meridian

ASSET MANAGEMENT (C.I.) LIMITED

INVESTMENT MEMORANDUM

Although markets remain in a fragile state as seen by equity price movements at the beginning of May, the quarter to the end of April witnessed a good recovery in prices and, for sterling investors, a well diversified international equity portfolio would be likely to be showing a modest positive return for the calendar year to date. Bond markets were mixed and, as a result of extreme monetary policy, a wide range of European and Japanese government bonds are showing negative gross redemption yields. There were some big currency movements with the US dollar particularly vocal and, perhaps significantly, commodity prices showed some recovery from very depressed levels.

The tables below detail relevant movements in markets :

International Equities 29.01.16 - 29.04.16

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	+6.8	+11.6	+15.3	+8.9
Finland	-6.1	-3.7	-0.6	-6.1
France	+0.9	+3.4	+6.8	+0.9
Germany	+2.5	+5.0	+8.4	+2.5
Hong Kong, China	+10.8	+7.7	+11.2	+5.0
Italy	N/C	+2.5	+5.8	N/C
Japan	-5.9	+3.1	+6.5	+0.6
Netherlands	+1.4	+4.0	+7.4	+1.4
Spain	+3.8	+6.4	+9.8	+3.8
Switzerland	-0.9	+2.5	+5.9	N/C
UK	+4.2	+4.2	+7.6	+1.6
USA	+7.3	+3.9	+7.3	+1.4
Europe ex UK	+1.2	+4.1	+7.5	+1.6
Asia Pacific ex Japan	+9.6	+8.6	+12.2	+6.0
Asia Pacific	-0.1	+5.6	+9.1	+3.1
All World Latin America	+18.8	+28.5	+32.7	+25.3
All World All Emerging	+9.6	+10.9	+14.6	+8.2
The World	+4.9	+5.0	+8.4	+2.4

Source FTSE World Indices

FTSE UK Government Securities Index All Stocks (total return) : N/C %

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

Currency	29.01.16	29.04.16
Sterling	1.56	1.73
US Dollar	1.92	1.84
Yen	0.10	-0.08
Germany (Euro)	0.33	0.27

Sterling's performance during the quarter ending 29.04.16 (%)

Currency	Quarter Ending 29.04.16
US Dollar	+2.8
Canadian Dollar	-8.0
Yen	-9.2
Euro	-2.5
Swiss Franc	-3.5
Australian Dollar	-4.2

Other currency movements during the quarter ending 29.04.16 (%)

Currency	Quarter Ending 29.04.16
US Dollar / Canadian Dollar	-10.5
US Dollar / Yen	-11.7
US Dollar / Euro	-5.2
Swiss Franc / Euro	+1.0
Euro / Yen	-7.0

Significant Commodities (US dollar terms) 29.01.16 - 29.04.16 (%)

Currency	Quarter Ending 29.04.16
Oil	+32.3
Gold	+12.7

MARKETS

It has been a satisfactory quarter for international equity markets which have made a good recovery from an unsettled start to the year. In local currency terms, the FTSE World index has shown a total return of 4.9%, in sterling terms 5.0%, in US dollar terms 8.4% and, in euro terms, 2.4%. In local currency terms, the stand out performers have been Latin America where the FTSE All World Latin America Index returned 18.8%, emerging markets where the FTSE All World All Emerging Markets Index returned 9.6%, the same as the FTSE Asia Pacific ex Japan Index. In local currency terms, above average returns came from the FTSE USA Index with a total return of 7.3% and Australia where the FTSE Australia Index returned 6.8%. The most notable underperformance came from the FTSE Japan Index which returned -5.9% and the FTSE Europe UK Index which returned 1.2%. If we look at sterling adjusted returns, the performance of the FTSE All World Latin America Index becomes even stronger, returning 28.5%. The return on the FTSE Australia Index increased to 11.6% and that on the FTSE All World All Emerging Markets Index to 10.9%. The strength of the yen meant that a negative return on the FTSE Japan Index in local currency terms turned into a positive return of 3.1% in sterling terms. On the other hand, weakness in the US dollar reduced the sterling return on the FTSE USA Index to a below average 3.9%, still a very satisfactory return.

