meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

It has been a steady quarter with international equity markets drifting upwards. There was little change in high quality international bond yields as measured by ten year government bonds. In the currency market, sterling rose against the US dollar and euro, whilst in commodity markets, oil and gold resumed their rise.

The tables below detail relevant movements in markets:

International Equities 31.05.12 - 31.08.12

Total Return Performances (%)				
Country	Local Currency	£	US$	€
Australia	+7.7	+11.2	+14.8	+12.6
Finland	+7.7	+6.4	+9.8	+7.7
France	+13.4	+12.0	+15.6	+13.4
Germany	+11.0	+9.7	+13.2	+11.0
Hong Kong, China	+7.3	+4.1	+7.4	+5.3
Italy	+18.0	+16.5	+20.3	+18.0
Japan	+1.8	-1.2	+2.0	N/C
Netherlands	+13.8	+12.4	+16.0	+13.8
Spain	+25.1	+23.6	+27.5	+25.1
Switzerland	+8.9	+7.6	+11.1	+9.0
UK	+8.6	+8.6	+12.0	+9.9
USA	+7.8	+4.5	+7.8	+5.8
Europe ex UK	+12.5	+11.9	+15.5	+13.3
Asia Pacific ex Japan	+5.9	+6.0	+9.3	+7.3
Asia Pacific	+4.2	+2.9	+6.2	+4.2
Latin America	+2.3	+1.5	+4.7	+2.7
All World All Emerging	+4.6	+2.5	+5.8	+3.8
The World	+7.7	+5.7	+9.1	+7.0

Source FTSE World Indices

FT Government Securities Index All Stocks (total return): +0.9%

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

Currency	31.05.12	31.08.12
Sterling	1.57	1.66
US Dollar	1.58	1.57
Yen	0.53	0.80
Germany (Euro)	1.21	1.34

Sterling's performance during the quarter ending 31.08.12 (%)

Currency	Quarter Ending 31.08.12
US Dollar	+2.9
Canadian Dollar	-1.7
Yen	+2.8
Euro	+1.2
Swiss Franc	+1.2
Australian dollar	-3.0

Other currency movements during the quarter ending 31.08.12 (%)

Currency	Quarter Ending 31.08.12
US Dollar/Canadian Dollar	-4.5
US Dollar/Yen	-0.1
US Dollar/Euro	-1.6
Swiss Franc/Euro	N/C
Euro/Yen	+1.6

Significant Commodities (US dollar terms) 31.05.12 - 31.08.12 (%)

Currency	Quarter Ending 31.08.12
Oil	+12.5
Gold	+6.0

Markets

International equity markets have performed well over the last quarter. In local currency terms, the FTSE World Index has shown a total return of 7.7%, in sterling terms 5.7%, in US dollar terms 9.1% and in euro terms 7.0%. Looking firstly at local currency returns, we see that the stand out performer has been the FTSE Europe ex UK Index which has returned 12.5%. Within that area, the outstanding performers have been the FT Spain Index which has returned 25.1% and the FTSE Italy Index which has returned 18.0%. The fact that the equity markets of two of the troubled eurozone economies have recovered strongly this quarter indicates the "risk on" nature of the quarter. The weakest of the major markets has been Japan where the FTSE Japan Index returned just 1.8%. Latin America, Asia Pacific ex Japan and Emerging Markets all underperformed, with their respective FTSE indices returning 2.3%, 5.9% and 4.6%, all useful performances, however. The UK and USA achieved slightly above average performances, with the FTSE UK index returning 8.6% and the FTSE USA Index 7.8%. As so often is the case, currencies made a difference for sterling investors. On the positive side, the strength of the Australian dollar raised a very respectable 7.7% return of the FTSE Australia Index in local currency terms to 11.2% in sterling terms. On the other hand, weakness in the US dollar and the yen reduced the performance of the FTSE USA Index in sterling terms to a still good 4.5% but the yen's weakness pushed the sterling return on the FTSE Japan Index into negative territory, -1.2%.

