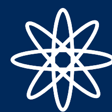

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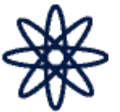
ASSET MANAGEMENT (C.I.) LIMITED



Investment Memorandum

For equity investors, it has been a poor quarter, although sterling based investors with substantial overseas assets were cushioned very significantly by the strength of foreign currencies against sterling, sterling having endured a very weak quarter. Good quality bonds performed well whilst commodities fell back from peak levels.

The tables below detail relevant movements in markets :

International Equities 30.05.08 - 29.08.08

Total Return Performances (%)

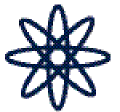
Country	Local Currency	£	US$	€
Australia	-7.7	-9.6	-16.6	-12.0
Finland	-11.2	-8.9	-15.9	-11.2
France	-10.4	-8.1	-15.1	-10.4
Germany	-9.2	-6.8	-14.0	-9.2
Hong Kong, China	-17.5	-10.6	-17.5	-12.9
Italy	-13.9	-11.6	-18.5	-13.9
Japan	-11.1	-6.3	-13.5	-8.7
Netherlands	-11.9	-9.6	-16.6	-11.9
Spain	-13.2	-10.9	-17.7	-13.2
Switzerland	-4.2	-1.3	-8.9	-3.8
UK	-5.9	-5.9	-13.1	-8.3
USA	-7.7	N/C	-7.7	-2.6
Europe ex UK	-11.0	-8.6	-15.7	-11.0
Asia Pacific ex Japan	-14.1	-12.0	-18.8	-14.3
Asia Pacific	-12.6	-9.1	-16.1	-11.5
Latin America	-21.6	-15.5	-22.0	-17.7
All World All Emerging	-18.1	-13.2	-19.9	-15.5
The World	-9.6	-4.8	-12.1	-7.2

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : 3.9%

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

Currency	30.05.08	29.08.08
Sterling	4.98	4.48
US Dollar	4.05	3.83
Yen	1.74	1.42
Germany (Euro)	4.45	4.17



Sterling's performance during the quarter ending 29.08.08 (%)

Currency	Quarter Ending 29.08.08
US Dollar	-7.7
Canadian Dollar	-1.6
Yen	-5.1
Euro	-2.6
Swiss Franc	-3.0

Other currency movements during the quarter ending 29.08.08 (%)

Other Currency	Quarter Ending 29.08.08
US Dollar/Canadian Dollar	+6.7
US Dollar/Yen	+2.8
US Dollar/Euro	+5.5
Swiss Franc/Euro	+0.4
Euro/Yen	-2.6

Significant Commodities (US dollar terms) 30.05.08 – 29.08.08(%)

Significant Commodities	30.05.08 – 29.08.08
Oil	-1.11
Gold	-6.0

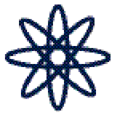
Markets

It has been a poor quarter for international equity investors although for sterling based investors who have international portfolios the effect has been somewhat mitigated by currency gains on the translation value of overseas assets, sterling having performed very poorly over the quarter. In local currency terms, the FTSE World Index has shown a total return of -9.6%, in sterling terms -4.8%, in US dollar terms -12.1% and in euro terms -7.2%. In local currency terms, areas of underperformance have been Europe ex UK, Japan, Asia Pacific ex Japan, Latin America and emerging markets whilst those holding up better than average were the UK, USA and Australia. In sterling terms, the strong recovery of the US dollar means that the FTSE USA Index showed no change in performance over the quarter. Within the Europe ex UK region, Switzerland held up particularly well showing a negative return in sterling terms of just 1.3%.

Bonds performed well over the quarter. As measured by the gross redemption yields on ten year government bonds, those on sterling bonds have fallen by 50 basis points to 4.48%, those on US dollar bonds by 22 basis points to 3.83%, those on yen bonds by 32 basis points to 1.42 and those on German government euro denominated bonds by 28 basis points to 4.17%.

Perhaps the most interesting moves this quarter have been in the currency markets where the dollar has shown a strong rebound and sterling has fallen sharply. Against the US dollar, sterling has fallen 7.7%, against the yen by 5.1%, against the Swiss Franc by 3.0% and against the euro by 2.6%. Perhaps reflecting the fall in commodity prices, the Canadian dollar, although rising against sterling, has been relatively weak with the US dollar showing a rise of 6.7% against it over the quarter.

In the commodity markets, prices retreated, at least temporarily, with oil falling by 11.1% and gold by 6.0%.



Economics

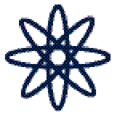
- *"Stagflation" raises its head* ...... the type of inflation we are now seeing can be difficult to contain because some of it is "cost push" driven.
- *There is some relief from commodity price inflation* ...... commodities are well off peak levels although it remains to be seen whether this is more than a temporary respite.
- *Central banks continue to follow different policy paths* ...... at one extreme is the US Federal Reserve with its aggressive rate cutting policy whilst, at the other end of the spectrum, the ECB which has recently raised interest rates.
- *The housing market has caused problems for certain economies* ...... those of the US housing market, the first into the downturn, are well documented but they have been joined by those in the UK, Spain and Ireland. The downturns exert a negative wealth effect on the economies in question.
- *Investors need to be aware of populist politicians in an economic downturn* ...... whether it is protectionism dressed up as nationalism in the USA and Europe or "windfall" taxes on energy companies proposed by some backbench MPs as a cheap way of buying popularity in the UK, there are potentially damaging economic consequences.