In the international bond markets, taking ten year government bonds as a benchmark, movements were less violent than we have seen in some recent quarters. The gross redemption yield on the UK government bond rose by 17 basis points to 1.73%, on the US government bond it fell by 8 basis points to 1.84%, on the German Bund by 6 basis points to 0.27% and, remarkably, on the Japanese government bond, it fell by 18 basis points to move into negative yield territory, -0.08%

There were some large moves in the currency markets with the US dollar noticeably weak this quarter and the yen, Canadian dollar and, to a lesser extent, the Australian dollar strong. Against the US dollar, sterling rose by 2.8% but it fell by 9.2% against the yen, by 8.0% against the Canadian dollar, by 4.2% against the Australian dollar, by 3.5% against the Swiss franc and by 2.5% against the euro.

Commodity prices showed signs of recovery with oil, as measured by Brent crude, rising 32.3% and gold by 12.7%.

ECONOMICS

Yet another downgraded set of economic forecasts, this time from the IMF. In the April edition of its World Economic Outlook, it has reduced its forecast for world economic growth this year by 0.2% to 3.2% and by 0.1% for 2017 to 3.5%. Within this global forecast, the figure for advanced economies has been cut by 0.2% to 1.9% for this year and by 0.1% in 2017 to 2.0%. Within this subset of advanced economies, all of the G7 economies have seen their forecasts reduced for this year and the same applies for next year with the exception of the UK where the January forecast has been left unchanged. For the USA, the IMF now projects growth for this year of 2.4%, a reduction of 0.2% from its January forecast and for 2017 of 2.5%, 0.1% lower than its previous forecast. The eurozone has seen the same reductions. For 2016, it is expected to grow by 1.5% and for 2017 by 1.6%. The biggest downgrade for 2016 has been in Italy where this year's projection has been lowered by 0.3% to 1.0%, whilst next year's forecast has been trimmed by 0.1% to 1.1%. Germany's 2016 forecast has been cut by 0.2% to 1.5% and next year's by 0.1% to 1.6%. For France, 2016's forecast has been cut back by 0.2% also to 1.1% and the same level of reduction has been applied to 2017 where the forecast is now 1.3%. Although not a G7 member, Spain emerges relatively well from these downgrades. The IMF has cut its forecast by just 0.1% for this year to 2.6% whilst it has left 2017's projection unchanged at 2.3%. The UK has been subject to quite a severe cut in the IMF's growth forecast for this year by 0.3% to 1.9% although, as mentioned above, no reduction has been applied to next year's forecast of 2.2%. The most savage cut of all has been applied to Japan where this year's growth forecast has been halved to just 0.5% and next year's reduced by 0.4% to negative growth of 0.1% in 2017. The remaining G7 country, Canada, has seen both years' forecasts cut by 0.2% to 1.5% for this year and 1.9% for next year.

Turning to Emerging Markets and Developing Economies, the picture is decidedly mixed. Brazil, in a state of political and economic turmoil, has seen its outlook downgraded for 2016 with the IMF cutting its forecast by 0.3% to negative growth of 3.8%. It has left 2017's forecast unchanged at flat. Russia, troubled by the weak oil price and sanctions, has seen a very significant cut in the forecast for 2016 of 0.8% to give negative growth of 1.8%. For next year, the IMF has reduced its forecast by 0.2% to 0.8%. On the other hand, China has seen an upgrade in the forecasts for both years of 0.2% giving a projected growth rate of 6.5% for this year and 6.2% for 2017. The 2016 and 2017 forecasts for India are unchanged at 7.5% for both years. Overall, the IMF now expects growth in Emerging Markets and Developing Economies in 2016 to be 0.2% lower than it expected in January at 4.1% and 0.1% lower for 2017 at 4.6%.