In high quality international government bond markets, there have not been significant changes in the gross redemption yields on ten year government benchmark bonds. Yields have risen on UK and German bonds by 9 basis points and 13 basis points respectively to 1.66% and 1.34%. There is very little change in the yield on ten year US Treasuries and the JGBs.

In the currency markets, sterling fell by 1.7% against the Canadian dollar and by 3.0% against the US dollar but rose by 2.9% against the US dollar, by 2.8% against the yen and by 1.2% against the euro and Swiss Franc.

In the commodity markets, oil made a partial recovery from the previous quarter's sharp fall, rising by 12.5% and the same situation applied to gold which rose by 6.0%.

Economics

Whilst the movement of stock markets over the quarter may suggest an improvement in the economic background and less concern about the main problem, the eurozone, such an impression would be misleading. As we have often emphasised, stock market movements do not have to move in tandem with the economy and this has been the case during the last quarter. Not only does the eurozone crisis rumble on but world economic growth is slowing, not unexpected given what is happening in the eurozone. Neither of these issues need be harmful to equity prices.

Perhaps it is worth picking up on this last point before we discuss the eurozone and general economic issues. In normal economic cycles, rather than the one driven by the present causes, i.e. the financial crisis starting in 2007/8, overborrowing (public and private) and the eurozone crisis, an economic downturn might be countered by lowering interest rates and expanding the government deficit (or moving from surplus into deficit). It is stating the obvious to say that these conventional economic levers have been tested to destruction. There is no room for any meaningful interest rate reductions and, in the problem economies, public finances are in a serious, and sometimes very serious, position. The need to take action to stabilise these countries' public finances has meant a tight fiscal policy but, in a time of low growth or recession, for some troubled economies this makes the situation even worse. Hence, we see very loose monetary policy in the form of very low official interest rates, augmented by non standard monetary measures, i.e. quantitative easing or money printing carried out electronically. For as far ahead as we can see, very loose monetary policy is going to remain in place to offset tight fiscal policy and that has implications for securities markets.

For high quality bonds, say AAA rated government bonds, it means that investors will be prepared to accept very low yields or even negative yields at the short end. As this is written, short term Danish and Swiss government bond yields are negative and there is no return on German government bonds. In other words, some investors are prepared to lend some governments money and receive less back. This is an extraordinary position and reflects the complete lack of confidence in the creditworthiness of some eurozone countries. Whilst understanding the reasons for negative or very small yields on highly rated government bonds, it does not mean that they are good value. One can construct a possible argument for Danish, Swiss and German bonds on currency gain terms. Whilst Denmark is not a member of the eurozone, its currency tracks the euro. The Swiss National Bank is intervening in the foreign exchange markets to prevent the Swiss Franc from rising against the euro and, therefore, temporarily, it is pegged to the euro. Investors in German government bonds may be speculating that either Germany will leave the euro or that some southern eurozone countries and, perhaps, Ireland, will do the same, which will result in the Deutschmark or the residual euro becoming a much stronger currency. For countries like the USA and UK, which control their own currencies, the current levels of government bond yield offer awful investment value. If anything like a semblance of normality returns, there are likely to be some very big losses sustained in the bond markets, given how far from any realistic yield some of them stand.

To our way of thinking, good quality equities, including those with an attractive dividend yield which is considered sustainable, offer a better alternative. In circumstances, such as those investors face at present, there is some justification for paying up for yield, certainly far more than being prepared to accept minuscule bond yields. Over time, dividends in carefully chosen companies may be expected to grow. We can have a high degree of confidence that interest rates in solvent countries will remain low for the foreseeable future so that the yield advantage of shares will last for quite a long time. That being the case, the elevated rating of some of the high yielding stocks can be justified, in our view, by the attractive dividend yields. This would not be the case if profits were likely to collapse and dividends be cut but we do not see that being the case in aggregate.