USA

- *Some modest cause for optimism* ...... the USA was the first into the economic downturn, now it look as if it may the first out of it.
- *Second quarter growth is revised upwards to a better than expected 3.3% annualised growth*...... net trade, a lower than first estimated drawdown on inventories and a rise in personal consumption more than offset the drag of a weak housing market
- *The Federal Reserve is certain to want to normalise monetary policy as soon as it can* ...... but its statement at its August meeting showed it still had enough concerns about downside risks to the economy to hold its fire on any interest rate increase.
- *The recovery of the US dollar is helpful* ...... but in the battle against inflation its importance should not be overemphasised as the US economy is a relatively closed one
- *Inflation remains the reason why the Federal Reserve would want to raise interest rates as soon as it sensibly can* ...... the latest headline consumer price index figure is 5.6% year on year and the core figure is 2.5%. The Federal Reserve's preferred inflation measure is 0.3% over the top of its target range.
- *Some modest glimmers of light in the housing market*...... the situation is still bad but the news on pending home sales, new home sales and inventory levels gives very modest cause for optimism.
- *A change in the economic news flow indicates the possibility of the second quarter's recovery being extended* ...... a number of the individual items of economic news were positive.

Japan

- *The economic slowdown has affected Japan* ...... a contraction of 0.6% in the second half almost offset the 0.8% gain of the first quarter.
- *The government downgrades its assessment of the economy to "deteriorating"* ...... the composite index of coincident indicators falls to its lowest level since it was established in 2005.
- *But the China story is a long term positive feature for Japan* ...... in July, it became the largest destination for Japanese exports which are still rising strongly to China.

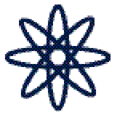


Europe Ex UK

- *Growth judders to a halt in the eurozone ......* the second quarter is estimated to have seen the eurozone economy contract by 0.2% after 0.7% growth in the first quarter. That leaves the year on year growth at 1.5% compared with 2.1%.
- *The German and French economies perform poorly in the second quarter ......* they contract by 0.5% and 0.3% respectively
- *The ECB remains disturbed by inflation ......* although the year on year consumer price inflation figure fell to 3.8% in June, down from 4.0% in August, it is still almost double the ECB's target.
- *With inflation at this level, there is no doubt that the ECB would like to raise interest rates ......* the ECB President talks about the ECB having "only one needle to its compass", price stability "not two needles", prices and growth like the US Federal Reserve. However, the ECB has had to take into account a "materialisation of risk" to economic growth since its previous meeting.
- *Individual items of eurozone data have been negative ......* unlike the USA, there have very few positive signals although the retreat of the euro against the US dollar will be helpful.
- *The "one size fit all" monetary policy is being severely tested ......* widely differing inflation rates as well as government bond yields point to stresses and fault lines with the euro project.

UNITED KINGDOM

- *It is difficult to find any grounds for optimism about the UK economy ......* nearly all the pointers are negative and the slide in sterling reflects what foreign investors think about the UK.
- *Although the international situation has aggravated the UK's problems, the majority of the problem is self inflicted ......* the huge increase in public expenditure, way beyond the ability of the UK economy's potential growth rate, has left public finances in a dire position with no room to take counter cyclical reflationary measures.
- *It is unlikely that sterling will continue to fall ......*for a long time, it has been overvalued but with a large current account deficit and changed foreign attitudes to the UK economy, the currency could well undershoot as currencies tend to do. There is no obvious support for the currency.
- *Growth came to a halt in the second quarter ......* this makes the Treasury's forecast, made at the time of the last Budget, look even more fanciful. The rate of growth this year, forecast to be 1.75% – 2.25% and, for next year, 2.25% – 2.75%, used to support projections for government borrowing has no chance of being met. This has severe implications for public finances.
- *The standstill in the UK economy has raised expectations of an early cut in UK interest rates ......* we consider this to be a very dangerous course of action if it is taken. Inflation is still too high, 4.4% in the consumer price index and 5.0% in the Retail Price Index and a premature cut risks an even greater fall in sterling which, because the UK is a relatively open economy, risks exacerbating inflation.
- *The housing market is in decline and it is unlikely to recover in the near future ......* the lack of mortgage finance is having a serious effect on the market and will create a negative wealth effect amongst consumers.
- *A UK recession is looking increasingly likely ......* amongst the unpleasant side effects will be an increase in unemployment.
- *Bonds continue to look unattractive ......* the yields on medium and long dated issues are unattractive measured against inflationary prospects and substantial new issuance to fund the large internal financial deficit of the government.
- *Many UK companies have substantial overseas business......* they should be a good way to play the falling pound.