However, all forecasts are just snapshots in time and involve varying degrees of subjectivity as the regular stream of downgraded economic forecasts show. The IMF's summary of its latest growth projections is "Global recovery continues, but at an ever-slowing and fragile pace". It highlights in its bullet points that financial risks are pronounced, together with geopolitical shocks and political discord and it stresses in its diagnosis of the cure the need for a three pronged approach spanning structural, fiscal and monetary measures. It is not a joyful outlook and it is hard not to agree with its diagnosis but it is difficult to be optimistic that its prescribed course of action will be followed. Monetary policy is doing the heavy lifting at present as it has been since the financial crisis erupted. Fiscal policy has been determined by many countries' budgetary position and the small number which theoretically have the ability to take action, with Germany the most notable example, have generally been unwilling to do so because of their internal budgetary disciplines. As far as structural measures are concerned, the IMF is likely to remain very disappointed about the outcome of its exhortations. Politicians are generally just too frightened or timid to do what is needed. It is important to outline again why structural reforms are so necessary to complement the other two approaches mentioned by the IMF. It is necessary to try to raise a country's long term growth potential. One reason why it is proving very difficult in many countries, particularly in the eurozone, to bring the levels of public debt under control is that their economies are not growing fast enough to improve their budgetary position. Because of the constraints of the Stability and Growth Pact which limits the size of budget deficits, measures to raise taxes or cut public expenditure bear down on growth whereas it is faster economic growth which will raise tax revenue and this is by far the best way to attack excess levels of public debt. Overregulation in the employment market, which is commonplace in the eurozone, has the opposite effect to what is intended. It makes companies unwilling to take on young people because it is too risky and results in appalling levels of youth unemployment and lost growth opportunities which, through higher tax revenues and lower social security costs, would promise an improvement in a government's finances. Similarly, structural reforms in the product and services markets can also help growth but there are losers. If we consider disruptive technologies, the benefits come through in increased efficiencies and lower costs which should raise a country's growth levels but the losers usually have powerful lobbies behind them which politicians are often fearful of upsetting. One of the dangers resulting from the aftermath of the financial crisis and recession is that protectionism is on the rise. One sees it in the US Presidential election campaign where anti free trade rhetoric and threats of penal tariffs have reached dangerous levels but they are undoubtedly striking a chord. In an ideal economic world, countries would produce and export goods and services where they have a comparative advantage and import those where they do not. Because consumers or businesses would be able to buy from the cheapest source, they would have more disposable income and create the conditions for faster economic growth with the benefits which this would bring on the tax and spending side for different countries. In difficult times like these, politicians will often veer towards protectionism to boost their standing with the electorate. Embarking on structural reforms and helping to make an economy as efficient as possible through labour market and product reforms amongst many other things would be very helpful. There would be costs in the short term and with high unemployment governments are very unwilling, understandably, to countenance this but it is a Catch 22 situation given the prospect of longer term benefits. Other supply side reforms like improved investment in education, training and infrastructure take many years to flow through to an economy but they are vital if long term growth rates are to be sustained and enhanced.

Perhaps the best current example of damaging resistance to change is in France. As we can see from the IMF's projections earlier in this review, France's growth prospects are not good although first quarter GDP performance was relatively good with quarter on quarter growth at 0.5%. The country has one of the most regulated labour markets of the advanced countries which benefits those in work at the expense of the young whom employers are generally very cautious about taking on because of the financial risks inherent in a highly regulated labour market. Most independent observers and, now, some in the French government realise the need to reduce the barriers to employment through some modest deregulation of the labour market but they have been met by a barrage of protest, ironically from the young whom the proposed measures were aimed to help, and the reforms have been watered down in the face of protests. This may be a more extreme example than most but it makes the point about how difficult the third element of the IMF's three pronged approach to the current economic problems is to implement in some countries. Moves towards protectionism will make the situation worse.

So, with many countries unwilling, because of budget constraints, to engage in fiscal activism, and with structural reform facing obstacles in others, the focus, as for a long time, remains on monetary policy which becomes more extreme by the day in a number of countries. Although the USA and UK have discontinued quantitative easing, it is happening apace in the eurozone and Japan and we now have an even more aggressive use of monetary policy through negative interest rates which are in place in the eurozone, Sweden, Denmark, Switzerland and Japan. We are in unprecedented times as far as monetary policy is concerned and it essential to think through the economic and stock market consequences of this very strange position. As well as negative official interest rates in these countries and areas, a wide swathe of government bonds in Europe and Japan are showing negative gross redemption yields. It is truly a bizarre situation.