One of the policy reasons for ultra low interest rates and quantitative easing, where it has been applied, is to raise asset values. Interestingly, this was one of the arguments used by the Bank of England in defending quantitative easing from the charge that it had cost pensioners and pension funds a significant amount of money. Savers have suffered a severe fall in interest income on deposits, whilst those buying annuities have found their annual income tumbling because of the collapse in gilt yields which has meant very poor annuity rates. The counter argument is that securities values have been boosted by cheap money (our argument for shares in the previous paragraph) and that therefore the value of pension funds and the pot of money available to buy annuities is larger than it would otherwise have been and the same goes for savers' securities portfolios. In a general economic sense, rising asset values imply a positive wealth effect which should encourage individuals and businesses to spend. That is one of the aims of very loose conventional and unconventional monetary policy, although it was not advertised much at the outset.

So, back to where we started, which is to reason why the extreme monetary policy which is being widely followed has distorted financial markets so much, particularly the bond markets. Whilst many bonds are wildly overvalued, that is not the case, we believe, for equities, where yield valuations are becoming increasingly important.

There has been something of a lull in August in news from the eurozone but September promises to be more lively. The eurozone's fundamental problems are as bad as ever. Probably what has improved sentiment has been the development of a plan which might bring some relief to the heavily indebted countries of the eurozone. Nothing has been agreed and there are many opponents of what seems to be the plan. This is that, in return for accepting a bailout, Spain and, perhaps, Italy, will see the ECB buy their debt, the theory being that the ECB will be less uncomfortable doing this if they know that the relevant countries are under external supervision. Another theory is that the ECB will intervene to cap yields but this idea comes with many difficulties, namely how does the ECB decide what is the "correct" yield in either absolute terms or relative terms? Certainly, this has relieved pressure on Spanish and Italian bonds, although yields remain highly elevated and unsustainable, especially as the economies are contracting. To be able to pay the interest rates demanded by the market on Spanish and Italian debt, the economies have to grow. If they do not, the medium term position is unsustainable. As this is printed, Mr Draghi has announced the ECB's plans which are in line with the first possibility mentioned above but not the second, i.e. capping yields.

The arguments about the viability of the euro project remain as they always have been. The economic differences between the members of the eurozone, in particular between northern and southern members, make a currency union, as presently formed, unworkable. To have a chance of succeeding, the countries have to be similar economically, but that was never the case with the eurozone. An important flaw was that some countries were more prone to inflation than others, which made a single interest rate highly inappropriate and, as was inevitable, dangerous. An example of the danger of an interest rate which was too low for some countries was the property boom in Ireland and Spain, which was fed by cheap money, the ECB interest rate being inappropriate for these countries. The deterioration in the weakest eurozone countries' current account position, as a result of falling competitiveness and overconsumption, has led to the position where they find it difficult to raise external finance. So, there are three possible outcomes. Firstly, as they are doing at present with the bailed out countries, they are under supervision to reduce their deficits through tax increases and public expenditure cuts and to claw back lost competitiveness through an internal devaluation. This latter policy is very painful for those involved. Because the affected countries cannot avail themselves of the usual escape hatch of devaluation to restore competitiveness, temporarily at least, the equivalent desired result is aimed to be obtained by reductions in costs, notably wages and pensions. This is a brutal way of achieving the same effect, but it takes longer, and will probably prove unacceptable in countries with a democratic political system. The affected eurozone countries are regaining some of their competitiveness, but it will be a long haul, and one doubts if the electorates will accept the continued austerity. Social unrest, particularly in Greece and Spain (not yet the subject of a formal bailout) is increasing and there are signs of it in Portugal (rather low key) and in Italy (not yet the subject of a bailout). Ireland is rather a different case. It has been able to re-enter the debt market but its position remains precarious. The hope of the eurozone is that the bailouts will enable Greece, (where private sector lenders have already taken a severe haircut), Ireland and Portugal to put their houses in order so that they will be able to re-enter the international debt markets again at a sustainable level of interest rate. In practice, except for possibly Ireland, this is almost certainly not going to happen. Economic conditions are so poor that it is not realistic to forecast any growth scenario which would encourage international investors to see that these countries' debt was a safe investment. Other countries, like Spain and Italy, could also require assistance, to which point we will come back shortly. The first option is, what we would term, the "muddle through" strategy. We would rate the chances of success as very low.