CHINA

- *After the Olympics, attention returns to the economy* ...... inflation and growth will be the issues.
- *The latest news on consumer prices, which were well over target, is better* ...... July's year on year increase in inflation was down to 6.3% from 7.1% in June. The authorities will wait to see if this spreads to consumer prices.
- *However, the economy remains very buoyant by international standards although it has slowed which, provided the trend does not go too far, should help control inflation* ...... as evidence of continuing strength in the economy exports in July were 26.9% higher than the previous year.

SUMMARY

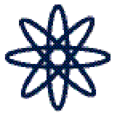
- *A world recession is unlikely* ...... growth will be patchy.
- *This will continue to affect the outlook for corporate earnings* ...... but low equity valuations should be able to accommodate this outlook and we think there is some good value around.
- *Bonds continue to look expensive* ...... yields are unrealistically low in this inflationary environment.
- *More volatility is likely in currency markets* ...... sterling continues to look vulnerable.

The issues, which have captured the headlines for many months, continued to dominate in the last quarter although the nuances may have been different in some cases such as commodities, for example, where prices have eased back from their highest levels.

The main issues remain problems in the financial markets which have led to a credit crunch, slowing or even negative growth, inflation and rising energy and food prices. In the financial markets, losses and write downs have been reported by many financial institutions and capital raising exercises continue to occur as banks try to repair their balance sheets. Difficulties in the money markets mean that funds available for lending have been restricted and, where they are available, they are often more expensive. Evidence of stress in the money markets can be observed in the continued wide spread between official rates and money market rates. Those whose borrowing rate remains tied to money market rates continue to pay a higher rate than would otherwise have been expected. Banks' lending criteria have also been tightened considerably. An example near to home of this is the return to what one might call old fashioned lending criteria in the UK mortgage market where loan to value ratios have been reduced and deposits required. The effect on the UK housing markets has been dramatic. US, UK and European banks have mainly been affected by these problems, those in the east have largely avoided them.

The reduction in the availability of finance has inevitably affected economic growth, which is slowing almost everywhere, even in China, although it still remains at a very high level there. But patterns are different with the USA showing some tentative signs of recovery whilst the eurozone and UK have effectively come to a halt.

"Stagflation", a phenomenon as unpleasant as the sound of the word, is increasingly mentioned in the current economic context. As its name suggests, it reflects a stagnant economy coupled with inflation, a difficult combination to tackle for economic policymakers. Normally, if an economy is in a period of negative economic growth, is flat or only growing slightly, inflationary pressures should ease. Two types of inflation exist, cost push and demand pull. If prices are being pulled upwards by excessive demand, then economic policymakers should be able to deal with this by tightening fiscal and/or monetary policy. The appearance of an output gap, meaning that the economy has some spare capacity, would normally be effective in bearing down on inflation. Wages would respond to weaker employment market conditions whilst companies' pricing power would be lessened. However, this linkage could be complicated when there are "cost push" factors which will not so easily respond to lower demand in the economy. In the present situation, food and energy come to mind. Factors such as land being set aside for biofuels or changing tastes because of rising living standards in, say, China provide an impetus for higher prices irrespective of the state of the world economy. In the oil market, the existence of the OPEC cartel,



accounting for about 40% of production, distorts the price mechanism. In the private sector, most competition authorities would never countenance such a situation but, of course, there is nothing that they can do here. OPEC production as a percentage of the world's output has been rising and, to some extent, consumers depend upon the goodwill of OPEC members, most of whom are moderates but not, of course, all of them.

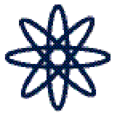
"Cost push" inflation is hard to deal to deal with. Of course, if fiscal and/or monetary policy is applied very fiercely, it should weaken inflationary pressures. But the political cost of doing so would be unacceptable for most governments since it would involve creating a recession and sharply rising unemployment. Although one might think that the oil producers hold all the cards, moderates amongst OPEC members, which have vast oil reserves, are also aware that, if the oil price is driven too high, it will accelerate the search for alternative energy sources which, if successful, could damage the value of the oil in the ground for future generations. For example, after the oil crisis of the 1970s and early 1980s, the search for more energy efficiency was intensified so that, now, energy intensity of production in countries like the USA and UK is about half of what it was in the early 1970s. The drive will be intensified by current high oil prices. An example of further progress is in the next generation of wide bodied aircraft from Boeing (the 787) and Airbus Industrie (A350 XWB) which, because the aircraft are going to be lighter, should be 20% more economical to run.

Although commodity prices remain high, they have fallen substantially from their peak earlier this year (about 22% at the time of writing). Given the magnitude of rises which we have seen, the resilience of the world economy to absorb them is impressive. In earlier times, they would have been absorbed much less well and inflation would have been much higher.

The difficulty of dealing with the current type of inflation, with the issue being clouded by the problems in the financial markets, is shown by the different approaches to monetary policy amongst major central banks. At the most extreme end of the spectrum is the US Federal Reserve where, because it has a much wider mandate over the whole economy, it has been prepared to cut interest rates so sharply that real interest rates are significantly negative in the economy. This would normally be considered a big risk mainly for inflation but also for the currency where interest rate differentials would compare unfavourably with those in other centres. But, as we will see later, the Federal Reserve's approach, unorthodox as it is, may be bringing some success in that, amongst the negative indicators, there are some positive ones, unlike the situation in many other large economies. Furthermore, which will please the Federal Reserve, the US dollar has staged a sharp recovery thus giving modest help in restraining inflation.