Why are we in this extraordinary position with monetary policy? As mentioned earlier, politicians often like to avoid making difficult decisions. Fiscal policy decisions can be difficult as can structural reform measures. Those relating to monetary policy are usually devolved to central banks and, in the current environment, lead to fewer problems for politicians. Monetary policy is having to do the heavy lifting of trying to stimulate sluggish economies. The theory of negative interest rates is simple, the practice is fraught with difficulty. The theory is that, if depositors are being charged for depositing money with banks, they will either spend the money, thereby stimulating an economy and creating an economic multiplier effect, or invest it and, if in shares, raise share price levels and create a positive wealth effect with resulting increased spending. Although borrowers, unless governments or top corporates, would still expect to pay a positive interest rate on their borrowings, it would be lower than before and might encourage more corporate or personal borrowing and, hence, spending. One way to stimulate an economy, although there are negative side effects, is through a currency devaluation which negative interest rates might expect to cause as foreign investors withdraw their money in search of better interest rates in another currency or domestic investors move their money into currencies with a positive yield. The theory is seductively simple but there are practical problems. Take the last issue first. If, as at present, different countries and areas are following the same official negative interest rate policy, it can become a zero sum game. Thus, the Japanese yen, which might have been expected to weaken when the Bank of Japan moved to negative interest rates, has been a strong currency, exactly what the Bank of Japan and the Japanese government do not want as it makes their inflation target even more difficult to achieve. The idea that, if depositors receive negative interest rates on their deposits or have to pay banks to keep their money with them, they will automatically spend the money or buy shares, is flawed. People or businesses need to keep precautionary levels of savings or deposits. Whilst it would not be practicable for businesses to withdraw their cash and hide it under the mattress, individuals might do so to avoid losing money in nominal terms, thereby giving banks some level of funding problem. Negative interest rates are likely to impact on banks badly. They may be reluctant to pass on the costs they incur from the central bank in the form of negative interest rates on customer deposits and also reluctant to charge customers for having an account with them. Their lending margins will probably be impaired. Apart from the apparently never ending flow of fines and settlements which are hitting the banks and, therefore, their profits, the banks face the mutually contradictory pressure from regulators and politicians to strengthen their capital base and to lend more. Instead of trying to stimulate growth, negative interest rates might have the unplanned consequence of impeding economic activity. Finally, there is the assumption that lower borrowing costs, the assumed outcome of negative interest rates, will encourage companies and individuals to borrow more, resulting in a stimulus to the economy. Given how low interest rates are at present, it is very unlikely that a small cut in borrowing costs will swing the argument for individuals and companies, as they assess whether to spend or invest, if the argument did not stand up before. Negative interest rates might stimulate the wrong sort of activity for investors in the form of their making more risky investments in order to chase income. The high yield bond market is one example of this where an increasing level of defaults is being seen in the US energy industry as companies buckle under the weight of depressed energy prices. As the effect of negative interest rates passes to the short dated end of the bond market and perhaps further down the yield curve, the effect on company pension schemes becomes more severe as the discount rate used for future pension liabilities falls and the net present value of the liabilities rises forcing some companies to pay in more funds to their pension schemes. Some of the downside risks from negative interest rates, which we have just outlined, show that they are not a one way bet for the economy. Herein lies the danger on relying so heavily on monetary policy to drive the economy in the desired direction. Monetary policy has been tested in an almost unimaginable way as fiscal policy and structural reform has lagged.

Yet there are serious suggestions of even more unorthodox monetary policy being brought into play in the form of “helicopter money”. The allusion is to a helicopter flying overhead distributing paper money to those living below who will then go out and spend the money, thereby stimulating economic activity. In practice, it could be a credit to each household or maybe the creation of money by the central bank to invest in infrastructure. Such policies would have been considered unthinkable until recently for the very good reason that they are dangerous as they would lead to inflation. Once the money has been spent, it cannot be clawed back and would pose a serious inflationary threat. With quantitative easing, whilst money has been created in the first place to purchase bonds from the private sector, it can be reversed as the money is sucked back out of the economy as the central bank sells the bonds back to the private sector. Even if a central bank dared to go down the “helicopter money” route, what could it do for an encore? Once the money had been spent, the stimulus would die down and a country might be back to where it was, although inflation may have begun to become a problem. It would be a seriously challenged economy even to consider risking the “helicopter money” approach.

So what does all this mean for securities markets given that the tone of this review so far has been rather negative? The answer has been what we have felt for a long time, namely that all this cheap and electronically created money is supportive to asset prices, even if not for the right reason. In the bond markets, prices have moved up to and yields down to levels which, a few years ago, one would have scarcely thought possible. As we have mentioned, large swathes of the European and Japanese government bond markets are standing on negative gross redemption yields so that, if one held such bonds to redemption, there would be a guaranteed loss. In normal circumstances, it would be difficult to understand why any investor would do this, so why are investors prepared to do this now? They could be expecting that the economy is going to experience a prolonged period of deflation so that, if the level of deflation exceeded the negative yield on the bond, the investor would make a real return. We think that this deflation scenario is very unlikely. The world economy is still growing and commodity prices are showing signs of turning up, albeit from very depressed levels. However, if an investor does believe that the world is in for a prolonged period of deflation, then that investor must believe that the world economy is going to be very depressed, making other asset classes very unattractive. In such a scenario, bonds, particularly well rated government bonds, could seem the least bad asset, but this would also imply a loss of confidence in cash, unless the deposit interest rate was negative and expected to remain that way. It should also be noted that, for regulatory reasons, many investors have to hold bonds so it is not a level playing field of choices. There are also short term traders who might feel that they have a chance to make a profit by selling on the bonds they bought at negative yields at an even lower negative yield, but this is pure speculation and, so, a risky course of action. As a company, which has been negative on the outlook for bonds, we must acknowledge that, at times, they have proved to be excellent investments but we believe that the market is dangerously overpriced and that, when a correction occurs, it will prove to be very costly for many bond investors. We would find it impossible, under any circumstances which we could imagine, to buy fixed interest securities on negative gross redemption yields. This is not yet, and almost certainly will not be, the case for UK government bonds. A ten year government bond yield of around 1.6% does not seem an attractive option, even with the yield being positive.