The second outcome, which federalists would desire, is for an economic union. The first component, monetary union, is in place, but the missing piece, the lack of which is a major cause of the current crisis, is fiscal union. Ignoring the fact that the electorates of the various eurozone countries would have been very unlikely to go along with a fiscal union and are even more unlikely to do so now, the presence of a fiscal union, as in the USA, would allow transfers from the more successful countries to the less successful ones. So, to give a simplified example, Germany would be able to provide funds for Greece. A variation of this is that the eurozone could issue a eurobond guaranteed by eurozone members. If some could not afford to repay it or pay their share of the interest payments, then the more solvent countries would assume the liability. It is very hard to see the northern eurozone electorates allowing this and that is before Germany's Constitutional Court becomes involved. It is due to give its opinion on the proposed Eurozone Stability Mechanism on 12 September. The ESM is a permanent mechanism to provide bailout support for eurozone countries but has been challenged as contravening the German Constitution. With anti bailout sentiment rising in the creditor countries, Germany, Finland and the Netherlands, eurozone officials risk being squeezed from both sides by creditors who resent paying and debtors who resent the economic policies being visited on them. We think that politicians who advocate a fiscal union, so that the necessary transfers can be made between eurozone countries, are out of step with their electorates.

The third possibility, which we have always felt to be the most likely, is that the eurozone will fragment, weighed down by the burden of its own contradictions. In these reviews, we have been through the arguments many times but the loss of exchange rate flexibility and the ability to control their own monetary policy has had a devastating effect on the affected eurozone economies. There is going to be no painless resolution of the eurozone's problems, whatever happens. If it breaks up, enormous bad debts will be crystallised, causing major concerns for the banking system. If it continues, the problems will become worse as economic growth is suffocated and, by delaying the inevitable, the pain will eventually be greater. Returning to their own currencies, which will obviously be weaker than the euro, if the latter continues to exist for a while for some countries, will give them an opportunity to benefit from a competitive currency, although, for this to be effective, strict measures to contain the inflationary fallout from a devalued currency will have to be taken. Whatever happens is going to be very messy but the longer the problem remains unresolved, the worse the eventual problems will become.

As we have felt all along, the most important player in this game will be the European Central Bank. When the President of the ECB said in, early August, that, to paraphrase, it will do all that is necessary, stock markets responded favourably but, as always with everything connected with the eurozone, it was not as simple as it sounds. Theoretically, the ECB could simply create unsterilised money and buy all the bonds it liked in the market. Unsterilised money is that created which is not offset by sales of ECB held securities so, in effect, it is money printing. Quite naturally, the ECB does not like this because of the inflationary implications as well as the prospect of losses should there be any defaults. In the case of Greece, it was the private sector which experienced the losses but the undesirable side effect of this was that it has deterred the private sector from buying questionable eurozone sovereign debt. Within the ECB board, Germany has been particularly critical of the possibility of large ECB bond buying. The ECB already holds about €211 billion of eurozone government bonds on its books through the Securities Market Programme. The way things have been developing, it seems that the quid pro quo for the ECB to buy the bonds of Spain and Italy would be for these countries to seek aid in return for conditions and supervision of their economies under an agreed programme. This would be very difficult for either country to accept but Spain appears to be preparing to shift its stance. The fall in Spanish and Italian bond yields from their peak reflects hopes that the ECB will act to buy their debt. Experience shows that it is unwise to be hopeful about events in the eurozone. There are many moving parts and it is becoming increasingly difficult to co-ordinate them. The ECB has now outlined its plans but those countries seeking to benefit from ECB bond purchases have to accept the conditionality of a bail out, something which remains to be seen.