At the other end of the spectrum, the ECB has followed a strictly orthodox policy although not to extreme ends which would surely have entailed higher interest rates than 4.25%, given the current level of eurozone inflation, 4%. The largest gesture to the difficult financial market conditions prevailing was what it did not do, namely raising interest rates further into rising inflation levels, now just over twice the level of the top of its target inflation range. Nevertheless, out of the largest central banks, it is the only one to have raised interest rates during these troublesome times in financial markets. However, its decisions are probably the most difficult ones to make given that it has to set a rate for fifteen countries and conditions vary greatly within the eurozone. Its task has been made even harder now because the eurozone, after surprisingly strong first quarter growth, has ground to a halt in the second quarter. However, one gains the impression that its thinking is heavily influenced by what is happening in the largest eurozone economy, Germany, and the news from there on pay settlements is not what the central bank wanted to hear. The counterpart of the US dollar's recent strength has been weakness in the euro, although not against sterling. Investors have taken notice of the slowdown in eurozone economic activity and the possibility of an improvement in US economic prospects and this has resulted in US dollar strength.

Somewhere between these extremes lie the UK and Japan central banks. Reluctantly, one feels, the Bank of England has cut interest rates to 5% in recognition of financial market conditions. There have been divided views in the MPC including three different ones reflecting every option. Although it has been surprised at the extent of the weakness in the UK economy, inflation remains a major consideration for it with the level approximately twice the target range. An increasingly important consideration for the Bank of England will be sterling. The openness of the UK



economy renders it vulnerable on the inflation front to a sliding currency. Its much more restrictive mandate than that of the Federal Reserve means aggressive interest rate cuts to kick start the economy are out of the question.

The Bank of Japan has, for a long time, wanted to follow a more normal monetary policy than the one implied by a 0.5% official interest rate but has been prevented from doing so by the presence of deflation. Now some inflationary influences are apparent in the various price indices but its hands are tied by a reduction in Japanese growth forecasts so plans for a more normal monetary policy are on hold.

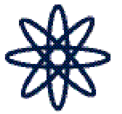
In these contrasting approaches to monetary policy, the US is aided by its more flexible employment market. It responds more quickly to changing economic conditions and this is a positive factor for those setting monetary policy because they can feel more relaxed about pay rises reflecting market conditions. The situation in the eurozone is different. Labour markets are sticky and unresponsive, in some cases, to economic conditions. In this respect, the ECB is concerned about the level of pay increases in Germany, the latest one being at Lufthansa following industrial action. Whilst it is one of the strongest airlines around, the ECB will be concerned at the spill over consequences. The relative inflexibility of the European labour market is a negative for eurozone monetary policy makers and is an argument, other things being equal, for a more robust interest rate policy than, say, the one followed in the USA.

So, against the rather difficult economic background, which we now see, what will turn it round and enable the world economy to point in a more promising direction which it will do at some stage? Lower inflation will be one help. If commodity prices were to fall sharply and be reflected in consumer prices, disposable incomes would rise and consumer spending increase. That would feed through to the corporate sector. We do not know that they will fall but insofar as rising agricultural commodity prices, for example, encourage additional production and the end markets are not distorted by protectionist measures, prices should eventually reflect additional production.

Where housing markets have been depressed – one thinks of the USA, the UK as well as Spain and Ireland, a recovery would reverse the negative wealth effect created by lower house prices. In the USA, the very competitive level of the US dollar has helped to stimulate demand for US exports which has provided some offset to the damage to the economy caused by the weakness in the US housing market. We will see later on, in our discussion of the US economic situation, that there are glimmers of hope for that market which entered a downturn first. If the US housing market does start to show signs of recovery soon, the effect on confidence is likely to be significant.

This is not a likely prospect for the UK in the foreseeable future. Prospects for the housing market are poor. The UK housing market has been in a bubble for some time, sustained by plentiful and cheap loans. Finance for house purchase is much less plentiful and it is dearer. The result is that the volume of transactions has fallen heavily and, where they are taking place, are generally at lower price levels than a year ago. The industries allied to the housing market are suffering and those who have a mortgage on their house are suffering a negative wealth effect. This affects their spending which has a reverse multiplier effect on the economy. Where the UK differs from the USA is that it has only recently entered this phase of the cycle. As far as we can see, this negative influence on the UK economy is set to intensify whereas it is possible that the US is at or has passed the position of maximum pain from this source. Within the eurozone, Spain and Ireland are experiencing severe pain in the housing market. Because they ceded control of monetary policy to the ECB when they joined the euro, they will not have this weapon to hand to counter the weakness. The effects of the weakness in the property market will be felt throughout their respective economies.

At times like this, investors have to be aware of politicians peddling dangerous populist policies in search of votes or seeking to divert attention from themselves to lay the blame elsewhere. Whilst it is tempting to ignore politicians' rhetoric, it can be dangerous. One only has to remember how, in France, the 35 hour week grew legs. It seemed to be lobbed in as an afterthought but came to be embedded in legislation as a right and, as expected, it has proved damaging to the French economy which has been losing competitiveness to Germany.