Leaving out property, equities remain the other option, and we continue to believe that this is the right one. This has been called a very reluctant bull market and one certainly cannot accuse investors of an excess of enthusiasm as equities move unevenly upwards, experiencing some significant dips along the way as we saw at times in 2015 and, again, at the beginning of 2016. Each time, they have recovered their poise, suggesting quite a firm undertone, although many people have been reluctant to acknowledge this. Certainly, there is no reason for an excess of enthusiasm but, if monetary policy is to remain very loose, equities should continue to benefit. The reason remains the disparity in yields between equities and bonds in most markets, quite the opposite to what most investors are used to. Over time, dividends can be expected to grow, perhaps at quite a modest rate, given the slow growth in nominal GDP, but that is still an attractive feature when yields or bonds are so low. Equities can even justify higher valuations than in the past if the competition, bonds and equities, offer such poor yields. The test will come when bond yields snap sharply upwards, as they will do at some stage, and we will be monitoring this threat. It is also the likely case that, when bond yields rise and bond prices fall, the latter may not recover as yields will probably not return to the extremely low or negative level at which they stand at present. Shares, on the other hand, are unlikely to be permanently depressed and will continue to offer the prospect of long term capital appreciation, albeit with the usual cycles. This extraordinary economic policy mix, which we are seeing at present, divides opinion on the relative attraction of each asset class but the grudging way in which the market has moved higher, and certainly showing no excessive optimism, is quite comforting for those of us who believe that equities represent the best value amongst the different asset classes. Although the weakness in commodity prices has different implications for producers and consumers, and many of the oil and other commodity producers are facing very difficult times, we continue to believe that low commodity prices are beneficial to the world economy. It is surprising that the benefit of low oil prices has not followed through more in the world economic data but we are hopeful that this will still happen.

Turning to look at various markets, and starting with the USA, we see a stock market which has recovered from a bad start to the year to be ahead of its closing 2015 level by the end of April. The major event this year in the USA, as most people see it at the moment, is the US presidential election, which has developed in a way that not many people foresaw, especially on the Republican side. One must assume that investors are taking a view on the outcome which is a belief that Hillary Clinton will win. She seems to have seen off her very left wing rival, Bernie Sanders, albeit that she has tacked left herself to respond to activists in her party. On the Republican side, the outcome is a victory for Donald Trump. Without wishing to be political in this review, it is fair to say that some of Mr Trump's policies would be met by alarm by investors and others. Punitive tariffs on Chinese imports, for example, would set off a trade war which could threaten an economic depression. However, it is important to bear in mind the checks and balances in the US constitution and that Congress, in the event of the election of a President who could be considered as outside the mainstream of US political views, might put a brake on some policies considered too extreme. Probably of more concern, if one, at this time, makes the working assumption that Mrs Clinton will become the US President, is the increased hostility to business and the finance sector in the USA and elsewhere which may find its outcome in more hostile laws and regulations. Wall Street seems to be under permanent attack but non financial business also. The effective blocking of the Pfizer-Allergan merger by the US Administration because it did not like tax inversions is one example of the more difficult environment in which US business may have to be operating in the future and another is the blocking of the proposed Halliburton-Baker Hughes merger. For the moment, though, it is fair to say that political concerns are not high on investors' minds in the USA.