Events in the eurozone are casting a baleful influence on the world economy. As well as seriously damaging the economic prospects of countries within the eurozone, including the hitherto resilient German economy, the problem affects other areas, not least the UK and, further afield, China. In the UK, there was a contraction of 0.5% in the second quarter (revised down from a 0.7% contraction on the first calculation) to give a year on year contraction of 0.5% also. In the USA, annualised growth was 1.7%, disappointing by US standards. The eurozone contracted by 0.2% in the second quarter. Contained in that overall figure was 0.3% growth in Germany, a flat outcome in France, modest growth of 0.2% in the Netherlands, a severe contraction of 1.0% in Finland and declines of 0.4% in Spain in the second quarter, 1.2% in Portugal and 0.7% in Italy. In China, quarterly growth was 1.8% or 7.8% year on year, a significant slowdown from the past peak of nearly 12% in 2010. In Japan, second quarter's growth was 0.3%. Like the Chinese economy, the Brazilian economy is also slowing down. The second quarter showed growth of 0.4%, just 0.49% higher than one year previously, dramatically lower than in 2010 when annual growth exceeded 9%. The eurozone was not, of course, responsible for all of the economic slowdown but, in every case, it was a contributor to a greater or lesser degree. Perhaps symptomatic of this slowdown is the J P Morgan Global Manufacturing Purchasing Managers Index, where the latest two readings have been consistent with a decline in activity overall.

Were there not so many problems in the eurozone, much greater attention would be focused on the USA where the possibility of a "fiscal cliff" occurring from next January is potentially a serious problem for economic activity. This possible event, which the most pessimistic forecasters believe could knock 5% off US GDP, arises from the impasse reached between the political parties in Congress and the Administration over budgetary matters, culminating in the very dangerous stand off last year over lifting the US government's borrowing ceiling. If agreement cannot be reached before 1 January on the budget between the various parties, then the Bush era tax cuts, payroll tax holidays and sequestration will come into play. Whilst dealing with the US budgetary situation is of paramount importance, such a shock as implied by the "fiscal cliff" would trigger a recession. The best way forward would be a gradual but enforceable reduction in the budget deficit. Whilst the Republicans and Democrats are so polarised, there is very little centre ground on which to meet. November's elections may or may not help. In many ways, having both houses of Congress and the Presidency in the same party's hands is helpful. Decisions can be made more easily because, although party allegiances are not as strong as, say, in the UK, when it comes to voting in Congress, agreement on a particular course of action is much more likely. If one party were to control both arms of government, the executive and legislature, it is likely to be the Republicans. As well as holding the House of Representatives, they could gain control of the Senate and opinion polls show the race for the White House to be tight. If control of the executive and legislature is split, one fears a continuation of the poisonous atmosphere will prevail in Washington. At the moment, Wall Street does not seem to be too distracted by this possibility given its steady performance but it looms on the horizon.