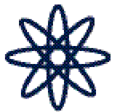
In the USA, the Democrats are espousing protectionist policies whilst, in the UK, some government MPs are pressing for a "windfall" tax on energy companies' profits, seemingly oblivious of the damage such action would cause. Apart from the obvious economic damage caused by protectionism and the arbitrary and capricious taxation of companies which damages the affected companies' share prices and the wealth of all those invested in them, it sends out a negative external message. If we take the UK, where the currency is weak, a positive message needs to be sent out. The UK has a large current account deficit which needs to be financed and to encourage foreign investment either directly or through acquisitions which could create a demand for sterling, it needs to be seen as a reliable place to do business. Positively for the UK, it has maintained a liberal and far sighted policy towards foreign acquisitions of UK companies, generally with none of the nationalism exhibited in countries like France and Germany and, to a lesser extent, the USA. If a new Administration in the USA takes protectionist measures aimed at, say, China or tries to undo NAFTA, the USA will become a less attractive place in the eyes of foreign investors. Similarly, countries which show unreasonable and protectionist opposition to Sovereign Wealth Funds could suffer economically. So, whilst it is natural that economic thinking should dominate investors' minds, the politicians also need careful monitoring.

Of the major industrial economies, the USA has the most cause for optimism although from a low base. The second quarter benefited from the Administration's fiscal stimulus package. The Commerce Department provided investors with a pleasant surprise when the latest estimate of second quarter growth was raised to an annualised rate of 3.3%. The upwards revision to the previous estimate of 1.9% was due to a downward revision of inventory drawdowns. Exports grew more strongly than originally estimated whilst imports fell more steeply. Consumer spending was slightly stronger than expected. Housing remained a significant drag on the economy. There was a significant downward revision of growth in the final quarter of 2007 where the previously reported growth of 0.6% was revised to a decline of 0.2%.

In keeping interest rates unchanged at its August meeting, the Federal Reserve's statement really made only nuanced changes to its previous remarks. It removed comments about diminishing downside risks and was less confident about consumer spending. It indicated that it felt it had done enough to deal with the risks to growth and highlighted its activity in maintaining liquidity in the money markets. It expressed uncertainty about the inflation outlook using the words "highly uncertain".

Having followed such an aggressive interest rate policy, which had led to negative real rates, the Federal Reserve will be keen to see that the risk to inflation, which would normally be highlighted by economists, does not materialise. It will gain modest encouragement from recent strength in the US dollar which will help to contain the prices of imported goods. The latest figures for inflation in the USA show that headline consumer price inflation in July rose by 0.8% over the month and by 5.6% over the year. The increase in core inflation for the month was 0.3% to give a year on year rise of 2.5%. At the producer price level, the monthly rise for July was 1.2% whilst the year on year rate was 9.8%. The increase in the core producer price index for the month was 0.7% with a year on year increase of 3.5%. Finally, the Federal Reserve's preferred measure, the core personal consumption expenditure index, showed a year on year rise of 2.3% which is above the top end of its target range, 2%. In the near future, the recent fall in energy prices should provide some short term relief but the reason for the Federal Reserve's concern is obvious even though the short term emphasis is on stimulating the economy. The Federal Reserve will want to move towards a more normal monetary policy as soon as it can. With Europe stalled, reasons for some optimism about US growth and the possibility of a narrowing interest rate differential against the euro, we would not be surprised to see further strength in the dollar.

For many quarters, the weakness of the US housing market has been a drag on economic growth and will have been one of the factors influencing the Federal Reserve's interest rate policy. Whilst the situation is still bad, there are just glimpses of better times ahead. The National Association of Realtors' index of pending home sales rose by 5.3% in June. This index relates to contracts signed but not completed. Figures for US housing industry new construction fell by 11% in July and building permits fell by 18%. Single family housing starts fell by 2.9% in



July. Some very modest encouragement can be drawn from evidence of a slowdown in the rate of price falls. The Standard & Poors/Case-Shiller house price index for June showed an annual decline of 15.9%. This covers twenty leading US metropolitan areas. The index indicates a moderation in the rate of decline to a monthly figure of 0.5% in June compared with 2.0% earlier this year. According to the Commerce Department, new home sales rose by 2.4% in July, albeit from a June level which had been revised down. A prerequisite for a better housing market is a more stable balance between the supply and demand for houses with a six month inventory in the past having been considered an equilibrium level. Although well above that level, the July inventory level of 10.1 months showed an improvement on June's figure of 10.7 months. So, amongst all this data, there are some glimmers of better times ahead.