On the economic front, as the IMF forecasts show, moderate growth in the USA is expected in 2016 and 2017, 2.4% and 2.5% respectively. However, the strong US dollar, although it has weakened somewhat recently, has provided headwinds for corporate earnings which are showing year on year declines, albeit that US corporate profits as a percentage of US GDP still remain high. The IMF supports its forecast by pointing to the improvement in the US government's finances and a stronger housing market which will help to offset the drag on net exports coming from a strong US dollar and weaker manufacturing. Looking at some of the immediate data, the important purchasing managers indices are the right side of 50, the dividing point between contraction and expansion, but not significantly so. The index for manufacturing stands at 51.8 and that for non manufacturing at 54.5. Industrial production figures, as touched upon indirectly by the IMF, showed a month on month decline of just under 0.6% in March and a year on year decline of 2.0%. The Conference Board's index of leading indicators, having fallen in January and February by 0.2 and 0.1 respectively, picked up slightly in March to slow a rise of 0.2. Lowish unemployment, although rising by 0.1% in March to 5.0%, remains a positive feature of the US economy, especially as the labour participation rate is rising. Although the unemployment rate has been falling steadily, some of the gloss has been taken off the figures because of the USA's low labour force participation rate. There is some early promising evidence that the trend is changing.

Perhaps the most interesting economic question in the USA surrounds US interest rates. Mixed signals have been coming from the Federal Reserve. An expected increase last September was deferred until December because of market uncertainty following the Chinese decision in August to widen the trading band of the renminbi. In December, when the first move upwards in US interest rates was made, it was expected that there would be four further increases by December 2016 to a central rate of 1.375%. The market weakness in the early part of 2016, now more or less reversed, reintroduced uncertainty with economic growth forecasts, like those from the IMF, being pared back. Expectations about increases in the size and number of interest rate rises have also been pared back. In normal times, interest rates in the USA would be much higher than they are at present, although still historically low. Pressures are beginning to rise in the labour market so that some level of positive real interest rate would normally be more appropriate than a negative one. From an economic management point of view, at least a partial return to normality is desirable. This is because, at present, with interest rates where they are in most countries, monetary policy is losing its power to influence the economy. They can hardly be cut any more and it is unlikely that quantitative easing can help much more. With a more normal interest rate regime in place, the ability to make a meaningful cut in interest rates could provide a stimulus to an economy in need of one.

Despite the political and economic uncertainties in the USA, the US equity market looks to be one of the safer areas in which to invest. Certainly the market faces headwinds in terms of political uncertainty and a growing hostility towards business, which is evident elsewhere, and some pressure on corporate earnings caused by the US dollar's earlier strength. But within an asset class, equities, which looks more soundly based than others, the USA looks one of the safer areas.

As the IMF's forecasts suggest, life remains very difficult in the eurozone with economic growth forecasts being pared back. With such low growth expected, it is difficult for countries to deal with excessive budget deficits and burdensome levels of outstanding public debt in relation to GDP. One thing is certain and that is that there is absolutely no reason for complacency in the eurozone just because the euro seems to have been temporarily saved. It is almost certain that there is going to be another crisis. Compounding the problems for eurozone policy makers is the increasing opposition to austerity policies being applied in the name of supporting the euro. In a situation where each country had its own currency, the currency level would, amongst other things, reflect each country's relative inflation position and would act as a safety valve. Policies would be applied, as necessary, where the currency sent out the relevant signals. So, for example, a country showing a high level of inflation would be likely to experience currency depreciation which would maintain its competitiveness even though requiring tough policy measures to bring inflation back under control. In the eurozone, with no currency flexibility, the safety valve does not exist. If a country becomes uncompetitive, the symptoms in the form of a deteriorating current account, slower growth, rising unemployment and a deteriorating budgetary position will show. Becoming more competitive will involve an internal devaluation such as was imposed on Greece by its creditors. Competitiveness will attempt to be restored by forcing down costs through, for example, pay cuts. In a country with a freely floating exchange rate, automatic stabilisers can work with the budgetary position reflecting the state of the economy. So, for example, in an economy suffering a recession or very low growth, the government will see its tax take under pressure and its spending pushed up by additional social security payments. The larger budget deficit will therefore provide a counter cyclical benefit to the economy. On the other side of the coin, if an economy is growing strongly and overheating, the tax take might be strong and social security payments reduced but the improved budgetary position would not be used to boost the cyclical upswing because overheating and inflation would follow. The euro is having the opposite effects. Fiscal policy, being determined by budget deficit targets, is exacerbating countries' economic problems. The anti austerity protests gathering pace in the eurozone are a result, amongst other things, of the attempt to support the euro, although not directly framed in that way. This is not to make a political point, it is merely to point out the consequences which arise in a monetary union when the component parts are performing so differently economically. Those who have experienced above average inflation and have therefore lost competitiveness cannot rely on a weakening exchange rate, relative to other members of the currency union, to help them out. The political aspect of this is that if in one or more of the larger eurozone economies, the anti austerity parties gain control and repudiate their predecessor's policies, there is a major challenge to the project. If a relatively small country like Greece can cause convulsions in the eurozone, a larger one could well cause the eurozone to diminish in size or break up. Recent election results in Spain, Portugal and Ireland show that the consensus is cracking.