There is mixed news from the USA. We have noted a slight upwards revision in the second estimate of second quarter GDP from 1.5% to 1.7%. The latest ISM Purchasing Managers Index for manufacturing stands at 49.8 (49.7) signalling a pretty flat economy. That for non manufacturing is slightly better at 52.6 (52.1). There is some slightly better news from the housing and construction market. The Commerce Department reported that construction spending in June was 0.4% higher than in May and that it was 7% higher than a year earlier. Residential construction was 1.3% higher in June. There was a strong rise in building permits which rose to the highest level since August 2008. This was also reflected in the sentiment survey from the National Association of Home Builders which reached its highest level since 2007. Sales of new single family homes rose by 3.6% in July reaching last May's level, itself a two year high. The National Association of Realtors reported that pending home sales in July rose to the highest level since April 2010. It is not all good news. For example, the median price of new houses fell by 2.5% from a year ago and housing starts were 1.1% lower in July compared with June. Elsewhere, on a slightly encouraging note, there was a rise in the Conference Board's consumers' attitudes index which rose from 62.7 in June to 65.9 in July. The jobs figures, although erratic, were better than expected in July, rising by 163,000. There was mixed news from industry. The latest data for factory orders showed a decline of 0.5% whilst durable goods for June rose by 1.3%. The Federal Reserve's latest Beige Book reported that "economic activity continued to expand gradually in July and early August across most regions and sectors". Six of the Federal Reserve's twelve districts reported a "modest" increase in activity. Three found "moderate" growth, whilst the other three reported "slow" or "mixed" expansion. This is the mix of responses which would be consistent with the level of economic growth reported for the second quarter, which was very modest, but not indicating a recession. It is against this background that the Federal Reserve's August meeting minutes suggested that its members had the appetite for taking more measures to stimulate the economy. Later, on 31 August, at the Jackson Hole gathering, Mr Bernanke emphasised the point, so that markets are now expecting further action at the Federal Reserve's next meeting. On a more sombre note, to emphasise the danger of the "fiscal cliff" which we discussed earlier, the non partisan Congressional Budget Office gave a timely warning. It said that if Congress took no action by 1 January, the USA would face a double dip recession, declining by 0.5% in 2013. It forecast that unemployment would rise from 8.2% in 2012 to 9.1% in 2013. If the "fiscal cliff" occurs, it forecast that the budget deficit would fall from 7.3% of GDP this year to 4% in 2013. This would result in the US economy shrinking at a rate of 2.9% in the first half of 2013 before recovering at a rate of 1.9% in the second half. If nothing were done to address the budgetary issues the USA's budget deficits would remain close to US$1 trillion a year. It goes without saying that the risks of doing nothing are very high and, even though the USA can print its own money, currency debasement would surely follow. Therefore, whilst the USA does not face an existential crisis like the euro, it is only benefiting by comparison with an area which is facing the break up of a currency union.

Given the attention to the fundamental problems of the eurozone and the currency itself which we discussed at length earlier, the detail of the various countries' problems seem of secondary importance. But the shockingly high record of unemployment level reached in July, 18 million people, and the unwelcome rise in inflation to 2.6% in August from 2.4% a month earlier, underline the challenges facing the eurozone.

The French government faces a severe test of its resolve in the face of the need to find substantial savings to meet its budgetary target. Neither of the main political parties in the recent French Presidential and parliamentary elections presented the electorate with the enormity of the fiscal challenge facing France, a country which has failed to balance the books since the mid 1970s and which has steadily lost competitiveness to Germany in recent years, putting the country's current account into deficit. The easy but economically counterproductive measures of raising taxes on large companies and the rich have gone down well, as has the reduction in the pension age from 62 to 60 for some people in the face of economic reality. By campaigning on a platform suggesting that there was an alternative to austerity, whilst sticking to the agreed budget targets, the government will have to do things which will disappoint those who voted for it because, with the French State accounting for 56% of GDP, the private sector will be "crowded out". The radical supply side reforms which France needs to improve its long term growth prospects are almost impossible to make in France and the government probably does not believe in them anyway. So, although French government bond yields are low, the country could be vulnerable should its fiscal targets be abandoned or not met.

Difficulties also beckon in Germany, where there is increasing opposition to the extent of Germany's participation in the bailouts. This feeling is likely to be exacerbated by the evidence of a slowdown in the German economy. We highlighted, earlier, the sluggish level of growth in Germany in the second quarter, 0.3%. The latest Purchasing Managers Index for the manufacturing sector has a reading of 45.1, which signals contraction. The latest ZEW Economic Sentiment Index in Germany has a negative reading of -28, which indicates a marked degree of pessimism. These are just some of the straws in the wind showing changed conditions in Germany.