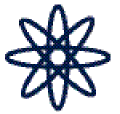
Individual items of news from the US economy have been mixed but there have been enough positive signals to suggest that a more encouraging trend is emerging. On the negative side, unemployment rose to a four year high in July. This was the seventh consecutive monthly increase. In the manufacturing sector, the ISM purchasing managers index fell slightly to 50. US incomes rose by just 0.1% in June, the lowest rate in over a year. Positive news items include an improvement in consumer sentiment. The Reuters/University of Michigan survey of consumer confidence rose slightly between late July and early August from 61.2 to 61.7. Interestingly, there was a fall in inflation expectations for one year forward from 5.1% in July to 4.8%. The Conference Board's indicator of consumer confidence rose sharply in August to 56.9 from 51.9 in July. In manufacturing, factory orders rose by 1.7% in June compared with a gain of 0.9% in May. There was a strong rise in personal spending in June, helped by tax rebates, of 0.6%. There was encouraging news in productivity, important if inflation is to be contained. The second quarter's annualised growth rate of productivity was 2.2% and the annualised unit labour cost increase was 1.3%, also an encouraging sign in relation to inflation prospects. We have noted that export growth, resulting from the competitive level of the US dollar, has helped to drive the economy forward despite a difficult international environment and the problems in the US housing market. The trade figures for June showed the trade deficit falling from US$59.2 billion in May to US$56.8 billion in June with exports up 4% whilst imports were up just 1.8%. US durable goods orders were stronger than expected in July, rising by 1.3%, the same as the upwardly revised figure for June.

Although Japan benefits from its important trading links with China, it has not been immune from the slowdown in the world economy as recent data shows. GDP in the second quarter contracted at the sharpest rate for seven years. Over the quarter it contracted by 0.6% wiping out most of the growth for the calendar year, the first quarter having grown by 0.8%. In August, the Japanese government downgraded its assessment of the economy to "deteriorating". This downgrading reflected a fall in the composite index of coincident indicators by 1.6 points to its lowest level since the index was established in 2005. The index of leading indicators fell by 1.7 points in June.

Notwithstanding the more gloomy news from Japan, an important benefit for the country, which is likely to be present for the foreseeable future, is its strong trading links with China. In July, it became the largest destination for Japanese exports, overtaking the USA. In July, exports to China rose by 16.8% whilst those to the USA declined by 11.5%.

Although the economy is subdued at present, one of the advantages of investing in Japan is that it provides one way of playing the China investment story in a relatively low risk way and modest exposure to this market remains desirable.

We move on now to the eurozone where the brakes have been slammed on sharply in the second quarter. Second quarter growth is estimated to have been negative by 0.2% to give year on year growth of 1.5% with the respective figures for the first quarter at 0.7% and 2.1%. The poor performances of the German and French economies have heavily influenced these figures. After growing by 1.3% in the first quarter the German economy contracted by 0.5% in the second quarter to give year on year growth of 1.7%. In France, growth of 0.5% in the first quarter was followed by a contraction of 0.3% in the second quarter to give year on year growth of 1.1%. Inflation, as we discussed earlier, remains well over target, in fact twice the target level. Although headline eurozone consumer price



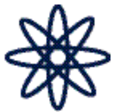
inflation was 0.2% lower in July than June, the year on year figure was 4.0%. At the core level, prices fell by 0.5% in July to be 1.7% higher than a year earlier. German prices rose by 0.7% in July to give a year on year increase of 3.5%. In France, the respective figures were -0.3% and 4.0%. But there are some disturbing year on year figures for the ECB to consider when they set interest rates. The latest figure from Belgium is 5.9%, 5.8% from Luxembourg, 5.3% from Spain, 4.9% from Greece and 4.3% from Finland. At the lowest end of the scale is the Netherlands at 3.0%. Producer price figures for the eurozone showed a month on month rise in June of 1.0% and a year on year rise of 8.0%. The latest figures for August, just released, show the year on year figure falling to 3.8%.

As we saw from the Federal Reserve's last statement when keeping interest rates unchanged, it left itself plenty of flexibility although most observers understand that it would like to normalise interest rates as soon as it safely can. As we have also noted, the ECB is constrained by its inflation target. The President of the ECB, Mr Trichet, put it very nicely when he spoke about the ECB having only "one needle to its compass", price stability, and "not two needles", prices and growth, like the US Federal Reserve. The ECB recognised a "materialisation of risk" to economic growth in the eurozone since its previous meeting but it still emphasised factors which contributed to inflation. The single needle in the compass also emphasises a desire to raise interest rates if it feels it safely can do which is obviously not the case at present and so no clear signal was given.

Most of the individual items of economic news from the eurozone have been negative in August. A KPMG/Markit survey of European manufacturers reported in the Financial Times showed a net balance of companies forecasting growth is actually falling to +14.1 against a January level of +43.5. Forecasts on prospects for company profits fell to -13.2 from +15.8 as nearly 40% of manufacturers now expected a fall. Employment prospect forecasts are also lower at -6.9 against +9.7. Interestingly, this pessimistic mood was not shared by manufacturers in the so called BRIC economies (Brazil, Russia, India and China). Industrial production in the eurozone was unchanged in June to give an annual fall of 0.5%. The RBS/Markit purchasing managers survey for August showed a weak position. The index for the manufacturing sector was fractionally higher at 47.5 against 47.4 in July whilst the reading for the services sector was fractionally weaker at 48.2 compared with 48.3 in July.