So, we note that the IMF is not currently seeing much change in the eurozone's growth rate in 2016 or 2017 compared with 2015 and, if these low growth forecasts turn out to be correct, it is not going to make inroads into the debt problems of over-indebted eurozone countries. The high level of debt holds back growth because of interest costs on the debt and the perceived need to bear down on debt levels. One reason why burdens have to be addressed, and which does not attract the attention it should, is that when interest rates start to rise, as they will have to do at some stage, the servicing costs of the debt will gradually rise and this will impose even greater burdens on government finances in the affected countries.

Closely followed data like the purchasing managers indices are consistent with the modest growth expected from the eurozone. The latest composite purchasing managers index for the eurozone stands at 53.0, a small but not insignificant margin over the 50 level divide between growth and contraction. Within that, the dominant services index stands at 53.2 whilst the smaller manufacturing index only just made the growth criterion at 51.5. Unhelpfully for the eurozone, the euro has been rising against the US dollar. One can always rationalise a currency movement after the event. In the case of the euro, it can be pointed out that the eurozone runs a healthy current account surplus of over 2% of GDP and that prospects for US interest rate rises are considered less certain than before. But, if the euro had fallen, it would have been equally possible to rationalise that in terms of negative interest rates and political worries. Whilst the negative yields on a wide range of eurozone bonds make that asset class very unattractive to us on a fundamental view, it does highlight the relative attraction of eurozone equities where dividend yields compare very favourably.

The IMF's forecasts show how difficult the position in Japan remains. As in the eurozone, extreme monetary policy is being applied to try to get the economy moving and to move inflation towards the target level of 2% but the Bank of Japan is having little success in this respect. The move to negative interest rates represented a significant attempt to weaken the currency but, as explained earlier in this review, when others are also practising this policy, the results can be unpredictable. A strong yen, of course, exerts downward pressure on inflation, the last thing the Japanese authorities want to occur. It is a very difficult position for policy makers, made more complicated by the planned introduction of the second part of the consumption tax increase in April 2017 which would take it to 10%. The need to address Japan's budgetary and public debt problems is urgent. The budget deficit is expected to be over 6% of GDP this year and outstanding public debt as a percentage of GDP stands at around 230%. Japan's demographics are awful which makes the need to get on top of the country's debt problems urgent. The best way to make inroads into a country's debt problem, as we said earlier, is for a country to achieve a decent growth rate as this benefits the expenditure and income sides of a country's financial account. The problem in Japan is that years of deflation have made consumers reluctant to spend because goods and services which were not essentials needing to be purchased immediately could wait, thereby imposing a downward pressure on demand and, hence, growth. To change this mindset of consumers, the government and Bank of Japan need prices to be rising so that it is no longer worth delaying the purchase of goods and services in the hope of purchasing them more cheaply. Japan is a major energy importer and, in most countries, the sharp fall in the oil price would be a boon but, in Japan, it has frustrated the policy of bringing some inflation into the system. Perversely, although for reasons explained earlier, the yen has risen, unhelpful if the policy is to introduce or raise inflation in an economy. A rise in consumption tax will have a one off effect on the inflation level but past experience is that it makes Japanese consumers even more cautious. The latest Japanese consumer price index shows a rise of 0.3% year on year and several monthly figures recently have been negative. As we see from the IMF's latest economic forecasts, it thinks there will be little growth this year, 0.5% and a recession next year, -0.1%. The latest purchasing managers indices are not encouraging with the composite level standing at 49.9. Industrial production is weak and, in March, it was 5.2% lower than the previous month's level and 1.2% lower on a year on year basis. The latest Tankan business confidence survey has also fallen slightly from 9 to 7. The Bank of Japan is going flat out in using monetary policy to stimulate the economy through quantitative easing and negative interest rates and, as we saw from the table at the beginning of this review, Japanese ten year government bond yields are in negative territory. With the fiscal position very poor and disappointing progress on structural reform, monetary policy has had to do a lot of heavy lifting. We have said in previous reviews that the jury is out on Abenomics but it now has to be said that recent developments have not been encouraging.