For Japan, these are trying times. The economy is growing. In the second quarter it grew by 0.3%, but it remains in a fairly tepid state. The aftermath of the natural and nuclear disasters last year has meant an increased import bill. One of the reasons for the latest quarter's GDP being below expectations was that net exports cut 0.1% from GDP growth because the loss of nuclear power capacity required more imported fuel. Private consumption grew by just 0.1% during the quarter. Incomes have been squeezed, with employees' nominal remuneration falling by 0.5% year on year. Deflation means that the real fall is not as bad, but any fall in real incomes augurs badly for economic growth. A sign of how things have changed for Japan is its move into a trade, although not a current account, deficit. In July, it posted a monthly trade deficit of the equivalent of US$6.5 billion. As well as being forced to import more fuel, the eurozone's economic woes have badly affected its exports to the area. Japan does have the world's second largest foreign exchange reserves, so, if it were to move into a current account, as opposed to a trade, deficit, it would not be as serious as for weaker countries. One might expect the yen to be reflecting the deteriorating trade position, but that is not the case, and it may be the desire of, say, the Swiss Central Bank not to be over exposed to the euro in their reserves which is supporting the yen, amongst other currencies. Whatever the reason, the strong yen makes life tough for many Japanese exporters. The country will have to undergo major structural changes to improve its long term growth prospects and also to address its very serious public debt position, with the gross level of outstanding debt at around 230% of GDP. Whilst most of its debt is financed internally which gives it some protection, Japan's public finances are seriously out of line. The proposed doubling of consumption tax in two stages is a necessary measure, although it risks depressing the economy. There remain many good Japanese companies in which investors should participate, notwithstanding the economy's problems and, relative to Japanese government bonds, there are some very attractive dividend yields.

With sluggish growth or recession in western Europe and very modest growth in the USA, even more attention than usual is focused on China where growth is slowing down. Second quarter growth was 1.8% quarter on quarter and 7.8% year on year representing a declining trend, which has been apparent since the peak of nearly 12% in early 2010. Indicators which have reinforced the impression of a slowing economy include a slowdown in the rate of increase of industrial production to 9.2% in July from 9.5% in June and the growth in retail sales from 13.7% to 13.1%. There has been a dramatic fall off in the rate of inflation which is now down to 1.8% year on year. The Chinese authorities are always wary of high inflation because of the potential for social unrest which it may cause, particularly when the food price element of inflation is high. Bad weather worldwide could cause problems later on but, for the moment, low inflation makes the risk of taking action to stimulate the economy modest. It is certainly what many industrialised economies will be hoping for.

Two of the other BRIC countries are facing a slowdown. In India, first quarter GDP figures show year on year growth down to 5.3%, which compares with a peak of 11.0% in early 2010. The country is suffering from political paralysis, with structural rigidities holding back growth, and the country is also suffering from significant budget and current account deficits and a weak currency. In the first quarter, Brazil's growth rate year on year fell to 0.75%. Structural rigidities cramp the country's potential growth rate and public finances are in a difficult state. The government has announced plans to bring the private sector into large infrastructure projects, which are badly needed if Brazil is to realise its potential again. But both of these economies' slower growth rate is affecting the industrialised countries.