We noted earlier that German GDP contracted in the second quarter by 0.5% after a strong start to the year. The news has generally deteriorated. Factory orders in June fell by 2.9% following a 1.4% decline in May. This was the seventh consecutive monthly fall and was led by weakness in orders from abroad. The earlier relative robustness of the German economy had been largely due to a strong export performance. Orders from within the eurozone were weak – they fell by 7.7% over the month which has obvious implications for the eurozone economy as a whole. There was a slight increase in industrial output in June, just 0.2%, which followed a 1.8% decline in May. Over the quarter, the fall in output was 0.5% in the second quarter following a 1.3% rise in the first quarter. Manufacturers are passing on price increases. The annual rate of increase in producer prices in July was 8.9%. Investor expectations were slightly less gloomy, however. The ZEW Economics Institute index was -55.5 in August compared with -63.9 in July. Retail sales remained weak – domestic consumption has not really given any impetus to the German economy which is why evidence of weakness in exports is disturbing. However, on a brighter note, unemployment fell to a sixteen year low in August, taking the level down to 7.6% from 7.7%.

A concern has been an increasingly protectionist outlook in Germany, perhaps caused by the basically unsatisfactory position with coalition governments. We have noted before some backsliding on economic reforms and now there is an increase in protectionism as the government puts forward a bill to give it greater powers to vet foreign investment in German companies. The bill would enable the government to reverse any acquisition of more than 25% of a German company by a non European investor. This is a depressing reminder of protectionist thinking which, whilst it might seem to be a good populist measure, sends out the wrong message and will ultimately be damaging to the economy. Understandably, German businesses have protested about this measure which could cause them problems if they wish to make overseas acquisitions. Sentiment amongst German business is weak anyway with the Ifo business sentiment index at its lowest level for three years.

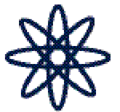


The situation is difficult in France too. As we saw, there was a 0.3% decline in French GDP in the second quarter. France's longer term problem is declining competitiveness. In recent years, it has lost ground to Germany which has reversed the previous position and grown more quickly than France. A manifestation of this has been the poor foreign trading position of France. In the first half of 2008, the trade deficit worsened from €15.8 billion in the first half of last year to €24.4 billion this year. Obviously, rising costs of imported oil have been a factor but France has steadily been losing market share. France urgently needs economic reforms to free the potential of the economy. The effective dismantling of the 35 hour week will be a help but wholesale reform is needed in France first to fulfil its economic potential.

The different negative issues for Germany and France, as well as problems elsewhere, including high profile ones in Spain, which caused the Spanish Prime Minister to recall the cabinet from it summer holidays in August cause economic policy making to be difficult. It bears repeating that the euro area is not an optimal currency zone, that the economic performances of its members are diverging and that having fiscal tools a domestic responsibility and monetary tools an ECB responsibility is not likely to provide a satisfactory outcome for eurozone economic problems. We are likely to see more political pressure exerted on the ECB. The stresses in the eurozone can be seen by the wide spread on the yields between various countries' government bonds. For example, the difference in ten year government bond yields between the largest eurozone economy, Germany, and the third largest, Italy, is currently around 63 basis points. When investors take vastly different qualitative views of the strength of two of the leading eurozone members economic convergence looks more difficult than ever. The euro was always a political project and not based on good economics and we expect the stresses to become worse.

At least in the UK, the beleaguered Prime Minister can take comfort from the wisdom of his decision to keep the UK out of the euro, an issue which has completely dropped off the political agenda. The UK's ability to deal with its current economic problems is not hampered by its inability to control monetary policy. Theoretically, it has all the weapons at its disposal although, in practice, some of them have been blunted by previous policy decisions. Having said that, we believe that the UK's economic position is as bad as any of the major industrial economies. It is difficult to find any immediate grounds for optimism and, without doubt, the UK is in for a very difficult time for the foreseeable future. The most objective evidence of this is the slide in sterling, firstly against the euro and, now, against the US dollar. The foreign investors' views of the UK are negative and there is little obvious support for sterling. The UK has been running an excessively large current account deficit for a long time and, whilst foreign confidence is high in the UK, for example manifested by foreign companies buying UK assets, that deficit can be financed. But that source of support has dried up, at least for the moment and foreign investors seem less keen to keep buying UK gilts which will be issued at an ever increasing rate to fund the steadily rising internal government deficit.

Nearly all the individual items of short term economic news are bad. We will highlight some of the issues we consider particularly relevant. The dire state of public finances is particularly serious. It is quite wrong to say that this is the result of unforeseen global circumstances. Yes, these have made matters worse but we have pointed out over a number of years the problems which the explosion in public expenditure, way beyond the potential growth rate of the UK economy, would cause. In a period of quite fast economic growth, albeit not good quality growth, the Treasury has consistently understated the government's borrowing requirement. This should have been a worrying sign that things were not well. The amount the government has to borrow each year is the difference between two very large figures, revenue and expenditure. Government expenditure is notoriously difficult to control but revenue is very sensitive to changed economic conditions. Although we are only four months into the new financial year, the omens, unsurprisingly, are not good. July, normally a good month for public finances, registered a surplus of £4.8 billion against £6.4 billion in the same month last year. Net borrowing so far this financial year is running at £19.1 billion compared with £10.7 billion a year earlier. Although it cannot take any sanctions against the UK because it is not in the eurozone, the EC is looking at the UK's deficit and this can only be an embarrassment to the UK. However, domestically, at a time when economic slowdown justifies reflationary measures, the government has no room for manoeuvre because of the dire state of public finances. The budget