With China now the world's second largest economy, attention is naturally increasingly focused on it. The latest quarterly GDP figures to the end of March show a 1.1% rise in GDP and a year on year rise of 6.7%. Some observers have their own lower projections of growth. China is a heavily borrowed country domestically in terms of private and public debt and this is a concern for the ramifications of high debt levels inevitably bear down on an economy in obvious ways, such as borrowers being concerned about the debt burden and reining back on their economic activity, caution caused by the cost of servicing debt, especially if it is expected that interest rates will rise and, for lenders, particularly the banks, that they will be caught out by a rise in bad debts. Over leveraging and concerns about the Chinese banking sector are a big background worry about China. The Chinese government is trying to manage a major transformation away from investment and exports and towards consumption and services to improve the quality of growth, albeit that it is unlikely that the Chinese economy will revert to the double digit growth rates which it achieved in the recent past. Because of the nature of the political system in China, action can generally be taken quickly to try to influence policy and the central bank still has some ammunition up its sleeve to loosen monetary policy as bank reserve requirements are still relatively high and can continue to be eased. It was, of course, China which started off the volatility in markets last August when it widened the trading band for the renminbi, leading those of a negative persuasion about the Chinese stock market and economy to believe that this was a devaluation caused by concerns about the state of the Chinese economy. The official line was that it was to increase the market orientated credentials of the currency in preparation for its entry into the IMF's Special Drawing Rights basket of currencies, which duly happened. Movements in foreign exchange reserves raised fears about a flight of capital from China but now things have quietened down with a recovery in the renminbi (which has caught out some investors) and foreign exchange reserve levels. For the moment, concerns about China have subsided from their highest levels and data emanating from the country will be monitored closely. In relative terms, it remains a bright spot. Meanwhile, China continues to be acquisitive overseas as Chinese companies build up their portfolio of assets, sometimes running into protectionist opposition, something highlighted in the US Presidential candidates' campaign but also in relatively free market Australia where opposition has developed to the proposed Chinese acquisition of more Australian farmland.

Finally, we turn to the UK where nearly all the focus is upon the 23rd June referendum on whether to remain in or leave the EU. Although one cannot be sure, it seems highly likely that sterling's weakness early in 2016 was caused by uncertainty about the outcome of the vote. It is not necessarily a judgement on whether it would be a good idea to remain in or come out of the EU but, rather, that markets do not like uncertainty. The pound has, however, staged a modest recovery, rising against the US dollar over the past three months although falling against all of the other major currencies But, unless the opinion polls show a decisive move one way or the other before the referendum, it is reasonable to expect some caution in UK markets.

Data from the UK suggests that the economy has slowed down modestly so far this year. Depending upon their view of whether to remain or leave the EU, economists have either interpreted the slowdown as due to Brexit fears or something else. First quarter GDP growth came in at 0.4% over the previous quarter to give a year on year rise of 2.1%. The purchasing managers index data has been weaker. The latest index for manufacturing fell below the 50 mark in April to stand at 49.2 (50.7), whilst that for construction eased back to 52.0 (54.2). In the important services sector the index fell to 52.3 (53.7) and overall the composite index fell to 51.9 (53.6). One issue we have often highlighted as a potential vulnerability for the UK's currency is the country's large current account deficit. This has to be financed and therefore it is vital that confidence in the UK remains high so that the UK is considered a good country in which to invest or to lend to. In the final quarter of 2015, the current account deficit was running at a barely sustainable 7% of GDP and, for the year, at 5.3%. Against this sort of background, which suggests at least some temporary softness in the UK economy, it is paradoxical that, in the propaganda war being fought in the EU referendum campaign, those opposing Brexit have a vested interest in promoting scare stories about what would happen to the UK economy in the event of Brexit which could make the current situation worse. Although the UK economy is performing relatively well, there are areas of concern, including the twin deficits, current account and budget, so sentiment is likely to remain fragile in the run up to the vote with an increasingly angry war of words being waged by both sides of the argument. As always, in our investment policy, we favour a broad geographical spread of investments to diversify the risks and the EU referendum is raising the risk profile of the UK.

We have seen no evidence so far this year to make us want to change our year end assessment that international equity markets would move modestly higher over the year but that, in between, there would be some difficult and negative periods of performance as a result of the disturbed political and economic background. Desperate monetary policy measures, which have pushed an important part of the European and Japanese government bond markets (but not those in the UK) into negative yield territory have made this asset class even more dangerously over priced. With very low inflation and modest economic growth forecast, nominal GDP growth will be low with implications for companies' revenues, profits and dividends but, in such a low inflation environment, investors must be realistic in their expectations for returns. Low nominal returns may still mean positive real returns, the investment objective for investors.

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