In the UK, the problems for the Chancellor mount up as the economy remains flat or in slight decline or may be not quite that bad because there is a puzzling difference between the GDP figures and the employment numbers, which hint at a situation which is not quite as bad as the GDP numbers show. As mentioned earlier, the latest estimate of second quarter GDP was -0.5%, as against the original estimate of -0.7%. The problems in the eurozone present a major difficulty for the UK economy and have contributed to its weak performance. But it is obviously not the only issue. The UK is heavily over borrowed, both in the public sector and in the household sector and, deleveraging, which is very necessary, is also highly painful. Markit, through its Household Finance Index, carries out a survey of household finances which indicates that debt levels are stabilising but at a high level, with the index showing a slightly less bad position, in August, at 38.9 against 37.5. Such a level of pessimism does not augur well for growth in the foreseeable future as households continue to reduce their leverage. In the government sector, the latest borrowing figures are disappointing. In July, normally a surplus month because of the incidence of corporate tax receipts, there was a deficit and, so far this year, the cumulative position is worse than a year ago by £9.3 billion. Government deficits fall into two categories, structural and cyclical. It is the structural element which the government is working to eliminate. In a recession, the economy's automatic stabilisers work to offset the effects of a weak economy. As we have said before, we do not go along with those who call for more public borrowing. Piling debt upon debt is no recipe for economic recovery. One positive side effect for the UK, at least for the time being, is that it retains its AAA rating, enabling it to borrow at interest rates one would not in the past have believed possible. Part of the reason for the extraordinarily low level of interest rates is quantitative easing as the Bank of England creates money to buy government stock. But it is also a matter of confidence and markets have respected that. Although it has been blown off course by the weak economy and the eurozone crisis and, of course, borrowing is still increasing, the UK has been relatively robust in its policy. Should markets feel that the government is losing its nerve, interest rates could rise sharply and, once confidence has been lost, it is very difficult to regain it. That would be a disastrous outcome and the Chancellor is right to stick to this course of action. One of the most astonishing side effects of the collapse in gilt yields is that the undated 3.5% War Loan stock now stands at over par, something, until recently, that one would have believed to have been impossible. The coalition government is under attack from all sides over its economic policy and there seems to be little doubt that the compromises needed to make a coalition work, at least in holding both parts together, are making policy decisions difficult and, to many observers and voters, ineffective. There is particular frustration at the inability to enact meaningful supply side reforms in the area of regulation and red tape, a major complaint from business. In the latest Bank of England quarterly report, it has reduced again its forecast for growth in two year's time from 2.6% to 2.1%. This is consistent with recent observations that forecasts for economic growth in the UK (and elsewhere) are consistently being revised downwards. The problems elsewhere in the world are highlighted by the effect which economic weakness has had on UK exports, where exports of goods in the second quarter recorded a volume decline of 3.1%.

Whilst the news has been generally gloomy, there have been glimmers of hope. We mentioned above the puzzle of the unemployment figures which have not been consistent with the GDP figures. In the 3 months to the end of June, unemployment fell by 46,000 to 8.0%, down from 8.2%. Something does not add up. One explanation could be that companies are holding on to employees and that productivity is suffering as a result. The Purchasing Managers Indices are closely watched data. The latest one for the UK manufacturing sector showed a rise from 45.2 in July to 49.5 in August, not quite yet signalling growth, whilst that for the services sector, a much larger part of the economy (77%), was up from 51.0 in July to 53.7 in August. These indicators may not mean a turning point in the economy but, together with the unemployment data, do qualify the gloom.

As we have said before, one must distinguish between economies and the companies within them. We have normally said this in the context of the eurozone, but it is equally true in the UK. The wide international spread of business of many large UK companies gives them defensive qualities and exposure to areas of the world which are performing much better than the UK, and this is reflected in some robust profits performances which has fed through to their dividends, something we consider very important in the current environment.

Our message remains the same as in previous months. The economic background is self evidently bad and very dangerous. However, the economic tools being used to deal with the crisis in the area of monetary policy are extreme but support the rise in asset prices which we have seen since extreme standard and non standard monetary policy came into being after the 2007/8 financial and then economic crisis. These measures have depressed bond yields to levels which pose great dangers for investors at some stage because they bear no relation to reality but, for equities, where dividend yields are often attractive in absolute and relative terms, investors are not, in our view, having to pay too much for yield. Corporate balance sheets of high quality "blue chip" equities are generally in a good state and the dividend experience remains good. Many of these companies are performing much better than the countries in which they are registered because of their diverse international operations. Because the economic background is so poor, there are bound to be unpleasant economic and financial shocks which hit the equity markets from time to time but, to our mind, equities are the most attractive asset class.