arithmetic and thrust of last spring's budget was completely undone by the compensation package for those who had suffered financially from the abolition of the 10p income tax rate. The money was borrowed. The normal policy in good economic times is to save for bad times to try to smooth out the economic cycles so that running a budget surplus in good times may provide the finance for looser fiscal policy in bad times. This is not an option for the UK. Simply borrowing the money raises an inflationary threat, could well mean higher interest rates as increasing amounts of government debt are issued and threatens sterling as foreign investors take a critical view of government policy and the economic outlook.

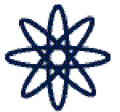
Nearly all independent observers were sceptical of the Treasury's growth forecasts for the UK economy made in the budget and used to support government borrowing forecasts. They did not look realistic then, now they are totally discredited. In the second quarter of the year, the ONS established that the economy ground to a halt. The latest IMF review of the UK pulls no punches. Whilst forecasting growth for this year of 1.4% and 1.1% next year, we can contrast these figures with the Treasury's Budget forecasts of growth of between 1.75% and 2.25% this year and between 2.25% and 2.75% next year. It gives a strong warning about the government's fiscal stance and is more pessimistic on inflation than the Bank of England as it believes inflationary expectations are rising and fears they will spill over into wages.

This, of course, is the Bank of England's main concern. As in most other countries, the inflation figures are well above target. The latest year on year increase in the consumer price index is 4.4%, on the core consumer price index 1.9%, on the Retail Price Index it is 5.0%, on producer prices it is 10.2% and on manufacturing input prices it is 30.1%. These are figures which will obviously be of concern to the Monetary Policy Committee and will give ammunition to the "hawks" whilst the "doves" will look at the economic standstill of the second quarter.

The Governor of the Bank of England gave a stark message about the reality of the situation facing the UK. He said that the UK economy required a "painful" adjustment to higher food and energy prices and predicted that the economy would grind to a halt for a year before recovery, probably to a slower growth path than before. He said that there was "bound to be a quarter of two" of economic contraction. He predicted that inflation would peak at 5% at least. The minutes of the latest MPC meeting show that the expected sharp slowdown in economic activity persuaded the MPC to keep interest rates unchanged despite the poor inflation figures. Reports it received from its agents around the country were downbeat and these reports obviously influenced some members' thinking.

One of the biggest issues for the UK economy at the moment is the state of the housing market. According to the latest Halifax figures, house prices fell by 1.7% in July to give a year on year decline of 11%. The latest Nationwide figures for August show house prices falling by 1.9% in August to give a 10.5% year on year fall. One of the major factors driving house prices lower is the shortage of available funds for lending. According to the Building Societies Association repayments exceeded new loans by £700 million in June. The RICS reported that housing transactions were down at levels not seen for four decades because of the drought in the mortgage market. The Council of Mortgage Lenders reported that the number of mortgages approved halved in the year to June. The buy to let mortgage market has also contracted severely. The number of loans was down 21% on a year previously. The British Bankers Association reported that the number of approvals of new home loans for house purchase, rather than remortgaging, were down 65% on a year earlier. Given the importance of housing to the UK economy, these figures make grim reading. They will do nothing for consumer confidence which will have negative ripple effects on the UK economy.

From an equity investor's point of view, this string of grim economic news need not be negative if our view that sterling is likely to continue its decline is correct. Many UK companies have substantial overseas earnings or are significant exporters. They will benefit from this trend in the currency. Costs will rise but the benefits should outweigh the costs. Companies such as these provide some hedge against sterling's depreciation. For sterling bonds, we do not think the outlook is appealing. Minimal or nonexistent real yields plus the prospects of a big increase in the issuance of government debt suggest that medium and long dated gilts are not offering realistic yields.



For China, the main economic issue at present is controlling inflation and, at the consumer price level, it is falling. The latest figure for July shows a year on year fall to 6.3% against 7.1% in June, helped by a sharp fall in food prices. However, at the producer price level, the latest figure shows a rise to 10.0% in July from 8.8% in June. Although growth has come back from peak levels which were too high for the authorities the economy remains buoyant. The trade surplus for July rose by 4% compared with July 2007 and exports were 26.9% higher. The key to further monetary or administrative tightening will depend upon whether the rise in producer prices arrests the drop in consumer prices. The economic news from the east contrasts with the rather depressing state of affairs in most of the major industrial countries.

It is unlikely that there will be a world recession and, overall, there will be growth in the world economy but, as our review suggests, it will be patchy. This will affect the outlook for corporate earnings but we believe that the modest ratings of international equity markets mean that they can withstand these difficult times. We believe that there is good value to be found. International bonds and, particularly, sterling bonds look expensive to us with yields not all attractive enough in the present inflationary environment. We expect more action in the currency markets where sterling continues to look vulnerable.

August 2008

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