minister. The VAT increase was imposed to help Germany to meet its Maastricht obligations. However, the situation is not as good as it looks because Germany faces economic headwinds, one of the problems being rising unemployment insurance costs following reforms at the beginning of the year. So, some caution about the implications of current German economic strength is in order.

The French economy, whilst facing very difficult economic problems, is enjoying some strength. In front of the elections next year, most of the interest centres around the jockeying for power within the parties and not much policy work is being done. As in Germany, the budget deficit is forecast to shrink to 2.5% of GDP next year from 2.7%. The finance minister plans to continue sales of state held shares to raise between €5 billion and €10 billion next year. Unemployment has been falling, although the quality of the fall has been called into question. It now stands at 9.0% in August, a slight rise compared with July, the second quarter and is expected to fall to 8.5% in 2007. Consumers are feeling more confident with a sharp rise in spending in August, up 3.3% over July.

In a further sign of better financial conditions in the eurozone, the Netherlands has seen its first budget surplus for seven years.

All the structural problems of the eurozone remain, however, and the reform process remains difficult. For example, the new Italian coalition is already facing problems with its deregulation and financial stability policies and this is a country which badly needs reform to enable it to make a start on addressing its major budget deficit and public debt problems. But, at the corporate level, Europe is showing great success. Corporate earnings are strong and M&A activity buoyant. Shares do not look highly rated and we believe Europe should command an important part of clients' portfolios.



Probably the most interesting economic question in the UK at present is the course of interest rates. It is generally expected that there will be at least one more increase but the situation has been complicated by the discovery of an error in the ONS's estimate of the cash value of national income in the second quarter where the figure has been revised downwards to an annual rate of 4.8% from 6.0%. Inflationary concerns will therefore be lessened at the Bank of England. Manufacturers have had some relief from falling oil prices. Their input prices declined by 1.2% between July and August to reduce the year on year rise to 7.6% from 10.2%. The implied squeeze on manufacturers' margins is shown not so much by the unchanged output prices for August but by the annual rise of output inflation of just 2.6%. CPI inflation in August rose to 2.5% from 2.4% in July. The Retail Price Index for August showed a year on year rise of 3.4% compared with 3.3% in July. These are not figures which will be welcome to the Bank of England on top of the very latest figures from the Nationwide on house prices which showed a 1.3% rise in September against August.

The IMF's economic growth forecast for 2006 and 2007 is 2.7% but it does warn about public spending, an issue which we have often raised. For an economy which has been growing quite strongly, government finances, as measured by the budget deficit, are in bad shape, indicating a structural deficit. Economic thinking suggests that a period of strong growth should be used to rein in deficits or run a surplus but the opposite has been true in the UK. Against the Treasury's forecast of public borrowing of £36 billion in the current financial year, the level for the first five months to August is £2.7 billion higher at £19.5 billion compared with the previous year. The current budget, which excludes capital investment, showed a deficit of £5.6 billion, £2 billion worse than a year ago. In its review of the UK, the IMF warns about the level of the budget deficit and urges restraint on public spending. It expects that one of the golden rules, net public debt in relation to GDP, will be broken by 2011 as it exceeds 40% of GDP. Unless there is effective restraint on public spending, tax increases appear probable and these would have an unwelcome effect on the UK economy.

One of the medium and long term concerns about the UK economy is losing what was a strong competitive position to over regulation and excessive taxation levels as well as inadequate training skills. The beginning of October has seen a further slew of regulation imposed on companies. It is not for us to comment on the wisdom or otherwise of these regulations but what is quite clear is that there will be an economic cost. It is not a zero sum game. Businesses are threatened by all sorts of additional risks arising from legislation. The effect will be felt first at the very smallest end of business size and work its way up. Increased regulation will stifle expansion plans and discourage hiring. These micro effects will gradually have macro effects in terms of affecting growth, government finances and unemployment to name three issues. UK tax rates are becoming increasingly uncompetitive and uncertainty over the interpretations of tax laws will affect companies' investment and, perhaps, location thinking.

It is our view that the quality of growth in the UK has not been as good as it might have been. There are potential problems, such as government finances, which have not yet come right to the fore, but will almost certainly do so.

In terms of investment policy, a slanting of exposure to large UK companies which are well diversified internationally and which tend to be on much lower ratings than medium sized and smaller companies appears to us to reflect the realities of the situation facing the UK.

Moving on to Asia, the Asian Development Bank has recently raised its forecasts for economic growth for developing countries in the Asia Pacific region. It has raised this year's forecast for the region ex Japan from 7.2% last April to 7.7% which, if accurate, would reflect a very slight increase over 2005. Next year's forecast



is 7.1%. For China, it expects economic growth this year to be 10.4% and India to be 7.8%. India has just released its growth estimate for the April-June quarter which was an annualised rate of 8.9%. South East Asian growth this year is now expected to be slightly lower at 5.5% against its earlier forecast of 5.5%. Risks, which it highlighted to its buoyant forecast, were higher long term interest rates arising from a fall in demand for US dollar denominated assets and rising inflation in the USA and Europe. It may be that with favourable trends recently, these worries are slightly less but nothing can be taken for granted. Still, we have little doubt that developments in Asia ex Japan are positive for the world economy, providing an important source of growth to supplement the improving but still relatively sluggish growth of Western Europe and Japan and, perhaps, temporarily, the USA as it slows down to a level of growth below its long term trend rate of growth .

We have noted in previous reviews that China is taking measures to rein in excessive expansion which could lead to inflationary pressures and problem bank loans. These are of an administrative and monetary nature i.e. direction of bank lending and interest rate increases. In its latest review of China, the IMF argues for a continuation of monetary policy tightening. Its own forecast for Chinese economic growth this year is 10.0%. We have argued before and still do that the Chinese economic phenomenon has been and still is beneficial for the world economy. Cheap Chinese exports have held down international inflation enabling monetary authorities to keep interest rates at levels below what they would otherwise have been. Consumers' purchasing power has been increased leading to higher economic growth. Of course, there have been losers as uncompetitive manufacturing capacity has been lost in advanced economies but the winners have outnumbered the losers. From an international economic and investment perspective, developments in China must be monitored closely because over expansion leading to inflationary pressures would damage China and the rest of the world economy. The Chinese authorities are well aware of these dangers and are acting accordingly.

As we enter the final quarter of the year, the background looks quite promising with regard to growth and inflation. We can also expect continuing corporate takeover activity to interest investors. We cannot be complacent, however. The risks to the world economy are well understood. Furthermore, as we saw in May, stock market squalls can occur at any time, reflecting the changing nature of investors. Longer term investors must ensure that their strategy is not derailed by these incidents but, rather, concentrate on the issues which matter for the long term performance of securities. As before, in the absence of any unexpected geopolitical events, we remain cautiously optimistic. Is the "Goldilocks" scenario a possibility? We have enough evidence to suggest that it could happen but it will require luck and good judgement. We do not, however, consider that shares are assuming that it will happen. Their ratings generally do not suggest this. We continue to believe that shares are more attractive than bonds.

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